Taxes, transfers and spending in Spain: the regions and the centre seek the right balance

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Spain is in the process of decentralizing its fiscal system to give more power and responsibility to the Autonomous Communities. (*)

In July 2001 the central government and the Communities of Spain agreed to expand and broaden the scope of what the Spanish call "ceded taxes." This was the second phase in a reform that started in 1996.

The main objective of that original reform was to make the Communities as responsible for the money they raised as they already were for the money they spent – thus decreasing what in fiscal federalism literature is known as "vertical fiscal imbalance." (This occurs when the revenues of one order of government do not correspond to its expenditure responsibilities. Frequently this imbalance takes the form of central government revenues exceeding its legislative and executive responsibilities while the constituent units' revenues are inadequate for their responsibilities.)

Until the 1996 reform, ceded taxes had been taxes levied by the central government whose yield was "ceded" or granted to Communities according to the amount raised in each community. In effect, ceded taxes were a kind of *transfer*, by which some of the central government's taxes were collected and administered by the Communities.

The 1996 reform contained a number of important provisions. First, the Personal Income Tax became a ceded tax – albeit only partially. Second, the central government gave to Communities the power to regulate some aspects of these taxes. The Communities gained control over such matters as tax brackets, tax rates and some tax credits.

Centre still has ultimate authority

The means of transferring this authority was what the Spanish call "a *delegation* of legislative powers" from the central government to the Communities. Unlike the constitutions and established practices of most other federations, the Spanish Constitution permits this sort of "delegation." But because the central government only delegates powers that are still in principle its own, it can both control how the Communities exercise those powers and, perhaps more important, revoke them at any time it chooses.

It is generally agreed, however, that if the central government were to actually try to exercise its power of revocation it would create great stress on the relations between the two tiers of government. For this reason, the new powers of Communities regarding ceded taxes are seen by most as being virtually permanent.

Following the reform, the yield from ceded taxes still accrues to each Community on the basis of taxes paid by its own taxpayers. But now, should a Community exercise its new legislative powers, the yield will be the result of the Community's own taxing autonomy. What until 1997 had been a form of *transfer* became a form of *tax sharing*.

The 2001 reform expanded the Communities' legislative powers and added to the list of taxes that could be ceded to them.

There are a great many different kinds of ceded taxes, ranging from the personal income tax to death and gift taxes to gambling taxes. Depending on the tax, the yield totally or partially accrues to Communities, which may or may not take on legislative powers, and may or may not be in charge of the tax's administration.

In fact, the powers that Communities have vary so widely, depending on the tax, that in some cases the ceded tax still operates as a mere transfer (for instance, in the case of the value added tax). In other cases, the broad scope of the powers granted makes the ceded tax something very similar to an autonomous tax (for example, in the case of gambling taxes).

From dictatorship to a gradual federalization

When Spain developed a democratic constitution in 1978, following the death of Franco, it provided for the formation of the distinctly Spanish entities known as Autonomous Communities. Regions could opt for a status similar to that of constituent units in other federations – or they could choose not to assume that status. What happened in practice was that all of the regions in Spain decided to assert their autonomy and the whole country is now divided into these Communities.

The Constitution does not define Spain as a federal state. Actually, it does not define the form of the state at all –

*** Note:** Spain is divided into 17 Autonomous Communities. What is said in the discussion in this article does not apply to the Basque Country and Navarra which, according to the Constitution, have special status (i.e. more autonomy), implying different taxation powers than apply to the rest of the Communities. The commentary in this article also does not apply to the two Autonomous Cities (Ceuta and Melilla), since they do not have legislative powers. The Canary Islands also have a special tax regime in some aspects (i.e. no Value Added Tax), but it does not differ greatly from the general system, so they do have most ceded taxes.

after Franco's centralized government, consensus on this matter was anything but easy to obtain. But it is generally agreed that, given the broad scope of its decentralization, Spain is in practice a federation.

In the years immediately following 1978 the Communities were financially dependent on transfers from the central government. They did not levy their own taxes to any significant extent.

This was not a problem, in part because during that period many Spaniards tended to regard the Communities with certain distrust. In fact, voters rejected Community efforts to establish their own taxes — as happened in the Community of Madrid, in 1987.

But, as time passed, the Communities gradually gained more authority and their financial needs grew. This resulted in a gradual expansion of the transfer system, and more financially dependent Communities.

Soon, debates about the Communities' fiscal responsibility became one of the main characteristics of the relationship between the central and Community governments. By the end of the eighties, some Communities were ready to play a more active role in taxation policy. In fact, they established new taxes.

The central government did not always accept such taxes and was unwilling to give up its *de facto* taxation sovereignty. It challenged some of these new taxes in Spain's Constitutional Court. The war on the sharing of taxes had been declared and it became obvious that there was a need to reassign taxation powers. The fiscal reforms of 1996 and 2001 were a way to buy peace between the centre and the regions and to get the Communities to take greater responsibility both for spending and for collecting revenue. Many doubt whether that purpose has yet been achieved.

The reforms have not yet delivered the hoped-for results

Autonomous Communities are given the option to choose whether they want to exercise their regulatory powers. This is coherent with the so-called "optional autonomy system" in the Spanish Constitution, by which each Community may decide what powers and authorities it wants to take on.

But the way that this option has been structured – and the fact that the central government still guarantees Communities lump-sum grants allocated on the basis of what they have historically received – serves to create a strong disincentive for Communities to use their new taxation powers.

Proof of this disincentive is the fact that, since 1997, Communities have mainly used their powers to create new fiscal benefits – assuring that they will be seen by taxpayers as the "Fairy Godmothers" who offer services to citizens without asking for money in exchange, while the taxing role of the "Wicked Stepmother" is played by the central government.

So although there has been a reassignment of taxation powers, and Communities now have more room than they ever had for designing their own taxation policies, they still prefer to rely mainly on transfers from the central government.

In the year 2000, conditional and unconditional transfers still represented roughly 60% of the Communities' total revenues while the yield derived from ceded taxes represented 25%. However, if we take into account that most ceded taxes act as "transfers" (where the Communities do not exercise any regulatory powers on the tax rates), transfers from the central government still represented, in the year 2000, the overwhelming bulk of the Communities' total revenues. Given that the Communities spend about 40% of total expenditure – while collecting only about 15% of the revenue — many observers argue that there is something askew in the fiscal system of Spain.

If one of the reasons for the reform was to increase the Communities' fiscal responsibility and make them more accountable to taxpayers for the money they spend, it has failed to attain its goal. It remains to be seen whether the latest increase of Community taxation powers will help to change this situation.

Most knowledgeable observers think that it will not, since the incentive problems just described remain largely the same in the laws putting the new agreements into practice.

The distribution of taxation powers in the Spanish Constitution

The constitution gives Autonomous Communities taxation powers (sections 133 and 157) but the central state can limit them through a special law (section 157.3). The central government made use of this power as early as 1980 by approving the *Autonomous Regions Finance Act.* This law imposes severe limits on the creation of new taxes by the Communities. The most important is the prohibition of double taxation, which prevents autonomous taxes from being similar to central state and municipal taxes. Since these two bodies had already established taxes on most of the imaginable sources of revenue, little tax room was left for Communities. Moreover, the Constitutional Court has interpreted these limits broadly, making it almost impossible for Communities to invent new taxes.

Therefore, despite constitutional provisions that guarantee Communities both the power to establish taxes and financial autonomy (section 156.1), the limits established by the central state have led to a system where taxation powers remain mostly in its own hands.