

Local government financing after the reform

– do municipal mergers necessitate a new system?

English summary

Norwegian local governments are facing a large reform that aims to reduce the number of small municipalities through mergers. This research project was established to identify the challenges this may create for the financing of local governments and to suggest possible solutions.

Norwegian local governments are financed partly by local taxes and partly by central government grants, which are distributed through a unified system, the General Purpose Grant System (GPGS). Through the tax-equalization part of the GPGS, income is redistributed from municipalities with a large tax base to municipalities with a smaller tax base. The expenditure equalization part of the GPGS redistributes resources from low cost municipalities to high cost municipalities. The redistribution is done according to objective criteria which values cannot directly be affected by municipal behavior. The set of criteria and their weights are constructed from statistical analyses.

Today's Norwegian municipalities range in population size from about 200 up to nearly 650 000. More than half the municipalities have less than 5000 inhabitants. A committee appointed by the government has suggested a lower limit of 15000 inhabitants for a new municipal structure, although it is realized that in some rural areas this is not achievable.

If the reform succeeds in reaching this goal, there will obviously be large changes to the municipal sector when it comes to population size and geographical size. On the other hand, essential parts of municipal activities will not be affected. The population of Norway will require the same services as before and live in the same locations, regardless of municipal borders.

Six central questions were defined for the project.

1. The system for expenditure equalization is not neutral to municipal mergers. How does this affect the distribution of resources in the case of a large number of mergers?

We find that there may be a need to adjust the weights of criteria in the expenditure equalization that are not neutral to municipal mergers.

2. Does the new municipal structure with fewer and larger municipalities require a new set of criteria or a new weighting of existing criteria for the expenditure equalization?

The set of criteria and associated weights used in the expenditure equalization are results of statistical analyses on municipal differences in spending on separate service sectors. We have reanalyzed the same models, adding separate parameters for small and large municipalities. Largely, we find that the existing model for expenditure equalization is adequate for a new situation with larger and fewer municipalities. The "Basis" criterion may however be dropped if most municipalities reach a size where economies of scale is not an issue. This criterion provides an equal amount to each municipality regardless of population size with the purpose of compensating diseconomies of scale.

3. How can new weights and new criteria be determined without knowing the new municipal structure or its cost structure?

If criteria and weights should be customized to a new municipal structure, the first challenge is that the new structure is unknown. The second challenge is that the cost structure is unknown, and it will continue to be for some time. The period after merging will be characterized by reorganization, and spending patterns will only weakly reflect the underlying cost structure.

4. Will the reform affect the need for tax redistribution?

Through merging, the municipalities will generally move toward the average as special characteristics even out. This is also the case for municipal revenue. Today, revenues vary considerably between municipalities. Differences in income and wealth taxes are largely equalized by the tax-equalization scheme, but there are also revenues that are not part of this redistribution system. Through merging, the variation in pre-equalization revenues is reduced, and the need for a strong tax equalization by the central government is therefore somewhat reduced.

5. Will the reform affect the need for region-specific grants or other specific grants?

There are some extra grants in the system that are designed to compensate specific challenges that are not covered by the main system. We provide some discussion on the purpose and the scope of these grants, but mainly conclude that any revision will mainly be a political issue.

6. If a group of municipalities is appointed more or fewer tasks than other municipalities, how can this be incorporated in the system?

We show that a system of different tasks to different groups of municipalities easily can be introduced by adding a new “step” of redistribution for each bundle of services that are performed by a specific group of municipalities.

In general, we conclude that the reform does not demand a large revision of the system. The fact that the municipalities are getting more homogenous, means that the system should not be less suitable than before. One natural consequence of the reform, is that the criteria that compensates small municipalities, the “Basis”-criterion, may be dropped if all small municipalities merge into larger ones.