

**FOR
AGENDA**

SM/08/157

May 23, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Austria—Selected Issues**

This paper provides further background information to the staff report on the 2008 Article IV consultation discussions with Austria (SM/08/155, 5/23/08), which is tentatively scheduled for discussion on **Friday, June 13, 2008**. At the time of circulation of this paper to the Board, the Secretary's Department has received a communication from the authorities of Austria indicating that they consent to the Fund's publication of this paper.

Questions may be referred to Mr. Hilbers (ext. 35337) and Mr. Kanda (ext. 35414) in EUR.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board and with the appropriate deletions, to the European Central Bank forthwith; to the WTO Secretariat on Tuesday, June 3, 2008; and to the European Commission, the Food and Agriculture Organization, and the Organisation for Economic Cooperation and Development, following its consideration by the Executive Board.

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INTERNATIONAL MONETARY FUND

AUSTRIA

Selected Issues

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Approved by the European Department

May 23, 2008

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I. PERSPECTIVES ON THE REFORM OF FISCAL FEDERAL RELATIONS IN AUSTRIA

A. Introduction¹

1. As noted in the accompanying staff report, Austria has experienced persistent fiscal deficits even in years of strong growth, and consolidation is needed to achieve the authorities' objective—and commitment under the Stability and Growth Pact (SGP)—of reaching structural balance by 2010. The need for fiscal consolidation is also buttressed by announced plans to implement major tax cuts in 2010. Thus, substantial expenditure savings are needed to make room for tax cuts and also meet the objective of structural balance by 2010.

2. In addition, more savings are likely to be needed over the medium and long term as population aging raises pressures on pension, health and long term care expenditure. The size of the aging pressures that are likely to occur over the long run are inherently subject to large margins of error. For example, the European Commission (2008) finds a low risk to fiscal sustainability from aging pressures, while the OECD (2007) predicts a reversal of the declining trend in the public debt-GDP ratio over the next decade as aging pressures mount, with public debt exceeding 100 percent of GDP by 2050 in the absence of offsetting measures. Kanda (2007) examines the likely margins of uncertainty in the long run projections, and concludes that there is a significant likelihood of sustainability problems which requires additional consolidation efforts.

3. There is consensus that the substantial and lasting expenditure savings needed will require reforms in fiscal federal relations. In this context, this paper examines Austrian fiscal federal relations against the background of practices in other countries, and attempts to identify areas where reforms could generate efficiency gains. Section B below describes Austrian fiscal federal relations, Section C discusses the principles for efficient fiscal federalism and compares Austria with other decentralized countries, and section D concludes.

B. Austrian Fiscal Federalism

4. Austria's federal system comprises the federal government and nine provinces (Länder). The federal parliament consists of two chambers: the Bundesrat and the Nationalrat. The Bundesrat comprises representatives appointed by the provincial parliaments, while members of the Nationalrat are directly elected. Legislation typically requires cooperation from both houses. However, with the important exception of federal budget acts, acts concerning federal guarantees, the issuing of debt or the rules of internal

¹ The author is grateful for helpful comments from Paul Hilbers, Erik Lundback, John Norregard, Ricardo Varsano, Margit Schratzenstaller-Altzinger, the Austrian National Bank, the Ministry of Finance, and participants at a seminar in Vienna.

procedures of the Austrian parliament the Bundesrat can delay but not veto legislation originating in the Nationalrat. On the other hand, the Bundesrat has an absolute veto concerning changes of Länder competences in the constitution. In addition, there are 2,357 municipalities (including cities and towns) in total within the Länder, belonging to at least one of two voluntary associations—the Austrian Association of Municipalities and the Austrian Association of Cities and Towns.² Among other things, these two associations represent the interests of municipalities in the periodic negotiations on intergovernmental revenue sharing. Given that Austria's population is about 8 million, the average municipality contains around 3,400 persons, and about 1,500 municipalities contain less than 2,000 persons. There are 24 municipalities with more than 20,000 persons, while the smallest municipality contains around 60 persons.

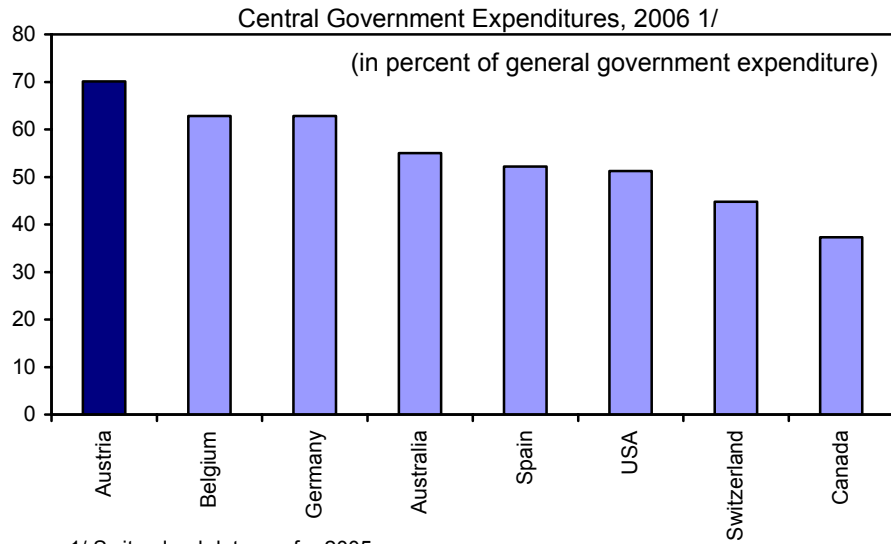
5. In addition to the Constitution and the Fiscal Constitutional Law, fiscal relations between the different levels of government are governed by several pieces of legislation, with a key one being the “Finanzausgleich” or Fiscal Equalization Law (FEL).³ The FEL specifies how revenues are to be allocated between the different levels of government, and how various transfers among the various governments (for vertical and horizontal equalization, environmental purposes, infrastructure, housing development, health, education, etc) are to be made. It is normally negotiated every four years but has on occasion been set over six year periods. Following national elections in late 2006, the FEL for 2005–08 was cancelled early, and a new one was agreed to cover a six year period (2008–13).

6. Another important piece of legislation is the Internal Stability Pact (ISP). The ISP, which is negotiated concurrently with the FEL, sets a multi-year general government fiscal balance target and allocates this target between the federal, provincial and municipality governments (see, e.g., Diebalek, Kohler-Togelhofer, and Prammer, 2005). In recent times there have been slippages in meeting ISP targets, particularly at the Länder level. For example, the ISP for the 2005–08 period targeted a balanced budget by 2008, implying significant consolidation and requiring surpluses at Länder level. Progress towards this target was limited, however, and under the new ISP for 2008–13, the target for achieving a balanced budget has been pushed back to 2010.

7. The federal system is rather centralized by international standards, with the federal government (including social security funds) accounting for about 70 percent of general government spending, the provinces accounting for 17 percent and municipalities accounting for 13 percent as of 2006.

² Reforms in the 1970s merged some small municipalities and reduced their total number by around 1,200.

³ Austria's federal system bears several similarities to that of Germany, including a consensus driven approach, low subnational tax autonomy, and a focus on achieving similar living standards across the country (see, e.g., Decressin and Braumann, 2004).



Sources: Country authorities and author's calculations.

8. In terms of expenditure responsibilities, the constitution lists all the competencies of the federal government, and anything not listed is generally handled by the Länder and municipalities. Among other things, the federal government is responsible for higher education, vocational training, labor legislation, most public pensions, all health care excluding hospitals, framework legislation for hospitals, and family support. Länder responsibilities include social welfare, primary education, hospitals, regional infrastructure, transportation, and pensions for Länder civil servants, while the municipality responsibilities include local police, local infrastructure, and social services.

9. In practice, however, there are several important areas where responsibilities overlap or where closely related activities are performed and co-financed by different levels of government, including health care, education, and the social safety net. For example, the health sector is financed and administered jointly by the federal government, state governments, municipalities, and the social security funds, with rather opaque lines of responsibility (see, e.g. Hofmarcher and Rack, 2006). While the constitution assigns primary responsibility for hospitals to the provincial governments, their financing is more broad based. For example, while municipalities are generally not responsible for hospitals, they are required to contribute amounts ranging from 35 to 60 percent of their own-taxes to their respective provincial governments to help finance health care. Fuentes, Wurzel, and Worgotter (2006) note that the responsibility for maintenance of schools is shared by provincial and municipality governments. Also, provinces are responsible for legislating working conditions for teachers, while school curricula are set by the federal government. Teachers employed by the provinces are typically paid by the federal government. The provision of child care and promotion of language skills is a Länder responsibility, but a portion of the expenditure is financed by earmarked federal grants.

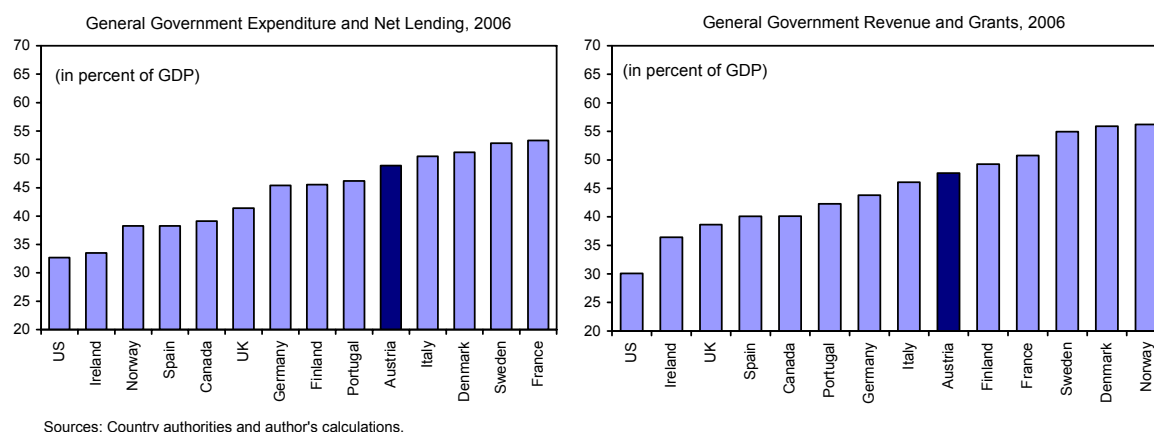
10. In addition, there is substantial delegation of tasks from higher to lower levels of government (see, e.g. OECD, 2005). With the exception of defense and taxation the bulk of the administrative tasks of the federal government are actually carried out by provincial officials. There is agreement that such tasks make up a large share of activities at the provincial level, but exact estimates are not available. Provincial governors and their subordinates are subject to directives from various federal ministries as they carry out federal administrative tasks. Moreover, in general changes in the administrative organization of provincial governments require federal government approval. The federal and provincial governments also delegate tasks to municipal governments, including elections, citizenship procedures, water, and livestock. As a result, discretionary spending currently constitutes around 2 percent of municipal budgets.⁴

11. This system of joint responsibilities in key spending sectors has been supported by a web of intergovernmental revenue sharing and transfers which remains complex and opaque, notwithstanding recent attempts at simplification. Up to 2004, different taxes were allocated among levels of government by different allocation formulae, with an unclear rationale for the differences in the allocation coefficients. Revenue sharing was supplemented by a system of equalization grants, earmarked transfers, and various co-financing agreements, the result of a history of numerous negotiated agreements and a drive for consensus. Since then, there have been attempts at simplification: the FEL for 2005–08 introduced a uniform allocation formula for most taxes (excluding only the real estate transfer tax “Grunderwerbsteuer” and the tax on advertisement “Werbesteuer”), while under the current FEL most federal government transfers have been converted into fixed unconditional shares of the total revenue pool from joint taxes. Currently, over 90 percent of all general government tax revenue is collected as joint taxes at the federal level, and 73 percent, 15 percent and 12 percent of the joint revenues are transferred to federal, provincial, and municipality governments, respectively.

12. In addition to their limited discretion over expenditure, subnational governments also have weak tax autonomy. Own-taxes of the provinces (mostly from the fire protection tax “Feuerschutzabgabe” and broadcasting fees “Lustbarkeitsabgabe”) constitute less than one percent of general government revenue, while own-taxes of municipalities (mostly real estate and municipal payroll taxes) constitute about 5 percent of general government revenue. As discussed below, the low tax autonomy has weakened the efficiency of spending at the subnational level and helped increase aggregate spending. Reflecting these inefficiencies, Austria has a relatively high ratio of government expenditure to GDP, which has also kept the tax burden high. General government expenditure in 2007 was 48 percent of GDP, while tax revenue constituted 42 percent of GDP, both above the average for advanced countries. Moreover, Austria has thus far been unable to implement sufficient expenditure savings to

⁴ A rough estimate provided by the Austrian Association of Cities and Towns.

offset tax cuts implemented in recent years, thus weakening the structural fiscal position. Recent fiscal outturns have been characterized by persistent deficits even in years of strong growth, despite the relatively high tax burden (see 2008 Staff Report).



13. Consolidation efforts are also hampered by limited disclosure and insufficient application of accounting standards for fiscal data, particularly at lower levels of government. ESA 95 accounting rules appear to have been applied in a creative manner in some instances with the objective of reducing reported deficits (see e.g. European Commission, 2008). For example, the budgetary treatment of health care spending appears to differ significantly across subnational governments, as much of this spending is carried out through a variety of extra budgetary arrangements, with the proportion of such spending that appears on-budget varying across subnational governments. There have also been reports of some health care expenditures being booked as loans. A correction to subnational fiscal data in October 2007 turned out to worsen the 2006 general government deficit by 0.3 percentage points of GDP. It appears difficult to obtain comprehensive high frequency fiscal data on individual provinces, and to assess the efficiency of spending in the various provinces. And the large number of municipalities makes an assessment of fiscal performance at that level particularly challenging.

14. Attempts have been made to restructure the federal system through constitutional change, but thus far without much success. A major constitutional reform effort (Konvent) was unsuccessful in 2005 because of the lack of support by the required parliamentary supermajority. However, there are still working groups tasked with making proposals for reforms. The current grand coalition government has the required votes to make constitutional changes, but lack of broad political support, including at the subnational government level, has so far prevented an agreement on fundamental changes.

15. Five areas are typically cited as needing reform, including, as discussed above (i) disclosure and accounting standards and benchmarking of expenditure norms, particularly at provincial and municipality levels, (ii) overlapping and unclear expenditure responsibilities across different levels of government, which blur accountability, (iii) the

complex system of revenue sharing and intergovernmental transfers, which creates incentive problems (iv) weak subnational tax autonomy, and (v) the multitude of small municipalities.

C. Broad Principles for Efficient Fiscal Federalism

16. The key advantages of federal systems—as opposed to unitary systems—are that they increase the scope for accommodating local preferences, and enhance beneficial yardstick competition across different local jurisdictions (see, e.g., Dafflon, 2006, and Inman, 2008). Local governments are believed to be better able to discern the preferences of their residents, more aware of local conditions, and also more accountable to their residents. Thus they can better accommodate the preferences of local residents, which improves allocative efficiency, the efficiency of provision of local services, and welfare. In addition, yardstick competition—which arises as local jurisdictions compete to solve similar problems countrywide—boosts the adoption of tried and tested welfare improving solutions across a country. Different localities can experiment with different solutions to similar problems, allowing the whole country to benefit from the lessons learned. In addition, a federal system is also thought to be effective in protecting the property rights of individuals, in checking abusive behavior by the central government, and in protecting minorities.

17. Overall, then, the more heterogeneous are the preferences within a population, the greater the potential gains from federalism. However, even in the case where preferences in a country are completely homogeneous federal systems can still benefit from yardstick competition. As such, efforts to completely harmonize public services across an entire federal country are likely to be counterproductive, as they will tend to reduce the benefits of federalism.

18. On the other hand, the key disadvantage of federal systems is that the decentralization of fiscal units generates significant coordination problems, which must be addressed by setting up appropriate institutions, processes and incentives. For example, macroeconomic stabilization is rendered more difficult where there are several fiscal units with different preferences and plans, which are not always consistent with those of the central government. Also, welfare-reducing competitions may arise in federal systems as local governments compete to attract companies, teachers, doctors, and other skilled professionals through tax and wage incentives. Fiscal units in federal systems also typically suffer from imbalances between their expenditure responsibilities and taxation powers, requiring in most cases a system of intergovernmental revenue sharing and grants to be set up. And policies in one fiscal unit can have spillover effects and externalities in other neighboring units, which, if left unaddressed, would lead to suboptimal outcomes. Also, an inability to restrict the enjoyment of a local service to local residents could lead to a suboptimal level of that service being provided.

19. Thus, minimizing the coordination problem while at the same time allowing for the free expression of local choices lies at the heart of a successful federal system. Coordination

problems can be alleviated by appropriate choices that minimize adverse incentives and free rider problems at the subnational level. The following sections study in more depth the issues that typically arise, including (i) the assignment of expenditure responsibilities across different levels of government; (ii) the assignment of taxing powers across different levels of government; (iii) revenue equalization and the achievement of nationally desirable objectives such as macroeconomic stabilization and minimum living, educational, and environmental standards; and (iv) the size of local and regional governments.

Expenditure Assignments

20. Country experiences suggest that there is a great deal of variety in expenditure assignments, and it is common to have responsibilities for various sectors shared across different levels of government (Table 1 and Figure 1). Nonetheless, the literature points to some considerations that are useful in determining the proper role of the different levels of government, including (see, e.g. Ter-Minassian, 1997):

- The subsidiarity principle indicates that expenditure responsibilities should generally be entrusted to the lowest level of government capable of carrying it out without at the same time producing substantial externalities and spillovers beyond its borders. This arrangement provides the greatest scope for accommodating local preferences, and for stimulating beneficial yardstick competition, thus maximizing the potential efficiency gains from federalism. However, if there are significant spillovers or externalities which need to be addressed, consideration should be given to assigning that task to the next higher level of government.
- In line with the subsidiarity principle, responsibilities with a national scope, such as defense, and foreign affairs, and those relating to coordination across the whole country should generally be assigned to the central government. As Table 1 demonstrates, in most countries defense, foreign affairs, pensions, competition policy, and labor market policy are primarily the responsibilities of the central government.
- Outside these areas the assignment of responsibilities is less clear-cut, and there is considerable variation across countries, with expenditure responsibilities typically reflecting historical and political events in each country.

Table 1. The Allocation of Expenditure Assignments in
Selected Countries 1/

Areas	Central	Subnational	Joint
(Percentage of countries)			
Defense	95.2	0.0	4.8
Foreign affairs	85.4	0.0	14.6
Old age and disability pensions	82.5	0.0	17.5
Competition	80.0	5.0	15.0
Justice	80.0	0.0	20.0
Labor market	76.2	2.4	21.4
Higher education	59.5	21.4	19.0
Local police	36.8	52.6	10.5
Health	30.0	7.5	62.5
Social assistance	29.3	22.0	48.8
Transport infrastructure	27.9	14.0	58.1
Primary & secondary education	21.4	47.6	31.0
Sanitation	12.2	63.4	24.4
Water	9.8	56.1	34.1
Local transport	7.1	66.7	26.2
Garbage collection	7.3	82.9	9.8

Source: Debrun (2006) - Based on a 2003 World Bank-OECD Survey

1/ Sample size varies between 38 and 43 countries depending on the area.

- But even in areas where primary responsibilities are usually placed in the hands of subnational governments, there often remains a significant coordinating role for the central government. Table 1 indicates that in most countries the central government plays a role in most sectors, either directly or jointly with subnational governments. This then points to the pervasive need for coordination in federal systems. For example, there is a potential role for central government in helping to determine the core curricula in primary and secondary education to facilitate mobility of students across the country. In the health sector, the central government is often involved in determining minimum standards of care. And the central government is often needed to limit the scope for damaging tax and wage competition across different localities.
- Accountability and efficiency concerns imply also that whatever expenditure assignments are decided upon should have clear lines of demarcation between the various fiscal units, and there should be clear and transparent reporting of progress in carrying out the various tasks. This also implies that as much as possible, closely related activities should be assigned to a single level of government. Where the involvement of multiple levels of government in closely related activities is needed, the interactions should be as simple and transparent as possible.

21. For Austria, although the broad assignments of expenditure tasks under the constitution are not inconsistent with subsidiarity, the practice of assigning closely related

tasks to different levels of government, coupled with earmarking of transfers, the delegation of tasks from higher levels of government, and complex co-financing arrangements has reduced the subnational expenditure discretion which subsidiarity is meant to generate. These arrangements have also rendered the system opaque, and limited accountability, efficiency, and yardstick competition, thus encouraging subnational expenditure inefficiencies while fostering a reluctance by the Länder to contemplate fundamental reforms.

22. A simplification and rationalization of the assignment of expenditure tasks is clearly warranted. The objective should be to substantially increase the discretion and accountability of subnational governments over the tasks assigned to them. As discussed above, this would require a clear demarcation of expenditure tasks, backed by greater transparency and the benchmarking of standards for provision of public services in order to stimulate yardstick competition. The delegation of tasks to lower government levels and pervasive earmarking would also need to be reconsidered. And finally, as discussed below, in order to entrench subnational discretion a higher level of tax autonomy would be warranted.

Subnational Taxation Powers

23. Discussions on taxing powers are often cast in the context of what taxes should be assigned to subnational governments, and the degree of discretion they should have over the base and rate of such assigned taxes.

24. There is consensus in the literature that a significant degree of tax autonomy is warranted for the proper and efficient functioning of a federal system, for the following reasons (see, e.g., Ambrosanio and Bordignon, 2006):

- A degree of tax autonomy is normally required in order for local governments to be able to adapt properly to the preferences of their residents. Moreover, the responsibility for levying taxes strengthens the accountability of local governments to their voters.
- Even in the extreme case of a completely homogeneous population with identical preferences and no mobility across local government units, tax autonomy can be beneficial, as it creates scope for citizens to distinguish between good and bad policy choices.
- Tax autonomy helps the federal government to harden the budget constraints of subnational governments, thus promoting the efficient use of public resources. Without this autonomy, a sub-national government that develops fiscal distress cannot be expected to resolve its own problems, as it has little scope for increasing its revenues to do so. As a result, the central government faces a time inconsistency problem, whereby it can be forced to bail out misbehaving local governments, and this expectation of a bailout may encourage fiscally irresponsible and sub-optimal behavior at the local level, including rapid growth in expenditure, misallocation of expenditure, free rider problems, and rent-seeking behavior.

25. Ideally, tax autonomy should be strong enough that at the margin a subnational government's choice to increase expenditure should require a commensurate increase in revenue from the local taxes over which that government has discretion. This link reinforces the accountability of that subnational government to its residents, and strengthens incentives to spend efficiently. For this to be operational requires that subnational governments should have significant policy discretion over at least a share of their total revenues.

26. Tax autonomy of Austrian subnational governments is not strong enough to allow the effective exercise of discretion. This is evident not only from the low share of own-taxes at the subnational level, but from international comparisons done by Blochliger (2006) (see Figure 2) which indicates that compared to other countries, subnational governments in Austria have limited discretion over the rates and base of their tax revenue. And since 2002, the share of joint taxes in general government tax revenue has increased further (see Schratzenstaller, 2008), suggesting no improvement in subnational tax autonomy.

27. Subnational tax autonomy should ideally be strengthened in a revenue neutral fashion. The issue of increasing subnational tax autonomy raises the question of what taxes should be assigned to each of the different levels of government. A subsidiarity principle applies here as well. In particular, taxes should be assigned to the lowest level of government capable of implementing them efficiently without creating significant spillovers and externalities to other regions. Spillovers and externalities in this case include the impact of the tax on the decisions by local residents regarding where to locate taxable economic activities, and the incidence of the tax on non residents of the locality. In this regard, the ideal local government tax is one that can be levied on a relatively immobile and well demarcated local tax base. For this reason there is a widespread international tradition of assigning property taxes to local governments.

28. For Austria, the OECD notes in recent Economic Surveys that the real estate tax has the potential to generate substantially higher revenues than is currently the case. This then provides a natural avenue for increasing tax autonomy at the municipality level. However, to increase real estate tax revenue would require upgrading the system for assessing the market value of the real estate tax base, as current valuations for tax purposes are considerably below the actual market values of property. Moreover, municipalities should be given considerable discretion over this tax if autonomy is to be increased, and generally any significant change in this tax should be implemented carefully in order not to disturb market conditions. To ensure revenue neutrality of such changes, the tax yield at the central government level would have to be reduced in commensurate fashion.

29. At the other end of the spectrum, since macroeconomic stabilization is normally a responsibility of the central government, it should also be assigned taxes with a strong cyclical component. Thus, profit taxes are generally not considered appropriate subnational taxes as they are strongly cyclical. In addition, unless the company operates only within that locality, it will be very difficult to determine which share of its profits can be considered to be a

part of the tax base of that particular locality. And companies operating across different local jurisdictions will typically move their operations around to minimize their exposure to taxation, creating distortions in resource allocation.

30. Ambrosanio and Bordignon (2006) note that in most countries discretion over VAT rates and base is typically left to the central government, even though VAT revenue is often shared between different levels of government. This is because allowing subnational discretion over VAT rates and base will typically greatly increase the complexity of the VAT tax system and generate substantial inefficiencies in the administration of the taxes. While they point out that there are possible configurations of VAT that allow some local autonomy over VAT policy, these generally require an increase in the complexity of the tax, and would not appear to be appropriate for Austria.

31. Personal income tax also has a cyclical component, and in virtually all cases it is levied by the central government. However, it is not unusual to have provincial governments also levying income taxes, including in countries like the United States, Canada, the Nordic countries, and Spain. In such cases, the typical arrangement is that provincial governments have some discretion over the tax rate, but use the same base as defined by the central government. This helps limit the scope for fragmenting the tax base through a multiplicity of local tax exemptions, which would increase the room for tax competition and add to the administrative difficulties of administering the tax.

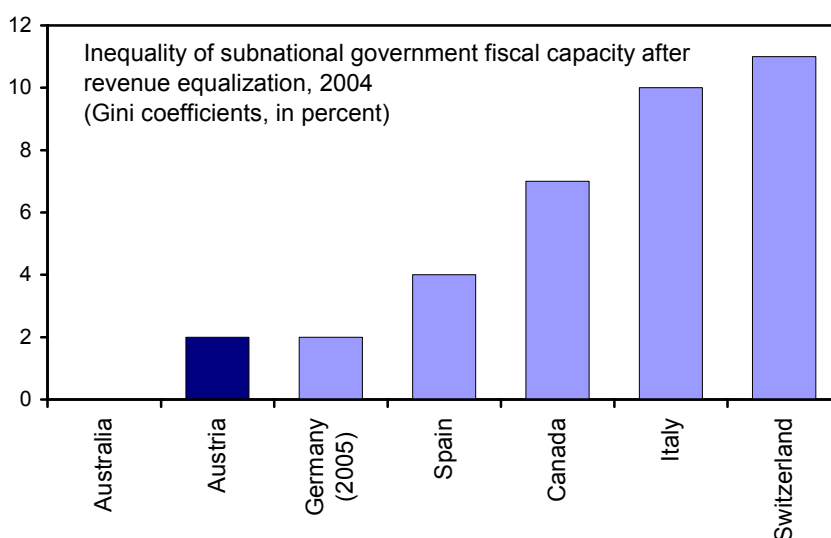
32. The current situation in Austria is that wage taxes are part of the pool of joint tax revenues shared by different levels of government. If it were decided to create a provincial income tax, this could be done, as in other countries, by allowing provinces to set a tax rate on the portion of the federal income tax base arising from their residents. To avoid complicating tax administration, all personal income tax revenue could be collected, as now, by the federal tax administration, and the provincial part passed wholly to the relevant provinces. Also, to limit the potential for damaging tax competition the variation in provincial income tax rates could be limited to a band.

Revenue Equalization

33. There are a variety of revenue equalization arrangements observed in various countries, and there is no one perfect system. Revenue equalization formulas normally seek to partly or fully offset differences between subnational governments in terms of fiscal capacity (often determined by the revenue the recipient government can raise, given norms for its tax base and tax rate), fiscal costs (often based on demographic or other characteristics that lead to differences in the per capita costs of providing public services), or both, across and within the different levels of government (see e.g. Blochliger et al, 2007). Revenue equalization is then an attempt, on equity grounds, to offset the impact of these characteristics that are beyond the control of subnational governments by redistributing resources. The degree of equalization that is attempted differs significantly from country to

country, partly for political reasons and also because such attempts at redistribution can create adverse incentives and rent seeking behavior that reduces the efficiency of the fiscal system. Such redistributive mechanisms also enable central governments to pursue other national objectives at the subnational level. They are also used to address externalities and spillovers at the subnational level, and provide insurance against asymmetric shocks to different areas of the country.

34. For Austria, the objective of the revenue equalization mechanism is to ensure roughly similar living standards across the country, and equalization formulas have included both fiscal capacity and fiscal cost criteria.⁵ This objective is largely met in Austria, with a low gini coefficient of fiscal capacity between subnational governments after equalization.



Source: Blochliger et al (2007)

35. However, there is a question whether the objective of country-wide similarity of results is compatible with an efficient fiscal federal system, where different localities could be expected to make different choices regarding the appropriate levels of public services and taxation. The push for uniformity may have helped increase the complexity of the system by increasing the number of co-financing and earmarking arrangements. It would seem more efficient to seek to equalize capacity rather than outcomes, as this allows for the free subnational adaptation to local preferences and yardstick competition, raising the potential gains from fiscal federalism.

⁵ This objective is not entrenched in the constitution as in the case of Germany, but is backed by a political consensus and tradition.

36. Whatever the objective of equalization, it is often the case that revenue equalization is associated with adverse incentives and free rider problems at the subnational level, and care should be taken to ensure that they are minimized. In this regard:

- Disincentives to subnational government tax efforts should be minimized. In particular, as much as possible increased subnational revenues arising from higher tax efforts should not be offset by reductions in inflows of transfers. Such disincentives (also known as equalization tax or compensation rate) undermine subnational autonomy and make it more likely that free rider and common pool problems will arise.⁶ For Austria, these offsets are large, and even more than 100 percent in some of the poorer areas, significantly reducing subnational discretion (see, e.g., Schneider, 2002, and Blochliger et al, 2007). Reducing such disincentives would require that the size of transfers should be independent of any actions or policies of the recipients. Thus, for example, assessment of revenue raising capacity should be based on well defined and comprehensive norms for the tax base and tax rate, rather than data on the actual revenues collected by the recipient fiscal unit.
- Similarly, rent seeking incentives in cost equalization mechanisms should be minimized. Given the complexities in assessing costs, subnational governments have a strong incentive to inflate estimates of their costs in providing public services, which can lead to upward pressures on aggregate spending. To counter this, assessments of costs should be based on well defined norms that cannot be adjusted by the recipient government. And equalization of cost differences arising from differences in economies of scale should be minimized, as it can reduce incentives for inefficiently small local governments to merge or to cooperate. In this regard, the use of municipality size as a factor in determining municipality revenue shares in Austria may need to be reconsidered (see e.g. Pitlik, 2008).
- If the bulk of subnational revenues comes from a share of a common pool of resources, this can create adverse incentives. Subnational governments can then act on the basis that increases in their expenditure do not come with commensurate responsibility to raise the required revenue, as the required revenue comes from a common pool and the burden is spread throughout the country. The greater the scope for a subnational government to change its level of inflows from the common pool by changing its behavior, the greater this adverse incentive will tend to be. This is therefore an argument against the pervasive use of earmarking and conditionality in determining transfers and revenue shares of subnational governments. It also argues for the use of simple and transparent rules for determining transfers and revenue sharing.

⁶ For example, a subnational government would have an incentive to increase its expenditures if it believes that it can acquire the necessary funding from the common pool of joint taxes, rather than through its own tax efforts, thus spreading the burden for its expenditure increase across the entire country.

37. The recent simplification of the revenue equalization mechanism in the current FEL is a good first step, as fixed unconditional revenue shares reduce the scope for rent seeking behavior, and increase subnational autonomy to some extent through the reduction of earmarking. However, there is need to address the fact that fixed unconditional shares of joint taxes encourages procyclical fiscal policy at the subnational levels of government. Booming revenues automatically increase revenues at subnational level, creating the temptation to increase spending, while, on the other hand, depressed revenues force painful cuts in spending. There are a number of mechanisms available to avoid this. For example, multi-year frameworks with explicit targets or ceilings on the size of the pool of revenues to be distributed would counter this procyclicality bias.

Size of Local Jurisdictions

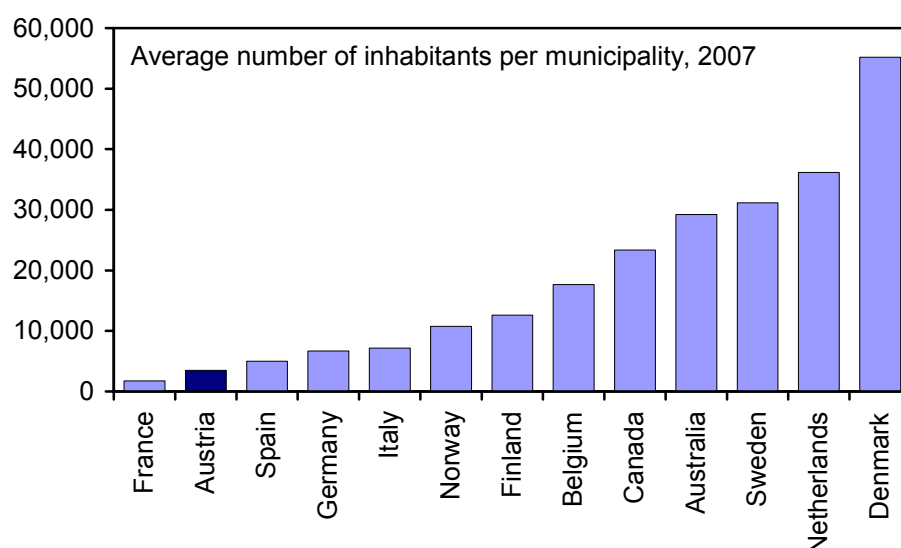
38. The size of local jurisdictions usually reflects the political history of a country rather than economic efficiency concerns. However, this variable has an impact on the efficiency of public spending. Thus, as in the case of Austria where efficiency savings are needed, this area is a natural one to examine. The issues here are whether economies of scale in service provision are adequately captured, whether there are significant spillover effects or externalities, and whether the local jurisdictions are large enough to attract high quality managerial expertise into their administrations.

39. A look at the average population per municipality in a selection of countries suggests that Austrian municipality size is well below average. The large number of small municipalities in Austria limits the scope for economies of scale in the provision of public services, and also greatly increases the logistical effort required to monitor the fiscal outturn. For example, calculations in OECD (2007) point to decreasing average costs as municipality size increases towards 5,000 residents. Moreover, the scope for efficiency gains can be further increased with the adoption of information technology. Although municipalities do cooperate in areas with significant spillover implications, such as infrastructure, these joint projects are often subsidized by higher government levels, and there seems scope for further efficiency gains by merging smaller municipalities, particularly if the autonomy of local governments were to be increased.

40. In recognition of these efficiency considerations, the new FEL provides modest financial incentives for voluntary mergers or cooperation agreements amongst municipalities, and also allows municipalities to cooperate across Länder borders. However the financial incentives offered are temporary and small—around 80,000 euros in the first year and declining thereafter—and have thus far not generated much response.

41. Given the weak subnational discretion over both expenditure and taxation, it does not appear that spillover effects are a major issue in Austria. However, small municipalities are reportedly experiencing some difficulties in attracting managerial talent, which also points to potential benefits from mergers.

42. Comparing Austria with some other European countries, it can be seen that several have moved to merge municipalities in recent decades, particularly in Scandinavia. For example, in Denmark the number of municipalities was decreased from 1,390 to 275 in 1970, and was decreased further in 2007 to 98, with the target that municipalities should contain at least 10,000 persons. In Sweden, the number of municipalities and cities was reduced from 2,414 to 949 in 1952, and there were further deep reductions in the 1970s. Currently the number of municipalities in Sweden stands at 290. Finland is currently debating a reduction in the number of municipalities (416 in 2007) along the lines of the Danish model. In the Netherlands, the number of municipalities was reduced from over 1,200 to 489 in 2003, and was further reduced to 458 by 2006.



Sources: Country authorities and author's calculations

43. Given the political implications of such changes, however, substantial public debate and preparation would be needed. The odds for success could be improved if the debate were informed by a comprehensive study that quantifies the costs of the status quo and points to the broad parameters of an efficient size for municipalities in Austria.

Transparency and Disclosure

44. Transparent, accurate, and standardized fiscal information is key to efficient fiscal federalism. This is needed to promote public accountability and enhance yardstick competition, and it is also helpful in increasing the efficiency of tax administration and capital market discipline on fiscal units.

45. One reason for the current inertia over reform is that disclosure and transparency standards do not permit the Austrian public to make informed comparisons about the efficiency of spending and the quality of outcomes in various subnational jurisdictions. Thus,

overhauling these standards would be useful in this regard, to stimulate public debate over public spending choices, and may well be a necessary first step to build a public consensus for deep reforms. In this regard, some practices which have often rendered fiscal transactions more opaque to the public, such as the extensive use of extra budgetary units in all levels of governments could be reconsidered. In this context, the move towards the full use of ESA 95 accounting standards in recent years is welcome. The fiscal framework could also be rendered more transparent and predictable by the vigorous implementation of commitments under the ISP to implement medium term expenditure frameworks at all levels of government, in addition to the plans to do so at the federal level in 2009. Alongside, a move to output-based budgeting, which is to be implemented in 2013 by the federal government, would also be helpful in this regard.

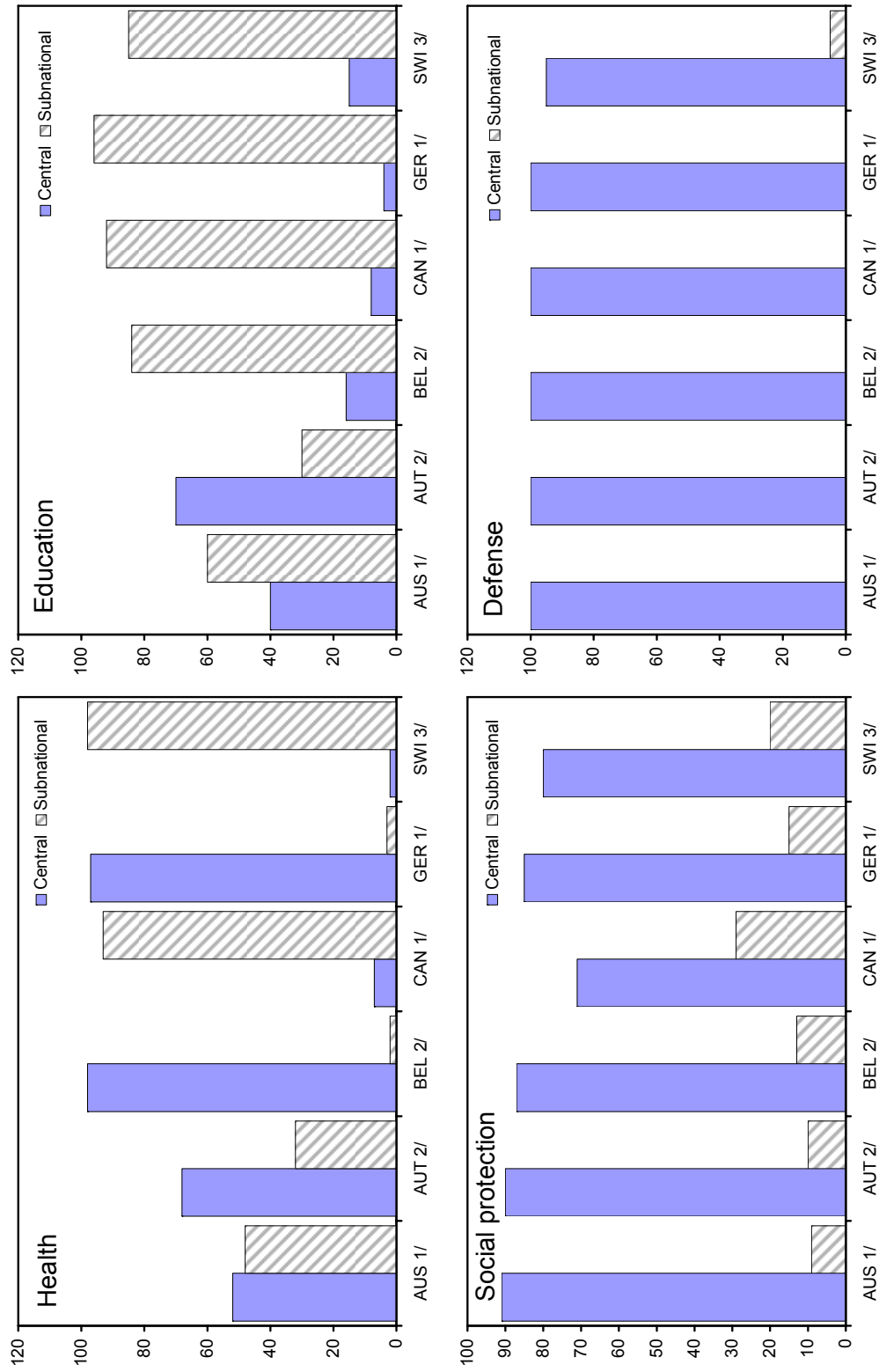
D. Concluding Remarks

46. While Austria's political system is clearly federal, its fiscal arrangements more closely resemble a unitary fiscal structure, given the limited discretion at subnational levels. The result of this is that the potential benefits of federalism have generally not been realized, as subnational governments have limited scope or incentive to tailor the provision of public services according to local preferences, or engage in yardstick competition under current arrangements.

47. While inter-governmental arrangements are inherently political, the impetus for reform of fiscal federal relations in Austria is driven by the economic realities that have to be addressed. The fiscal position needs to be put on a firmer position in the context of significant tax cuts envisaged for 2010 and the buildup of aging pressures over the medium and long term. Achieving this goal requires substantial expenditure savings to be generated, which can plausibly be done only by overhauling the fiscal federal system to strengthen accountability, transparency and incentives at the subnational level. Given the timing for tax cuts, it is evident that efforts to reform the fiscal federal system need to be intensified.

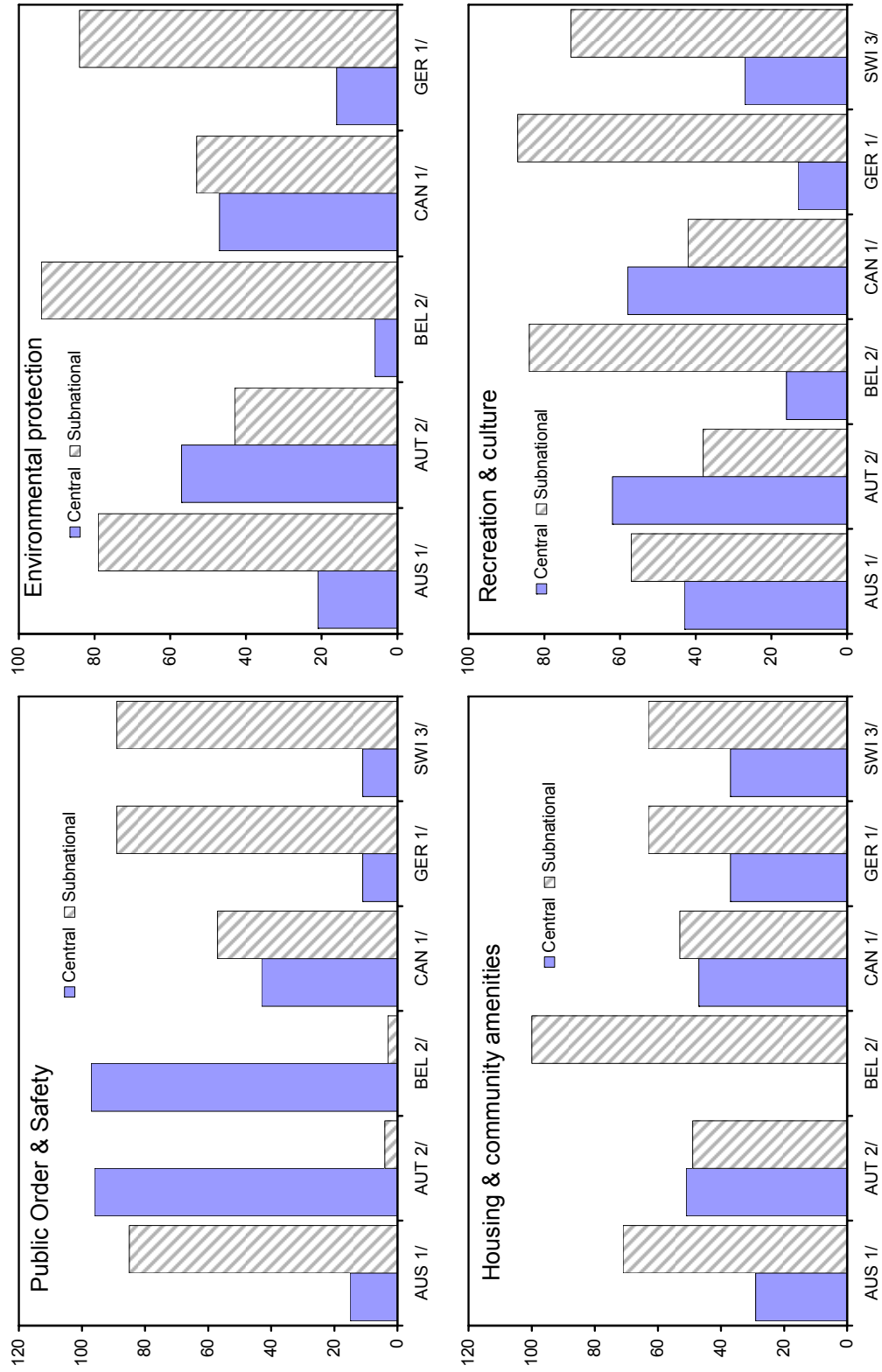
48. While there is scope for significant reforms even under the current framework, a rationalization of expenditure responsibilities across governmental levels, needed for a more fundamental streamlining of the system, would require constitutional change. In this context, given the important role the overhaul of fiscal federal relations has to play in ensuring fiscal sustainability, efforts to achieve the necessary consensus for constitutional reform in this area should be intensified.

Figure 1. Allocation of Expenditures Between Central and Subnational Government in Selected Countries
(In percent)



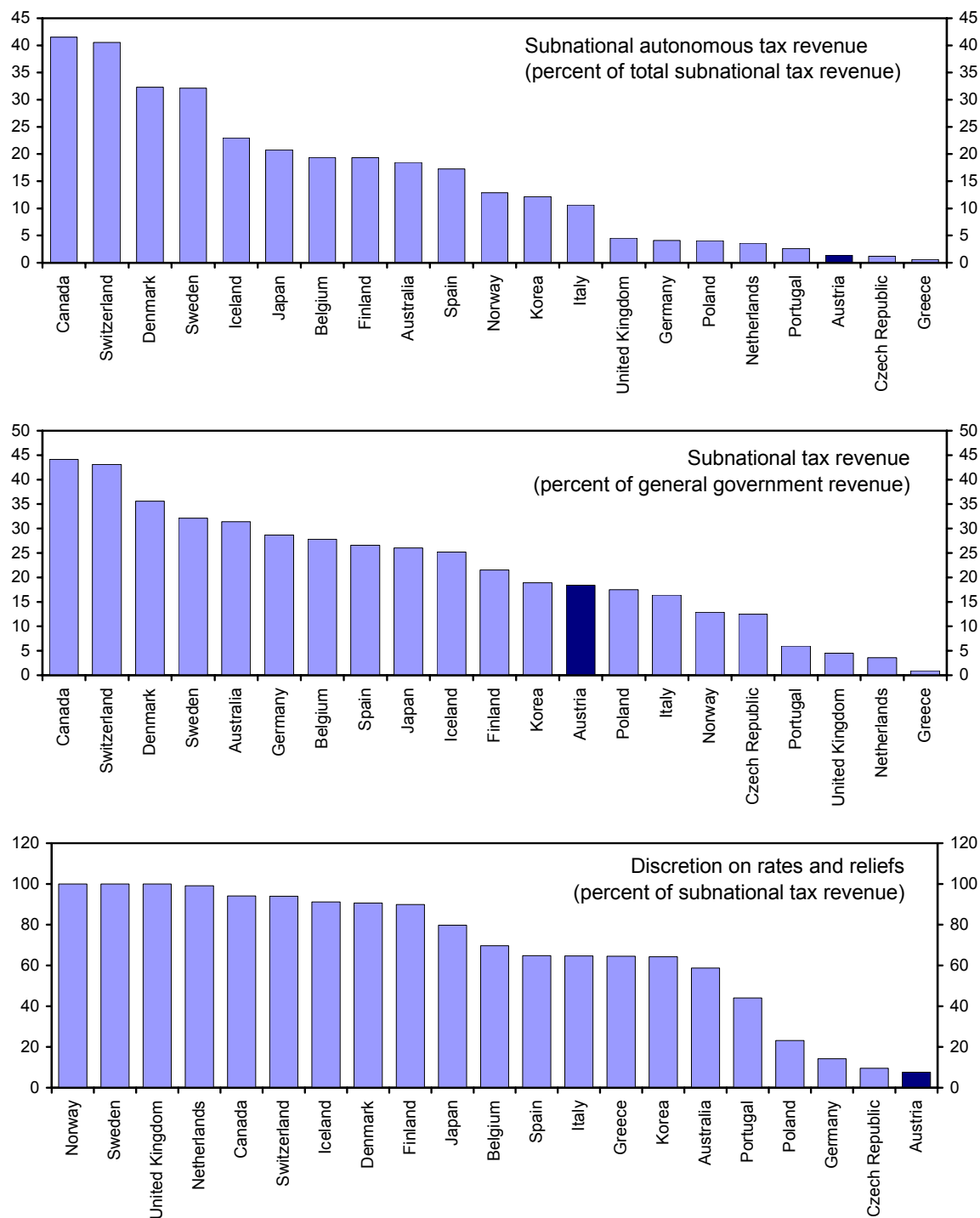
Source: Warren (2006)
1/ 2003 data; 2/ 2002 data; 3/ 2001 data

Figure 1 (contd). Allocation of Expenditures Between Central and Subnational Government in Selected Countries
(In percent)



Source: Warren (2006)
1/ 2003 data; 2/ 2002 data; 3/ 2001 data

Figure 2. International Comparison of Subnational Government Tax Autonomy, 2002



Source: OECD, Blochliger (2007)

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