

Incentives detrimental to growth in the local income equalisation system?

Summary and recommendation

The Swedish National Audit Office has audited whether the local income equalisation system has negative effects on municipal growth. The purpose was to provide evidence that can be used in designing the income equalisation in accordance with central government objectives for the general grants to municipalities. The audit conclusion is that there is no evidence for whether the degree of equalisation in the local income equalisation system has a negative impact on tax base growth. It turns out that it is not possible to evaluate the implemented reforms with standard quantitative methods. It is previously known that there are methodological difficulties in studying local growth incentives. Local growth is a complex phenomenon, and isolating the role of the income equalisation is a major challenge. The Swedish NAO therefore sees a further need for well-founded evidence for how to design an efficient local income equalisation system. A possible way forward is to dig deeper into local growth investments and into the mechanisms underlying local growth.

The income equalisation is key for reaching the goal of the municipal equalisation system, to decrease capability differences among the municipalities. However, there is a long-standing concern that the income equalisation affects municipalities' incentives for growth negatively. Based on the international economic research literature, this concern is justified. Economic theory makes clear that there is a risk of such negative side effects. But investigating this empirically is associated with methodological difficulties, and the Swedish NAO has assessed that there is a lack of evidence for how to best design the income equalisation.

The Government is responsible for the design of the local income equalisation system and has thus been the audit subject.

The audit was based on the following audit question:

What effect does the local income equalisation system have on the municipal tax base?

Quantitative methods for evaluation have been used to answer the question. Specifically, the effect of three reforms that reduced the degree of equalisation in a set of municipalities was studied.

To broaden the understanding of whether the incentives in the income equalisation may affect municipal growth, we also studied local growth investments, in particular by conducting a survey.

Audit findings

The audit conclusion is that there is no evidence for whether the degree of equalisation in the local income equalisation system has a negative impact on tax base growth. Although the quantitative analysis shows that the tax base increased in municipalities where the degree of equalisation was reduced, the increase cannot be referred to the reform. At the same time, the audit shows that municipalities think of local growth as being more than merely tax base growth, and that they cooperate among one another. One possible interpretation from these findings is that the income equalisation does not primarily hamper growth.

According to the Swedish NAO, well-founded trade-offs between equivalence and efficiency are required when implementing changes to the income equalisation. This has been lacking in previous reforms. Unfortunately, the audit does not provide any conclusive evidence, but rather emphasises that the matter is associated with significant methodological difficulties. Combined with the complexity of the income equalisation, this means that there is a further need for well-founded evidence on how design an efficient local income equalisation

Recommendation

The Swedish NAO as well as the Government Committee on Municipalities have previously pointed to the importance of a continuous management and administration of the municipal equalisation system as a whole. Based on this audit, the Swedish NAO wishes to emphasise that such a task should include comprehensively studying how incentives in the income equalisation affect municipalities, and how the income equalisation should be designed. Our audit has shown that it is not possible to study the effect of previous reforms with standard quantitative methods. Instead, a possible way forward is to dig deeper into the mechanisms underlying local growth. In addition, the Government should ensure that there are good conditions for evaluating the effects of future changes in the local income equalisation system. The reforms ought to be designed and implemented so that the methodological problems identified in this audit are avoided. The changes made should be clear and affect sufficiently many municipalities, and relevant comparisons with other municipalities should be possible.

Based on the audit findings and conclusions, the Swedish NAO makes the following recommendation to the Government:

- *Comprehensively and continuously analyse how the local income equalisation system affects municipal growth.* By better understanding the mechanisms behind local growth, the analysis of growth incentives in the income equalisation can hopefully go further. The Government should also ensure that there are good conditions for evaluating future reforms in the income equalisation.