

Spain: Redefining Fiscal Equalization and Fiscal Relations

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The democratic Constitution of 1978 opened a process of political and fiscal decentralization in Spain which led to the formation of three orders of government - as opposed to the two orders, central and local, operating prior to 1978. With the new Constitution, and thanks to the pressure of leading regions like the Basque Country and Catalonia, 17 “Autonomous Communities,” or states, with legislative and executive powers were created between 1979 and 1983. This gradual process of decentralization, beginning with the Constitution of 1978, has been successful in areas of spending and revenue collection; however, other aspects seem unfinished, specifically in the areas of fiscal responsibility, fiscal equalization, and fiscal relations.

In 2003, the expenditures of the Autonomous Communities accounted for approximately 35 percent of total public spending, including social security. This is a sharp rise from 1978 when the states had yet to come into being. As early as 1982, some state governments like those of Catalonia and the Basque Country were already providing education, health, and policing services and by 2002 all Autonomous Communities provided these services, except personal social services, road maintenance, and other less costly services.

Today, citizens view Autonomous Communities as service providers but without the mandate of tax collectors. The consequence of this perception is that state parliaments do not use the full extent of their taxing powers, with the exception of introducing tax credits or lowering tax rates. **This reticence to use full powers suggests a lack of fiscal maturity and fiscal responsibility on the part of state governments and voters, and some impetus is sorely needed in order to increase fiscal accountability, resist the pressure of citizen demand for more services, and balance state budgets.**

At the state order there are two financial systems: the “common,” applied to 15 Autonomous Communities, and the “special,” applicable to the Basque Country and Navarre, both of which have enjoyed special status for centuries. For instance, the Basque Country and Navarre possess greater powers concerning devolved taxes - notably with regard to the corporate tax. This fiscal asymmetry has created a peculiar situation: in instances in which there is competition to attract a company to set up operations in a particular area, governments with a special regime can introduce attractive tax credits or a reduction of tax rates in corporate or personal income tax, leaving the neighbouring Autonomous Communities unable to compete because of their own inadequate taxing power. The result is that companies choose to set up in the states with a special regime.

The common regime is regulated by the Basic Finance Law of Autonomous Communities (*LOFCA*) which was approved in 1980. Under the Basic Finance Law, some taxation powers have been devolved to Autonomous Communities, and there are established tax-sharing, revenue-sharing, and equalizing grants. Since 1997 all Autonomous Communities have a personal income tax – established on the tax base of the central government’s personal income tax, share both Value-Added Taxes according to state consumption, and excise taxes. In addition, Autonomous Communities possess “devolved taxes” (e.g., wealth tax, property transaction tax, inheritance tax, stamp duties, gambling tax, etc.) with the power to vary tax rates, tax credits, and even some tax bases. They also have power to raise surtaxes on devolved taxes and to create new taxes in tax fields not used by the central government.

Some Autonomous Communities have recently started a “race to the bottom” by competing with each other to lower inheritance tax rates. This dangerous race may result in the state abolition of the tax and the loss of the tax base, as happened in Canada and Australia in the 1970s. A central inheritance tax with minimum tax rates, wherein state inheritance taxes could be deducted as a tax credit, could act as a safety net and solve the present tax competition. However, no state government has dared to assert this idea.

The financial system of the 15 Autonomous Communities with a common regime contains an explicit mechanism of equalization. This consists of an equalizing grant that balances tax capacity and needs. The equalizing formula has evolved through different reforms, but the explicit criterion of horizontal equity among jurisdictions has never been defined. Furthermore, the goals of “need” and “capacity equalization” have never been specifically designed by the central parliament. While the present system of state finance has a high level of equalization among the 15 Autonomous Communities under a common regime, the equalizing formula is clearly biased in favour of relatively poorer governments.

In any federal country, the per capita tax revenue – including tax sharing revenue – varies between state units because tax bases and tax capacities differ significantly. The role of equalizing grants is precisely to reduce these fiscal differences, not necessarily to eliminate them, and certainly never to create new discrepancies in the opposite order. The formula that determines the unconditional equalizing grant, the so-called *Fondo de Suficiencia*, is designed in such a way that the final per capita revenue is often higher in poorer Autonomous Communities than in wealthier ones. In other words, the equalizing grant not only reduces differences in standard per capita tax revenues of Autonomous Communities, but it changes the order of the Autonomous Communities according to total per capita revenue in the basic model. Outside the basic model there are yet other grants: investment grants for development purposes from the central government and the European Union, that only benefit the 10 poorest states.

There were reforms to some statutes in the 1990s and there is a new wave of reforms currently being led by Catalonia, a comparatively wealthy state. In its proposal for asymmetries in fiscal powers, it established a bilateral relation with the central government and a new criterion of equalization. Any gains in Catalonia may well have a “domino effect” and be adopted by other Autonomous Communities. Further asymmetric fiscal powers are unlikely to be agreed upon with the central government, but it is expected that a new criterion for equalization grants will soon be adopted. Any equalizing target must be compatible with some level of efficiency in terms of giving incentives to governments to increase the state tax base by increasing the state economy. This financial reform, whenever it does take place, will result in a more federal and less unitary financial system.