

Accountability and Control in the Financing of Local Government in Denmark

by
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In Denmark, nearly all public services for individuals and families are delegated to local authorities, resulting in high quality and flexible delivery. The financing of these services is mostly ensured by tax revenues determined by the individual local authority but linked to the central government income tax. Local accountability in this regard has recently been called into question. Although local borrowing is strictly controlled, the system of grants and equalisation does not give incentives for cost efficiency in local government. Other accountability instruments (matching grants, general grants, the long tradition of negotiations) are analysed in light of their impact on control.

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1. Introduction

The high degree of decentralisation in Denmark has resulted in high user satisfaction and flexibility in delivering public services. But in recent years the central government has questioned local accountability and felt a need for better control of local authorities.

1.1. Accountability

In Denmark borrowing is strictly controlled, but the central government believes that local accountability in the decisions on local tax increases is failing and that local councils too often find local tax increases more acceptable to implement than measures to improve local efficiency.

There is a 25-year-old tradition of annual negotiations with local authorities attempting to strengthen local accountability but the government does not find the results of this system satisfactory – especially after the introduction in 2001 of a national tax freeze. Attempts to introduce incentives for improving cost efficiency in the grants and equalisation system have not been successful.

Improved accountability while maintaining the system of local taxation rights will be on the agenda for the coming years and a solution will be difficult to find. Rather significant changes in the traditional framework for the implementation of local taxation rights are likely to result.

1.2. Control

In addition to unsatisfactory local efficiency policies, the central government also finds that central priorities for welfare services have not been followed well enough by local authorities. There are many possible ways of control. But a return to detailed regulation or to open-ended “earmarked, mandatory matching grants”¹ is not an option. The experience with these has been negative.

Experiments with grants for improved old age care designed either as general grants combined with negotiated agreements with the local government associations or as close-ended matching grants by application have not been totally satisfactory from the point of view of efficiency. A new grant design for the hospitals using marginal matching grants in a close-ended version, however, has been a success story.

The difference between these grants can be explained by the fact that measuring output is not as easy for old age care as for hospitals. One conclusion is that measuring output is the great challenge for better control.

Another conclusion is that the time lag between political decision and visible effects must not be too long.

1.3. Future prospects

The future may see big changes in the traditional high degree of decentralisation of the public sector in Denmark. These will involve a change in the regulations governing local taxation rights as well as better measures of output in order to make grants more efficient instruments of central control.

2. Overview of the Danish local government structure

In Denmark nearly all public services for individuals and families (schools, old age care, health, social support, etc.) are delegated to local authorities. The result is a relatively high degree of decentralisation of the public sector (Table 1). The decentralisation of the supply of these services is believed to have resulted in high quality and in flexible delivery of public services.

Table 1. Structure and size of local authorities, Denmark

	Municipalities	Counties/regions
2006 (before reform)¹		
Number	271	13
Average size	20 000	367 200
Main functions	All services for individuals: child care, schools, old age care, utilities, etc.	Health, complicated social services, education for ages 16 to 19, planning and environment.
Expenditure per capita in 2005	EUR 8 996	EUR 2 770
Expenditure as percentage of GDP (2004)	16.5%	7.2%
2007 (after reform)		
Number	99	5
Average size	56 500	1 082 200

1. In 2007, the number of municipalities will be reduced by more than half, the number of counties will be reduced to five regions (before the reform, three municipalities have county functions), and the assignment of functions will be changed.

The financing of the local authorities differs from that in many other countries by the high proportion of own tax revenues, *i.e.* revenue depending on tax rates set by the individual local authority (see Table 2).

Table 2. Financing of local governments (municipalities, counties and metropolitan authorities)

Budget 2004	Per cent of total revenue	Per cent of GDP
Net expenditure, including net interests		23.7
Tax revenues	74	17
Matching grants	11	3
General grants	15	4
Net borrowing (utilities)	1	0
Other	0	0
Total revenues	100	24

3. Accountability problems in local government financing

The term accountability is used here to mean that local councils respect taxpayers' preferences so that the marginal benefits of increased local spending exceed or equal the marginal offer for taxpayers. The institutional conditions for accountability are discussed below for each of the local financing items.

The **local tax revenue** is the major source of financing, yielding nearly three-quarters of the total local financing. The local income tax is a "piggy-back" arrangement: the local authorities decide their own rates for a flat rate levy collected with the central government income tax. The municipal average tax rate is around 20% and the county tax is on average 10% (the latter will be replaced by general grants as of 2007). The variation in local tax rates has been declining over the years and is now around 6%.²

It has been argued that the collection of the local income tax with the PAYE collection of the central government tax makes it less visible. Tax payers are not well aware of the local tax rate. This argument was behind the decision by the government to abandon the county tax in 2007 so that there will be only one local tax rate. Still, the government is not convinced that the local councils always find the costs of raising income tax rates more burdensome than the political costs of improving efficiency and of changing local spending priorities to reflect changing needs.

The **matching grants** amount to 11% of total financing (see Table 2). In Denmark, they are used for local expenditure on social transfers to households only. Though social transfers are basically cyclical in nature, the government believes that there are some problems of accountability. The local authorities decide who gets disability pensions, they have instruments to control sick leave, and they can reduce unemployment using their activation policies better. However, these accountability problems have been brought under better control by central government reducing the

reimbursement rates, and the results have been significant changes in local behavior.

Easy access to **local borrowing** is often seen as a main reason for failing accountability. However, borrowing by local authorities in Denmark is strictly controlled, the general rule being that local authorities are not allowed to borrow except for investment in utility services.³ The exemption of utilities, however, has in recent years been used by local authorities to debt-finance their needs by reducing the balances with their utilities. The government has now decided to enforce a strict separation between the public utilities and their local authority owners, and borrowing by the utilities can no longer be used to finance local government services.

The **general grants** are about 15% of total financing (see Table 2) and play an important role in the management of the local government sector. The annual size of the grant is subject to negotiations between the government and the chairmanships of the local government associations. The grant is to smooth out cyclical fluctuations and is set at the amount deemed necessary for balancing the local economy without changes in local tax rates.

The rules laid out in the legislation require among other things that:

- The grants are based on the grants the preceding year. This often creates an accountability problem when local spending in the year preceding the agreement turned out to exceed what was agreed. Once the agreements have been broken it is close to impossible for the local associations to promise that their members will roll back their spending to the level agreed for last year.
- Grants must include increases in local government wages and prices. This is also an accountability problem because the local governments through their associations are themselves responsible for the wage negotiations. (For example, for 2006 the result of the local wage negotiations exceeded the central government guidelines by more than one per cent. In order to obtain agreement, the government in the end had to finance this wage increase over the grants.)
- Grants must include financial consequences for municipal expenditure of new legislation or regulation (a rule serving to strengthen accountability in the central government departments).
- Grants must reflect changes in municipal expenditure (positive or negative) for social transfers to households.

4. Negotiations as an instrument to improve accountability

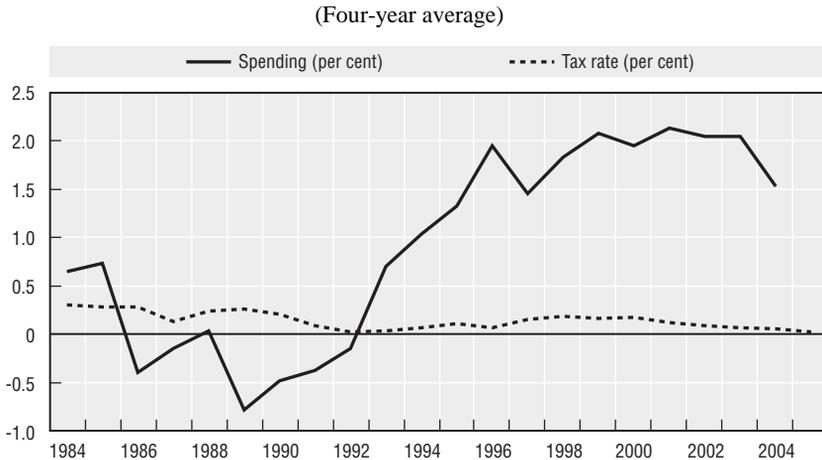
In Denmark there is a long tradition of negotiations between the central government and the local government associations.⁴ During the 1970s, annual agreements were used to tighten the rules for local borrowing to finance investment (in 1979 local borrowing rights had been reduced to nothing). It was then decided to broaden the scope of the agreements to cover not only investment but the total local finances. The purpose became to reduce the then very high annual rates of increases in local spending and taxation.

The new type of negotiations has now existed for 27 years and has covered many issues but has in fact been centered on the same very basic issue: the local government associations on their side have agreed to recommend to their members not to increase taxes; in return the government has agreed to seek parliamentary approval of the negotiated size of the general purpose grant.

Many other items have entered the agreements over the years, but the basic issue has been for the government to hold local tax increases down. The benefit for the government is that these agreements, concluded with the “non-political” local government associations, carry considerable weight in Parliament. For the local government associations, the annual agreements have helped to hold together their membership and have perhaps strengthened their legitimacy to collect membership fees from their members.

How well has the negotiation system worked? Figure 1 suggests that tax increases were high but real expenditure growth was low during the 1980s while the opposite – low tax increases and high expenditure growth – has been the picture since then. The difference reflects different ways of using the general grants as an instrument of control.

In the early years, whenever local tax rates were increased more than agreed, grants were cut to claw back the extra revenue from the tax increases from the local sector. However, the brutal cuts in grants severely strained the relationship between the two sides, and from around 1990 the policy had to be changed. As a result, the recommendations to reduce the increases in the local tax rates became more effective but it is questionable whether the effectiveness of the system measured on the expenditure side has been maintained. A recent internal study suggests that the policy of the early years was more effective and that the years since 1990 have seen annual growth rates of municipal expenditure raising spending standards with about 0.8% annually on the top of the (significant) effects of changes in demographic expenditure trends.

Figure 1. Annual change in municipal expenditure and in income tax rates, 1984-2004

It is a valid question how such a system of annual negotiations could improve local accountability. Why should any individual municipality feel constrained by an agreement made by the unions to hold taxes unchanged for all municipalities seen as a whole? The answer is that the local government associations have been willing to exert a lot of pressure and salesmanship to dissuade their individual members from tax increases. But this apparently has not been enough. In particular after the introduction of the national tax freeze, any local tax increases – even the relatively minor increases of the most recent years – have been unacceptable to the government.

Negotiations have now been initiated on how to improve the framework of the system of annual negotiations in a way that allows local authorities to keep their rights to set their own tax rates but at the same time guaranteeing that the average local tax rate does not increase.

No matter the reasons for the local breaches of the agreements – be it that the local authorities are reading the popular preference for public versus private services better than the central government or that there are imperfections in the local political process – the design of such a new framework will be difficult and may probably need to change traditional concepts of local taxation rights.

Solutions mentioned in the Danish debate have been the introduction of collective sanctions if the tax level is increased more than agreed, or the introduction of a system of permits to increase taxes requiring other

authorities to agree to lower taxes correspondingly. None of these ideas has been greeted with enthusiasm by the two sides.

5. Can accountability be improved by changes in the grant system?

In recent years, political interest has been expressed for changing the system of grants and equalisation so that the system gives incentives for more cost efficiency in local government. A standing committee, the Finansieringsudvalget⁵, was asked to make proposals on how this could be done. The committee concluded in 2004⁶ that the present system of grants and equalisation, when compared to the older systems with the many conditional grants and earmarked grants, has improved cost efficiency in local government. But to take further steps in this direction would involve building efficiency measures into the systems to be able to reward efficiency. However, after having examined the available methods of assessing efficiency, the committee concluded that none of the existing methods is resilient enough for legislation to be based on any of them.

6. Grants policy as an instrument for control

There has recently been a wave of new developments making it harder for the local authorities to deliver the desired services within the existing budgets. Examples are the introduction of citizens' rights and increased attention in the media on examples of service failures. Examples are the focus on waiting lists for child care, for old age homes and in the health care sector.

Parliament has been increasingly concerned over the efficiency and quality of local services. These concerns have been difficult to meet. On the one hand, nobody wanted to go back to detailed regulations or to direct open-ended matching grants. On the other hand, the central government and Parliament do not believe that increases in general purpose grants result in the desired improvement in service quality. Instead, experiments have been made with new types of grants being both close-ended, like general grants, and at the same time linked to an activity, like matching grants.

Three examples of new grant designs are described below – first, two examples of grants for old age care, then a grant for improved hospital production – and finally some conclusions are drawn.

6.1. First example: Matching grants on application for reforms in old age care

The finance bill for 1998 included a grant of DKK 225 million for initiatives to improve quality and to give clearer rights to citizens regarding home care. Applications for 150 projects were approved for implementation in 144 municipalities. The municipalities were obliged to report on progress twice: a mid-term report and, no later than three months after the conclusion of the project, a final report.

In 2004 an evaluation of the effects of the grant was done. It showed that only 45 municipalities had reached the objectives they had set for their projects, but many evaluations had not yet been submitted.

The Ministry of Social Affairs then renewed the contracts with the evaluating consultants to follow up on those municipalities that had not yet finished their projects. Those that failed to report back before 1 June 2005 would be asked to return the grant. As of September 2005, the Ministry has demanded repayment of DKK 0.5 million from three municipalities; it still needs to take a decision on 10 other municipalities.

In summary the experience has been seen as useful though not only positive. There have been very considerable administrative costs, first to define and approve the project proposals received from the municipalities, second to follow up and enforce repayment of grants. The grant payments stopped in 2001, but four years later considerable work still needs to be done to ensure that the grant money has been spent correctly.

The conclusion drawn by the government is that, considering the size of the grant, the visible political gains have been too weak. The time lag between the decision in 1998 and the information in 2005 on the effects was too long in a political perspective.

6.2. Second example: General grants for old age care combined with voluntary agreement with the municipal associations

During the election campaign in 2001, the government party had proposed an increase in the old age care spending of DKK 0.5 billion. The instrument of implementation was to be the annual agreement between the government and the municipalities. The agreement for 2003 said: “In continuation of the law on free choice of home for elderly and the law on free choice of supplier of old age care functions, the government will pay the municipalities DKK 500 million in 2002 and in 2003. The grant is distributed according to a demographic key”. In other words, this was seen as an annual addition to the general grant to the municipalities.⁷

The agreement with the municipalities clearly stated that the extra grant money was meant to give impetus to the old age care services. It was also meant to cover the municipal costs of the simultaneous introduction of free choice of old age home and of supplier to deliver home help, as well as the costs imposed on municipalities for their new obligation to pay compensation to clients if the home help is not delivered as promised.

In 2004 a political discussion developed. The opposition and the media expressed doubts that the extra funds had actually been spent on improvements in old age care. It was said that the municipalities instead had spent the grant for administration or for other purposes. The government had to admit that it did not find it possible to follow the exact spending of the DKK 0.5 billion in the municipal budgets. All local authorities are required to apply a common standardised accounting system but, as often happens, it turned out that the specifications in the system failed to meet the specific analysis needed to prove where the money had been spent. Recording of the spending of the grant therefore did not exist.

In the end a thorough (and expensive) analysis was made including special questionnaires to all municipalities. The conclusion was presented in 2004, informing the critics that the municipalities had spent an amount equal to the grant to implement the reforms and to improve old age care. Only then did the political debate stop. In this case also the political benefits did not seem very visible in spite of the quite large government outlay.

6.3. Third example: Automatic matching grants (but marginal and close-ended) for higher hospital output

The agreement with the counties for 2002 included a grant of DKK 1.4 billion to finance an increase of the capacity in the health sector in order to reduce waiting time for medical treatments. This grant has been continued in the agreements for the following years.⁸

In the preceding years the government had increased the general grants to make financial room for increased spending, and it had been stated in the annual agreements that this increase should result in better treatments of heart diseases and of cancer (much like the grant described as example 2 above). But the new government was not convinced that the spending of the extra funds had been effectively focused on increasing the capacity in the health sector. The government wanted to design the grants in a way to give clearer incentives for increased production.

The production is measured using the DRG (Diagnosis Related Grouping) system, *i.e.* a system assigning a specific price to each different

hospital treatment, thus permitting a summing up of the total cost for all treatments performed by a hospital in a given period.

Not the whole increase in production can earn grant money. The county in question first has to increase production corresponding to the expected improvements in productivity of 1.5% annually before it can earn grant money. Thus the base line was that production in 2001 would be increased annually by 1.5% and adjusted for wage and price increases. In 2002 the DRG value was refunded 100% but, realising that the marginal costs were lower than the DRG prices, the refund was reduced to 70% for 2003 and 2004.

The whole amount of the grant was provisionally distributed at the beginning of the year to the counties according to objective demographic factors. In this way the counties were supplied with liquidity to take steps to increase production. The grant is close-ended in the sense that no county can earn more in the end than this initial distribution. If they fail to generate the volume necessary to earn their provisional share of the grant, they lose half of the difference but are allowed to transfer the other half of the unused grant to the following year. This was the case for three out of 15 counties in 2002 and for five counties in 2003.

The division of the potential grant to all counties was done so that the counties that were already the most efficient would not claim too much of the total grant. This could have accelerated differences in the service level among counties. This solution also helped to soften the anger of the counties that found the new system excessively centralistic.

The design and implementation of the grant has raised a number of problems. For one thing, the counties have complained about budget uncertainty because of late announcements of their annual baselines.

The grant resulted in improvements in the DRG system of recording hospital output. There was already in Denmark a system of central registration of all hospital treatments, but the introduction of the system encouraged all counties to make sure that their DRG registrations were working and up to date. Furthermore, the DRG prices had to be designed to give an incentive to prefer out-of-hospital treatments over hospital treatments, and concern has been voiced that the incentive to increase the number of hospital treatments will hurt functions not covered, like psychiatric care, education and training, research, IT investments, etc.

To handle the problem of “DRG-creep” (*i.e.* that doctors within the DRG system classify patients in closely related groups under the group having the highest value), a limit has been introduced so that no more than a

2% increase (1.5% in the following years) in DRG value per contact is accepted.

However, the bottom line is that the results of this new grant have been visible and generally recognised. The number of operations increased by 11% from 2001 to 2002, and in 2003 the increase was 2-2.5%. For the first time, waiting time has begun to fall, decreasing by 20-25% from 2002 to 2004.

6.4. Conclusions on grant design

It cannot be concluded from these examples that the model of the hospital grants can easily be copied for the old age care sector. In the case of hospitals, the output is measured reasonably well by the national DRG recording system, but in the case of old age care a quantitative description of the output is much more difficult.

The conclusion is that the construction of better ways to measure output is the great challenge for better control, and it has now been agreed between the central government and the local government associations to work together to establish such better measures.

Another feature that improves efficiency in the case of the hospital grants has been the use of grants conditioned not by total activity but by the change in activity, adjusted for the expected average annual productivity gains. Also, an advantage of the model for the hospital grant is that it is close-ended and involves no budgetary risk for the central government. Finally, the results of the hospital grant have been visible and without much delay from the time of decision to the time of effects, making it an effective political instrument.

Notes

1. In the following, the terminology of the questionnaire for the OECD Network on Fiscal Relations across Levels of Government has been used.
2. There is also a small land tax with own local setting of rates yielding about 5% of the local tax revenues, and an even smaller amount of tax-sharing receipts from the company tax and some capital taxes.
3. The prohibition of local government borrowing raises a number of problems, for example how to treat sale and lease-back arrangements. Pedersen (2002) gives an interesting overview of these problems.

4. There are two such associations in Denmark, one for the municipalities and one for the counties, and all local authorities are members except two metropolitan units that are both municipalities and counties. In connection with the reforms, the two metropolitan units have become members of the municipal association, and the future of the county association after the reform is still undecided.
5. The Finansieringsudvalget is a committee composed of civil servants from the Ministries of the Interior and Health, Finance, Education and others, together with civil servants from the municipal associations. For more than 25 years, all changes in grants and equalisation policies have been prepared by this committee, now headed by the Ministry of the Interior and Health.
6. Et ny udligningssystem, Betænkning nr. 1437, Copenhagen, January 2004.
7. The grant has now become a permanent annual grant and is accordingly included under “non-earmarked mandatory general purpose grant” in the Danish reply to the questionnaire for the OECD Network on Fiscal Relations across Levels of Government.
8. For 2002, DKK 1.4 billion was disbursed; for 2003, disbursements were 1.0 billion and for 2004, 1.1 billion.

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