

# Summary

## **Background and subject matter**

In most countries the responsibility for parts of the public sector is decentralized to a lower decision making level with an independent political system and administration. The model of decentralization developed in Sweden is among the most extensive in the world. Local governments are responsible for large and important services and they have large autonomy by international standards. In decentralized systems of this type central government grants are an essential part of the financing. In Sweden the central government grants amount to about 50 billion kronor (net) and represent about 15 percent of total revenue in local governments.

Two motivations to have central government grants stand out. The first motivation is based on an imbalance between decentralized spending and revenue. The imbalance follows from large social gains of decentralizing government spending and at the same time lower social costs of tax financing at the central government level. This explains the logic of central government arranging financing to local governments. The other motivation is an imbalance between local governments. This imbalance follows from differences in tax bases and spending needs between local governments and consequently different local conditions for decentralization. The central government can arrange equalization of economic conditions between local governments.

In practice central government grants are also used as a policy instrument of the central government to influence local government decisions. Examples of this kind include specific programs to strengthen the capacities of schools and kindergartens or grants to promote investments in environmental protection.

The grant system has got attention in the public debate in Sweden in recent years. The discussion is related to the challenges

of economic stagnation. The main questions addressed concern the need for extraordinary grants during a period of deep recession and whether the grants should be earmarked or general. Also the discussion has dealt with how central government grants can be adjusted to the business cycle to promote stability in the local government activity level over time. Both the local government tax base and elements of local government spending (e.g. support for families) are sensitive to the business cycle. In March 2010 it was decided that a separate report is worked out about how procyclical elements in local government activities should be handled.

This report discusses the effects of different types of central government grants for local government decision making.<sup>1</sup> The basic understanding is that central government grants influence the incentives of the local decision makers and thereby local governments' resource use.

## Analysis of the report

Three main types of central government grants are treated in this report:

- general grants
- earmarked and matching grants
- tax equalization grants

*General grants*, the dominant form of central government grants in Sweden since the reform in 1993, imply that local governments themselves decide how to spend the money. No rules or regulations or restrictions to the use of the money are attached, and the grant is not related to the spending level – the grants arrive as lump sum money. *Earmarked and matching grants* are basically applied to influence the local government resource use towards specific priorities of the central government. Earmarked grants must be used to finance spending in specific areas. Matching grants imply that the central government gives subsidies to local government costs; a matching rate of 20 percent means that local government covers 80 percent of the costs while the central

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<sup>1</sup> The analysis in the report is mainly directed towards the local governments ("primärkommunerna"), but is also relevant for regional governments.

government covers 20 percent. *Tax equalization grants* are designed to equalize differences in tax base between local governments.

For each of these grants we study theoretically the incentive effects for the local government choice of spending and taxation and then discuss the relevant empirical studies, both main results from the international literature and from studies on Swedish data.

In the report we discuss three other aspects of central government grants. First we deal with the dynamic effects of grants, how they influence local government spending and taxation over time. Second we discuss discretionary grants - grants decided by the central government on a discretionary basis, and how they can lead to soft budget constraints for the local governments and tactical allocation by the central government. Soft budget constraints follow when local governments expect to be bailed out by the central government in case of future financial problems, and this expectation may lead to fiscal irresponsibility today. If the grants are discretionary, the central government may allocate them for political purposes such as to influence the probability of reelection. The third aspect discussed is the adjustment of grants to the business cycle.

## Lessons from the analysis

We draw five main lessons from the analysis and discussion in the report:

*(i) General grants and imbalance between local government spending and revenue*

Financial imbalances can be financed by general grants. General grants have no distorting price effects between different services and local government priorities will then reflect the local cost conditions of the services. In this case local government allocation between services can be socially efficient. The central government can best handle the imbalance between local government spending and revenue (the vertical fiscal gap) using a per capita grant to the local governments. Grants to cover vertical fiscal gaps are socially efficient because they allow for efficient decentralization of spending combined with an efficient tax system to finance public spending.

The central government can influence the vertical fiscal gap, and even the horizontal imbalance between local governments, and thereby the need for a grant system. The vertical gap can be reduced by more decentralization of revenues or centralization of spending. Sweden has one of the most decentralized systems in the world, and the comprehensive decentralized spending is to a large extent financed by decentralized income tax. Given the decentralization of the spending, the vertical gap can be reduced by increased decentralization of taxes, like extending the local income tax, and increased use of other local revenue sources such as fees. The general grant must also be set dependent of the central government target for the activity level of local governments. The central government must have a long term goal for the size of the local government services and must adjust the size of the annual general grants based on macroeconomic concerns.

In the design of decentralization of revenue and spending, and thereby the size of the general grant, the central government must take into account the consequences for government control – both for local governments and for the central government. Local governments will be dependent of central government financing and this may reduce the local responsibility for the service level. The key concept in the literature is 'accountability' and describes the local government responsibility of financing and services. The local responsibility, and thereby the local democracy, can be weakened if the voters don't hold the political leadership of the local government responsible for the local resource allocation and this may influence the efficiency of resource use. The central government is made partly responsible for local government services and political pressure for central government financing of local governments may result. This can lead to a game between the central government and the local governments where local governments behave strategically to have extra grants from central government.

In Sweden the challenges related to large general grants are reduced by the low degree of vertical fiscal imbalance. The larger the share of the total revenues generated by the local governments themselves, the larger is the probability that they can be held accountable for their services (the possibility of holding the central government responsible is lower). The central government grants on average represent about 15 percent of total local government revenue. By international standards this is a small part. In addition

the local governments have the capacity to generate large own resources (they can set the local income tax and can borrow at both domestic and international capital markets with no restriction).

An important advantage of general grants, as opposed to earmarked and matching grants, is that they place no restriction on the local government decision-making, which supports the local accountability. Since the grant reform of 1993 the main part of the central government grants has been general. The reform was improving the conditions for local accountability and the trend towards more earmarked and matching grants should be constrained. Still there exist situations when restrictions to local government decision making are favorable. In such situations matching grants should be evaluated against alternative ways of regulating the resource use of local governments.

The strength of general grants is that they are consistent with local responsibility and local self-government.

*(ii) General grants and the imbalance between local governments*

Grants to arrange for equalization between local governments can also be designed as general grants. The equalization of the horizontal gap can be designed so that it is self financed.

General grants can be applied to equalize differences in local cost conditions and needs (expenditure equalization) and differences in tax base (revenue equalization or tax equalization). General grants with distribution determined by characteristics of local governments can give distortionary incentives to efficient resource use. If local government resource allocation shall reflect social costs, a local government should not be able to influence the size of the grant with own behavior. It follows that the grant must have clear criteria for the distribution and the criteria should be based on objective factors that cannot be influenced by each local government. In practice there may be a conflict between the desired distribution and the existence of objective factors that can guide the distribution. In particular there will be incentive effects of tax equalization since local governments can influence the tax base and the equalization can influence the local cost of taxation.

Tax equalization affects the marginal costs of financing of the local governments. The tax equalization represents a wedge between the tax base and the tax revenues resulting from the local decision to tax. Also there will be fiscal externalities between the levels of government since the local government tax decision will

influence the tax base of the regional governments and the central government. The tax equalization consequently has social costs. The problem is limited when the tax equalization is independent of the local tax rate as in Sweden. In general the tax equalization results in lower marginal costs of tax financing for the local governments compared to the social costs. The total incentive effects of the tax equalization system in Sweden is a complicated issue.

The ambition of the tax equalization is a political issue. Sweden has stronger equalization of tax revenue than any other country. On the one hand this means that local governments are less dependent on their own tax base and have less incentive to develop it. On the other hand the local governments can decide their own tax rate and at the same time have equalization of the service level. The tax decision of the local governments is assumed to be important for the local accountability.

Grants to equalize spending needs are meant to give local governments conditions to give an equal service level. The central government must decide the ambition for the equalization and what services to include. The spending equalization captures both demand factors and cost conditions in the local governments that influence the costs of having a particular service level. The age structure of the local population is the most important factors since local government services basically address the young and the elderly. In practice the design of the spending equalization will be a compromise between factors desired to include and the possibility of representing these factors with objective indicators. It is important to evaluate the incentive effects of the factors that are included in the spending equalization.

*(iii) Earmarked and matching grants*

The application of earmarked and matching grants should be motivated by particular arguments. Matching grants can be motivated in the same way as subsidies in the private market when local government services give positive externalities to other local governments. Since each local government will not take into account the positive externalities for others the total production of the service will be lower than socially efficient. As for private markets it is difficult to set the degree of matching to correct for the exact externalities present. And the central government should evaluate matching grants against other ways of taking into account

externalities, and in particular the regulation of welfare services. Most countries have strong regulation of services to secure an equal service level across the country. In this context it should also be considered whether to move the responsibility of the service between government levels.

In practice matching grants are mostly used to promote central government priorities towards local government services. In the national political debate the parties compete to take initiatives to develop certain services in the local governments. Many countries have had periods of strong growth of matching grants followed by reform and consolidation of matching grants into general grants. Many matching grants imply many price signals and thereby it is difficult to sort out the incentive effects at the local government level. Local government services are then not primarily based on social costs and the attention of the local governments is directed towards the financial arrangements of the central government.

During the recent years many countries have applied temporary matching grants to stimulate fast expansion of particular services. Temporary grants mean that local governments that have already expanded the particular service cannot take advantage of the grant and consequently they give incentives to postpone service expansion in areas that have high political focus at the national level. At the same time temporary grants have limited influence on long term resource use as local governments over time will adjust the service allocation to social costs and own preferences.

Earmarked and matching grants, and other instruments to correct for externalities such as regulations, put restrictions on the local government decision making and can weaken the local accountability.

*(iv) Discretionary grants*

It is a great challenge for the central government to provide a system with large general grants in a way that promotes economic efficiency. There will be disagreement about the size of the vertical fiscal gap, and the local governments can affect the size of the gap with own decisions that affects the quality and the cost of the provided services. It is important that the central government has clear motivations for the design of the general grants that are provided to cover the vertical fiscal gap and that the local governments cannot affect the amount of the grants they receive. It takes a strong central government that commit to long-run plans

and thereby secures stable and long-run conditions for the local governments. The central government should hence as far as possible avoid discretionary grants with unclear rules, especially grants aimed at rescuing local governments with financial problems. This type of grants can affect the expectations of the local governments for financial help in case of financial problems. Such expectations about future rescue actions can affect the local government decision-making today and can lead to a situation in which the local governments act less responsible when taking their economic decisions, and that they as a consequence get soft budget constraints.

Discretionary grants should also be avoided for another reason. The central government can be tempted to use that kind of grants tactically in order to win votes in future elections. No matter if it acts in that way or not, the suspicions will be there.

Sweden's history when it comes to discretionary grants is less successful. Since 1966, discretionary grants have existed for long periods, both for financially distressed local governments (for example the extra grants that existed between 1966 and 1992 and the Local Authority Delegation that existed in the end of the 1990s and the beginning of the 2000s), and for specific campaigns (e.g. grants for investments in an ecological sustainable development). Discretionary grants should be avoided.

*(v) Grants and the business cycle*

National political authorities must assess all large spending areas in relation to the macroeconomic situation. The size of the grants to the local governments and the high spending level of the local governments imply that the dimensioning of the activity level must be evaluated in relation to the macroeconomic conditions.

However, the spending related to the services provided by the local governments is not well suited for active business cycle policies. The local government spending mainly consists of services that should be provided on a long-run and stable basis. The activity level in primary schools, elderly care and child care is not suited for fast changes following changes in the business cycle. It is therefore important that the economic conditions for the local governments are established so that they can provide their services independent of short-run fluctuations.

When the local government revenues to a large extent are based on an income tax, the tax revenues will by construction vary with



the business cycle. In the literature, the local governments are described as a possible source of "automatic destabilization" since fluctuating tax revenues will give a similar fluctuation in the expenditures when at the same time a balanced budget is required. A reduction in tax revenues will lead to a reduction in expenditures in order to keep the budget balanced and the adjustment can enhance a downturn in the business cycle. In the same way, we will get an upward pressure in a booming economy. The local governments could in principle be able to counteract this destabilization themselves by generating funds that they can use to equalize fluctuations in tax revenues, or otherwise the central government can counteract the destabilization by regulating the size of the grants. The central government can then increase grants in economic downturns to keep up the local government service level and employment in a period with diminished tax revenues. The central government can, in the same way, decrease grants in booming economies to keep an activity level that is sustainable in the long-run.

It is a common view that it is not suitable to use the local governments as part of an active business cycle policy that increases service supply in economic downturns and decreases the supply in economic upswings. It is desirable to have a stable level in the supply of the services. However, the local government investment activity can be adjusted to the business cycle conditions. The central government can use grants to increase investments in downturns and decrease investments in upswings. No country that we know of use grants for investments in a systematic and symmetric way over business cycles. Many countries use earmarked grants to increase the activity level in the local governments within specific areas. The adjustment to such designs can imply that the local government investments to a lower degree take social cost conditions into account.

## **Challenges for Swedish politics**

Sweden has today a grant system that contributes to a strong equalization across local governments with different tax bases and different spending needs. The system is mainly based on the principles that we have discussed to take equalization and economic efficiency into account. In this way, Sweden tries to

combine the importance of grants with local self-government and local responsibilities.

But in spite of this there are challenges that are worth mentioning:

- 1) Discretionary grants invite to a game between the local and central governments and can provide incentives to socially inefficient use of resources. The allocation of grants should be based on strict rules, long-sightedness and predictability.
- 2) Some of the variables that are accounted for in the cost equalization system can be affected by the local governments and can give incentives to adjust to the grant system. The cost equalization should be designed to minimize the risks for this.
- 3) The comprehensive tax equalization system that compensates for a weak tax base implies that many local governments do not fully take the costs of taxation into account. Effects of the local government tax policy on the own tax base are compensated by the central government. The strong equalization also provides limited economic incentives for the local governments to strengthen their tax base. The incentive effects of the tax equalizing system should be evaluated.
- 4) Earmarked and matching grants are used to affect the local government spending in specific areas. Such grants induce the local governments to take other considerations into account than economic efficiency when making their priorities. In a situation of many such grants the incentives for the local governments become hard to grasp. Earmarked and matching grants should be limited and should only be used as a tool for internalizing externalities for local governments.
- 5) There is an ongoing discussion in Sweden about adjusting grants to the business cycle. It is true that general grants can be used to stabilize the local government service levels over the business cycles. This can be done within the running dimensioning of grants and can be viewed together with other business cycle tools. In this context, the local government incentives to adjust to their own intertemporal budget constraint should be evaluated. In other countries a larger weight is put on the opportunities for local

governments to stabilize their service levels to reduce dependency on central government control and to increase local accountability. The analytical basis for business cycle adjusted grants is still relatively weak.