

# Local Government and Economic Growth<sup>1</sup>

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One of the most striking features of the Swedish economy today is the growing dominance of the local government sector. Out of the national income almost one third is channelled through the budgets of local governments, who employ one fifth of the labor force. Local government spending has been outrunning the GNP with a growing margin, doubling its share over the last twenty years.

Organizational power has grown with the money. In the postwar period there has been a gradual concentration of the decision-making process. While the number of local government has decreased to about one-fourth in the last fifteen years—24 counties and 277 municipalities right now—some of the most expansive areas of service production, like mental health care and secondary schools, have been taken over from the state by local government.

The sphere of responsibility of local governments has, therefore, widened significantly both in form and in content. Individual counties and municipalities today have much greater possibilities of independent long-term planning and procurement and of negotiating with the central government and with large corporations. Along with the successive diversification of the services supplied there has also been a widening of their area of responsibility through their increased participation in distribution and stabilization policies.

Throughout this expansion the local governments have retained a degree of financial independence of central government, which is rather high by West European standards. Of their total gross expenditures only about one-fourth is paid by state grants, while local taxes make up for 45 %, fees and user charges 20 %, with loans and capital income making up the remaining 10 %. For highlighting the degree of tax-financing of the local services, another way of calculating may however be more relevant. If one includes only net profits—or losses—of public utilities, net new borrowing and net transfers from the state (i.e. subtracting taxes and fees paid by local governments to central government) another financial picture emerges. Of the total local government spending directed toward the private sector about 90 % was paid by taxes of which only one sixth was channeled through the state budget. The remaining 10 % was made up of some 7 % for fees and only about 3 % of new loans.

The growing importance of local governments as an independent force in

<sup>1</sup>Most of the material used in this article has been more fully presented in other IUI publications, in particular: B.-C. Ysander, "Offentlig ekonomi i tillväxt" (An Expanding Public Sector), Chapter 9 in *Att välja 80-tal* (Choosing the 80's), IUI 1979, and T. Nordström and B.-C. Ysander, *Offentlig service och industriell tillväxt* (Public Service Supply and Industrial Growth), IUI Research Report No. 11 1980.

the Swedish economy has motivated an econometric study within IUI, from which the historical data and perspectives presented in the following are extracted.

### **A Long-Term Perspective**

Figure 7 represents total local government expenditure as a percentage of GNP at factor prices. The figure shows how a relatively slow rate of growth during the 1920's, 30's and 40's was replaced, from the beginning of the 1950's, by a dramatic expansion that is still continuing.

Figure 8 shows how local government expenditures were distributed among spheres of activity in the years 1913, 1953 and 1977. The relative development pattern changed from the period between the two world wars to the postwar period. While, for example, in the earlier period education and industrial activities tended to increase their share of total local government expenditure, they now account for a successively smaller part of the budget. Provision for housing, however, shows a development in the opposite direction, while medical and health care has, during the entire period, increased its share of total expenditure.

Figure 9 represents the three largest and fastest growing categories of local government expenditure—education, medical and health services and social services. The latter two categories are the only ones that, in terms of averages for the whole period, have expanded faster than total expenditure.

Medical and health services have been growing fast since the 1930's, while the growth rate of social service expenditures has substantially exceeded that of total expenditure only during the beginning of the 1930's (the years of the Great Depression) and the 1970's. Expenditures on education have throughout followed the same pattern of growth as total expenditure.

Figure 10 presents in a corresponding manner the development of local government expenditures on those spheres of activity that are, in a wider sense, inter-connected with physical planning. During the inter-war period, expenditure on housing increased at a rate slower than that of total expenditure but has made up for this by growing faster after World War II.

Expenditures on roads and highways showed similar development until the beginning of the 1970's but have since been given a low priority both by central and local government. Finally, expenditures on justice and law enforcement, municipal planning and general administration show a relatively irregular development where, for example, stagnation during the latter part of the 60's gave way to an accelerated expansion during the 70's, particularly marked in the case of expenditure on general administration. Part of the accelerated increase of this group of expenditures is probably explained by the numerous mergers between municipalities in the early 70's.

Figure 7. *Local government expenditure as percentage of GNP, 1913—1980*

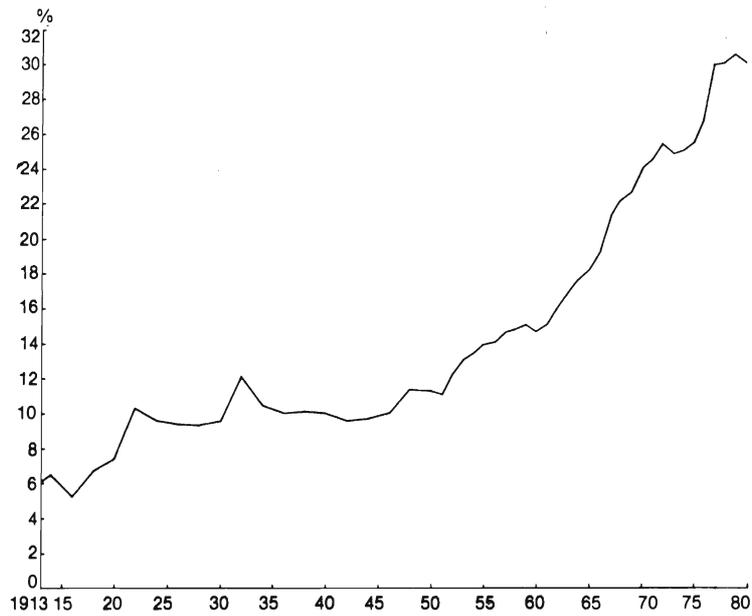


Figure 8. *Distribution of local government expenditures on types of activity, 1913, 1953 and 1979*

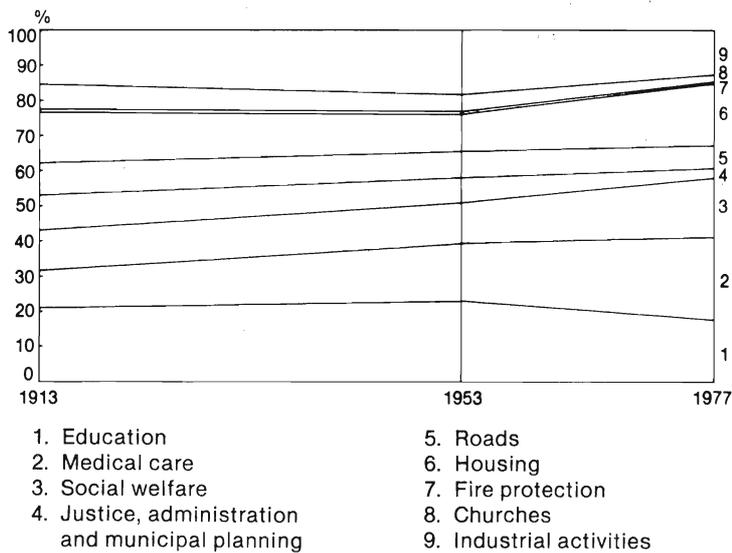


Figure 9. *Local government expenditure for education, medical care and social services, 1913—1977*  
 Index 1913 = 100

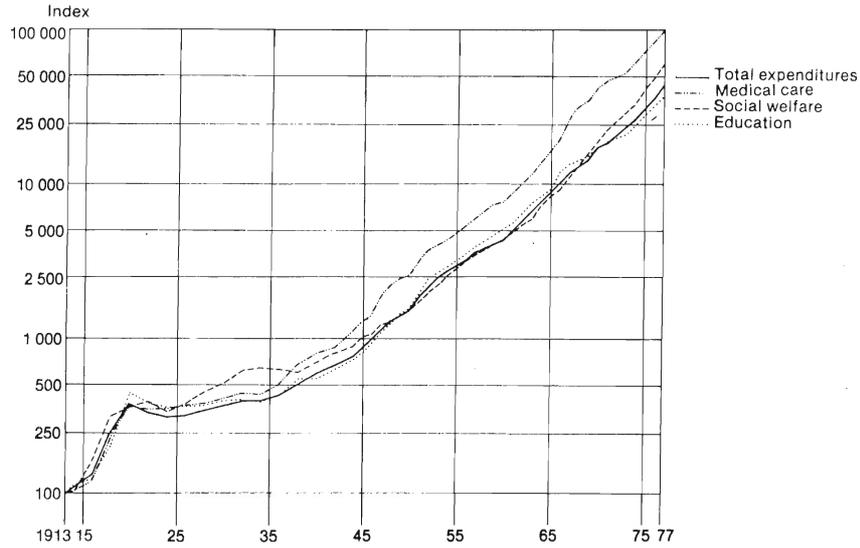
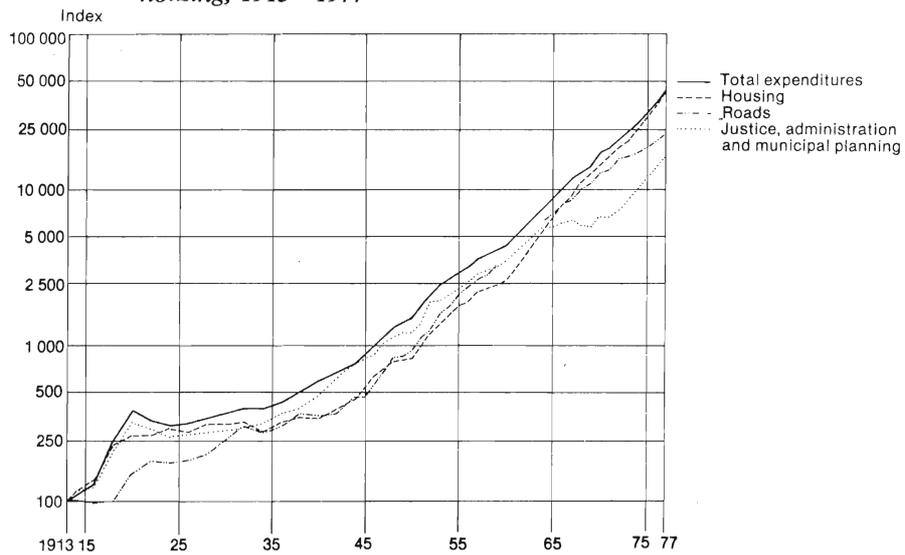


Figure 10. *Local government expenditure for justice and law enforcement, general administration and municipal planning, road services and housing, 1913—1977*



### **The Swedish Welfare Strategy**

The restructuring of the Swedish economy in postwar years has been rapid although not exceptional compared to other western countries. Over the thirty years since 1950 agricultural employment has been drastically reduced and corresponds today to less than 5 % of the total labor force. The matching increase has occurred in the services, particularly in the public services, which doubled their share of GNP and trebled their employment share. The major part of this expansion took place within the local government sphere—in education, medical care and social welfare. Manufacturing industry meanwhile kept its share both of GNP and employment relatively unchanged. The enlarged public service provision was almost entirely paid for by taxes, which trebled relative to GNP. It was again local governments that were responsible for the major part of the tax increases.

What has given the Swedish welfare state a characteristic profile of its own is not only the size of the public budgets, although it tops the list of international statistics in this respect, with roughly two-thirds of all income being channeled through public budgets. There also is what could be called a characteristic Swedish welfare strategy concerned with the ways of using public budgets for redistribution purposes.

On the spending side there are two major alternatives as to how to make social services freely available. Government can do it by subsidized insurance schemes or by direct income transfers to cover the necessary costs, leaving at least part of actual choice of service procurement and use with the individual. Alternatively, the government may assume monopolistic responsibility for service supply and distribute the service free of charge but constrain and regulate the access. Sweden has in postwar years very decisively chosen the latter course. Compared with major West European countries like Italy and France both the postwar growth and the level reached of public transfers relative to total income have been rather moderate in Sweden. It is instead the public price subsidies, in particular the tax-financing of the social services, that have grown exceptionally fast and now dominate the public budgets. This choice of strategy has at least partly been induced by the prevalent notion of free medical care and social welfare services having a more substantial redistributive impact than any alternative payment schemes.

The importance in Swedish public budgets of price subsidies in this general sense is demonstrated by Figure 11, where total public spending has been divided according to the “mode of distribution” into expenditures for traditional collective goods like defense, justice and central administration, price subsidies dominated by local government provisions and finally income transfers of which a major part are social insurance payments from central government.

A marked concern for redistribution also characterizes the Swedish “taxing strategy”. In all countries the importance of indirect taxation has grown

in the postwar period along with income transfers—partly due to the enlarged coverage of social insurance. As shown in Figure 12 the personal income tax in Sweden, however, has increased in step with total taxes—in contrast to the changing tax structure of i.a. France, Italy and West Germany. The central government part of the income is highly progressive, although it is hard to know how much of actual redistribution that is effected. We can also see from the figure that the households nowadays receive almost as much transfer money from government as they pay out in income taxes.

Figure 11. *Mode of distribution of public spending in Sweden 1950—1980*

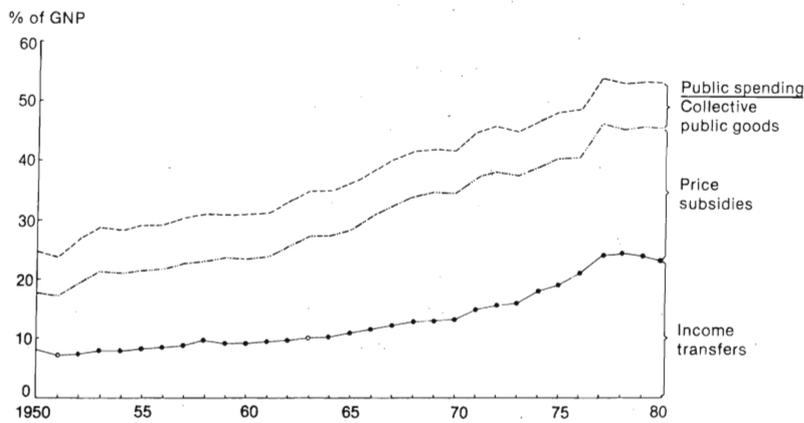
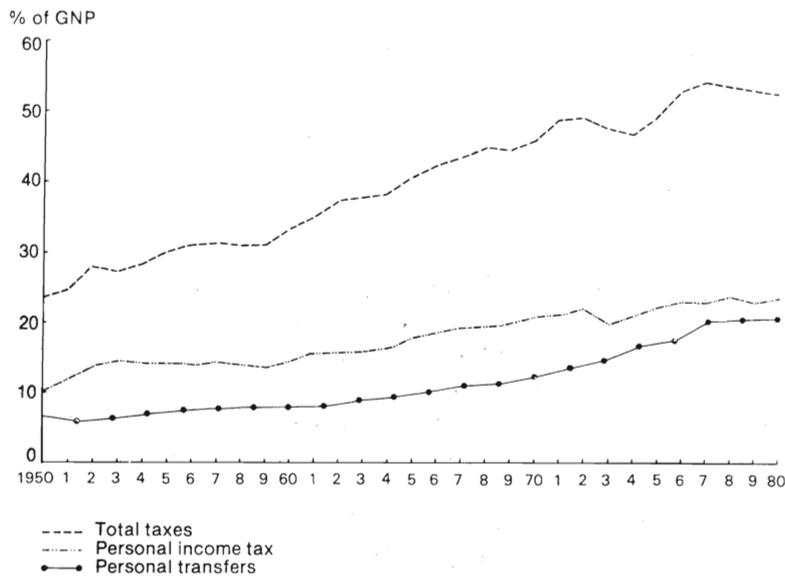


Figure 12. *The taxing strategy*



## Is Local Government Spending Out of Control?

In recent years there has been a rising concern in Sweden about the development of local government expenditures. The rapid expansion of local government services has often been blamed not only for pushing up the tax scales and with that inducing various disruptive tendencies towards tax evasion and tax adjustment. It has also been suggested that local government competition in the labor market has contributed significantly to wage inflation and recruitment problems within Swedish industry. The accelerating cost increases in the social services during the latter part of the 70's have been interpreted by many as signs of a falling productivity due to agencies creating too many new service jobs as part of the efforts to keep down open unemployment.

Looking ahead into the 80's one of the few things we can be fairly certain about is that local government expansion cannot be allowed to continue at the rate established during the 60's and 70's. We have neither the goods nor the people to sustain that kind of growth. Even in absolute amounts the annual increases in local government resources will have to be somewhat reduced if we want to get rid of our external payment problems before the 90's and avoid having in the meantime to lower real net wages and private standards. However, making the municipalities change fast enough into a slower growth-track in spite of good liquidity and rather rigid long-term plans may well prove to be one of the crucial economic problems in the next few years.

## Researching the Problems

It is against this background that IUI has started an econometric study of local government behavior in Sweden. An explanatory model of local government spending—split up into 16 different categories—and taxing decisions has been estimated on data from the 60's and 70's. Based on this model, various specific problems are now being researched. Service production data are tested to detect possible changes in production “techniques”. The effectiveness of central government grant policy in various areas of service production will be measured.<sup>1</sup> By integrating the local government model into a large growth model for the total economy we are able to study interactions between local government expansion and growth in other sectors.<sup>2</sup> Finally the model has been used for projection of actual local government spending and taxing into the 80's.<sup>3</sup>

<sup>1</sup>A first attempt of a closer look at the effects of grants on local government expenditures and employment has been presented in: E.M. Gramlich and B.-C. Ysander, *Relief Work and Grant Displacement in Sweden*, IUI Working Paper No. 30, 1980.

<sup>2</sup>One such projection was documented and discussed in: B.-C. Ysander, “Offentlig ekonomi i tillväxt” (Public Service Growth), Chapter 8 in *Att välja 80-tal* (IUI Medium Term Survey 1979), IUI, 1979.

<sup>3</sup>Cf. i.a. T. Nordström and B.-C. Ysander, “Offentlig service och industriell tillväxt” (Public Service Supply and Industrial Growth), IUI Research Report No. 11, 1980.