

Hans Pitlik

Theoretical Key Elements for a Fundamental Reform of Federal Fiscal Relations

At the beginning of 2008, a new revenue sharing period started in Austria with a planned duration of six years. The new system essentially continues the existing one with a few added innovations to the structures in place up to now. However, the revenue sharing pact also includes the establishment of a commission of experts that will present a proposal after a first three-year period for a fundamental reform of the federal fiscal relation principles governing revenue sharing. From a theoretical perspective, the key issues of such a reform are the unbundling of competencies by reforming the federal state, strengthening sub-central government's autonomy for collecting revenues as well as a reform of the progressive population factor and of the system of transfers.

Hans Pitlik is an economist at WIFO. The author is grateful to Margit Schratzenstaller for helpful and constructive comments. • The data were processed and analysed with the assistance of Dietmar Klose. • E-mail-address: Hans.Pitlik@wifo.ac.at

The federal government, Länder and municipalities reached agreement surprisingly fast in October 2007 on the new regime for revenue sharing to apply from 2008 to 2013. The new rules have replaced the Revenue Sharing Act of 2005 as of the beginning of 2008 that would have been valid until the end of 2008. The premature revision of federal fiscal relations had become necessary, because the federal government passed political programs concerning minimum incomes and homecare regulations that affect the financial positions of all territorial bodies. However, possible findings of the body of experts on the reform of the state and administration were not taken into account at the time the agreement was reached.

The new revenue sharing pact is planned to last six years. The new system will essentially continue the existing one with a few added innovations to the structures in place up to now. After an initial phase of three years, a review has been agreed on. The clause that stipulates a review is a good idea because, among other things, any reform of the state and administration is expected to entail consequences for the financial relations between the federal, state and municipal levels. Therefore, the pact provides for the creation of an expert commission that is to prepare proposals for a far-reaching reform of federal fiscal relations before the start of the second three-year phase. This article discusses the fundamental aspects of the rules governing the federal structure for revenue distribution before this backdrop and outlines the key issues of a possible reform in Austria from the perspective of the economic theory of federal fiscal relations¹.

With a few exceptions, all modern states irrespective of whether they are organised as a unitarian or federalist state need a financial constitution that defines the rules for sharing tasks and fiscal relationships between the territorial levels. Public finance theory has been analysing the problems of a rational design for the framework of fiscal relations in multi-tier systems (Oates, 1972, Peffekoven, 1980, Pitlik, 1997) for some time. Analyses usually make a distinction between "passive" and "active"

**Tax and spending
competences**

¹ An analysis and evaluation of the new rules agreed on for revenue sharing 2008-2013 is published in WIFO-Monatsberichte, 2008, 80(1), http://www.wifo.ac.at/www/jsp/index.jsp?fid=23923&id=31043&typeid=8&display_mode=2, and Austrian Economic Quarterly, 2008, 13(1), http://www.wifo.ac.at/www/jsp/index.jsp?fid=23923&id=31839&typeid=8&display_mode=2.

competences. Passive competence regulates which governmental level is responsible for which tasks and their related expenditure within a state. In this context, the economic theory of federalism has developed a number of principles and criteria according to which the ideal vertical assignment of competence for tasks and expenditures should be defined (Box "Assignment of Responsibilities in Economic Theory of Federalism").

Assignment of Responsibilities in Economic Theory of Federalism

The theory of fiscal federalism (Oates, 1972, Pitlik, 1997) attempts to arrive at the ideal political decision-making level through economic cost-benefit considerations for the diverse policy fields. The starting point is the idea that public services benefit different spatial regions. According to the "principle of fiscal equivalence" (Olson, 1969) that sovereign level should have responsibility for the provision of a service in which the group that uses the service is the same as the group that funds the provision of the service. The theoretically ideal distribution of competencies results from the balancing of the advantages and disadvantages of the centralisation of policy-making bodies.

An argument in favour of centralisation is that this makes public goods available at lower costs if provided collectively rather than in smaller units, because of their indivisibility. Moreover, in the case of central competences, external effects (spillovers) of spending decisions are less pronounced and thus the related inefficiencies can be avoided. The basic advantage of decentralising economic policy competences is that this enables policies to be better adjusted to interregional preference differences in the population and that competition among municipalities and the Länder creates stronger incentives for an efficient administration and the development of innovative policy solutions.

Subordinate territorial bodies (Länder and municipalities) are assigned the principal responsibility for regional and local infrastructure services within the scope of allocation policy, while the central unit (federal level) clearly has competence for supra-regional infrastructure and for stabilisation policy. Theory is not clear regarding interpersonal re-distribution policy. The higher the interregional mobility of labour, the more the theory tends to assign competence for re-distribution policy to the central level.

Based on the allocation of competence for tasks and expenditure, active revenue sharing regulates the revenue collecting competence of the territorial bodies. The focus is on the vertical allocation of the rights to tax and levy charges at the federal, Länder and municipal levels².

As regards tax competences, a distinction is made between law making, and tax revenue and administration powers. The sovereign right to pass tax laws refers, on the one hand, to the competence to tax objects, i.e., the right of the legislative territorial authorities to pass laws on taxable events. On the other hand, it includes the competence to define the rules for determining the tax base and to fix the tax rates (tax discretion). Therefore, the competence to pass tax legislation is based on the degree of freedom of the territorial authorities to define tax policy, which may be shared across various tiers. The tax revenue competence covers the right of the territorial authorities to the tax revenues collected. In this case as well, exclusive and shared rights are possible. The administrative competence includes rules of procedure for tax collection.

In theory and practice, there are numerous combination possibilities for the vertical distribution of taxation competence at the level of the territorial authorities. The classification according to legislative and tax collection competences distinguishes the following systems as typical (Peffekoven, 1980, Nowotny, 1999, Kollmann et al., 2005):

- Pay-as-you go systems,

² Rules of indebtedness, such as those defined by the internal Austrian stability pact, have been gaining significance in the recent past (e.g., Sutherland – Price – Jourard, 2005). However, they are not discussed here.

Allocation of responsibilities for tax collecting

Revenue sharing system

- Separation systems,
- Surcharge systems,
- Shared taxation systems,
- Grant systems.

The *Pay-as-you-go system (PAYG)* gives legislative rights over taxation fully to the sub-central units. The central level is fed only by financial allocations from the "bottom". In a federal system in which the central level has a significant scope of competence over expenditure, a PAYG system hardly seems applicable. Therefore, we will not deal with this type in any more detail.

The common feature of *separation systems* is that the taxes collected belong exclusively to a territorial authority level as its "own tax". Several variants are conceivable for the allocation of legislative competence. In the *free separation system*, there are no restrictions to the authority to define the taxable events and the tax rates, and it is feasible for one taxable event to be taxed several times at several tiers. By offsetting taxes paid, the problems of double and multiple taxation of single taxable events can be ameliorated³. By contrast, in the *connected separation system*, exclusive responsibility over the individual sources of tax is assigned. Each level has full freedom in designing and collecting taxes with respect to the taxable events assigned to it. The so-called *weak separation system* refers to a regime in which the sub-central levels receive the full amount of taxes collected despite centralised fiscal competence⁴.

In *surcharge systems* the highest level has the exclusive right to the taxable events and also regulates the tax base and tax rates, but the subcentral units participate in taxation receipts through surcharges. These surcharge rights may be limited in order to prevent excessive taxation of single taxable events.

In the *shared taxation systems*, all taxes are defined exclusively by the central level, with the sub-central levels participating in total tax revenues (shared authority over revenues) according to defined ratios (share in revenues). Individual unified taxation systems may vary depending on the co-determination and participation rights of the subordinate territorial authorities in the political definition of the distribution ratios.

Just like in the unified taxation system, subordinate territorial authorities in the *grant system* also receive funds from the taxes collected at the central level. The financial transfers either are earmarked for specific purposes or are allocated for general use without any specific purpose. In contrast to unified taxation systems, fixed volumes of funds are frequently transferred, thus minimising the risk of loss of revenues for the sub-central levels (Blöchliger – King, 2006).

In the context of the allocation of taxation competence, autonomy for tax collecting of the sublevels plays an important role. The crucial question is the extent to which the subcentral units are able to influence the tax revenues at their disposal through *independent tax policy decisions* (OECD, 1999, Blöchliger, 2007). The core issue are the rights of the Länder and municipalities to define taxes and taxable events. Therefore, a classification by separation, surcharge, shared taxation and grant systems fails to fully reflect the tax autonomy of sub-central units. For this reason, shares of the Länder and municipalities in total taxation revenues explain the actual tax autonomy of the subcentral governments only to a limited extent.

In pure grant systems, sublevel units have no real tax autonomy. Depending on the degree to which the funds are earmarked for specific purposes, the spending autonomy of the transfer recipients varies. Centralised competence is generally also part of the unified taxation system and the weak separation system. According to the aspect of sub-central tax autonomy, these systems differ with respect to how far subordinate units have co-determination rights for fixing revenue shares (Table 1). As

Tax autonomy of the subcentral units

³ Loss in prosperity occurs if none of the levels takes into account the repercussions of their own taxation policies on the revenues of the other levels (Wrede, 1999).

⁴ In this model, territorial authorities with the right to collect taxes may also be granted the right to co-define taxation.

the tax revenues flow exclusively to the Länder or municipalities in the weak separation system, sub-central autonomy is higher here. The surcharge system also requires centralised decision-making competence and shared tax revenues, but the subordinate units have the authority to define tax policy up to a certain degree within the scope of their rights to define tax rates. Tax autonomy of the territorial authorities with the power to impose surcharges on taxes may therefore be ranked as higher than in the weak separation system. Even more pronounced is tax autonomy in a separation system with fixed allocations and it is highest in a free separation system.

Table 1: Tax autonomy of the sub-central units (SCU)

| | |
|---------|---|
| Highest | SCU can determine rates and rules for the taxation base without the involvement of the central units (CL) |
| ↑ | SCU can determine rates and rules for the taxation base after consultation with the central units (CL) |
| ↑ | CL defines the rules for determining the taxation base, the SCU can determine the rates freely |
| ↑ | CL defines the rules for determining the taxation base, while SCU can determine rates, CL defines the highest and the minimum tax rates (surcharge systems) |
| ↑ | CL defines the rules for determining the taxation base and the rates, the SCU can define individual tax reliefs. |
| ↑ | Tax sharing arrangements in which the SCU defines the revenue split |
| ↑ | Shared taxes for which the revenues shares can only be defined with the approval of the SCU |
| ↑ | Tax sharing arrangements in which the revenue split may be defined unilaterally by the CL, but the revenue shares are fixed for a period longer than one year |
| ↑ | Tax sharing arrangements in which the revenue split may be newly defined unilaterally and annually by the CL |
| None | Other systems in which the CL defines the taxation base and rates (grant systems) |

Source: Adapted from OECD (1999). CL . . . Central level, SCU . . . Sub-central Unit.

In reality, hardly any of the systems described above will be found in pure form. What we rather tend to see – also in Austria – is a mixed system that combines elements of ideal types. In Austria, the original vertical tax revenue distribution is dominated almost completely by elements of a shared taxation system⁵. Traditionally, receipts from income and value added taxes as well as mineral oil taxes since 1987 flow into the unified taxation system. The fiscal significance of joint federal tax revenues that are shared according to quotas by the federal level, Länder and municipalities⁶ has increased sharply in the past few years from 74.6 percent of total revenues (1990) to 91.2 percent (2005) (Table 2)⁷. The share of exclusively federal taxes also dropped during the same period from 17.4 to 2.9 percent. Without the charge for housing subsidies ("Wohnbauförderungsbeitrag") applied until 2008 as a purely federal tax item that is automatically transferred 80.55 percent as a (mostly) dedicated subsidy to the Länder, the share is even only 2.0 percent.

This tendency of centralisation of the past few years was driven mainly by the transformation of high-revenue taxes (corporation tax, tobacco tax, insurance tax, motor vehicle tax, energy taxes, capital transfer tax) into joint taxes. At the municipal level, the weighting of receipts from own taxes (especially property taxes and municipal tax) declined from 7.3 percent (1990) to 5.4 percent (2005) of the entire tax revenues. The exclusive taxes collected by the Länder (especially fire protection tax, hunting and fishing tax, entertainment taxes earmarked for defined purposes) were negligible at 0.5 percent (2005) versus 0.7 percent (1990) of total revenues.

The high weighting of the joint federal taxes over which the federal government has the sole tax law making competence already shows the minor degree of independence of Austrian Länder and municipalities for taxation policy. Even for taxes

⁵ For an in-depth analysis of revenue sharing, see (Rechtslage 2005) Hüttner – Griebler (2005) and Matzinger (2005).

⁶ With the exception of the advertising tax, the land transfer tax, and the land value duty for which special distribution ratios apply, all joint federal spending has been distributed since 2005 vertically according to a uniform ratio of 73.204 : 15.191 : 11.605 to the federal level, Länder and municipalities.

⁷ This also applies if one also considers the employer's contributions to the Family Income Equalisation Fund, which is formally an exclusively federal spending item as well as the fees for the use of municipal facilities and installations: The share of own federal spending thus decreased from 22.5 percent (1990) to 8.9 percent (2005), while the share of joint taxes rose from 67.9 to 82.9 percent. The share of own spending by the Länder dropped from 1990 to 2005 from 0.7 to 0.4 percent and the share of exclusively municipal spending from 8.9 to 7.6 percent.

The situation in Austria

over which they have full authority to collect, the subcentral levels hardly have any autonomous rights to define the taxes. Thus, for example, municipal taxes, which in 2005 amounted to € 1,470 million and thus contributed over 60 percent to the tax revenues of municipalities (ex Vienna) of € 2,392 million are uniformly defined by federal law (weak separation system). Municipalities have a limited right of determining the factor only for property taxes from among the fiscally relevant taxes. The Länder level has de facto no autonomy of fiscal relevance for defining tax policy.

Table 2: Total tax revenues

| | Joint taxes at the federal level ¹ | Exclusively federal taxes | Exclusively Länder taxes Million € | Exclusively municipal taxes ² | Total |
|-------------------|---|---------------------------|------------------------------------|--|--------|
| 1990 | 24,561 | 5,736 | 241 | 2,399 | 32,938 |
| 1995 | 31,752 | 6,000 | 277 | 3,050 | 41,080 |
| 2000 | 45,017 | 5,359 | 263 | 3,190 | 53,830 |
| 2001 | 50,628 | 5,571 | 237 | 3,010 | 59,446 |
| 2002 | 49,312 | 5,634 | 241 | 3,034 | 58,222 |
| 2003 | 48,237 | 5,261 | 269 | 3,125 | 56,892 |
| 2004 | 50,686 | 5,519 | 277 | 3,200 | 59,681 |
| 2005 | 55,365 | 1,791 | 300 | 3,283 | 60,739 |
| Percentage shares | | | | | |
| 1990 | 74.6 | 17.4 | 0.7 | 7.3 | 100.0 |
| 1995 | 77.3 | 14.6 | 0.7 | 7.4 | 100.0 |
| 2000 | 83.6 | 10.0 | 0.5 | 5.9 | 100.0 |
| 2001 | 85.2 | 9.4 | 0.4 | 5.1 | 100.0 |
| 2002 | 84.7 | 9.7 | 0.4 | 5.2 | 100.0 |
| 2003 | 84.8 | 9.2 | 0.5 | 5.5 | 100.0 |
| 2004 | 84.9 | 9.2 | 0.5 | 5.4 | 100.0 |
| 2005 | 91.2 | 2.9 | 0.5 | 5.4 | 100.0 |

Source: National accounts; Statistics Austria, accounting overviews; WIFO calculations. – ¹ According to the federal government accounts, Chapter 52, exclusive of business tax. – ² Including business tax, exclusive of fees for the use of municipal facilities.

The primary distribution of tax revenues in Austria is supplemented and corrected by an extensive and complex system of intergovernmental grants. Transfers flow from the federal level to the Länder and municipalities, from the Länder to their municipalities and in the opposite direction in the form of taxes and charges of the municipalities that flow to the Länder. In this context, some grants are not earmarked (allocations according to fiscal needs, per capita equalisation) while others are earmarked (e.g., subsidies to hospitals, residential housing subsidies, environmental measures, public passenger transport, roads). The system of tax allocation is finally supplemented by a number of vertical cost reimbursements with mixed responsibility among the different tiers. Thus, the federal government has the basic competence over mandatory schooling, while the Länder have extensive freedom with respect to the employment of teachers at the Länder level, although a greater share of the wages are carried by the federal level. Table 3 illustrates the supplementary vertical redistribution through transfers and the assumption of costs in continuation of the original taxation revenue distribution. In 2005, a total of € 9.45 billion was thus redistributed among the territorial authorities, which corresponded to 15.6 percent of total taxes collected of € 60.7 billion. From the vertical perspective, the federal level and the municipalities (based on Länder charges and other contributions for the financing of hospitals and social assistance, etc.) are the "losers" of the redistribution processes. According to the revenue sharing 2005, the federal level received 57.4 percent of taxes collected, the Länder (ex Vienna) 22.9 percent, and the municipalities (ex Vienna) 10.6 percent, while Vienna (as a Land and municipality) received 9.1 percent.

Therefore, it is hardly surprising that according to more recent OECD studies (*Blöchliger – King, 2006, Blöchliger, 2007*), Länder and municipalities in Austria have a much lower degree of tax autonomy in international comparison than countries with federal – and in some cases even unitarian structures. This is an assessment shared in

expert literature also when alternative measures are applied to assess the centralisation of tax competence (Handler – Schratzenstaller, 2005)⁸.

Table 3: Revenue sharing between the federal level, Länder and municipalities

| | 1990 | 1995 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|-------------------|---------|---------|---------|---------|---------|---------|---------|
| | Million € | | | | | | | |
| <i>Revenues from taxes</i> | 32,938 | 41,080 | 53,830 | 59,446 | 58,222 | 56,892 | 59,681 | 60,739 |
| Federal ¹ | 22,077 | 27,309 | 37,723 | 42,546 | 41,790 | 40,808 | 42,872 | 43,621 |
| Länder ex Vienna | 3,894 | 4,903 | 5,689 | 5,939 | 5,786 | 5,599 | 5,876 | 5,964 |
| Vienna (Land and municipality) | 2,673 | 3,320 | 3,924 | 4,084 | 3,918 | 3,841 | 3,957 | 4,027 |
| Municipalities ex Vienna | 4,293 | 5,548 | 6,494 | 6,877 | 6,728 | 6,644 | 6,976 | 7,127 |
| <i>Transfers and costs assumed</i> | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Federal | - 4,360 | - 6,192 | - 7,401 | - 7,853 | - 8,199 | - 8,736 | - 8,347 | - 8,786 |
| Länder ex Vienna | 3,569 | 5,290 | 6,124 | 6,766 | 7,316 | 7,651 | 7,616 | 7,938 |
| Vienna (Land and municipality) | 770 | 1,081 | 1,365 | 1,425 | 1,439 | 1,474 | 1,451 | 1,515 |
| Municipalities ex Vienna | 22 | - 179 | - 88 | - 338 | - 556 | - 389 | - 720 | - 667 |
| <i>Total revenues after revenue sharing</i> | 32,938 | 41,080 | 53,830 | 59,446 | 58,222 | 56,892 | 59,681 | 60,739 |
| Federal ¹ | 17,717 | 21,117 | 30,322 | 34,693 | 33,591 | 32,072 | 34,525 | 34,835 |
| Länder ex Vienna | 7,463 | 10,193 | 11,813 | 12,705 | 13,102 | 13,250 | 13,492 | 13,902 |
| Vienna (Land and municipality) | 3,443 | 4,401 | 5,289 | 5,509 | 5,357 | 5,315 | 5,408 | 5,542 |
| Municipalities ex Vienna | 4,315 | 5,369 | 6,406 | 6,539 | 6,172 | 6,255 | 6,256 | 6,460 |
| | Percentage shares | | | | | | | |
| <i>Total revenues after revenue sharing</i> | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| Federal ¹ | 53.8 | 51.4 | 56.3 | 58.4 | 57.7 | 56.4 | 57.8 | 57.4 |
| Länder ex Vienna | 22.7 | 24.8 | 21.9 | 21.4 | 22.5 | 23.3 | 22.6 | 22.9 |
| Vienna (Land and municipality) | 10.5 | 10.7 | 9.8 | 9.3 | 9.2 | 9.3 | 9.1 | 9.1 |
| Municipalities ex Vienna | 13.1 | 13.1 | 11.9 | 11.0 | 10.6 | 11.0 | 10.5 | 10.6 |

Source: National accounts; Statistics Austria, accounting overviews; WIFO calculations. – ¹ Exclusively federal taxes ex employer contributions to Family Burden Equalisation Fund, ex charges and reimbursements in legal matters.

From the perspective of fiscal management, when assigning spheres of competence for taxation to the federal levels, the primary aim should be to achieve a greater degree of institutional congruence as regards the responsibilities for tasks, expenditure and revenues (Blankart, 2007). The issue on hand is not only the distribution of tax revenues to ensure that the territorial authorities have the necessary funding at their disposal to carry out their duties. Institutional congruity also refers to the relationship between the responsibility for ensuring the financing of public services and the spending behaviour of the political decision-making bodies. The approach is based on the idea that an economically efficient expenditure decisions requires that groups that use services also decide on the amount and quality of these services and also fund the required expenditure themselves. This institutional congruence is a requirement for fiscal equivalence and the identification of true costs in the political process. Under this principle, autonomy over expenditure requires independent revenue responsibilities.

Essentially, the principle of institutional congruence helps to avoid external effects of political decisions regarding expenditure and revenues. The bodies that decide to offer the services should bear the costs for providing such services directly, as this is an incentive to use funds more efficiently. Institutional incongruence hinders efficiency in the application of the funds mainly because expenditures are financed in part or completely by groups of the population subject to other territorial authorities. This lowers the costs borne by the resident population, creating an incentive for policy-makers to spend more than the optimal allocated volume (Weingast – Shepsle – Johnsen, 1981). Incongruence thus also means a lack of transparency of political responsibility and the dilution of democratic control by the constituents.

**Congruity of tasks,
expenditure and
revenue competence**

**The principle of
institutional congruence
as guidance**

⁸ Combined indicators feature methods to measure the degree tax revenue and tax design competence in order to obtain a view as comprehensive as possible. In academia, however, there is no consensus regarding the "ideal" indicator for the (de-)centralisation of tax competence.

The preferred system for achieving institutional congruence is the separation system (with fixed allocation) as an organisational principle in which the territorial authorities enjoy a high degree of autonomy in defining taxes. The horizontal distribution of revenues among the Länder and municipalities should result from the local taxes raised. To this end, the competence for expenditure and financing should be distributed across the levels in such a manner to create congruence between the group benefiting from the public services and the group carrying the taxation burden for the provision of such services.

According to this concept, the services provided by municipalities should be funded mainly by the local resident population and businesses. This can be achieved by levying charges and contributions or municipal services that can be individually allocated. The first tax that comes to mind as ideal in this context is a property tax based on real market value, because the quality of the local infrastructure are reflected in the local land and real estate prices (Musgrave, 1983). Municipal taxes on businesses should be imposed to attain equivalent taxation of the use of municipal infrastructure by local businesses. Only if municipalities are able to tax private households and businesses to raise funding will an incentive be created to adjust the local infrastructure to the needs of the two social groups (Zimmermann, 2007). In order to strengthen transparency, the rules for determining the taxation base should be harmonised at the federal level and the municipalities granted only the legislative right to define tax rates.

Institutional congruence moreover implies that taxes which serve as instruments for achieving specific economic policy goals may be defined by the territorial authorities who are responsible for fulfilling the tasks. Thus, the competence for revenue collecting and taxation schemes for environmental charges should be transferred to the federal level if it is responsible for environmental policy. At the same time, progressive income taxes, for example, are deemed as suitable instruments for steering economic development and for redistribution policy. As there are some arguments for transferring the two tasks to the central level due to the higher degree of mobility of production factors (Oates, 1972), the power to define and collect taxes would have to be assigned to the federal level. Payroll-related and corporate taxes at the regional and municipal levels are generally also well suited to achieve equivalence between tax payments of private households and businesses and public services they consume. It would therefore be conceivable to grant the Länder and municipalities – perhaps limited – authority to define these tax rates (Zimmermann, 2007).

The authority of the local units to add a surcharge to income tax collected by the federal level would mean that several levels access the same tax base. Essentially, this would produce an undesired effect of double taxation of income. Lacking vertical coordination between the higher and the sublevel units could soon result in a higher tax burden, especially if the interregional mobility of the taxable subjects is not very high. One possible way to counteract this effect is to install a netting system that offsets local taxes against taxes due to the higher-ranking territorial authority. If local taxes can be deducted from federal taxes, the municipalities (or the Länder) would be able to obtain higher revenues through surcharges at the expense of the tax revenues of the higher-ranking levels – and thus of taxpayers in all other tax jurisdictions. This would breach institutional congruence.

The legislative right to define taxes on mobile taxation bases implies the possibility of a tax competition among the sublevels. The consequences are viewed as controversial in economic literature:

- On the one hand, positive efficiency effects of tax competition created by competitive pressure are stressed (Feld – Schneider, 2002). To prevent private households and businesses from migrating, the services provided by territorial authorities must be in line with the preferences of the local residents (Tiebout, 1956). Competition between the Länder and municipalities to attract private households and businesses could thus promote the equivalence of individual taxation and collective use.

Institutional congruence in separation, shared taxation and grant systems

Rights to define taxation

- On the other hand, attention is drawn to the risk of a contest to cut taxes on mobile factors that could threaten the financing of local public goods or be detrimental to non-mobile households (Zodrow – Mieszkowski, 1986)⁹.

To limit tax competition, an option would be to define minimum taxation rates at the federal level without suspending institutional congruence to any degree of significance.

If competence for taxation is completely centralised at the federal level, potential undesired tax competition among subordinate authorities could be eliminated. The Länder and municipalities would only be able to compete to attract private households and businesses through regulations (e.g., spatial planning policy) and public spending. The tax revenues of the Länder and municipalities are not determined by separate tax policy decisions, but rather a result of a share in the joint revenues. In the shared taxation system and in the weak separation system, the principle of institutional congruence of expenditure and revenue decisions is diluted at the subcentral level and at times even completely suspended. The magnitude of the deviation from the congruence principle depends on the criteria selected for the horizontal distribution of the revenue shares. When revenues are distributed according to local volumes collected, this is a lesser breach of the principle, because there is an incentive for policymakers to secure their regional or municipal tax base. When the revenue shares from joint tax receipts are allocated according to specifically defined needs criteria, there is always less congruence. Thus, the groups that use the services diverge from those that decide and finance the services and "everybody pays for everybody" (Blankart, 2007)¹⁰.

Centralised competence over taxation is also a feature of grant systems. Transfers are recommended in the literature mainly as a supplement to the original distribution of revenues. Intergovernmental transfers may pursue allocative as well as distribution and stability policy goals. The main argument used in theory supporting vertical transfers by the central level to subcentral units is the existence of spatial spillover effects. Thus, it is mainly the larger cities that provide public services that are used free of charge by the population of the surrounding municipalities. In such cases, higher-level units use grants to subsidise services used by a supra-local population in order to achieve welfare gains.

Ideal solutions require a co-financing by the groups that receive earmarked transfers for specific purposes (Oates, 1972). Lump sum transfers are less suitable for compensating supra-local spillovers, because they also subsidise that part of the range of supply of the receiving unit that does not generate spillover effects. However, according to the notion of institutional congruence, direct financial cooperation between the central places and the surrounding municipalities would be preferable. In the case of a financial participation of the federal government, private households and businesses indirectly contribute to the financing of services that they do not consume themselves. Hence, compensation for supra-local services is primarily a matter of the concerned municipalities.

Another theoretical argument in favour of financial transfers from the central level refers to the varying degrees to which public goods are supplied to populations in fiscally poorer or wealthier regions. Lump sum transfers according to financial needs and financial capacities of the regional units could help to achieve financial equalisation to secure a more or less equal degree of supply of services to the population and to avoid inefficient factor movements (Buchanan, 1950). The more the differences are smoothed, the greater the incentive for the poorer regions as well as for the wealthier territorial authorities to maintain their own tax bases by pursuing sound economic policy.

⁹ Empirical findings in Switzerland have not revealed up to now that fiscal competition at the municipal or canton level could lead to "ruinous tax competition". However, Feld – Kirchgässner – Schaltegger (2003) state that intensive tax competition results in local and regional units tending to raise funding more from charges and contributions rather than from income and wealth tax.

¹⁰ Another problem of the shared taxation system is that a tax reform usually involves long negotiations between the political representatives of the involved levels of federal government.

Centralised legislative competence

Furthermore, determining fiscal need and fiscal capacity is theoretically and practically difficult (Musgrave, 1961). Typically, an abstract measure of the "needs" of the population is applied. However, the relationship between population figures and fiscal needs is unclear. The provision of public services in densely populated regions could entail higher per capita costs that should be compensated by financial transfers. The empirical evidence of this "Brechtian law"¹¹ is controversial, and even proven higher per capita costs might be due "only" to a higher level of supply (Kittlerer, 1994). Vice versa, less populated regions and smaller municipalities would offer qualitatively equally good services only at above average per capita costs, because they cannot take advantage of economies of scale¹². By raising the volume of funding, it would be possible to offset the cost disadvantages in order to achieve a uniformly good supply of public goods to the population.

Agglomeration and deagglomeration costs are influenced, of course, by migration. In a long-run migration equilibrium interregional net utility differences are equalised. Households and businesses only take individual costs and benefits of the place of residence or business location into consideration in their migration decisions. External costs or benefits that arise to the remaining population and businesses of the municipality due to in- and out-migration are not taken into account. External in-migration benefits result, for example, from the fact that the tax burden to finance the public services decreases per capita of the population. This contrasts with the possible rise in congestion costs. Vice versa, out-migration from thinly populated regions raise per capita costs of collective goods provided.

An efficient distribution of the population across municipalities requires that the differences between marginal agglomeration benefits and costs are equalised. However, due to the external effects such an efficient spatial allocation driven by market forces is not guaranteed. A differentiated system of transfers might be able to correct the inefficiencies (Boadway – Flatters, 1982). However, due to numerous counteracting effects it is not possible to say a priori if the high agglomeration or thinly populated regions should benefit from the fiscal allocations. A mechanistic equalisation of higher per capita costs in revenue sharing therefore may thus reinforce possibly inefficient migration incentives for households and businesses rather than correcting their consequences (Peffekoven, 1987).

Intra-governmental transfers may also serve as insurance against asymmetrical economical shocks: If individual regions are more strongly affected due to their economic structure, negative employment effects can be ameliorated by vertical financial allocations (Sala-i-Martin – Sachs, 1992). Of course, these transfers diminish incentives to pursue structural changes using own resources.

The theoretical considerations presented supply a number of points of departure for a fundamental reform of the federal fiscal relations in Austria in the future. Without going into any detailed individual regulations at this point, the general thrust of a reform of the revenue sharing system in Austria may be outlined as set out below:

A first step towards establishing a more rational economic basis of fiscal relations among authorities would be the consistent execution of a state and administration reform that has been debated repeatedly in the past years. Generally, a revision of fiscal relations should be discussed based on a reformed distribution of tasks.

The principal purpose of a reform should be to unbundle competencies, which give the federal government, the Länder and municipalities exclusive responsibilities. An important measure is the principle of subsidiarity as formulated in the economic theory of fiscal federalism. From a theoretical standpoint, the concrete distribution of competencies is by no means completely predetermined. To the extent to which uniform solutions seem reasonable in a specific policy field, the exclusive responsibility of the federal government for policy-making should be strengthened. Differenti-

**Starting points for a
fundamental reform of
federal fiscal relations**

**Unbundling com-
petences by reforming
the federal state**

¹¹ Brecht (1932) argued mainly with the disproportionate rise in the costs of crime fighting at an increasing population density.

¹² Most empirical literature arrives at the conclusion that there are no economies of scale in consumption at the local and regional levels (Reiter – Weichenrieder, 1997, oder Lüchinger – Stutzer, 2002).

ated solutions to interregional and inter-communal problems can be achieved by giving independent decision-making competence to the Länder and municipalities.

The clearer the scope of responsibilities of the territorial authorities is delineated, the more likely the efficiency-promoting principle of institutional congruence will be achieved. Joint policy competences of two or even three levels usually involve combined financing that veils fiscal and political responsibilities. The costs of the federal government such as for education or healthcare could be reduced to a minimum or even eliminated completely if tasks are reasonably unbundled. The unbundling not only contributes to the fiscal responsibility of the decision-makers, but also to fiscal transparency. A three-pillar model according to which mixed responsibilities are demanded for many policy areas in addition to the exclusive competence of the federal level and Länder carries a risk of inefficient policy decisions and redundancies.

As a means of better implementing institutional congruity, the reorganisation of fiscal relations among the federal bodies should focus on strengthening the autonomous competence of the Länder and municipalities for tax collection. Independent tax legislation competence at the Länder level exists in reality only for insignificant minor taxes. The right to define taxes of the municipalities is also of minor importance apart from the authority to fix municipal tax rates for property tax. In Austria, tax sharing is far too dominant. In order to strengthen the principle of institutional congruence, a reformed revenue sharing system would have to stress the elements of a separation system with fixed allocations or a surcharge system.

A step towards reinforcing tax autonomy of the Länder would be the complete transfer of the legislative and revenue competence for the charges for residential housing subsidies. If the subsidisation of residential housing is classified as a task of the Länder, institutional congruence could be achieved by allocating decision making autonomy to the state in combination with an earmarking of revenues for this specific purpose. At the level of municipalities, autonomy should be secured mainly with respect to the definition of rates for property taxes.

Strengthening subcentral revenue autonomy

Table 4: Criteria for the horizontal distribution of revenue shares

| | 1990 | 1995 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 |
|-------------------------------|-------------------|-------|-------|-------|-------|-------|-------|-------|-------|
| | Percentage shares | | | | | | | | |
| <i>Länder</i> | | | | | | | | | |
| Population figure | 76.7 | 80.0 | 80.3 | 77.8 | 77.7 | 77.0 | 77.5 | 77.8 | 77.6 |
| Fixed factor | 0.0 | 5.6 | 17.7 | 19.9 | 20.0 | 20.9 | 20.6 | 22.1 | 22.0 |
| Revenues collected | 20.4 | 11.6 | 2.0 | 2.3 | 2.3 | 2.1 | 1.9 | 0.1 | 0.4 |
| Other | 2.9 | 2.8 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |
| <i>Municipalities</i> | | | | | | | | | |
| Population figure | 16.6 | 14.4 | 14.0 | 12.4 | 13.3 | 13.0 | 13.6 | 13.7 | 13.6 |
| Progressive population factor | 53.4 | 59.2 | 58.1 | 56.3 | 55.9 | 55.6 | 54.8 | 54.7 | 54.2 |
| Fixed ratio | 0.4 | 0.5 | 20.3 | 23.7 | 23.5 | 23.6 | 23.5 | 23.5 | 23.3 |
| Revenues collected | 29.1 | 25.5 | 7.5 | 7.6 | 7.3 | 7.8 | 8.1 | 8.1 | 8.9 |
| Other | 0.5 | 0.4 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Total | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 | 100.0 |

Source: Federal Ministry of Finance, WIFO calculations.

However, even in a shared system it would be possible to broaden tax autonomy of subordinate authorities by allocating revenues more according to local tax receipts. In 1990, the distribution of joint federal revenues according to local receipts was 29.1 percent for municipalities and even a solid fifth of joint federal revenues for Länder, while today (2005) this share is only 8 percent to 9 percent for municipalities and even less than 1 percent for Länder (Table 4)¹³.

¹³ To preserve the principle of congruence, the problems of commuting should be dealt with at the municipal level, and at least one part of payroll tax revenues should be broken down by place of residence and another part by business site.

A special problem is posed by the reform of the progressive population factor for the distribution of the revenue shares at the municipal level. Since the Revenue Sharing Act of 2005, the multiplier¹⁴ for municipalities with a population of less than 10,000 has been 1½, and thus the relation between these small and the largest municipalities (population of over 50,000 and Vienna) with a multiple 2⅓ is still 1 : 1.55. Thus, larger municipalities still have an advantage over smaller ones in the horizontal distribution of taxes. The weighting is explained by the additional costs of securing central functions by larger cities and municipalities that need to be compensated. However, higher weights subsidise the entire scope of supply of the central places and not only those services that are also used by the population in the surrounding area. Moreover, the compensation of these effects in the shared tax system means that ultimately taxpayers from other regions are also tapped for financing even though they do not consume the supra-local services themselves – which is a violation of the principle of institutional congruence.

On the other hand, the higher weighting of larger municipalities is argued to serve as compensation for the additional costs of providing public goods. Nonetheless, clear empirical evidence for higher per capita costs for the provision of services in agglomerations does not exist, as already mentioned. Proof of higher expenditure per capita of population is in any case not sufficient evidence, because additional costs could also indicate a higher level of services or inefficiency in the provision of services.

In an analysis of financial statistics of the per capita administration expenditure of Austrian municipalities in 2002, *Bröthaler – Wieser* (2005) discovered indications of a U-shaped trend in administrative outlays. From the standpoint of cost reimbursement, an even higher multiple would be justified for smaller municipalities in order to cover their (alleged) additional costs. On the other hand, smaller increments in the progression of the multiple for a population of less than 10,000 would be an incentive for the smallest municipalities to cooperate and for some to merge in order to exploit economies of scale. Prior to a possible change of the progressive population factor, agreement should first be reached on which goals are being pursued by such a reform.

The preferential treatment of larger municipalities tends to enable better services. Over the long term, differences in quality of municipalities' services induced by the revenue sharing system could trigger the out-migration of private households and businesses from smaller municipalities to agglomerations. Assuming that the hypothesis of the U-shaped trend in average costs contingent on the population factor is valid, over the long-term, the migration effects would lead to higher per capita costs in highly agglomerated cities as well as in smaller municipalities and thinly populated regions. A more precise empirical review would be required to determine if the factual or alleged extraordinary burdens could be smoothed by weighting the population or whether other special economic, demographic, or topographic factors are better suited to serve as needs indicators or supplements (*Lehner, 2005*).

Even before the backdrop of the objective to keep the tax burden from rising further in Austria, but rather to lower it over the medium to long term, enlarging the scope of revenue autonomy of the subordinate territorial authorities should be linked to lowering the overall transfer volumes and to an adjustment of the intra-governmental transfer systems. A requirement for such an adjustment is an unbundling of the competencies for tasks and expenditure in the course of the state reform. Likewise, the problem of defining the financial transfers is closely related to the distribution of competence for tasks and the degree of sub-central tax autonomy. Generally, the need for intra-governmental grants should be reduced to a minimum by clearly defining the distribution of tasks and expenditures, and the assignment of the corresponding competences. A supplementary transfer system should help to solve three problems:

Special problem of the reform of the progressive population factor

Reform of the transfer system

¹⁴ The multiplier indicates the weighting assigned to a person from the resident population in the horizontal distribution of joint tax revenues.

- In the light of the differences in the fiscal capacities between the Länder and the municipalities that would probably become even clearer if their tax autonomy were to be enlarged, a new revenue sharing regime should include a certain compensation for the per capita fiscal capacities. To minimise the negative incentives of the redistributive transfers, complete levelling should not be the aim. This level may be defined as a horizontal transfer system in which financial transfers flow from wealthier units to fiscally poorer authorities as a way of making redistribution transfer flows more transparent (Bergvall *et al.*, 2006).
- Spatial spillovers could be compensated by earmarked transfers from the central level with a pro rated own share to be contributed by the receiving levels. Horizontal agreements between territorial authorities involved would be preferable to a system of vertical grants. The system of population weighting used up to now with non-earmarked fund allocations is less suited for compensating these effects.
- Finally, it might be considered giving up population weighting as a method for considering any special burdens carried by Länder and municipalities in the distribution of the revenue shares, but rather specifically compensating these burdens by vertical financial transfers. To achieve the goal of transparency and avoid rent seeking when negotiating and politically defining special needs (Pitlik, 2005), the number of the special factors to be considered should be kept within narrow limits (Blöchliger *et al.*, 2007).

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Theoretical Key Elements for a Fundamental Reform of the System of Federal Fiscal Relations – Summary

As of the beginning of the year 2008, a reformed system of federal fiscal relations will start in Austria with a planned duration of six years. The new system is essentially a continuation of the previous system. However, the agreements also include the establishment of a commission of experts that, after a first three-year period, are to present a proposal for a fundamental reform of the regulations governing revenue distribution.

From the perspective of fiscal management, when assigning tax competences the aim should be to achieve a greater degree of institutional congruity as regards the tasks and responsibilities for spending and revenues. The issue at hand is not only the distribution of tax receipts to ensure that territorial authorities have the necessary funding at their disposal to carry out their duties. Institutional congruity also refers to the relationship between the responsibility of financing public services and the spending behaviour of political decision-making bodies. The bodies that decide on services should also bear the costs for providing such services directly, as this is an incentive to use funds more efficiently.

A closer look at the current system of federal fiscal relations in Austria shows that the principle of institutional congruity, which is supportive of greater efficiency, is often violated. The original vertical distribution of tax receipts is characterised almost entirely by a highly centralised system of revenue sharing. The fiscal significance of the common federal tax receipts has increased steeply from 74.6 percent of total receipts (1990) to 91.2 percent (2005). The primary distribution of tax receipts is moreover supplemented and corrected by a complex transfer system lacking transparency. According to studies by the OECD, the *Länder* and municipalities of Austria have a relatively low degree of tax autonomy in international comparison.

Institutional congruity is moreover violated at the horizontal tax distribution level. Local tax receipts as a measure for the distribution of tax revenues are practically unimportant today. Over 50 percent of the shared federal tax receipts are distributed according to a weighted population scheme that favours larger municipalities over smaller ones.

A first step towards establishing a more rational basis for revenue distribution among the territorial authorities would be a resolute execution of state and administrative reforms. A clearer separation of competences of territorial authorities will make more structures that are efficient possible. A reorganisation of fiscal relations among federal bodies should focus on strengthening autonomous tax competences of the *Länder* and municipalities to better implement institutional congruity. The aim would be to combine tax autonomy with a cutback of shared taxes, a reduction of the total transfer volume and an adjustment of the system of intra-governmental transfers. A more precise empirical review is required to determine if actual or alleged extraordinary burdens should be smoothed by population-weighting, or whether, other special economic, demographic or topographic factors would be better suited to serve as a (supplementary) indicator of fiscal needs.

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