5 Principles for the design of the General Purpose Grant Scheme

The General Purpose Grant Scheme (GPGS) must weigh up several, often conflicting, factors. A key objective of the GPGS is to help enable local authorities to provide an equitable service provision. The economic conditions for providing an equitable service provision vary, and these differences need to be equalised. However, the GPGS must also take into account local self-government, which includes locally underpinning the local authorities' revenues. This entails each local authority being allowed to retain a portion of its local tax revenues, and requires acceptance for a certain disparity in revenues between local authorities. Furthermore, local authorities' revenue base must remain as predictable and stable as possible. The GPGS should also be uncomplicated and easy-to-understand. These principles underlie the design of the current GPGS.

As per the mandate, the committee must consider which principles should be applied to the design of the GPGS going forward. The mandate also provides some clear guidelines. It is assumed that framework funding will continue to be the main funding model for the local government sector, and that the principle of generalist local authorities will remain unchanged. This entails all local authorities having the same tasks and responsibilities, and highlights the importance of the GPGS in ensuring that they can all offer an equitable and high-standard service provision.

In this chapter, we will review the assumptions underlying the design of the current GPGS and discuss which principles should be applied to the mechanism going forward.

5.1 What is the GPGS – and what is it not?

The introduction of the GPGS in 1986 represented not only a change in how the local government sector was funded but also a shift in central government's control over the sector. This involved a transition from around 50 earmarked grants and closely controlled finances by central government to a single block of funding that local authorities were free to utilise within the applicable laws and regulations.

A mechanism based on framework funding has several advantages compared to one based on earmarked grants. It promotes local self-government by giving local authorities decision-making powers – within the framework of overarching central government guidelines – for how the service provision can best be structured to meet local wishes and needs. This approach enables more effective prioritisation than a mechanism with extensive earmarking.[1] Framework funding also incentivises local authorities to optimise efficiency in their service delivery, as they retain any gains resulting from efficiency measures. The GPGS is easy to administer, meaning efficiency gains for both central government and the local authorities. The annual general grant is disbursed in ten instalments, and local authorities do not need to apply for or report on how they use grant funds beyond the accounting and service reporting in Municipality-State-Reporting (KOSTRA).

The design of the GPGS must align with the overarching objectives of the mechanism. It is crucial that the mechanism does not incentivise local authorities to prioritise certain services or design the service provision in a particular way. As much of the local authorities' revenues as possible should be unrestricted revenues, whereby local authorities can prioritise local needs at their discretion. The criteria for expenditure equalisation must be objective and formulated in a way that does not

[1] Official Norwegian Report NOU 1996: 1 on a simpler and fairer GPGS for local and county authorities

reward specific activities or actions with increased grants. The GPGS should not function as a reimbursement mechanism. It is therefore not appropriate to use measurements of local authorities' activity levels, such as the number of residential places in care homes, as a criterion in expenditure equalisation as this would incentivise them to prioritise activities that yield benefits in the equalisation in preference to other activities. Instead, objective criteria such as the number of people in specific target groups, such as the elderly, would form a better picture of local authorities' needs.

The committee has received input suggesting that the GPGS must incentivise local authorities to prioritise work on innovation and restructuring, industrial and commercial development, reducing greenhouse gas emissions, and nature preservation etc. The current design of the mechanism indirectly incentivises work with industrial and commercial development and innovation and restructuring. Local authorities that are actively engaged in industrial and commercial development and expanding their tax base in the municipality will be allowed to retain a portion of the resulting increased tax revenues. This could lead to job growth, higher employment and a potential population influx to the municipalities, leading to higher per capita grants and tax revenues. Local authorities also have indirect incentives to work on innovation and restructuring. If they improve efficiency in their work and in the provision of public services, they can retain any savings made, as the unrestricted revenues are distributed independently of the local authorities' actual consumption.

With regard to direct incentives to guide local authorities' priorities, such as reducing greenhouse gas emissions and nature preservation, these are not areas that should be addressed through the GPGS. Achieving these objectives would require incorporating criteria into expenditure equalisation that, for example, rewards local authorities for implementing specific measures or reducing emissions. This would interfere with the local authorities' priorities, which is not the role of the GPGS. The GPGS is a funding mechanism that is intended to facilitate local self-government, allowing local authorities to prioritise sectors and various initiatives within the applicable laws and regulations. Local authorities should be incentivised through other means than the GPGS.

5.2 Principles on which the current GPGS is based

Since the GPGS was introduced, there has been political agreement that its overall aim is to ensure an equitable distribution of income between the local authorities. In previous reviews of the GPGS, the emphasis was on an equitable income distribution that levels the playing field in terms of economic conditions for achieving an equitable service provision.[2] Norway is a unitary state in which local and county authorities have been delegated power by the Storting (Norwegian parliament). Through the GPGS, a system has been established to equalise differences between municipalities to prevent major disparities in their service provision. However, it is also important to consider local self-government, and the GPGS must facilitate local democracy in the municipalities.

In this section, we examine the key considerations behind the design of the current GPGS. In Section 5.3, the committee discusses how these considerations should be weighted in the committee's GPGS proposal.

Equitable service provision

Local authorities are key players in the production of national welfare services. The economic conditions for an equitable service provision vary throughout Norway. The tax revenue per capita varies significantly between municipalities, giving different starting points for financing municipal services. The need for municipal services and the costs of producing these services also vary from

[2] Official Norwegian Report NOU 2005: 18 on distribution, simplification and improvement. The GPGS for local and county authorities

one municipality to another. Without equalisation of the economic conditions for providing municipal services, there would be substantial disparities in the service provision. For example, in 2019, the expenditure of the municipality with the highest estimated expenditure (Utsira), was almost triple that of the municipality with the lowest expenditure per capita (Tromsø). In Bykle, the municipality with the highest revenues from income tax, wealth tax and natural resource tax, the total tax revenue was more than four times the tax revenue per capita in Kautokeino, the municipality with the lowest tax level before equalisation in 2019.[3] If additional revenues such as property tax, revenues from obligatory sales of power, licence fees and aquaculture revenues are included in this calculation, the municipality with the highest tax revenues will have approximately nine times the tax revenue of the municipality with the lowest tax revenue in 2019. In terms of essential welfare services such as schools, Early Childhood Education and Care (ECEC), and care services, significant disparities in the service provision are not acceptable.

What does an equitable service provision entail? If an equitable service provision meant that the service provision was the same, this would not be compatible with the need for local adaptations. Local authorities are independent and democratically governed and must be able to tailor the service provision to local conditions. They should also, therefore, be able to prioritise certain services over others within the applicable laws and regulations.

In light of this, it has been argued that local authorities should have the same *conditions* in order to be able to offer an equitable service provision. Local authorities that make the same choices and priorities should be able to provide municipal welfare services at the same level (of the same standard or quality), and the GPGS must empower them to do this. If local authorities were to receive the same income regardless of their choices and priorities, this could weaken the incentive for efficient service production and remove the incentive to work towards increasing their own tax base. It is therefore crucial for the GPGS to assume that local authorities are responsible for their own choices and, as a general rule, not compensate for factors that are within their own control. In practice, it is difficult to determine which factors are within or outside the local authorities' control.[4] For example, there may be different assessments of the degree to which cost disparities arising from settlement patterns and diseconomies of scale should be compensated for. One can also question the extent to which the tax base is beyond the individual local authorities' control or whether they can influence tax base development through, for example, industrial and commercial development.

The committee discusses the consideration for equitable service provision in more detail in Section 5.3.

Local underpinning of the revenues

The consideration for local self-government calls for a degree of local underpinning of local authorities' revenues. Local authorities are independent entities that should have financial autonomy and revenue decision-making powers. Local self-government can also lead to more efficient use of resources and a service provision that is tailored to local conditions. Norway has adopted the European Charter of Local Self-Government,[5] which includes provisions on local authorities' financial autonomy, and states that within the framework of the national economy, local authorities should have their own financial resources that they can freely dispose of to the extent their authority

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[3] Tax revenue is defined here as revenue generated from income tax, wealth tax and natural resource tax.

[4] Official Norwegian Report NOU 2005: 18 on distribution, simplification and improvement. The GPGS for local and county authorities

[5] Proposition (Bill) 46 (2017–2018) to the Storting, entitled *Lov om kommuner og fylkeskommuner (kommuneloven)* (available in Norwegian only)

allows. The Charter also stipulates that a certain portion of the resources at the local authorities' disposal should originate from local taxes and fees that they themselves have the authority to set rates for within statutory limits.

In general, one way of locally underpinning revenues could be to create a link between the taxpayers in the municipality and the local authorities' revenues. If local authorities' revenues are distributed in line with the local tax base, this will incentivise local authorities to try to increase the local tax base through, for example, an active business policy.

Another form of local underpinning relates to the degree of taxation freedom, where local authorities have revenue decision-making powers in that they can choose which taxes to levy and at what rate. Taxpayers will be interested in following how the taxes are spent in their municipality. Politicians elected at the municipal level must be accountable for decisions on tax levels and how tax revenues are spent. This can result in a service provision that better aligns with local preferences and facilitates improved coordination between private and public services at the local level. Local taxation freedom can also be viewed as a tool that can strengthen local democracy and stimulate local political debate and voter participation in local elections.

In principle, Norwegian local authorities have little decision-making power when it comes to their own revenues, and the local taxation freedom is limited. Although they have the option to set tax rates for income and wealth tax within a certain range, all local authorities have, in practice, applied the same tax rates.[6] Property tax provides some degree of taxation freedom as local authorities can choose whether to impose property tax as well as which types of property are to be taxed. They also have the option to set tax rates and the basic tax-free allowance within the framework of national regulations.

The consideration for local underpinning of revenues also entails local authorities retaining a portion of their tax revenues. If they are successful in increasing their tax base, they should benefit from this. The income equalisation in the current GPGS is already significant and may weaken the local underpinning of the local authorities' revenues.

The committee notes that the taxation freedom of local authorities in Norway is relatively limited compared to that of Sweden and Denmark. Norwegian local authorities have little opportunity to influence revenues by, for example, setting the tax rate themselves. Although equalising the economic conditions of local authorities is important, the existing local underpinning of municipal revenues should not be significantly reduced. Changes with a view to greater equalisation between local authorities or a more stable revenue base must be balanced against the consideration that local authorities should still have incentives to increase their own revenue base.

Predictability and stability in the revenues

Predictability in revenues is an important consideration in the financing of the local government sector. Tax revenues and general grants fund welfare services in municipalities, and ideally, these should not vary significantly from year to year.

Tax revenues are less predictable than general grants, and the predictability of local authorities' revenues therefore depends on the proportion that is generated from tax. A higher tax share, in isolation, would result in a more unstable revenue base. The government gives an indication of the growth in the unrestricted revenues for local authorities for the following year when the revised national budget is presented each May. This enables local authorities to factor this into their

[6] All municipalities have used the maximum rates for income tax and wealth tax for the past 40 years. However, in 2021, the wealth tax in Bø municipality was reduced from 0.7% to 0.2%.

budgeting. The national budget provides an estimate of tax revenues, but the actual tax revenue received will differ from this to a greater or lesser extent.

The uncertainty surrounding tax revenues can be linked to two factors. Firstly, it is uncertain whether the national tax estimates will correspond to the actual tax revenue received by the local authorities. Secondly, it is uncertain to what extent the tax revenue received by the individual local authority will follow the national trend. Income equalisation helps reduce local risk but does not address the risk associated with national tax estimates. It is therefore crucial that the local authorities' tax base is as stable as possible.

Predictability in local authorities' revenue framework is also important for central government. The local government sector constitutes a large portion of the public sector, and the need for stability in the national economy also calls for stability in the local authorities' revenue framework. The GPGS should therefore also facilitate macroeconomic management of the local government sector.

In recent years, the actual tax revenue received has meant considerable excess tax growth for local authorities, and it has become more challenging to estimate their revenues from income tax. This is mainly due to changes in dividend tax, as dividends are part of the basis for tax on general income. Despite the fact that local authorities, in this case, received higher tax revenues than initially estimated, the committee believes there are several undesirable aspects of unpredictability in this tax base. In Chapter 8.1.2, this problem is reviewed and the stability of the local authorities' tax base is discussed.

A simple and transparent GPGS

A final consideration for the GPGS is that it should be simple, well-documented and easy to understand. The GPGS has often been criticised for being too complicated and not easily accessible.

It should be possible for politicians and administrators at the municipal level to understand the mechanisms of the GPGS. This is essential in order for them to understand revenue development and anticipate how the GPGS will impact on their own municipality. It is also crucial that politicians and voters alike can assess the fairness of the mechanism if they are to have the opportunity to influence its design. If the GPGS is not widely accessible, this could undermine its legitimacy.

There will often be a trade-off between the desire to have a fair and accurate system and the need for simplicity. Local authorities differ considerably in terms of tax revenue levels and conditions for providing municipal services. The more elements included in the GPGS to capture different aspects of local authorities' needs, the more complicated the system becomes. According to the committee's assessment, efforts should be made to keep the GPGS as simple as possible, and the committee has examined whether there are elements in the GPGS that are unnecessarily complicated and can be removed or simplified.

The committee considers there to be a relatively good balance between fairness and simplicity in the current GPGS. The distribution of revenues is mainly based on a per capita allocation, before considering arrangements for equalising tax revenues among local authorities or accounting for differences in their expenditure for service production. A number of additional elements also complicate the GPGS, such as cases distributed based on special criteria or regional policy grants. Such elements should be justifiable based on other considerations the GPGS is designed to address.

5.3 The committee's assessment – more emphasis on the equitable service provision

In this chapter, we discuss considerations that should be focused on in the design of the GPGS. The overall aim is for the GPGS to facilitate local authorities' equitable service provision. The redistribution in the current GPGS is already significant, but the committee has assessed the need for further equalisation in light of the developments in local authorities' framework conditions and responsibilities in recent decades.

Chapter 4 highlighted some factors that can contribute to variations in service production among the local authorities. Some differences arise from varying priorities and different levels of demand for various services among residents. Other variations are due to differing cost disadvantages in service production and inequal financial framework conditions. Variations in the service provision can also be attributed to varying production efficiency levels and/or disparities in competence and capacity between the local authorities.

One of the objectives of the GPGS is to empower *all* local authorities to offer an equitable and high-standard service provision to their residents. A key question in the design of the GPGS is, therefore, what constitutes an equitable service provision. An equitable service provision does not necessarily mean that the services must be identical in all municipalities. Local authorities are independent and democratically governed entities. The main principle of state governance should be to provide a framework within which the services can vary between municipalities depending on local needs.

The consideration for local self-government and local underpinning of the revenues also calls for revenue decision-making powers in the local authorities, e.g. in relation to tax revenues, and for them to retain a significant share of their local tax revenues. This entails revenue disparities between the local authorities.

Meanwhile, local authorities are responsible for providing welfare services that are under significant pressure both from national authorities and the public. A key question in this context is the extent to which the funding mechanism should accept differences between local authorities that stem from factors for which the local authorities have limited or no control over, such as cost conditions, the demography of the population and the tax base determined by the residents' income and wealth levels.

Currently, the GPGS equalises differences in tax revenues through income equalisation and differences in expenditure needs through expenditure equalisation. A situation that is completely devoid of such mechanisms represents an extreme that could potentially lead to substantial disparities in service provision between municipalities. Another extreme is an absolute transfer system that fully compensates for differences in tax bases and involuntary disparities in cost and demand conditions. This extreme gives all local authorities the same opportunities to provide services to their residents but goes against the principal of local underpinning of revenue, i.e. the desire for local authorities to have some decision-making powers with regard to the level of their revenues. An absolute transfer system would also make local authorities entirely financially dependent on central government, which would be contrary to the consideration for local self-government, which has a value in itself.

The Borge Committee discusses a middle-ground alternative to the two extremes described above, where local authorities making the same choices and priorities can offer the same service provision to their residents.[7] Such an approach entails full compensation for involuntary cost and demand conditions and for differences in local authorities' tax bases, but also requires the local authorities

[7] Official Norwegian Report NOU 2005: 18 on distribution, simplification and improvement. The GPGS for local and county authorities

to fully bear the consequences of their chosen tax rates. This is commonly referred to as giving local authorities equal fiscal capacity. When fiscal capacity is fully equalised, any disparities in service levels that arise due to different tax rates are considered compatible with the equitable provision of services and should not be further equalised. However, differences in service levels stemming from varying income levels among residents (different tax bases) are not compatible with the equitable provision of services and should therefore be equalised.

The municipal revenues from income, wealth and natural resource tax are equalised in the current income equalisation, but only partly. The redistribution reduces the financial disparities between local authorities by raising them all to a minimum level, which in practice amounts to around 94% of the national average for the included tax revenues. Since differences in tax revenues are not fully equalised, local authorities that succeed in increasing their tax base will benefit financially.

Local authorities' service provision is also affected by the revenues that are not redistributed. Property tax, revenues from the Aquaculture Fund, revenues from obligatory sales of power, financial income and service user fees are excluded from the current income equalisation. Consequently, there is no equalisation of fiscal capacity on the revenue side in these areas. The unequal distribution of some of these revenues among the local authorities means that some local authorities have a much higher level of municipal services. This in turn can impact on the general perception of what constitutes an equitable and high-standard service provision, thus putting more pressure on local authorities with lower revenues.

Through expenditure equalisation, local authorities are compensated for involuntary differences in demand and costs in municipal service production. Consequently, local authorities that are relatively more expensive to run receive higher revenues than those that are relatively less costly to run, which evens out the conditions for providing local services. The current expenditure equalisation covers approximately 80% of local authorities' gross operating costs, and within the included areas, the disparities are fully equalised. Some important questions in the design of expenditure equalisation are which cost differences should be equalised, which sectors should be included, and the degree of equalisation.

The committee's assessment – equalisation as a basis for an equitable service provision

In light of the foregoing, the committee deems it reasonable to interpret the equitable service provision as entailing slight variations in the local authorities' capacity to meet residents' needs for services. The current GPGS contributes considerably to the equalisation of this capacity between the local authorities, with full equalisation of involuntary cost disadvantages and a significant equalisation of tax revenues.

In recent years, there has been a trend towards greater emphasis on uniform services, across municipalities. Increased use of staffing norms etc. is reducing local authorities' ability to meet the residents' needs by tailoring the service provision and use of resources. Local authorities that had previously leveraged economies of scale through organisational structures will have limited opportunities to do this if staffing norms vary. Such norms are problematic within a framework funding model, since norms in one service area will also have implications for other service areas. Norms for one service govern the local authority's production of that service, and within a given framework, the local authority will effectively have no other choice but to reduce the provision of other services in order to comply with the norms.

According to the committee's assessment, if this trend continues, it should also have implications for the distribution of income between the local authorities. If their service provision is expected to be more equitable, the income disparities between them must be minimal. The committee therefore believes that the consideration for an equitable service provision should be given greater weight in the design of the GPGS.

In terms of population, there are already major disparities between municipalities, both with regard to population trends and demographics. These disparities are likely to increase in the future. The GPGS must be designed to accommodate all types of municipalities: those experiencing population growth, population decline and changes in the demography of the population, including shifts in the proportion of elderly people and children below the age of 16. The income distribution through the GPGS also needs to adapt to such trends in order to ensure that the revenues align with the developments and needs of each municipality. The total revenue framework for the local government sector will likely face more pressure going forward. The committee believes it is crucial to continue placing a large emphasis on demographic trends when determining the unrestricted revenues. It will also become more important to distribute scarce resources effectively among local authorities through the redistribution in the GPGS.

In the committee's understanding of the equitable service provision, the design of income equalisation largely becomes a matter of striking a balance between the need for fairness and for the local underpinning of local authorities' revenues. It is difficult to provide an authoritative answer on how these considerations should be balanced, and this will largely be a political decision. However, the committee points out that this balancing act is not just about choosing the tax share and the degree of equalisation in income equalisation; it also requires making decisions about which revenues should or can be subject to equalisation, whether all revenues should be equalised with the same factor, and within what range local authorities should be able to set rates themselves. Effective decision-making in this regard necessitates a thorough understanding of the interplay between these various factors. Chapter 8 discusses the design of the tax elements in the GPGS, which revenues the committee considers suitable for equalisation, and how such equalisation can be structured. The discussion also addresses how income equalisation should be designed if local authorities' freedom to set rates below the national maximum rate was applied. The design of expenditure equalisation is further examined in Chapter 9.