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**Special Edition: State Funding Reform in the Australian Federation**





Spanish dictator in power since 1939), died. Three years later, on the 6<sup>th</sup> of December 1978, Spaniards voted in favour of as of 2011 the longest lasting Constitution in their history. On the first of January 1986, Spain became a Member of the European Union. In less than ten years, Spain was radically transformed.

## 2.2 The Design and the Functioning of the “Estado de las Autonomías”

### 2.2.1 Deciding on a model

One of the main challenges to design a coherent decentralization system in 1975 was the fact that the intensity of regional identity differs greatly from one region of Spain to another. Article 2 of the 1978 Constitution even distinguishes between “regions” and “nationalities”. The difference between these terms is not always clear, but the fact that the Constitution uses these two words reflects that regional identity and sentiments regarding autonomy are stronger in some regions than in others. Historically, Catalonia and the Basque Country have most actively sought a higher degree of autonomy and political identity. In contrast, other regions such as Extremadura or Murcia have only later on shown a desire for greater political autonomy. This varying intensity of regional sentiments is clearly reflected in the type and strength of local political parties. In both Catalonia and Basque Country specifically nationalist regional political parties have won majorities in the respective community governments<sup>9</sup>. It is important to note that the Spanish case shows that it is not only political motivations, or economic incentives, that drive decentralization, but a number of closely intertwined factors<sup>10</sup>.

In this context, it was difficult to decide which was to be the final model of decentralization. The solution finally adopted was akin to an asymmetric federalism system, at least in its initial design. The Constitution met the challenge by not defining the new system, but by establishing a procedural framework instead. Thus, what the Constitution does is to establish an “optional autonomy system” (the so-called ‘*principio dispositivo*’) which entails the possibility of asymmetry, as it does not force decentralization<sup>11</sup>.

Soon after the Constitution was ratified, almost all of the regions expressed a desire to obtain the higher degree of autonomy, seeking the same powers as those granted to Galicia, Catalonia and the Basque Country. Granting the higher degree to all regions at once would have necessitated the immediate creation of a federal system, and Spain’s administrative and political structure made that impossible or at least impractical. It took then three years, and an attempted *Coup d’État* in 1981 (23 February) for the political parties to finally agree on a regional structure for the country. Seven regions would immediately attain the higher degree of autonomy (Catalonia, Galicia, the Basque Country, Andalusia –which held a referendum to choose this- Valencia, the Canary Islands and Navarra. The other ten chose the lesser degree of autonomy.

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<sup>9</sup> Another significant feature of the Spanish political system is the coexistence in parliaments of both political parties organized nationwide and regional parties which are nationalist. Furthermore, there have always been separatist movements or parties that seek the total independence of the region-autonomy. See: López Guerra, L.: “National and Regional Pluralism in Contemporary Spain...cit. pp. 20 et seq.

<sup>10</sup> See the sophisticated model proposed by León-Alfonso, S.: *The Political Economy of Fiscal Decentralization. Bringing Politics to the Study of Intergovernmental Transfers*. Barcelona: Instituto d’Estudis Autònoms, 2007, pp. 59 et seq.

<sup>11</sup> López Guerra, L.: “El modelo autonómico”. *Revista Catalana de Derecho Público, Autonomies*, n. 20/1995, p. 171.









quite a politicized issue in Spain that has been the cause of much stress between the state and some Communities (especially Catalonia and the Basque Country). There are two major types of agreements, which are closely related: agreement between different political parties and negotiations between the State and the Communities (both bilateral and multilateral).

The process usually unfolds as follows: First, a multilateral agreement between the State and all the Communities is reached. This is done in the Finance and Tax Policy Council (*Consejo de Política Fiscal y Financiera*), where the finance ministers of all Communities and the state are represented. Once an agreement has been approved, bilateral agreements with the state are signed. This is done in the “Mixed Commissions” (*Comisiones mixtas*)<sup>19</sup>.

This agreement system serves to give weight to the Communities’ opinions on the allocation of resources. It has been broadly criticized, however, for its lack of transparency, as the agreements take place behind closed doors and the results are only partially made public, which results in a restriction of democracy<sup>20</sup>.

2. Autonomous Communities are represented at the Senate, which operates as a second Chamber that revises legislation. However, so far the Senate is only in theory a representative Chamber of the Communities. The main cause for this lays in two reasons: First, the fact that most senators are elected by universal suffrage from provincial voting districts, while only a minority (46 out of 253) are appointed by the Parliaments of the Autonomous Communities. Thus, according to section 69 of the Constitution and section 165 of the Law of General Elections (Organic Law 5/1985, June 19<sup>th</sup>), there are four Senators per Province that will be elected directly by citizens. Then, every Community may choose one Senator, plus one more for every million inhabitants in the Community. Second, the Senate has very limited powers in making State laws. One of the proposals on the Socialist government agenda when it entered into power in 2004 was the reform of the Senate. This was never attained. A strong Senate would promote multilateral action, and some Communities still prefer to relate to the centre on a bilateral basis. This is certainly the case for Catalonia and the Basque Country.

3. Finally, the rulings of the Constitutional Court have played, and still play, a significant role in the definition of authority in the Statutes of Autonomies<sup>21</sup>. Taking into account that the vast majority of the matters listed in the Constitution are actually shared between the Central Government and the Communities, it is not hard to

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<sup>19</sup> See J. Ramallo Massanet and J.J. Zornoza Pérez: “El Consejo de Política Fiscal y Financiera y las

imagine that this has been a source of permanent conflict between these two tiers of government. The Court, as the only body competent to resolve such conflicts, has undertaken a very important task in the evolution of the Statutes of Autonomies<sup>22</sup>. Of course this role has been reinforced by the “unfinished” nature of the different provisions regarding regional autonomy established in the Constitution, and by a certain ‘didactic’ tendency of the Court to fully explain and thus to clarify the rules governing the Statutes of Autonomies. Moreover, the Court has often ruled in favour of the Communities, which in the first years of the decentralized model was almost revolutionary in a country with such a long tradition of centralization<sup>23</sup>. However, it is probably time that it played a secondary role in the shaping of the State of Autonomies, in favour of a stronger role for the Senate. At present, the following statement dating back to 1998 is still true: “it is becoming almost routine in Spain to discuss any Law of certain importance in two forums, a first debate in the Parliament, and a second, and decisive one, in the Constitutional Court”<sup>24</sup>. In fiscal federalism matters, there have been many relevant Constitutional Court’s Opinions that have reinforced the Communities’ spending power, declared void AC taxes because they were similar to State or municipal taxes and asserted the right of Communities to establish taxes, provided they do so in matters that fall within their scope of competence<sup>25</sup>.

### **2.3 Rethinking the model after the financial crisis?**

The financial crisis has brought to the forefront different structural problems in the Spanish State of Autonomy, namely the growth of indebtedment in Autonomous Communities<sup>26</sup> and their inability to fully develop a sound revenue system by using the taxing powers that they have.

A recentralization of authority, an unthinkable idea until not long ago, has been proposed by different politicians, including those from the PP (People’s party), which now holds since November 2011 an absolute majority at the State level.

## **3. FINANCING AUTONOMOUS COMMUNITIES**

There are currently two systems to finance Autonomous Communities, the “common



**Box 1: National Tax Collection Agency: the big numbers**

The Agency<sup>31</sup> had a 2009 budget of €1,414.3 million and a total of 27,755 employees.

The total number of registered taxpayers is 47,999,499, of which: 1,682,509 are registered as small companies (revenue does not exceed € 8 million), 5,154,706 are individual business people and professionals and 41,477 are large companies.

The AEAT's results of 2009 were a total net collection of €144,023 million for a public collection cost of 1% of revenue collected

The number of tax returns processed in 2009 for the main taxes of the system (i.e., in terms of revenue) were:

- Personal Income Tax: 19,467,138
- Corporation Income Tax: 1,389,514
- Value Added Tax: 3,525,821
- Excise Duties: 9,130,549

Source: the author and *Memoria AEAT 2009*<sup>32</sup>

**3.2 Outline of the System: Taxes and Transfers**

1. It is commonplace in the fiscal federalism literature to refer to “Vertical Fiscal Imbalance”, abbreviated as VFI<sup>33</sup> as the situation that arises when one tier of government – usually the Central Government – has a greater power to obtain revenues than it actually needs for the exercise of its assigned level of authority, while the other – usually sub-national governments – is in the opposite situation. This creates an imbalance that must be resolved in order to guarantee to the sub-national governments the autonomy required for the exercise of their authority. Ultimately VFI needs to be addressed in order to protect the citizen's right to obtain the services they pay for via taxation. This means that at least *some* distribution of resources needs to take place following a decentralization process.

The problem is easily understood and conflicting parties – the State and sub-national governments – normally agree that it must be resolved and that the allocation of resources must be “re-balanced”. Conflict usually arises when deciding which of the different possible solutions should be used. VFI imbalance can be solved either through transfers from the State or through a reassignment of taxation powers. In practice, a mix of the two will be used, so that most sub-national governments receive financing in the form of both transfers and own taxes. When sub-national governments receive financing almost exclusively in the form of transfers, an incentive is created to spend those monies in a less responsible way. The idea is simple and similar to the ‘moral hazard’ problem. It is easier for governments to spend money when (a) they do not shoulder the political burden of having to raise it (ie establishing or raising taxes),

<sup>31</sup> The Agency collects all taxes, including ceded taxes (and only included taxes created by the Autonomous Communities, which are really minor).

<sup>32</sup> Latest available complete data, at: AEAT Report 2009, “Key figures for 2009”, pp. 7 et seq. Available online (English version): [www.aeat.es](http://www.aeat.es).

<sup>33</sup> Also known as *fiscal mismatch*, “*fiscal gap*” o del “*revenue gap*”; See: Oates, W. E.: “An Economist's Perspective on Fiscal Federalism”, at (Ed. Oates, W. E): *The Political Economy of Fiscal Federalism*. Toronto: Lexington Books, 1977, p.. 16; Boadway, R. W.; Hobson, P. A. R.: *Intergovernmental Fiscal Relations in Canada*. Canadian Tax Papers, no. 96. Toronto: CTF, 1993, pp. 28 et seq and 77 et seq.

and (b) there is no need for them to explain to voters/taxpayers the relationship between monies raised and monies spent. In other words, the situation creates a lack of accountability that may not be advisable. This has been, and to a certain extent still is, the situation for common-system Communities.

Horizontal fiscal imbalance (HFI) will arise when there are significant differences in income and thus public resources among sub-national governments<sup>34</sup>. Resolving this imbalance may also mean better addressing citizen's rights to their services, but it is much harder to solve than VFI. In particular because an increase of sub-national taxation systems will normally make HFI more obvious (richer regions also have higher taxing capacity). Both VFI and HFI have been present in the debates about the Communities' fiscal responsibility, which have become one of the main issues in the relationship between the State and the Communities. Since early on, the transfer of at least *some* taxation powers to such sub-national tiers of government, so that they have fiscal responsibility "at the margin"<sup>35</sup>, has been considered essential in order to reinforce a certain level of political autonomy.

2. As stated above, one feature of the Spanish fiscal decentralization model is the radical asymmetry that exists between two groups of Communities. On the one hand, the financing systems applicable to the two *foral* Communities are known as *Concierto* (Basque Country) and *Convenio* (Navarra) systems<sup>36</sup>. The main characteristic of this kind of system is that it entails a maximum level of taxation autonomy, which means these two Communities have powers to pass legislation, with only few limitations<sup>37</sup>, on two of the main taxes of the Spanish fiscal system. Because the Central Government is still responsible for the provision of some public functions or services within the territory of these two Communities, it is entitled to receive a certain sum of money from them, known as the "*cupo*" (quota).

In contrast, the so-called 'common system', which applies to the other fifteen Communities, is the opposite of the *cupo*. The main difference lies in the fact that, under the common system, the Communities have more limited taxation powers, which results in a greater financial dependence upon the Central Government. Hence, (still) most of their revenues are provided by the Central Government, in the form of transfers<sup>38</sup>.

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<sup>34</sup> See Boadway, R. W.; Shah, A.: *Fiscal Federalism: Principles and Practice of Multiorder Governance*. Cambridge, 2009; Boadway, R. W.; Hobson, P. A. R.: *Intergovernmental Fiscal Relations in Canada...cit.* pp. 30-32.

<sup>35</sup> Heald, D.; Geaghan, N.: 'Financing a Scottish Parliament', in S. Tindale (ed), *The State and the Nations*. London: Institute for Public Policy Research, 1996, pp.167-83. Boadway, R.: "Intergovernmental Fiscal Relations: The Facilitator of Fiscal Decentralization", *Constitutional Political Economy*, vol. 12, no. 2, 2001, pp. 93-121.

<sup>36</sup> Both these terms (*concierto* and *convenio*) translate into English as 'agree5( Fis93R(. ))TJ6 0 0 6 141.84 8(1)-1.2 -28.98s9)

The mere existence of such asymmetries has been, and still is, the cause of much political discussion. The Constitution in its first supplementary provision states that “the Constitution protects and respects the historical rights of the *foral* territories”. However, it is unclear whether this provision actually calls for totally different financing rules. It has also been argued that it is not feasible to maintain such asymmetry in the long term as this will have a negative impact on the efficiency of the system. It would lead to increasingly divergent tax systems<sup>39</sup>. Furthermore, and more worryingly, this system ends up entailing that they do not share the full cost of the centrally provided services, which also implies their citizens are enjoying higher per capita public spending than the rest of the country<sup>40</sup>.

In fact, it is not the legal design but the way it has been implemented which has resulted in a situation where the current Basque Country and Navarra do not fully cover the central governments costs (both within the territory and as a pro rata share of other costs) relative to them. In that regard, C. Monasterio has pointed out that “As a way of decentralizing the Public Sector, oa.4(si.5(ms uee8.3(chectsF0001 Tces, wh57 Tw a)l72 (7 icinn.8ean.8ne)134(E)r56.8fecr()-6.9(ter)515t Dtir(tt

### 3.3 Sharing Taxes

1. The Spanish Constitution (sections 133 and 157) bestows taxation powers upon the fifteen Communities<sup>44</sup>. In accordance with the recognition of autonomy, or, stated more accurately, the recognition of the right to be autonomous, the Spanish Constitution grants Communities “financial autonomy for the development and execution of their authority” (art. 156)<sup>45</sup>. Apart from stating this principle of financial autonomy, the Constitution establishes a list of resources that will constitute the Communities’ income. This list includes almost all kinds of possible existing resources. Thus, they may obtain revenues from: ceded taxes; surtaxes on existing Central Government taxes; their own taxes; public debt; and transfers (section 157.1).

However, it also allows the Centre to approve a special “organic” law (*ley orgánica*) regulating both how the resources listed in section 157.1 will be distributed among Communities and the limits on the exercise of their financial power on the resources (i.e. whether and to what extent they may create new taxes, etc)<sup>46</sup>. This implies that the Central Government is given the power to both limit and control the financial autonomy of the Communities. In fact, soon after the Constitution p9727 s lyy yFom1aaees; tho

designing the main structure of the financing of the Autonomous Communities<sup>47</sup>. The Constitutional Court has also stressed this role of the LOFCA (Opinions 179/1985, 68/1996, 183/1988, among others) even if it has also underlined the relevance of the Statutes of Autonomy in the definition of the financing system (Opinion 31/2010) *within the framework of the LOFCA*<sup>48</sup>.

The LOFCA imposes severe limits on Communities' capacity to create new taxes. The most important limitation is the prohibition of double taxation (article 6.2 and 3), which prevents AC taxes from being similar to taxes created by the Central Government and the Municipalities. However, this limitation has been largely offset by the sharing taxes system, put into place in 1997, so that in practice, Communities have substantial taxing powers.

The original limitation of their tax powers has an obvious explanation; when the Constitution (1978) and the LOFCA (1980) were approved, both Municipalities and the Central Government had already established taxes on most of the possible sources of revenues, which has left little tax room for Communities. In fact, some of the attempts of Communities to establish their own taxes were declared unconstitutional by the Constitutional Court, on the basis of sections 6.2 and 6.3 of the LOFCA<sup>49</sup>. A recent reform of article 6.3 of the LOFCA has considerably eased the limit<sup>50</sup>. But so far Communities have not created any new taxes. It is not always clear whether it is the limitations on establishing new taxes or the unwillingness to withstand the political consequences of increasing the tax burden that has deterred Communities from creating new taxes, but the traditional existence of such limits underlines the importance of intergovernmental transfers in Spain. When the level of tax autonomy is so low, the possibilities for Communities to obtain their own resources are scarce, hence the need for transfers from the Centre. This situation also explains the substantial imbalance between the common-system Communities spending autonomy – which has been strongly supported by the Constitutional Court (case 13/1992, among other) – and their limited power to raise their own revenues.

2. There is a widespread view that to achieve a fundamental decentralization of powers, the sub-national tiers of government must be able to raise revenues in addition to the Central Government transfers they receive. That view holds that the transfer of at least some taxation powers to sub-national tiers of government is essential in order to achieve a certain level of political autonomy. This inspired the reforms undertaken

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<sup>47</sup> This idea at: Palao Taboada, C.: "La distribución del poder tributario en España". *Crónica Tributaria*, n. 52/1985, p. 184; Medina Guerrero, M.: *La incidencia del sistema de financiación en el ejercicio de las competencias de las Comunidades Autónomas*. Madrid: CEC, 1992, p. 342.

On the other hand, when the Constitution was approved there were no Autonomous Communities, so it would have been difficult to perfectly outline their financing system.

<sup>48</sup> The relationship between the LOFCA and the Statutes cannot be fully established ex ante. It depends on what type of authority the LOFCA and the Statutes are dealing with. For example, in the case of limits to taxes, the Constitution does bestow the LOFCA the authority to establish the limits within which autonomous Communities may operate.

<sup>49</sup> Organic laws, such as the LOFCA, that refer to how authority is distributed in Spain have a particular status in the process before the Constitutional Court



in 1996, when there was a fundamental change in the financing system of Communities along these lines. Some taxes traditionally belonging to the Centre, and including the personal income tax, were transformed into shared taxes (ceded taxes or *impuestos cedidos*) in 1997, substantially increasing the taxing powers of Communities. Subsequent reforms in 2002 and 2009 have further increased Communities' powers over these taxes<sup>51</sup>.

The main goal of these reforms was to make Communities more involved in the establishment of taxes and thus more directly accountable to their taxpayers for the monies they spend. Simply put, the reforms consist of the sharing of some tax room that until then had been occupied solely by the Centre. This has been done through a type of resource called a 'ceded tax'. Until 1997, ceded taxes were Central Government taxes whose yield was granted to Communities according to the taxes paid within each AC's territory (derivation principle). Due to powers delegated by the Centre, Communities had also taken on the responsibility for administering and collecting these taxes. Ceded taxes were, therefore, virtually a kind of transfer, by which some of the taxes 'owned' and until 1997 regulated exclusively by the Centre accrued to, and were administered by, the Communities. They differ from transfers in that the Communities may receive a 'bonus' in some cases. Thus, if the actual yield of the tax is greater than what had been forecasted by the central government, the AC receives the difference. If the yield is less than the forecast, the Community still receives the initially forecasted amount. However, an increase of the yield may or may not be a consequence of better tax administration; for example, it may be merely due to economic conditions<sup>52</sup>. Therefore, this bonus only partially serves as an incentive for Communities to administer ceded taxes more efficiently. On the other hand, the Communities' decision-making powers over these kinds of taxes were, previously, almost non-existent.

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<sup>51</sup> The latest reform, which entered into force on January 1<sup>st</sup> 2010 (although most of its provisions actually

Ceded taxes thus changed substantially following the 1996 reform (which entered into force in 1997). The reassignment of taxation powers resulting from the shared taxes mechanisms constitutes the most important tax reform since the State of Autonomies became a reality. Under the new system, common-system Communities have substantially increased their taxation powers. Although the gap between the powers of the *foral* and common-system Communities remains quite large, it has certainly been reduced by the reform. If the tendency continues, the possibility that the two systems end up converging should not be completely ruled out. Such convergence derives mainly from the common-system Communities' newly acquired taxation powers.

Until 1997, only *foral* Communities could pass legislation and control some of the main taxes of the system (such as the personal income or the corporate income taxes). Since then, common-system Communities have gradually gained access to most important tax bases (and rates), excluding corporate income taxes. Although the gap is still wide, considering that common-system Communities can only regulate certain aspects of some of these taxes while *foral* Communities may regulate most elements of the said taxes except for certain aspects, the tendency is towards a degree of convergence. However, when we compare the powers that the common-system and *foral* Communities hold on the main taxes of the taxation system, it is clear from the following table that a profound asymmetry prevails.

Communities may now regulate certain aspects of the personal income tax, the wealth tax, the death and gift taxes, stamp duty and gambling taxes. The use of those powers by Communities is entirely another story. In fact, because Communities do not actually use their powers, at least not extensively, I submit that ceded taxes often work, *in practice*, as a type of transfer. Technically of course, in budgetary terms, they are classified as Communities own taxes. It is the lack of fiscal responsibility, or generally the lack of interest shown by Communities to actually employ their taxing powers to increase their revenues that make them similar to a transfer.

Until 2009, if an AC failed to do so or decided not to exercise such powers, there would be no consequences; the Central Government would continue to regulate every aspect of these taxes in that AC, so it would not lose any revenue by failing to legislate. If an AC were to decide to pass legislation modifying the above-mentioned authorized aspects over any ceded tax, it could do so by enacting legislation which would then substitute for Central Government law, in those areas where the AC has the authority to legislate.

The way that this option was structured – and the fact that the Central Government still guarantees to Communities lump-sum grants allocated on the basis of historical shares in its transfers, *regardless of whether they exercise their powers or not* – served to create a strong disincentive for Communities to use their new taxation powers.

Starting in 2011 the Central Government does not regulate the *ceded* part of the tax any longer. Hence “lazy” Communities will lose their revenue if they fail to legislate. This was a central government's initiative, as no Community has asked for this. It is supposed to reinforce fiscal responsibility, if only by *forcing* Communities to exercise their powers. However, most Communities have (even with the current crisis) merely

used their powers to copy the Central Government's legislation in the same exact terms, which is why I submit that ceded taxes remain a form of transfer.

**Table 2: Autonomous Communities powers on ceded taxes (2009)**

Ceded Taxes	AC share (%)	Administration	Legislative Powers that Communities <i>must</i> assume
Personal income tax	50	State	Tax rates (must have same number of tax brackets as the State tax) Tax credits, under certain conditions Personal deductions
<i>Wealth tax (repealed in 2009, reestablished in 2011)</i>	100	<i>Communities</i>	<i>Tax rates</i>



those Communities whose bargaining position was weaker would get less money to exercise the powers that fall within their scope of authority<sup>55</sup>.

The new financing system for Autonomous Communities that entered into force in 2009<sup>56</sup> was approved at a difficult economic conjuncture for Spain. With the end of the housing bubble and the abrupt end of construction activity, national unemployment hit 20 per cent (July 2011 data), and according to official reports, there is no real hope for recovery before two or three years<sup>57</sup>.

The 2009 system follows the traditional formula applied since 1997, by which the total financing that a Community needs (or is entitled to) is calculated and then different resources are added to arrive at the figure. Roughly put, there are two general sources of revenue that stem directly from the financing system established by the central government. These two sources are a mix of transfers and revenue from ceded taxes – both taxes administered by the Centre and the Communities. Other revenues that Communities may have, such as those deriving from own taxes, are not part of the formula. This is, or should be, an advantage, to the extent that Communities may increase their own revenues by establishing new taxes. However, the political cost of such a measure has generally prevented own taxes from being a significant source of revenue.

The said two sources are the following<sup>58</sup>: revenues that are received on an annual basis and revenues that are received periodically, and adjusted once all the data is known. The first group is formed by ceded taxes which are administered by Communities. The second, much larger, type of source is a mix of ceded taxes revenue (which are administered by the central government) and transfers that intend to equalize revenues on the basis of different needs criteria (population, age of population, etc). The second source may be negative or positive, that is, a Community may be forced to return part of the revenue obtained from the Central Government from the lump sums (*Fondo de Garantía* and *Fondo de Suficiencia Global*) of transfer schemes that are designed to equalize the fiscal capacity of Autonomous Communities. In July 2011 the Consejo de Política Fiscal y Financiera and the Ministry of Economy publicly announced the final data of tax revenues for 2009 (the first year this new system was applied). Because of the crisis, tax revenues, in particular in income taxes, have considerably decreased, which has resulted in the need for many Communities to pay back to the Central Government part of the transfers they received as an advance.

The financing formula first determines the amount that each Autonomous Community is entitled to receive in a given fiscal year. That needed amount or “total financing” (the law calls it “*Necesidades Globales de Financiación*” -NGF) is established for each Community (see below, Table 4).

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<sup>55</sup> León-Alfonso, S.: *The Political Economy of Fiscal Decentralization. Bringing Politics to the Study of Intergovernmental Transfers*. Barcelona: Instituto d’Estudis Autònoms, 2007.

<sup>56</sup> The system was established by two laws: Organic Law 3/2009, which reformed the LOFCA and the above mentioned Law 22/2009.

<sup>57</sup> See the latest report from the Ministry of Finance in Spain, at: <http://serviciosweb.meh.es/apps/dgpe/TEXTOS/SIE/siepub.pdf>.

<sup>58</sup> Santiuste Vicario, A.: “La aplicación práctica del sistema de financiación de las Comunidades Autónomas de régimen común regulado en la Ley 22/2009, de 18 de diciembre”. *Presupuesto y Gasto Público*, 62/2011, pp. 101-117.

The figure will depend on a number of factors, a main one being what the Community had been receiving before (what revealingly is called “total Status Quo”, Table 4), but also other elements such as how scattered the population is or whether the Community has an own language that deserves to be protected (Catalonia, Galicia, Valencia and Balearic Islands fall in this group). The goal is that all the services that are now rendered by the Communities (and in particular the most expensive, Health and Education, which in 2001 became almost entirely the Communities’ responsibility) can continue to be rendered with roughly the same standards as before, as well as with a minimum across the country.

This is actually a consequence of article 149.1.1<sup>a</sup> of the Spanish Constitution, which mandates the Central Government to regulate “*basic conditions guaranteeing the equality of all Spaniards in the exercise of their rights and in the fulfillment of their constitutional duties*”. Furthermore, the Constitution also mandates that certain equality (not uniformity) must be achieved and that the Central Government is in charge of guaranteeing that equality at least at the margin. While Section 137 establishes that “*The State is organized territorially into municipalities, provinces and the Self-governing Communities that may be constituted. All these bodies shall enjoy self-government for the management of their respective interests*”, Section 138.1 establishes that “*The State guarantees the effective implementation of the principle of solidarity proclaimed in section 2 of the Constitution, by endeavoring to establish a fair and adequate economic balance between the different areas of the Spanish territory and taking into special consideration the circumstances pertaining to those which are islands*”. Furthermore: article 138.2 states that “*Differences between Statutes of the different Self-governing Communities may in no case imply economic or social privileges*”. According to section 139 “*All Spaniards have the same rights and obligations in any part of the State territory*”. The financial consequences of these provisions are contemplated in article 158 of the Constitution, which establishes that “*1. An allocation may be made in the State Budget to the Self-governing Communities in proportion to the amount of State services and activities for which they have assumed responsibility and to guarantee a minimum level of basic public services throughout Spanish territory*” and that “*2. With the aim of redressing interterritorial economic imbalances and implementing the principle of solidarity, a compensation fund shall be set up for investment expenditure, the resources of which shall be distributed by the Cortes Generales among the Self governing Communities and provinces, as the case may be*”.

These constitutional mandates are reflected in the different types of transfers designed into the system<sup>59</sup>. I will dedicate the following lines to the general outline of the system, leaving out the specifics of the different funds, as well as the special equalization scheme that results from article 158.2, which is regulated in a specific law<sup>60</sup>.

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<sup>59</sup> See, in detail: Zabalza, A. and J. López Laborda, “The new Spanish system of intergovernmental transfers”, *International Tax and Public Finance* (2011) 18: 750-786.

**Table 4: Global financing needs (*Necesidades Globales de Financiación*)**

Community	Total "Status Quo"	Resources to keep the Welfare State	Scattering of Population	Low density of population	Special language (Catalan, Galisian...)	Total additional resources	Global financing needs
	(1)	(2)	(3)	(4)	(5)	(6)=(2)+(3)+(4)+(5)	(7)=(1)+(6)
Cataluña	15.214.740,10	951.399.58	0,00	0.00	97.957,56	1.049.357,14	16.264.097,24

Going back to the "Global Financing Needs" (GFN), the 2009 system added new elements to the formula, making it a very expensive system<sup>61</sup>. Before then, only an updated "status quo" would be taken into account. The new system attempts to link the GFN to different criteria that may significantly make the provision of services, in particular Health and Education, more or less expensive. With that purpose, new specific funds have been added to the formula. These funds are to be distributed unevenly among Communities, depending on how much they need. That specific need is assessed through a mix of criteria. Thus, elements such as population, its age distribution, the total surface of the Community and how scattered the population are taken into account just to determine the GFN or amount every Community should achieve. These new funds are revealingly named "Resources to keep the Welfare State".

<sup>61</sup> As pointed out at Zabalza, A.; López-Laborda, J.: "The new Spanish System of intergovernmental transfers...cit.

The distribution of the GFN among Communities can be seen in Table 4<sup>62</sup>. A second step of the system is to define what types of resources will form part of the Global Sufficiency Fund (see Table 5).

**Table 5: Global sufficiency fund for 2009**

Autonomous Community	Global Financing Needs 2009	Taxing Capacity 2009 (ceded taxes)	Transfers from a Guarantee Fund 2009 (Health, mainly)	Global Sufficiency Fund 2009
	(1)	(2)	(3)	(4)=(1)-(2)-(3)



**Table 6: Communities with per capita GDP lower than 90 per cent of the average (thousands of euro)**

Autonomous Community	GDP 2007 (thousands of euro)	GDP 2008 (thousands of euro)	GDP 2009 (thousands of euro)	Population 2007	Population 2008	Population 2009	Average GDP per capita Last 3 years	Communities that will benefit
	(1)	(2)	(3)	(4)	(5)	(6)	$(7) = [(1)+(2)+ (3)] / [(4)+(5)+(6)]$	
<b>Cataluña</b>	197.166.994	202.695.024	195.644.827	7.166.031	7.270.468	7.288.071	27.411,67	
<b>Galicia</b>	54.107.607	56.220.304	54.857.447	2.728.772	2.738.098	2.737.034	20.134,97	<90% average
<b>Andalucía</b>	144.949.006	148.915.411	142.994.677	7.989.013	8.105.608	8.177.351	17.998,50	<90% average
<b>Principado de Asturias</b>	22.936.864	23.736.703	22.725.577	1.058.743	1.059.089	1.057.145	21.858,16	
<b>Cantabria</b>	13.347.745	13.888.906	13.346.291	567.088	573.758	577.885	23.612,15	
<b>La Rioja</b>	7.762.984	8.037.214	7.843.401	309.360	313.772	316.341	25.166,87	
<b>Región de Murcia</b>	27.100.446	28.164.464	27.182.448	1.392.368	1.430.986	1.452.150	19.283,66	<90% average
<b>C.Valenciana</b>	102.478.051	105.833.509	101.793.151	4.824.568	4.950.566	5.019.138	20.961,13	
<b>Aragón</b>	32.906.696	34.071.768	32.497.506	1.286.285	1.306.631	1.318.923	25.429,46	
<b>Castilla-La Mancha</b>	35.729.134	36.857.370	35.784.888	1.951.388	2.001.643	2.017	2.001.643	2.a

This means that, to a certain extent, the system also provides for inter-regional equalization, with richer Communities partly financing poorer Communities. This is also often contested. Of course any tax system –and the current financing model is largely based on taxes- as well as any redistribution or equalization scheme will produce that result. Whether or not it should be accepted is another matter, and the ultimate answer, largely ideological<sup>64</sup>.

In 2009, new specific balancing transfer systems were introduced. The new types of transfers were intended to equalize AC public revenues and guarantee the provision of “essential public services”, or services related to Education, Health and other Social Services (support for the elderly, etc.). The cost of these transfers has considerably increased, especially in Communities where immigration growth has been quantitatively relevant (such as Madrid and Catalonia, among others).

This final set of transfers is designed to further equalize resources between Communities, not on the basis of the authority that they have but on the basis of a number of elements that set them at a disadvantage. These two “Convergence Funds” (*Fondos de convergencia*) are the “Cooperation Fund” (*Fondo de cooperación*) and the “Competitiveness and Compensation Fund” (*Fondo de competitividad y convergencia*). The criteria that set the relevant amounts revolve around the per capita income, scarcity of population, growth of population and per capita tax capacity (which is a criterion not unrelated to income).

As can be seen in Table 6, taking the most revealing indicator, the per capita income<sup>65</sup>, six Communities have benefited from the “Cooperation Fund”, as they had a per capita income “less than 90 per cent of the average”; see following table (Galicia, with a per capita income of 20,134 euro, Andalusia, 17,998, Murcia, 19,283, Castilla La Mancha, 18,089, Canary Islands, 20,415 and Extremadura, 16,556. By contrast, the richest Communities, in terms of per capita income, are Madrid (30,513), Catalonia (27,411), La Rioja (25,166), Aragón (25,429) and the Balearic Islands (25,217).

When the final results of the system for 2009 were revealed last July 28<sup>th</sup>, 2011, as all the final data on the yield of the different

**Table 7: Final results of the financing system (2009)**

ACs	1.PIT revenues	2.VAT revenues	3.Excise revenues	4.Transfer from the Guarantee Fund	5.Global Sufficiency Fund	6.Final results 2009 resources	7.Global convergence funds	6 + 7	9.Advanced funds
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## 4. SHARING THE DEFICIT

### 4.1 Economic Situation and Growth of Deficit and In-Debtment

The current economic crisis has forced Spain to adopt a number of measures that should prevent the need for a European bail-out<sup>66</sup>. With a 20 per cent unemployment rate and a total deficit larger than the agreed ratio to GDP in the European framework, to name just two indicators, further measures may be needed.

Even if Spain does not have a debt / deficit problem greater than other EU members, there is a strong credibility problem, which is the main reason why the system should be reformed.

A mild reason for optimism is that foreign direct investment (FDI)<sup>67</sup> is slowly beginning to grow again, after falling sharply in 2009. In fact, in 2010 there was an increase of 41.5 per cent, with a total volume of €23,415 million. However, it is

<sup>66</sup> Among the most controversial, a decrease of public servants salaries of between 5 and 15 per cent and the increase of the general rate of the Value Added Tax from 16 to 18 per cent.

<sup>67</sup> See latest official data at: "Note on 2010 inward FDI data – Investment Registry, March 2011", available at:

<http://www.investinspain.org/icex/cma/contentTypes/common/records/viewDocument/0,,00.bin?doc=4469127> (access on 27.June.2011).



economic crisis has brought to the political forefront a debate that was almost non-existent outside expert circles.

In 1992 the Treaty of Maastricht made the limitations on debt (60 per cent) and deficit (3 per cent) a prerequisite to enter the “third phase” of the common currency. The 1997 “Stability and Growth Pact” (SGP) and several Rulings by the Commission set strict rules, which until 2005 included sanctions, for those Member States that did not comply with the limitations. The Pact reflected a widespread consensus, consolidated during the late 1980s and 1990s, on the wisdom of curbing excessive deficits. While the tendency towards excessive deficits is almost a structural feature of democratic governments, when they occur, a number of disadvantageous economic consequences are bound to ensue, such as higher interest rates or a higher debt burden that will have to be passed onto future generations by means of higher taxes, social security fees, etc. On the other hand, public expenditures tend to consolidate and to grow, while a sometimes organized resistance to pay higher taxes curtails the possibilities of revenue growth<sup>71</sup>. Of course, the main problem is also part of the solution, which is that the best way to secure compliance in policy is a genuine belief from policy-makers. But even if governments and decision-makers share this conviction, the question at stake is why would governments comply if the costs of failing to do so can be transferred to the whole EU. This explains the codification of the Pact.

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**Table 9: Stability objectives (deficit projections) for 2012-2014**

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	2010	2011	2012	2013	2014
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to impose these limits to sub-national entities without the constant claim that it may limit their autonomy.

Second, the reform also limits debt, not just the deficit. Thus, section 135.3 establishes that the total in-debtment may never be higher than that established in European law. Again, not a radical reform but good news that it is now enshrined in the Constitution.

Third, the reform does have elements of flexibility:

A first element is that the numbers will be established in an Organic Law, which is easier to change than the Constitution. It has been announced that this law will be approved before the June 30<sup>th</sup>, 2012, and that there is already agreement (between the two main political parties) on its content. According to press releases (as reliable as they can be) the new Organic Law, to be approved before next



of the State's Public Debt, a matter that was then, and still is, for that part has not been modified, completely outside the democratic debate. Even if both the Government and the Parliament "forgot" to include the necessary credits to repay the public debt in the budgetary document, they would still be automatically included.

It is remarkable, in my view, that article 136 has not been amended. This article refers to the Auditing Court (*Tribunal de Cuentas*), a totally independent body, accountable



## 5. CONCLUSIONS

The decentralization process in Spain has been remarkably swift and, generally speaking, quite successful. Authority has been devolved to Communities in an orderly fashion and this new tier of government has been well accepted by citizens.

Nonetheless, far too many issues remain unresolved. Among others, the level of fiscal responsibility is insufficient. Despite the significant reallocation of taxation powers, the system is still largely based on the assessment of need by the Central Government and the allocation of funds according to that need. Furthermore, and to a large extent the basic formula of the system guarantees funds to Communities without sufficiently taking into account their fiscal responsibility, whether they decide to establish new taxes or increase tax pressure in order to obtain more funds, and regardless of whether they control their indebtedness and deficits. Indeed, the law prescribes that all

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