

# NORSK ØKONOMISK NASJONALRAPPORT

## LOCAL TAX FINANCING IN NORWAY

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### *Abstract*

The paper discusses the tax financing of Norwegian municipal and county governments, including recent changes and proposed reforms. The local tax financing in Norway is similar to the systems in the other Nordic countries in the sense that taxes make up a substantial part of total revenue, the personal income tax is the dominating local tax, and there is ambitious tax equalization. The main difference is that local tax discretion (in practice) is more limited in Norway. Proposed reforms in the tax system give room for a more general an extended property tax that may increase the tax discretion for the municipalities.

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## 1. Introduction

The purpose of the paper is to provide an overview of local tax financing in Norway, including recent changes and proposed reforms. The proceeding Section 2 gives a short summary of present system. The next four sections provide more thorough discussions on the criteria for local tax financing (Section 3), local tax discretion (Section 4), tax equalization (Section 5) and property tax (Section 6). Finally, Section 7 offers some concluding remarks.

## 2. The present tax financing of local and county governments

As in the other Nordic countries, the local public sector is an important provider of welfare services like kindergartens, education (from primary education to high-schools), primary health-care and care for the elderly. Other important tasks are roads, public transportation (busses and boats), infrastructure and culture. From January 1 2002 the responsibility for hospitals was moved from the counties to the national government.

Table 1: Sources of revenue, billion Norwegian kroner (NOK) and percentage of total revenue, 2003.

	Billion NOK	Percentage of total revenue
Local taxes	97.1	48.1
Grants	71.1	35.2
User charges	30.8	15.2
Other	3.0	1.5
Total	202.0	100.0

Source: National accounts, Statistics Norway

Table 1 provides an overview of the revenue composition. Total revenue was slightly above 200 billion NOK in 2003, which amounts to 16 percent of mainland GDP. Local taxes is the most important revenue source and accounts for nearly 50 percent of the revenue. The other main revenue sources are grants and user charges.

Local taxation in Norway is based on the following four tax bases:

- Income tax (individuals)
- Wealth tax (individuals)
- Property tax (individuals and businesses)
- Natural resource tax (power companies)

The base for the local income tax is so called general income (*alminnelig inntekt*), which is labor income, pensions and capital income less allowances. General income is taxed at flat rate (28 percent) and the revenue is shared between the municipalities, the counties and the central government.<sup>1</sup> The tax rate for each government tier is decided annually by the Parliament. The 2004 tax rates are respectively 13 percent (municipalities), 3.24 percent (counties) and 11.76 percent (the central government).<sup>2</sup>

Wealth tax is levied at the municipal and the central government level. The tax base is net wealth less a standard basic deduction. The municipal part of the wealth tax has a flat rate of 0.7 percent, whereas the central government wealth tax has a more progressive rate structure.

Property tax is levied at the municipal level only and comprises both residential and business property. The tax is not available to all municipalities since it is restricted to urban areas and certain facilities (*verker og bruk*). The property tax is a voluntary tax, and in practice around 230 of the 434 municipalities have property tax. Business property tax can not be taxed unless the municipality also taxes residential property.<sup>3</sup> The tax base is assessed property value. It is up to the municipality to decide the size of an eventual standard basic deduction for residential property.

Municipal and county governments receive natural resource tax from power companies. The base for the tax is power production above a specified minimum level. The

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<sup>1</sup> In the tax system there is a second income tax base, personal income, which is a gross income tax base comprising labor income, income from self employment and fringe benefits. The tax on personal income is highly progressive and is received by the central government.

<sup>2</sup> In the most northern part of Norway the central government tax rate is 8.26 percent and the total tax on general income is 25 percent.

<sup>3</sup> Power stations and other certain facilities can be taxed without taxing residential property.

municipal governments receive 0.011 NOK per kWh and the county governments 0.002 NOK per kWh.

Table 2: The composition of the local tax base, billion NOK and percentage of total tax revenue, 2003.

	<u>Municipal governments</u>		<u>County governments</u>	
	Billion NOK	Percentage	Billion NOK	Percentage
Income tax <sup>a</sup>	70.5	88.3	16.6	98.8
Wealth tax <sup>a</sup>	4.9	6.2		
Property tax	3.2	4.0		
Natural resource tax	1.2	1.5	0.2	1.2
Total	79.8	100.0	16.8	100.0

<sup>a</sup> The separation between income and wealth tax for the municipalities is based on own calculations.

Source: Tax accounts, Statistics Norway

Table 2 reports the revenues from the different tax bases in 2003. In the official statistics income and wealth tax to municipalities cannot be separated from each other. The separation in Table 2 is based on own calculations.<sup>4</sup> As in the other Nordic countries, income tax from individuals is the most important local tax. It amounts to 88 percent of municipal taxes and 99 percent of county taxes. Other taxes constitute a small share of aggregate local tax revenue, but property tax and the natural resource tax are important revenue sources for individual municipalities. The most prosperous municipalities are small rural communities with waterfalls, where property tax and natural resource tax from power companies make up substantial amounts per capita.

### *Tax discretion*

Formally municipal and county governments have substantial tax discretion. The municipalities can choose tax rate within an interval for the income tax, the wealth tax and the property tax. In 2004 they can choose an income tax rate between 9.4 and 13 percent, a wealth tax rate between 0.4 and 0.7 percent, and property tax rate between 0.2 and 0.7 percent.<sup>5</sup> However, during last 25 years all municipalities have applied the

<sup>4</sup> Since 1998 the municipal wealth tax as fraction of total tax on general income and municipal wealth tax has been quite stable around 3.1 percent in the tax assessments. This estimate is used to separate out municipal income and wealth tax.

<sup>5</sup> In addition they can choose whether to have the property tax or not.

maximum rates in income and wealth taxation, and in practice tax discretion is limited to the property tax.

Local governments can also influence their revenues through user charges. County governments enjoy the same formal tax discretion in the income tax as the municipalities. In 2004 they can choose a tax rate between 0 and 3.24 percent. Since the introduction of a separate county tax in 1977, they have all applied the maximum rates. Income tax, wealth tax and natural resource tax can be denoted regulated taxes as there is no variation in the tax rates.

### *Tax equalization*

There is substantial variation in tax revenues across municipalities and across counties. These differences are equalized through tax equalization, which is a part of the block grant system. The tax equalization is based on regulated taxes per capita, i.e. income, wealth and natural resource tax for the municipalities and income tax and natural resource tax for the county governments, and do not include the property tax.

Municipalities with tax revenue below 110 percent of the average receive a grant that equals 90 percent of the difference between 110 percent of the average and own tax revenue. In addition, half the tax revenue above 134 percent of the average is withdrawn to the state. The tax equalization for the county governments is similar. The differences are that reference level is 120 percent of the average instead of 110 and that there is no state withdrawal of high tax revenues. The high compensation rate in the tax equalization weakens the relationship between the local tax base and local government revenue.

In 2003 390 (or 90 percent) of the municipalities received tax equalization grant, whereas the state withdrawal of high tax revenue comprised 16 municipalities. All but one county government received tax equalization grant.

### *Summing up*

The local tax financing in Norway is similar to the systems in the other Nordic countries in the sense that taxes make up a substantial part of total revenue, the personal income tax

is the dominating local tax, and there is ambitious tax equalization. The main difference is that local tax discretion (in practice) is more limited in Norway.

### **3. Criteria for tax financing**

The local tax financing in Norway was changed in important respects in the late 1990s. The background was a government expert commission set up to evaluate the financing of the local public sector and to propose reforms.<sup>6</sup> The commission delivered two reports, one report on the grant system (NOU 1996: 1) and one report on broader issues of financing (NOU 1997: 8).<sup>7</sup> In the latter report the commission explicitly evaluated local taxes according to the following four criteria derived from the economics literature on tax assignment:<sup>8</sup>

- The principle of residence and benefit taxation
- Low mobility
- Even distribution
- Stability over the business cycles

Local revenue raising creates a link between service use and tax payment, and lays the foundation for good spending and taxing decisions. When those who votes for higher spending also pay the taxes, the benefits of higher spending must be traded off against the costs of increased taxation. The residence principle, which implies that local taxes should be restricted to local residents and paid by as many residents as possible, is a good rule of thumb when local authorities provide local public goods that benefit all residents. When local authorities provide private services, the residence principle is no guarantee for efficiency. In this case local taxes should be restricted to the beneficiaries of the services, but with possible problematic distributional consequences.

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<sup>6</sup> The author of this article was involved in the commission as its secretary.

<sup>7</sup> A brief survey of the two reports (in English) can be found in Borge and Rattsø (1998).

<sup>8</sup> The following paragraphs are based on Borge and Rattsø (1998).

The mobility of the tax base is given much attention in the economics literature. Oates (1996) clarifies the conditions for efficiency-enhancing competition among jurisdictions, notably the use of benefit taxation. When these conditions do not hold, a mobile tax base may encourage tax competition and lead to low taxes and underprovision of local public services. On the other hand political economy considerations have led to a more positive view on tax competition. The argument is that tax competition may counterbalance political failures that lead to a large and inefficient public sector.

The most obvious argument for an even distribution of the tax base is equity since an uneven distribution of the tax base is a source of differences in service standards across local governments. The central government can compensate for differences by a tax equalization system, but an ambitious tax equalization program weakens the link between the local tax base and local government revenue. An even distribution of the tax base can also be defended on efficiency grounds, since it reduces the incentives for fiscally induced migration. The discussion in Section 2 revealed that all local taxes in Norway are proportional in the tax base and that highly progressive (income and wealth) taxes are in the hands of the central government. This design reduces differences in tax revenue across local governments compared to a situation where also progressive taxes were raised locally.

The local public sector is typically considered as destabilizing in a macroeconomic context. When local tax revenues are pro-cyclical, balanced-budget-rules imply that local public spending tends to increase in booms and fall in recessions. A tax base that is stable over the business cycle can serve as an automatic stabilizer.

#### *The abolition and reintroduction of a local corporate income tax*

The commission's most controversial proposal was to abolish the corporate income tax as a local tax based on the argument that it did not meet the criteria for good local taxes.

First, the corporate income tax was very unevenly distributed between local governments. The max-min ratio was 20:1 across the municipalities and 8:1 across the counties.

Second, the corporate was strongly procyclical. It was referred to the booming year 1995

where the aggregate corporate income tax base grew by 21 percent, more than three times the growth of the personal income tax base. At the local level the corporate income tax was even more volatile, mainly because industry is less diversified at the local level. Another source of unpredictability and instability at the local level was the coordination of tax assessment of companies with activity in several municipalities. A local firm that ran a surplus did not generate much tax revenue if it was included in a company or concern that ran deficits in other municipalities. Third, the mobile corporate income tax base encouraged tax competition. The municipalities and counties did not compete by lowering tax rates, but rather by offering subsidized sites and buildings, and advice and services from the local development agency. The opponents of the proposal argued that the corporate income tax was important in order to give municipalities and counties proper incentives to promote economic development, an argument that also was acknowledged by the commission.

Although the proposal was controversial politically, the parliament, with a majority comprising the center parties and the socialist parties, decided to abolish the corporate income tax as a local tax from 1999. The conservative party was against the proposal, and when it joined the government after the 2001 election it took initiative to reintroduce a local corporate income tax. In the spring of 2004 the government put forward a proposal to introduce a new corporate income tax for the municipalities from 2005. In the new tax a fraction (that may vary from year to year) of the corporate income tax is reserved for the municipalities. For companies with activity in several municipalities the tax is distributed according to the municipalities' share of the company's employment. In the old tax the distribution was based on a detailed calculation of economic profit in each municipality. The new tax is considered to give a more just distribution of the corporate income tax across municipalities. It also requires less tax administrative resources, but do otherwise have the same weaknesses. A more ambitious tax equalization program is proposed to counterbalance the adverse distributional implications (see Section 5 for further discussion).



Negotiations in the parliament revealed that a majority will support the new municipal corporate income tax and more ambitious tax equalization. It was harder to agree on specific issues like the municipal share of the corporate income tax and compensation rates in the tax equalization program, and these issues are postponed until the fall.

### *Why personal income tax?*

The personal income tax has a long history as a major revenue source for Norwegian local governments. During the second part of the 19<sup>th</sup> century it replaced the property tax as the most important local tax. The driving forces were industrialization and development of a money based economy that weakened the relationship between taxability and property. Taxation of income (and wealth) was introduced and extended to provide a more just tax system and to facilitate the financing of an expanding local public sector. Local taxation of income and wealth was made compulsory by the 1882 Tax Law, and by the end of the 19<sup>th</sup> century the income tax was twice as important as the property tax.

The income tax performs well according to two of the criteria discussed above. First, it is quite evenly distributed across local authorities. In Norway, the max-min ratio is around 3:1 across the municipalities and around 2:1 across the counties. Second, it fulfills the residence principle since it is paid to municipalities and counties according to residence.

The main weakness of the personal income tax is its instability over the business cycle. The obvious reason is that labor and capital income is procyclical. In recent years the instability and unpredictability of capital income have received much attention. Realization of capital losses due to falling stock prices has led to lower tax revenues than projected in 2002 and 2003. The downward adjustment of tax revenues has occurred late in the fiscal year, and it has been difficult for the local governments to adjust spending accordingly. Consequently, the instability and unpredictability of the income tax has contributed to the weak fiscal performance the recent years.

In general the income tax also may be problematic in terms of mobility. This point is heavily emphasized by Söderström (1990, 1998) and denoted the competition problem. The idea is that local governments try to achieve fiscal gains by attracting high-income individuals. The result may be that service provision (and possibly also taxes) is tailored in favor of the rich, which is particularly undesirable in a situation where local governments are important providers of welfare services. In all Nordic countries this competition problem is 'solved' through extensive tax-equalization programs.

Although the income tax performs well in terms of the residence principle and even distribution, and that the competition problem is solved through tax equalization, its role as a major local tax in the Nordic countries is probably best understood in terms of its revenue-raising capacity. The local governments in the Nordic countries are responsible for important welfare services, and as a consequence the local public sector is large (in terms of revenues as share of GDP) compared to most other countries. There has also been a desire to have substantial local financing in terms of taxes and/or user charges. Substantial tax financing of a large local public sector can only be achieved by giving local governments access to tax bases that can generate much revenue. In this context the income tax is an obvious candidate.

Moreover, other taxes that may generate substantial revenue like VAT or the payroll tax get a lower score than the income tax on the criteria for good local taxes. The VAT has a more mobile tax base (location of trade centers etc) and the residence principle is violated due to cross border shopping. The same arguments are relevant for the payroll tax if it is paid to the municipality and county where the employer is located. If it, on the other hand, is paid to the municipality and county where the employee resides, it becomes more similar to the income tax in terms of a local tax. However, because it only includes workers, it has a lower score on the residence principle. Anyway, the regional differentiation of the payroll tax, to stimulate employment in rural areas, makes it unsuitable as a local tax in Norway.

We argue that the income tax is well suited to achieve substantial tax financing of a large local public sector that is responsible for important welfare services. However, substantial tax financing must be combined with an ambitious tax equalization program to limit differences in service provision and to solve the competition problem. The tax equalization weakens the relationship between the local tax base and local government revenue, and makes the tax financing less real. From a narrow economic perspective that focuses on incentives on the margin (to develop the local tax base), the combination of substantial tax financing and ambitious tax equalization seems unnecessarily complicated. The same marginal incentives can be obtained by a combination of less tax financing and a less ambitious tax equalization program. In addition, the macroeconomic control of local government revenue will be improved and the revenue of individual local governments will be more stable.<sup>9</sup>

The narrow economic argument above implicitly assumes that the share of taxes in local government revenue is of little importance. However, in a political context the tax share may be important. Jackman (1988, p.7) notes that proposals of less tax financing and less ambitious tax equalization "... has been attacked by political scientists on the ground that distinguishing the total from marginal expenditures is confusing in a political context, and thus may undermine the political preconditions for democratic accountability". The proposition that the share of taxes in local government revenue is of political importance seems to be widely accepted in Norway. Based on the commission's proposal the parliament has decided to increase the share of taxes in local government revenue to 50 percent. However, there is scope for further investigation of the issue of why and how the tax share is important for local democracy and independence of the central government, and possibly also for economic efficiency.

#### *The natural resource tax*

The natural resource tax on power production is an anomaly according to the criteria for good local taxes. A tax related to one particular industry will tend to be very unevenly

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<sup>9</sup> Macroeconomic control and stability of local government revenue is less important in Denmark and Sweden where taxes are collected nationally and distributed to local governments in the same way as grants.

distributed across local governments, and it is. The justification of the tax is that it provides compensation to the local communities for damage to nature from the building of power stations etc.

#### **4. Local tax discretion**

If we only look at the tax rules described in Section 2, Norwegian local governments have substantial tax autonomy. The municipalities can choose tax rate within an interval for the income tax, the wealth tax and the property tax, and the counties can choose tax rates within an interval for the income tax. The real picture is quite different since all local governments have used the maximum tax rates in income and wealth taxation during the last 25 years. In practice tax discretion is restricted to the municipal property tax. The municipalities can also influence their revenues through user charges. The county governments have less tax discretion than the municipalities since they do not have property tax and because user charges to a less extent can be levied on their services.

Limitations to local tax discretion started with the introduction of tax limits with the 1911 Tax Law. More limitations were introduced after WWII when the building of the welfare state was combined with local responsibility for important welfare services like education and health care. The substantial differences between local governments, where larger urban communities enjoyed the lowest tax rates and the best services, were considered to be in conflict with the policy goal of equalized provision of welfare services throughout the country. The national policy response was to narrow the interval for local tax rates and to increase the share of grants in local government revenue. The grant system was of the matching type with differentiated matching rates to take account of differences in spending needs and tax bases. The differentiation was to some extent based on judgment, and there was a tendency to set the matching rates lower for local governments that kept the tax rates below the maximum. In 1979 the last local government gave in, and since then they have all used the maximum rates in income and wealth taxation.

*Why is the discretion in income and wealth taxation not utilized?*

Why do we not observe that even a single local government chooses a tax rate below the maximum in income and wealth taxation? One possible explanation is that the local public sector is ‘underfinanced’ (see e.g. Norman 1997), i.e. all local governments have desired tax rate above the maximum. The problem with this argument is that if the local governments were underfinanced, one would expect that they also utilized other revenue sources (property tax and user charges) to the maximum. But they do not. Many municipalities do not use the property tax and have relatively low user charges.

The puzzle is rather why the richest local governments do not reduce their tax rates, and a more reasonable understanding is that the local governments fear that the central government will respond to lower income and wealth tax rates by reducing their grants. A lower tax rate is partly a signal for good economic conditions, and may thereby be a disadvantage in the competition for central government grants. In the short term grants that are distributed on the basis of judgment and/or negotiations may be affected, and in the longer term also the rules of the grant system. If this explanation is the correct one, increased utilization of the formal tax discretion in the income tax can only be achieved if the central government clarifies the working of the grant system and is able to convince the local governments that the budget constraint is not as soft as they seem to believe.

*Possible consequences by more local tax discretion*

The main economic argument in favor of local tax discretion is related to the decentralization theorem of Oates (1972). When the local tax rate can adjust to varying spending preferences and cost conditions, a decentralization gain can be achieved compared to a situation with a uniform tax rate decided at the national level.

Borge (2003) provides some tentative calculations of which effects more local tax discretion may have for efficiency (decentralization gains) and service provision. The analysis is based on median voter model that is calibrated on Norwegian data for 1996, and is based on the assumption that local tax discretion is negligible. The model is first

used to calculate desired service provision and income tax rate in a hypothetical situation with full tax discretion. Tax discretion increases the choice set of the median voter, and as a consequence, he will be better off than in the present situation without tax discretion. The decentralization gain is then calculated as the income reduction he can accept under tax discretion and still be as well off as in the present situation without tax discretion.

In the benchmark case (with price elasticity of -0.4 and price elasticity of 0.6) the decentralization gain is calculated to nearly 1000 NOK per taxpayer or 3 billion NOK in aggregate. In addition increased local tax autonomy may give a much more equal provision of local public services. The coefficient of variation for local public services is reduced from 0.27 to 0.08. The main driving force is that small, rural communities (with high levels of service provision and low private disposable income within the present system) are predicted to reduce their tax rates, whereas larger, urban communities (with relatively low levels of service provision) are expected to increase their tax rates.

The analyses discussed above were based on a median voter model where tax limits by definition are associated with an allocative efficiency loss. However, a major argument for imposing such limits is that median voter model may not be the correct description of the workings of local democracy (e.g. McGuire 1999). To deal with this issue Borge analyzes how the decentralization gain is modified when he allows for overspending and X-inefficiency. The calculations indicate that the net gain is close to zero if tax discretion is combined with overspending of 15 percent or X-inefficiency of 3 percent.

#### *The use of property tax and user charges*

Given that the discretion of income and wealth taxation is not utilized, it is of great interest to analyze how the remaining instruments to influence current revenues, property tax and user charges, are applied. A central issue in our context is how property tax and user charges are affected by other revenue sources, mainly block grants and regulated income and wealth taxes. Property tax and user charges are fiscally motivated if they tend to increase when other sources of revenue become more restricted, and also if they respond positively to the costs of serving the municipal debt. Several empirical analyses (Borge 1995, Hanssen and Pettersen 1995, Spjøtvoll 1995, Follestad 1999, Klungerbo

1999, Borge 2000, Borge and Rattsø 2004) document that this is the case. Many of the studies also find significant effects of political institutions. Both a fragmented local council and a high share of socialists contribute to higher property tax and user charges.

*Problems with local tax discretion in the income tax*

As discussed in Section 2, the income tax is shared between the municipalities, the counties and the national government. The share of the income tax received by local governments is an important tool for the national government to achieve an equal growth of taxes and block grants. The background is that balancing of taxes and block grants has important distributional consequences because the share of taxes in local government revenue varies substantially between local units. An economic boom with high growth rate of local taxes will benefit local governments with a high share of taxes in total revenue. On the other hand, local governments strongly dependent on grants will not take much part in the boom, in particular if grants are reduced in boom years.

Local governments can not be given full discretion in the income tax as long as there is a need for the national government to balance taxes and block grants. Alternatively they could be given discretion to decide tax rates within an interval, and where the national government decides the placing of the interval to balance taxes and block grants. A major problem with this alternative is that it probably would converge towards the present situation where all local governments use the maximum tax rates. The alternative will be particularly vulnerable in booms where the national government runs a tight fiscal policy. Balancing between taxes and block grants must then be achieved by moving the interval downwards. But given that the national government prefers a low growth of local government revenue, it is unlikely that the local tax rates will be adjusted downwards in tandem with interval. It is probably a better prediction that most local governments eventually end up using the maximum tax rates.

## **5. Tax equalization**

Until the mid 1990s the tax equalization was designed to guarantee a minimum level of per capita revenue. The guaranteed revenue was 96.2 percent of average tax revenue for the municipalities and 113.25 percent for the counties. In addition, half of municipal tax revenue above 140 percent of the average was withdrawn to the state. The main disadvantage by this design was that it, for the minimum revenue communities, removed the fiscal incentives for economic development and in practice turned local taxes into grants.

From 1997 the tax equalization was changed so that all local governments now receive fiscal a gain by improvements in the local tax base. For municipalities and counties with low tax base the compensation rate was reduced from 100 to 90 percent. To avoid revenue reductions in local governments with low tax base, the reference level was raised to 110 percent for the municipalities and to 120 percent for the counties.

The main argument for the tax equalization system is of course equalization. However, tax equalization also provides insurance against reductions in tax revenue. For local governments that receive tax equalization grant 90 percent of a tax reduction is compensated by increased grants. The insurance aspect of the tax equalization was highlighted in the late 1990s when the system was changed such that the tax equalization grant was paid in the same year as the corresponding tax revenue. Until then it was a two year lag in the tax equalization.

In order to avoid adverse distributional implications of the reintroduction of a local corporate income tax, the government has proposed more ambitious and more symmetric tax equalization for the municipalities. The symmetric part of the system implies that municipalities with below average tax revenue receive 50 percent compensation (with the average as reference), whereas 50 percent of tax revenues above the average are withdrawn to the state. In addition municipalities with tax below 90 percent of the



average will receive an extra 40 percent compensation (with 90 percent of the average as reference).

The marginal incentive effects of the proposed system depend on the level of tax revenues. The fiscal incentives to promote economic development is increased for municipalities with tax revenue between 90 and 110 percent of the average (the compensation rate is reduced from 90 to 50 percent), and is reduced for municipalities with tax revenue between 110 and 134 percent of the average (the compensation rate increases from 0 to 50 percent). Since about 130 municipalities (of which many are larger cities) have tax revenues between 90 and 110 percent of the average and less than 30 have tax revenues between 110 and 134 percent of the average, the net effect of the proposed system is to increase the fiscal incentives to promote economic development.

## **6. The property tax**

During the first decades after introduction of local democracy and local self rule in 1837 the property tax was the dominating local tax, and around 1850 the property tax amounted to two thirds of local taxes. The benefit principle was applied to large extent. The tax was collected for different purposes (like schools and roads), and distributed among the property owners according to the (expected) benefit of the service. As discussed in Section 4, the income tax became the dominating tax in the second part of the 1880s due to industrialization and introduction of a money based economy. In addition the benefit principle came under pressure when the local governments to a larger extent moved into poor relief and redistributive services (education and health care). By the turn of the century the property tax was reduced to around 25 percent of local taxes. During the 20<sup>th</sup> century the relative importance of the property tax was further, and it now amounts 4 percent of municipal taxes.

In an international perspective, the property tax is the most common local tax, and it performs well according to the criteria discussed in Section 3. The property tax is paid by

homeowners and firms located in the community, and is clearly linked to the municipality as long as the tax burden is not exported to individuals or firms outside. It will work as a benefit tax if consumption of public services is proportional to house or the quality of local public services is capitalized into house values (Hamilton 1975). Although the property tax is not perfectly immobile, it is probably the tax with the least mobile base. The property tax base is relatively stable over the business cycle as new construction is relatively small compared to the existing base, and the tax assessment is typically not affected by short-term fluctuations in market prices. The distributional aspects of the property tax will depend on the specific tax design, and in particular whether business property is included or not and whether specific industries (e.g. farming) receive special treatment.

#### *The use of the property tax*

The property tax is a voluntary tax for the municipalities that can be levied on property in urban areas and on certain facilities (in both rural and urban areas). The law does not provide a definition of these certain facilities, but in practice they are defined as larger works used for production of goods or maintenance. Property tax can be levied on certain facilities without taxing all property in urban areas. Sauar (2003) provides a detailed survey about the municipalities' use of property tax. He finds that 230 municipalities (53 percent) levy property tax. Among these 119 levy property tax on certain facilities only, while the remaining 111 tax business and residential property in urban areas as well as certain facilities.

The Norwegian Association of Homeowners (*Huseiernes landsforbund*) has provided more detailed information about residential property tax. For 54 of the 111 municipalities with residential property tax the association reports information about property tax rate, tax assessment in percentage of market value and tax payment for a house with a market value of 1.5 million NOK. Table 3 reports some summary statistics of these variables.

The cross section variation in the property tax rate corresponds to the allowed variation, i.e. the tax rate varies between 0.2 and 0.7 percent. However, more than 70 percent of the

local governments in the sample use the maximum rate of 0.7 percent. There is much more variation in the assessment rate, which varies between 10 and 88 percent with an average of 34 percent. There is a strong negative correlation between the tax rate and the assessment rate (-0.67), which means that municipalities with a property tax rate below the maximum tend to have a high assessment rate.

Table 3: Property tax rate, assessment rate and tax payment for a house with market value of 1.5 million NOK

	Average	Min	Median	Max	CV
Tax rate (%)	0.6	0.2	0.7	0.7	0.238
Assessment rate (%)	34	10	30	88	0.571
Tax payment (NOK)	2 845	1 050	625	5 600	0.405

The tax payment for a house with a market value of 1.5 million NOK varies between 1 050 NOK and 5 600 NOK, with an average slightly below 3000 NOK. The variation in tax payment is mainly driven by the variation in assessment rate, but the variation in tax payment is somewhat lower than the variation in the assessment rate because of the negative correlation between the tax rate and the assessment rate.

#### *A more general and extended property tax*

Both the property tax commission (NOU 1996: 20) and the recent tax commission (NOU 2003: 9) have recommended major changes in the property tax law. A major proposal by the property tax commission was to introduce a general property tax that includes all property, not only property in urban areas and certain facilities. In addition assessed property value should correspond to market value. Although the property tax commission proposed to reduce the maximum tax rate to 0.3 percent, property tax revenue could be increased because of the increased assessment rate and because it would be possible to tax property in rural areas also.

The tax commission had a broader mandate and could see the property tax in relation to the wealth tax and the tax on the imputed rent on housing. The commission emphasized equal taxation of return on different types of capital, and argued primarily for an increase in the imputed rent tax by higher assessment rates and by using a higher interest in the

calculation of the imputed rent. However, the commission acknowledged the political signals to reduce the imputed rent tax, and considered increased property tax as the best alternative to get taxation of housing more in line with the taxation of other types of capital. A reduction of the wealth tax was also proposed.

The commission considered the property tax as well suited for local tax discretion, and proposed a mandatory property tax with a minimum and a maximum rate. However, the commission did not conclude whether the mandatory part of the property tax should be national or municipal. To avoid that the mandatory property tax is considered as an imputed rent tax with a new name, all property, not only residential property, should be subject to the increased property tax.

The new tax system proposed by the government in May 2004 (St. meld. nr. 29) implies that the wealth tax will be reduced by 50 percent in 2006 and 2007, that the imputed rent tax on housing is eliminated and that the property tax is maintained as a voluntary tax for the municipalities. The government will consider introducing a general property tax that covers all property, not only property in rural areas, which is estimated to increase property tax revenue by up to 10 percent.

#### *The future potential of the property tax*

The present property tax does not generate much revenue, only 4 percent of municipal taxes or 0.25 percent of mainland GDP. These figures are low compared to many other countries, partly because Norway has a relatively high wealth tax. The proposed reduction of the wealth and the elimination of the imputed rent tax, may lay the ground for an extended municipal property tax with tax discretion. Based on the international experience, an extended property tax could amount to about 3 percent of GDP. A property tax of this order would be a substantial tax for the municipalities as it would amount to nearly 40 billion NOK or 50 percent of municipal taxes. However, it is far from clear that the potential to extend the property tax will be utilized. The political background for the proposed elimination of the imputed rent tax is that taxation of

housing should be strongly reduced. In this context it may not be politically acceptable to extend the property tax.

## **7. Concluding remarks**

The paper has discussed the tax financing of Norwegian municipal and county governments, included recent changes and proposed reforms. It appears that the local tax financing in Norway is similar to the systems in the other Nordic countries in the sense that taxes make up a substantial part of total revenue, the personal income tax is the dominating local tax, and there is ambitious tax equalization. The main difference is that local tax discretion (in practice) is more limited in Norway.

Three commissions (the property tax commission, the local public finance commission and the tax commission) have argued for the introduction of a more general and extended property tax with municipal tax discretion, and proposed reforms in the tax system (lower wealth tax and elimination of the tax on imputed rent on housing) give room for increased property tax. However, the general resistance towards taxation of housing may obstruct and economically sound reform of the tax system and the financing of the municipalities.

Local tax discretion in the income tax is more problematic, and may not work because the central government needs the local income tax rates as instruments to balance taxes and block grants. However, if the property tax is not increased, there is a stronger argument for municipal discretion in the income tax, but it may require consolidation of municipalities (less variation in tax bases) and/or a more ambitious tax equalization to reduce the need to balance taxes and block grants.

The responsibilities of the county governments were substantially reduced when the national government took over the responsibility of the hospitals, and there is an ongoing debate on the future role of the middle tier. Tax discretion for the middle tier is not an

issue right now, and can only be an issue in the future if the counties merge into larger regions with substantially increased responsibilities. It is symptomatic that the politicians never considered reintroducing the corporate income tax for the counties.

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