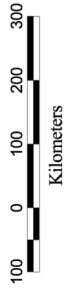
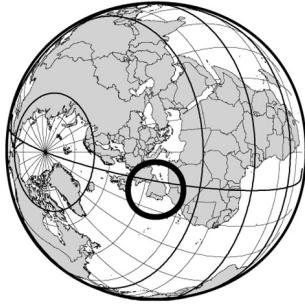


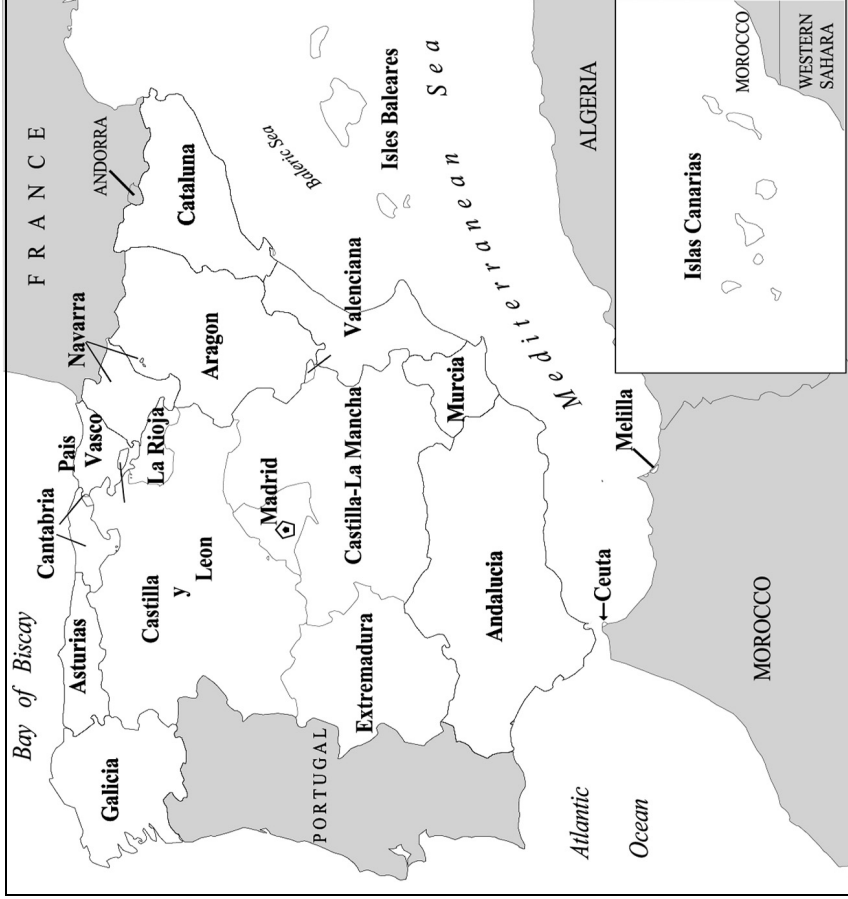
Spain

Capital: Madrid
(Madrid Province)
Population: 40 Million
(2001 est.)

Boundaries and place names
are representative only and do
not imply any official endorsement



Sources: ESRI Ltd.; CIA World Factbook;
Times Atlas of the World



Kingdom of Spain

JULIO LÓPEZ-LABORDA,
JORGE MARTÍNEZ-VÁZQUEZ,
AND CARLOS MONASTERIO*

The Kingdom of Spain, defined in the 1978 Constitution as a parliamentary monarchy, is a unitary country with most of the features of a federation. Currently, Spain's population of a little over 44 million, and its territory covers 505,997 square kilometres, incorporating the mainland in the Iberian Peninsula plus the Balearic and Canary Islands and the North African city-enclaves of Ceuta and Melilla (see Table 1). The official language is Castilian (Spanish), which is co-official with Catalan, Euskera, and Galician in the communities in which these languages originate.

Historically, Spain emerged from a process that involved the unification of different kingdoms and territories and culminated in the later part of the fifteenth century. Its constituent units, often identified with significant geographical and climatic differences, had and continue to have strong cultural identities, including different languages. Spain's historical legacy is crucial in understanding that country's strong demands for self-government and fiscal decentralization. In the last quarter of a century, Spain was transformed from one of the most centralized countries in the world at the time of General Francisco Franco's death in 1975 into one of the most decentralized. Spain's historical legacy is also the fundamental reason that the Spanish Constitution adopted an asymmetric system of intergovernmental finance whereby, as we will see below, two regions (the Basque Country and Navarre) have a fiscal framework that is completely different from that of the rest of the regions. The fast pace of reform displayed by Spain's fiscal federalism is influenced in many ways by these historico-political issues.

Table 1
Basic political and geographic indicators

Official name: Kingdom of Spain
Population: 43,398,190
Area (square kilometres): 505,987
GDP per capita: 20,864 euros (2005)
Constitution: Parliamentary monarchy
Orders of government: Three
Constitutional status of local government: Yes
Official languages: Castilian (Spanish), which is co-official with Catalan, Euskera, and Galician in the communities in which these languages originate
Number and types of constituent units: 17 Autonomous Communities (as the regional governments are called), two Autonomous Cities at the intermediate level, and 50 provinces and 8,109 municipalities at the local level
Population, area and per capita GDP of the largest constituent unit: Andalusia, with a population close to 8 million, an area of 87,597 square kilometres, and a per capita income of 16,196 euros (in 2005)
Population, area and per capita GDP of the smallest constituent unit: La Rioja, with a population of 297,000, an area of 5,000 square kilometres, and a per capita income of 22,326 euros.

The current vertical organization of government includes, besides the central government, 17 Autonomous Communities (as the regional governments are called), two Autonomous Cities at the intermediate level, and 50 provinces and 8,109 municipalities at the local level. The Constitution explicitly recognizes the existence and right to self-governance of local governments and the Autonomous Communities.¹ Although the Autonomous Communities have some regulatory powers over the local governments, the structure of government and the fiscal system is not essentially hierarchical. Local governments have their own sources of revenues and receive transfers directly from the national government in what we may refer to as a bifurcated system of finance. Under this system, the national government deals directly with the intermediate level and the local level governments, and there are minimal fiscal relations between intermediate and local governments.² Overall, the very significant decentralization thrust of the past twenty-five years has benefited the intermediate level of government – the Autonomous Communities, which have gone from not existing to representing 36 percent of the consolidated public sector.³

The Autonomous Communities are the fastest-growing level of government, with total expenditures financed largely by transfers from the central government and mainly focused on health and education – the two largest components of total public expenditures after pensions.

Meanwhile, local government budgets have continued to represent 13 percent of total expenditures, very close to what they represented at the start of the decentralization process a quarter of a century ago. The fact that the decentralization process has been dominated by the devolution of competences and revenues to the Autonomous Communities has led many observers and political forces in Spain to talk about the need for a “second decentralization,” which would be focused on local governments.⁴

The level of political accountability is relatively high as all government representatives are democratically elected and responsible to their respective constituencies. At the same time, there is a significant civil society presence; however, there are no important elements of direct democracy.⁵ The Constitutional Court handles disputes between different levels of government. At the national level, there are two dominant political parties positioned at the centre-right and the centre-left, but regional parties, especially in Catalonia and the Basque Country, have played key roles in their regions and as coalition members in the national Parliament.

Over the past twenty-five years of rapid decentralization, Spain enjoyed high rates of economic growth and prosperity, spotted with unusually high rates of unemployment associated with rigidities in labour market institutions. In 2005, GDP per capita was \$25,500. Over the same twenty-five-year period, Spain underwent a considerable increase in tax effort. In 1975, total tax revenues as a percentage of GDP stood at less than 20 percent. By comparison, at that time, the average OECD country was collecting 31 percent of GDP in tax revenues. By 2002, Spain had converged upon the OECD average, with total tax revenues representing over 35 percent of GDP. Over the past quarter century, the increases in real GDP and the considerably higher presence of the public sector in the economy allowed a significant jump in the provision of public services at all levels of government.

THE ASSIGNMENT OF RESPONSIBILITIES

The Constitution addresses the fundamental division of responsibilities across different levels of government. Table 2 shows the current assignment of responsibilities.⁶ The actual assignment has evolved over the years, with the Autonomous Communities taking on responsibility for the provision of a wide range of public services of a regional-local nature, including most health and education services. For example, the full devolution of health care responsibilities to regional governments took place only in 2002.

An interesting aspect of the devolution of responsibilities in Spain is that it has been asymmetrical. Originally, and mostly for historico-political reasons, only a small group of Autonomous Communities was devolved responsibilities in education and health matters. This led to a distinction between “high-level communities” (i.e., those with a high level of devolved

Table 2

Assignment of responsibilities at different levels of government in Spain

1. Central government

Defence

International representation

Justice

National police

Regulation and economic planning

Financial system regulation

Customs

Income and wealth redistribution

Basic social security legislation and funding

National infrastructure: highways, railroads, and hydraulic river works across more than one Autonomous Community; commercial ports and airports

2. Autonomous Communities (intermediate level)

Education at all levels (primary, high school, and college)

Health

Agriculture

Industry, energy, and mines

Environment

Tourism and domestic trade

Social services

Historical and artistic patrimonial protection and own region's language protection

Housing and territorial arrangement

Regional infrastructures: highways and railroads within the Autonomous Community, sport ports, and sport airports

*3. Local governments**3.1 Municipalities*

Water supply

Sewerage systems and garbage collection

Public lighting systems

Social protection

Cemeteries

Repair and maintenance of non-university school centres

Parks and public gardens

Street paving

Municipalities with more than 50,000 inhabitants

Urban transportation

Local environmental protection

3.2 Provinces

Funds destined to small municipalities for infrastructure and public services

Legal assistance and managerial support to small municipalities

Delivery of services of a super-municipal nature

Source: Authors' elaboration.

responsibilities) and “low-level communities.” With time, all Autonomous Communities came to have substantially the same responsibilities, although some minor asymmetries persist (e.g., only some communities have the power to run the prison system and the police). A more permanent manifestation of asymmetrical assignments occurs at the local level, where only municipalities with more than 50,000 people have responsibilities for urban transportation services and environmental protection. In addition, the provinces (the first tier of local government) perform some administration services and conduct infrastructure projects for small municipalities that lack the capacity to do so themselves.

Generally, the assignment of responsibilities follows accepted principles, including subsidiarity. The responsibilities assigned to the national government are for services that benefit the entire national territory (e.g., economic stabilization policy, income and wealth redistribution, international relations, defence, customs, financial system regulation, basic social security legislation and funding, national infrastructure, and transport). Local governments are assigned services with typically local benefit areas, such as water and sewerage, parks, and street lighting. It is notable that none of the education services (e.g., basic education) or health services (e.g., primary health) are assigned at the local level. Although there has been and continues to be considerable discussion about the devolution of more expenditure responsibilities from the intermediate to the local level of government (in particular, basic education), in the context of the “second decentralization” nothing much has been done. It is usually argued that the main roadblock is the very low administrative capacity of many small municipalities. Rather than waiting for the difficult amalgamation of those small municipalities, one possibility that has been discussed involves the adoption of an asymmetric approach, whereby the provinces could be put in charge of providing those services that the smaller municipalities lack sufficient administrative capacity or scale to provide for themselves. In Spain, a cooperative approach among local governments with insufficient scale for the provision of a variety of services has taken root. The cooperative arrangements are known as *mancomunidades*, and they operate as special districts across several local governments to provide water services, garbage collection, tourism, and social services.

The responsibility assignments in Table 2 need to be further qualified. While, in some cases (e.g., regional public works, infrastructure, and transport), the Autonomous Communities exercise their powers freely, in other cases their autonomy is restricted, with varying intensity, by upper-level governments. For example, in the cases of environmental protection and agriculture, European Union (EU) directives determine such matters as minimum environmental quality standards and the kinds of crops that may be grown.⁷ However, the most significant limitations occur in the area of

Table 3
Direct expenditures by function and level of government, 2004 (Percent)

<i>Function</i>	<i>Federal (%)</i>	<i>State or provincial (%)</i>	<i>Local (%)</i>	<i>All (%)</i>
General public services	67.0	21.3	13.7	100
Defence	100	0	0	100
Public order and safety	54.9	19.3	25.8	100
Economic affairs	50.8	35.6	13.6	100
Environmental protection	8.3	23.3	68.4	100
Housing and communal services	3.1	24.8	72.1	100
Health	7.7	90.6	1.7	100
Recreation, culture, and religion	24.1	32.2	43.7	100
Education	6.5	89.4	4.1	100
Social protection	87.8	8.4	3.8	100

Source: Ministry of Economics and Finance; authors' elaboration.

social services – specifically health care and education. These are truly co-shared responsibilities. Although the Autonomous Communities have responsibility for delivery and implementation in those areas, the central government has significant regulatory powers with regard to, *inter alia*, establishing the basic conditions for the provision of the service and the rules governing access to it. These rules typically provide minimum standards nationwide and cannot be altered by the regional governments. However, the Autonomous Communities have the power to enact specific regional laws that are applicable within their territory, the purpose being to improve service provision and so on.

Table 3 presents the distribution of functional expenditures at different government levels.

A significant issue in Spain's fiscal federalism has been the methodology employed to estimate the expenditure needs associated with the devolution of responsibilities to regional governments – the so-called “effective cost method.”⁸ Fundamentally, this is a historical cost-cum-update index methodology. Because practically all the service responsibilities devolved were previously provided by the central government, the fiscal-financial information available on those costs of provision at the time of devolution has been used to cost the expenditure needs associated with those responsibilities. The methodology suffers from certain well-known problems, not the least of which is obsolescence due to changing conditions (e.g., population changes, the development of technology, etc.). Nevertheless, the effective cost method did provide an effective bridge in the process of

devolution and avoided excessive budgetary tensions. The problem lies in the fact that this methodology is, to a certain extent, still being used for the computation of equalization grants and other important operational aspects of the decentralization system, and no clear alternative has yet been developed.

FISCAL FEDERALISM AND MACROECONOMIC MANAGEMENT

Membership in the EU has come to shape in detail Spain's macroeconomic management within a setting of fiscal federalism.⁹ Due to Spain's integration in the euro area, the European Central Bank (ECB) is in charge of monetary policy management. The ECB has autonomy from Spain and other member countries in conducting monetary policy, and its actions are guided by the objective of price stability throughout the entire euro area. These arrangements eliminate any possibility of budget deficit financing via monetary emission.

Conducting fiscal policy is also affected by membership in the EU, which, among other things, has encouraged overall fiscal discipline and the coordination of fiscal policy among the different levels of government, especially in the area of public debt management. Spain experienced a period of large deficits and rapid debt accumulation at the central and regional levels from the mid-1980s to the mid-1990s. This followed not only several economic downturns associated with international macroeconomic shocks but also ambitious and not well-disciplined public spending programs. In the mid-1990s, general government gross liabilities as a percentage of GDP had reached – for the first time in Spain's history – the average level of OECD countries. However, this situation improved quite sharply in preparation for Spain's joining the euro zone in the late 1990s. The Growth and Stability Pact and the Protocol on Excessive Deficits established a maximum combined public deficit of 3 percent of GDP and public debt levels not in excess of 60 percent of GDP. These so-called Maastricht criteria were met in time for Spain to join the euro zone. Actually, in recent years, Spain, with Finland, has been the EU country with the best results in deficit control.¹⁰

As mentioned above, these fiscal restrictions imposed by the EU have forced a strong level of coordination in fiscal policy among all levels of government in Spain. This coordination became a necessity because, while the central government became responsible for the overall deficit of the public sector, it only directly manages half of the total public budget. In 2001, the national Parliament approved the Budgetary Stability Law, which has served as a domestic multilevel government pact of stability. This law has provided the means to distribute the general government's target deficit

between the different levels and, at the same time, has toughened the deficit performance of all governments. In fact, during the first stage, between the promulgation of the law in 2001 and its recent reforms, which were approved in May 2006 (and will take effect at the start of fiscal year 2007), the general performance rule was budget balance.

The budget balance rule was duly criticized because it induces a procyclical fiscal policy, especially in the area of investment in capital infrastructure. For this reason, the 2006 amendments to the Budgetary Stability Law emphasize budget balance over the economic business cycle. However, it allows a maximum deficit of 1 percent of GDP during economic slowdowns, while demanding a budgetary surplus during periods of economic expansion.¹¹ In addition, the amended law allows a permanent deficit equivalent to 0.5 percent of GDP targeted to finance productivity-enhancing investments.¹²

According to the Budgetary Stability Law, the global fiscal objective (deficit or surplus) for the entire public sector is distributed among the different levels of government. It is interesting that, of the maximum combined public-sector deficit of 1.5 percent of GDP, regional governments can accumulate up to 1 percent (with the central government at 0.4 percent and local governments at 0.1 percent), or 75 percent of the entire public sector. Thus, the new law is more generous with the regional governments (i.e., Autonomous Communities), which is a concession to their consent and agreement. However, the amended law also establishes that any regional government that fails to fulfill its deficit objective must present a “financial recovery” plan for the next three years and must get the central government’s authorization for any new debt emissions as long as the non-performance situation persists.

Two important intergovernmental institutions are charged with, among other things, the horizontal distribution and negotiation of the deficit target among all levels of government units. These institutions are:

- 1 The Fiscal and Financial Policy Council (CPFF), which acts as a consultative body linking the central and the regional governments. Its membership includes the central government’s ministries of finance and public administrations as well as the finance counsellors of the Autonomous Communities. Regional alliances in the CPFF tend to form more around regional income levels than around political party affiliation. Income levels tend to define who among the regions are the gainers and losers when it comes to the divisive question of the extent and reach of the unconditional equalization grants (or Sufficiency Fund), which are discussed below.
- 2 The National Commission of Local Administration (NCLA) represents all municipal and provincial governments. The NCLA leads discussions and negotiations with the central government.

ISSUES IN REVENUE-RAISING RESPONSIBILITIES

The system of revenue assignments in Spain is rather complex by international standards. This complexity arises from two sources. First, there are significant differences in the bifurcated revenue assignments at the intermediate and local levels of government, and those two systems need to be discussed separately. Second, the system of revenue assignments at the intermediate level of government is complicated by a very marked asymmetry between two groups of Autonomous Communities. Thus, for the purposes of discussion, it is useful to separate the two types of financing of regional governments from the financing of local governments.

*Revenue Assignments of the Autonomous Communities*¹³

The Spanish Constitution establishes two basic systems for financing the regional governments – the common regime and the special regime. The common regime applies to all Autonomous Communities with the exception of two: the Basque Country and Navarre. These two Autonomous Communities operate under the special (in Spanish, *foral*, or charter) regime.¹⁴ The two systems introduce a fundamental asymmetry into the financing of regional governments that, fundamentally, benefits the two Autonomous Communities that operate under the special regime.

The common regime. The revenue assignment in the common regime was originally established by the Autonomous Communities Financing Act, 1980 (*Ley Orgánica de Financiación de las Comunidades Autónomas [LOFCA]*), which was comprehensively refurbished in 2001. For this reason, the revenue assignments in the common regime are typically known as the LOFCA system. While LOFCA establishes the basic principles of the system, specific implementation issues as well as disputes are settled within the CPFF, the intergovernmental body discussed above. One of the most important responsibilities of the CPFF has been to assess the evolution of the regional finance system on a regular basis and to recommend any necessary changes. Significant reviews of the LOFCA system took place in 1986, 1992, 1996, and 2001.

Initially (late 1970s and early 1980s), the financing system of the regions in the common regime was based on lump-sum general grants. These grants were calculated to cover the expenditure needs arising from the devolved expenditure responsibilities, using the “net effective cost” method. This approach had several weaknesses. First, it tended to perpetuate whatever differences existed across regions, under the centralized provision of services, before their devolution to the regional governments. Thus, it did not guarantee an equal provision of public services. Second, the complete

reliance on grants, as opposed to own taxes, meant that regional governments had practically no revenue autonomy. This blunted the greater efficiency and accountability benefits typically associated with fiscal decentralization.

Both central and regional government authorities commonly agreed to the problems posed by the lack of revenue autonomy. The subsequent evolution of revenue assignments to regional governments can be seen as a continued strategy of gradual corrections to this problem, starting with the tools offered by LOFCA's initial version in 1980.

One side of the strategy consisted of modifying the method used to calculate expenditure needs. In 1986, there was an agreement to replace the net effective cost method with a quantification of regional spending based on indicators that would more accurately reflect the *expenditure needs* of each Autonomous Community. The concept of expenditure needs was identified as the costs each regional government would need to incur in order to provide the same level of public goods and services as did other regional governments. The indicators currently applied, and their relative weights, were last reformed in 2002. Three different sets of indicators are used, respectively, for three blocks of expenditure responsibilities: health services, social services, and other services (including education). Clearly, population is the indicator with the highest weighting in all three groups of responsibilities. However, despite the introduction of these indicators into the quantification of regional expenditure needs, the effective cost has continued to play a decisive role in their determination. This is because all of the regional financing reviews approved by the CPFF have included a "hold harmless provision," such that no regional government can be assigned lower revenues than it had received in the previous period.

The other side of the strategy was to reform revenue assignments properly. Funding of regional governments exclusively on the basis of general purpose grants was abandoned after an initial period and was replaced during 1982–84 with a system consisting of a set of devolved, or "ceded taxes" (*tributos cedidos*), and a general equalization transfer. The latter was first referred to as "revenue sharing in central government taxes" (*participación en ingresos del Estado*) and, since 2002, has been referred to as the Sufficiency Fund (*fondo de suficiencia*). These measures provided regional governments with standard revenue sources, much in line with standard practices in other decentralized countries.

However, until 1997, the ceded taxes could not be categorized by the regional governments as "own taxes" because, besides being introduced at the will of the central government, they were strictly regulated by the central authorities. However, while the regional governments were granted no discretion vis-à-vis the structure of the ceded taxes, in some cases they were put in charge of their administration and collection. Thus, in the initial period through 1997, the ceded taxes should be considered an extension of

the tax-sharing system rather than own taxes that provided regional governments with meaningful tax autonomy. Starting in 1997, several degrees of discretion were granted to the regional governments vis-à-vis some of the ceded taxes, allowing the Autonomous Communities to set the tax rate and establish tax credits and allowances. Thus, for the regional governments, the ceded taxes progressively became own taxes.¹⁵ A quite different story involves how the newly gained discretion was actually used or not used by the regional governments. In general, and along the lines of international trends, the Autonomous Communities have reduced their fiscal effort for direct taxes (personal income, inheritance, and gift taxes) and have increased it for indirect taxes (capital transfer tax, stamp duties, and hydrocarbon retail sales tax).

Table 4 provides the current status of ceded taxes with regard to the arrangements for the distribution of revenue collections, the level of government in charge of administration and collection and the discretionary powers granted to the regional governments over that particular tax. From Table 4 it can be seen that many important taxes have been either ceded as own regional taxes (e.g., 33 percent of the personal income tax) or actually shared with regional governments, as in the case of the value-added tax (VAT) and excise duties. The central government has been assigned exclusive authority over the collection, administration, and regulation of corporate income tax, the tax on insurance premiums, import duties, payroll taxes, and non-resident taxes.

The arrangements for the personal income tax deserve a special note because they are not those found in the typical piggyback schemes used by other decentralized countries. The law divides the tax schedule for the personal income tax into a central government schedule and a regional government schedule. The revenue from the central government schedule, which is equal to 67 percent of the total tax, is allocated at the central level, while the regional schedule, which is equal to 33 percent, is allocated to each Autonomous Community. The regional governments may maintain this tax schedule, in which case they will receive 33 percent of the total tax take, or they may increase or reduce the rates, but with the requirement that the rate schedule has to be a progressive tax having the same number of brackets as are found in the central government's income tax. The regional governments may also establish their own tax credits, which would only affect their differential tax take. While many regional governments have changed tax credits, only the Autonomous Community of Madrid has actually modified the tax rate schedule.

Overall, the current level of regional autonomy in the personal income tax is exercised in a coordinated and harmonized fashion with the central government in order to minimize taxpayer compliance costs. The definition of taxable income is common for both central and regional taxes. Taxpayers

Table 4
Current revenue assignments to regional governments

<i>Tax</i>	<i>Sharing of collections (%)</i>		<i>Administration by regional governments</i>		<i>Discretion by regional governments</i>	
	<i>Common Regime</i>	<i>Charter Regime</i>	<i>Common Regime</i>	<i>Charter Regime</i>	<i>Common Regime</i>	<i>Charter Regime</i>
Personal income tax	33	100	No	Yes	Tax schedule and tax credits	Full
Tax on net wealth	100	100	Yes	Yes	Threshold, tax schedule, and tax credits	Full
Inheritance and gift tax	100	100	Yes	Yes	Allowances, tax schedule, tax credits, administration, and collection	Full
Corporate income tax	–	100	–	Yes	–	Full
Non-Resident income tax	–	100	–	Yes	–	Full for permanent establishments
Capital transfer tax, taxes on the raising of capital, and stamp duties	100	100	Yes	Yes	Tax rates, tax credits, administration, and collection	Full, with some exceptions
Gaming taxes	100	100	Yes	Yes	Allowances, taxable base, tax rates, administration, collection, and inspection	Full, with some exceptions
Vehicle excise (registration)	100	100	Yes	Yes	Tax rates	Tax rates, declaration and payment forms and payment periods
Hydrocarbon s retail sales tax	100	100	Yes	Yes	Tax rates, administration, collection, and inspection	Tax rates, declaration and payment forms and payment periods

Table 4

Current revenue assignments to regional governments (*Continued*)

Tax	Sharing of collections (%)		Administration by regional governments		Discretion by regional governments	
	Common Regime	Charter Regime	Common Regime	Charter Regime	Common Regime	Charter Regime
Value-added tax	35	100	No	Yes	No	Tax declaration and payment forms and payment periods
Excise duties (alcoholic beverages, tobacco, and petrol)	40	100	No	Yes	No	Tax declaration and payment forms and payment periods
Electricity tax	100	100	No	Yes	No	Tax declaration and payment forms and payment periods
Tax on Insurance Premiums	—	100	—	Yes	—	Tax declaration and payment forms and payment periods

Source: López Laborda, J., Financiación y gasto público en un Estado descentralizado, *Economía Aragonesa*, 24 (2004): 63–82.

need to fill out only one tax return, which incorporates the central and regional income taxes. In the case of the regions under the common regime, the State Tax Administration Agency (AEAT in Spanish) collects and distributes the revenues between the central and regional governments.

Besides the ceded taxes, regional governments subject to the common regime have other sources of financing. First, regional governments may introduce their own regional taxes and surcharges (which are different from the devolved or ceded taxes). For these taxes, the Autonomous Communities have full powers of collection, administration, and regulation. However, the LOFCA imposes strict bounds on the type of taxes regional governments can introduce on their own. Most important, this law prohibits regional governments from using the same tax bases or types of taxes already assigned or used by the central government and municipal governments. The exclusion

of cohabitation of the same tax bases at different levels of government explains why regional governments have so far introduced so few genuine regional taxes (basically environmental and gaming taxes) as well as why the revenue collections from this source are so small. Other sources of financing for regional governments under the common regime include equalization grants, known as the Sufficiency Fund, and conditional grants. The nature of these transfers is discussed below.

Of the (non-financial) revenues for the Autonomous Communities under the common regime for 2004, own revenues, including revenues from ceded taxes and those from genuine regional taxes, amount to 34 percent of regional non-financial revenues. Shared taxes represent 21 percent; equalization grants, 24 percent; and conditional grants, 21 percent of non-financial revenues.

The charter system The charter financing system applies to two Autonomous Communities: Navarre and the Basque Country. The financing arrangements for these two regions are called the *Convenio* in Navarre and the *Concierto* in the Basque Country, with both terms referring to the asymmetric conditions incorporated into the two special laws for the two regions: the Economic Agreement between the State and Charter Community of Navarre Act, 2003 (*Ley del Convenio Económico entre el Estado y la Comunidad Foral de Navarra*), and the Economic Agreement with the Autonomous Community of the Basque Country Act, 2002 (*Ley del Concierto Económico con la Comunidad Autónoma del País Vasco*).

In contrast to the common regime, the charter system is not based on the assignment of specific revenues to fund a given level of spending. The chief feature of the charter system is that it provides the two regions concerned with a much higher level of fiscal autonomy than is found in the Autonomous Communities under the common regime. Both the *Convenio* and the *Concierto* basically recognize the capacity of the charter regions to establish and regulate their own fiscal systems, provided that the solidarity principle and the freedom of movement and residence of people and the freedom of movement of goods, services, and capital are all ensured.

In essence, the charter regions are financed exclusively through tax revenues known as “agreed taxes” (*tributos convenidos* in Navarre and *tributos concertados* in the Basque Country). These two regions have wide powers over these revenue sources, which are, in general, considerably greater than are the powers that, under the common regime, have been granted to the Autonomous Regions in the form of ceded taxes.¹⁶

In most cases, the charter regional governments have full power over the agreed taxes. The only taxes that are currently outside the charter regime list of agreed taxes are import duties and payroll taxes for social security (see Table 4).

In contrast to the revenue assignments for regional governments under the common regime, the charter regions have full powers over all personal and corporate income taxes. The finance departments of the charter regions also have control over the administration of the main indirect taxes, the VAT, and excise duties.¹⁷ However, for indirect taxes the charter regions have no regulatory powers, mainly because of the restrictions imposed by EU rules governing the harmonization of those taxes.

In practice, the charter regional governments have used their ample discretionary powers to reduce tax burdens within their borders. For example, in the case of the corporate income tax, depreciation allowances are more generous here than they are in the rest of the regions under the common regime; also, tax credits for investment and job creation are higher, while tax rates in general are lower.¹⁸

The long list of significant taxes fully assigned to the charter Autonomous Communities and the relatively high income levels of these two regions guarantee the full financing of their expenditure needs without any transfers from the central government. In fact, the asymmetric regimes for the Basque Country and Navarre call for negative transfers to be remitted from the regional governments to the central government. These negative transfers are called the "quota" (*cupo*) in the case of the Basque Country and the "contribution" (*aportación*) in the case of Navarre. The rationale for these negative transfers is that the two regions should help finance the cost of public goods provided by the central government throughout the national territory. In contrast to this single payment by the charter regions, the regions under the common regime have several ways of "contributing" to the financing of central government services. The most important of these are the non-ceded taxes collected in their territories (67 percent in the personal income tax, 100 percent in the corporate income tax, 65 percent in the VAT, and so on).

The actual amount of the negative transfers, or quota, is based on a fairly complex formula. The share in the cost of central government services attributable to each charter region is based on an "imputation index," which is basically a relative income function (*vis-à-vis* the entire national economy). The imputation index is 1.6 percent for Navarre and 6.24 percent for the Basque Country.

Since the central government still collects certain revenues in the charter regions (arising from the "non-agreed" taxes as well as from non-tax revenue sources), and part of central government expenditures are financed through "below the line" deficit financing sources, a distinction is made in the calculations between the "Gross Quota," GQ , and the "Net Quota," NQ . The NQ is calculated as the GQ less all revenues obtained by the National Treasury in the charter regions. The amount of the GQ in the "base" year for charter Autonomous Community f is as follows:

$$GQ_{f0} = i_f \cdot G_0 \quad (f = \text{Navarre, Basque Country})$$

where i_f is the imputation index for charter Autonomous Community f , and G_0 represents the level of public services provided by the central government in the “base” year. In addition, let us identify the revenues not covered by the financing agreements as TN , and the deficit of the central government by D (note that in the case of a surplus, this variable would simply work in the opposite direction). Finally, the value of the NQ , which is the amount actually transferred by the finance departments of the charter regions to the central government’s Ministry of Finance, is given by:

$$NQ_{f0} = i_f \cdot G_0 - i_f \cdot TN_0 - i_f \cdot D_0 = i_f \cdot [G_0 - (TN_0 + D_0)]$$

The quota is not calculated on an annual basis. The calculation methodology is reviewed every five years. For any year t subsequent to the base year, the amount is calculated by applying to the base year value the rate of growth in central government taxes equivalent to the agreed taxes, which is denoted by IE :

$$NQ_{ft} = NQ_{f0} \cdot \frac{IE_t}{IE_0}.$$

Hence, the revenues kept by charter Autonomous Community f in year t are the difference between the revenues actually obtained from the agreed taxes, T_f , and the amount of the quota remitted to the central government:

$$R_{ft} = T_{ft} - NQ_{ft} = T_{ft} - NQ_{f0} \cdot \frac{IE_t}{IE_0}.$$

The discussion above provides a description of the “basic financing model” for the charter regions. But, as in the case of the regions under the common regime, the Basque Country and Navarre also have other sources of revenues with which to finance their expenditures, such as own taxes, surcharges and fees, and borrowing.

An evaluation of the charter system produces a mixed scorecard. This system scores high from the standpoint of the financial autonomy and accountability of subnational governments. In contrast to the still heavy reliance of the regional governments under the common regime on revenue sharing and transfers, the charter regions would appear to finance all their expenditure out of their own revenues. But there is more. In fact, the degree of fiscal autonomy provided by the charter system to the regional governments is unique in the international experience. A similarity can be found in the “single channel” scheme that some Russian regions practised in the early 1990s against the wishes of the federal government, whereby the regions collected on their own all taxes, including those that were supposed to be federal taxes, and negotiated with Moscow a single payment or remittance.¹⁹

It would be misleading to confuse the degree of autonomy granted to the charter regions in Spain with that existing in the world’s most fiscally decentralized countries, such as the United States, Switzerland, and Canada. In those countries, some of the federal taxes may be administered by the

subnational governments and then remitted (e.g., Canada and Switzerland), and subnational governments have their distinct separate taxes (e.g., the United States and Canada). But in none of those countries are subnational governments assigned most or all the taxes and then expected to negotiate with the centre a single payment transfer as a contribution to the cost of providing federal services.

The important drawbacks of the charter system emanate from the asymmetric nature of the arrangement vis-à-vis the common regime applied in the rest of the Spanish regions. In the first place, the greater financial autonomy provided by the charter regime provides the means and incentives for asymmetric tax competition between these regions and the regions under the common regime. For example, if a charter region decides to implement tax measures to attract firms from other regions, for the most part the regions under the common regime are unable to react because, for example, they do not have regulatory powers over corporate income tax.

Second, the charter regime may be seen as unfair to the rest of the regions under the common regime. A comparison of the structure of the common and charter financing systems shows that an equal level of tax effort will provide the charter regime regions with higher revenues, while both types of regions have the same expenditure obligations. In other words, the regions under the common regime would need to levy higher tax rates on their constituents to provide the same standard of regional-type public services. An explanation for this difference is that the charter system is designed so that, out of their taxes, the citizens residing in the charter regions fund the cost of regional public goods and, with the quota remittance, the respective share of national public goods. The citizens residing in the common regime regions *also* finance equalization grants (the Sufficiency Fund) to allow those Autonomous Communities with low fiscal capacity or high expenditure needs to provide the same level of regional public goods and services as is enjoyed by the other communities.

Revenue Assignments of Local Governments

Municipal governments have their own revenue assignments separate from those of the regional governments. Local revenues are regulated by the Law on Local Finance (*Ley Reguladora de las Haciendas Locales*), 1988, which was updated in 2004. As in the case of the charter regions, and in contrast to what is practised in the common regime regions, the financing system of local governments is not based on the computation of expenditure needs that then have to be financed with a particular set of revenues.

Five taxes are currently assigned to local governments: property tax, local business tax, vehicle tax, tax on increased property values in urban

areas, and tax on construction, facilities, and infrastructure. Of the five local taxes, three are mandatory in all the municipalities: the property tax, the local business tax, and the vehicle tax. The other two taxes – a tax on increases in property value and a tax on construction, facilities, and infrastructure – are optional taxes; it is up to the municipal council whether or not they are introduced.²⁰ In practice, most municipalities have decided to use these two optional taxes. In general, municipal governments enjoy a high level of autonomy in setting tax rates, allowances, and tax credits for local taxes within the framework of the (centrally issued) law, and they make wide use of these rights. Therefore, it is fair to say that local taxes are truly own municipal taxes.

In the case of the property tax, the Ministry of Finance, through the Office of the Cadastre (*Dirección General del Catastro*), centrally manages the most significant aspect of this municipal tax – the assessment of property values. This is an unsatisfactory situation for many municipalities, especially in the case of large cities, which feel they would be better able to manage the assessment of property values within their borders. Large local governments have at different times asked the central government to let them do their own property assessments. In periods of fast increases in property values, as has been the case since 2000 throughout Spain, the delay in assessed values catching up with real market values has made this problem more acute. This situation has led to expensive emergency revisions of cadastral values in order to increase revenue collections from the property tax. Nevertheless, the typical municipality has proceeded to lower property tax rates after a revised increase in cadastral values. Property tax burdens have become a particularly sensitive issue, and the overall equity of the tax has been increasingly questioned, especially in light of the fact that housing expenditures are proportionally higher for lower-income people and that there are no circuit-breakers for pensioners whose property values have increased quite considerably but whose incomes have not.

With some exceptions (such as property assessments or the register of economic activities), local taxes are administered by the municipal governments. However, in the case of small municipalities lacking administrative capacity and skilled personnel, tax administration is often delegated to the tax agency of the province or the regional government. Despite the significant degree of local tax autonomy, there has not been a considerable degree of tax competition, perhaps with the exception of the anecdotal case of the vehicle tax, where some small municipalities near large cities have bet on the minimum tax rates allowed in order to attract the vehicle rental market.

Another important revenue source for municipalities involves charges based on the straight application of the benefit principle, such as user fees for local services for water, access to municipal sports facilities, and local

transport. Other significant sources of revenues for local governments are unconditional transfers, including revenue sharing and tied grants. These are discussed in the next section.

In 2004, own revenue sources represented 60 percent of non-financial revenues. This means that there is a significant level of autonomy and accountability at the municipal level, although there are significant variations in fiscal pressure (and expenditure levels) across municipalities. Shared taxes and grants represent 40 percent of non financial local revenues. The only tax revenue actually received by the provincial government is a surtax on the local business tax raised by the municipalities in the provincial territory.

Table 5 shows the recent changes in non-financial revenues by level of government. Comparing these figures with the evolution of non-financial public expenditures, we can see that the vertical fiscal gap has evolved favourably for the regional governments.²¹

FISCAL EQUITY AND EFFICIENCY CONCERNS AND INTERGOVERNMENTAL FISCAL TRANSFERS

Because Spain's decentralization system works in a bifurcated fashion, without any significant hierarchical relationship between regional and local governments, it is necessary to discuss the system of central transfers to the regions and the system of central transfers to local governments separately.

Transfers to Regional Governments

Regional governments receive general unconditional equalization grants and conditional grants. The main equalization grant for regions subject to the common regime is the Sufficiency Fund.²² This equalization grant is formula-driven and is generally based on the fiscal gap between the expenditure needs and the fiscal capacity of the regions. The central government computes for each ceded tax a "standard yield" that each regional government should obtain by making the same tax effort as the other regions. To the extent that this aggregate standard yield is less than the region's expenditure needs, the system provides an equalization grant to cover the difference between expenditure needs and fiscal capacity. However, those regions for which expenditure needs are less than fiscal capacity (as measured by the standard yield) are assigned a negative grant and need to remit the "excess" funding to the central government. In summary, the Sufficiency Fund operates as a conventional unconditional equalization grant with a mix of sources of funding, from central government general revenues and from the contributions (negative grants) of the "surplus" regions.

Table 5
Composition of non-financial public expenditures and revenues by level of government (%)

YEAR	Central Government*		Autonomous Governments		Local Governments	
	Expenditures	Revenues	Expenditures	Revenues	Expenditures	Revenues
2001	54.1	80.2	33.0	9.5	12.8	10.3
2002	53.3	70.6	33.6	19.3	13.1	10.1
2003	52.6	69.0	34.1	21.2	13.4	9.8
2004	53.1	67.6	34.4	22.2	12.6	10.2
2005	51.2	67.5	36.0	22.6	12.8	9.9

* Including the social security system

Source: Ministry of Economics and Finance and authors' elaboration.

However, the actual computation of the equalization transfers is unconventional. The following paragraphs describe the most salient features of the methodology used to determine the Sufficiency Fund transfers. The intergovernmental CPFF establishes a "base" year for the system and calculates the expenditure needs of each Autonomous Community, E_{i0} , and the standard yield for the ceded taxes, T_{i0}^* , for that base year. The Sufficiency Fund for the base year, SF_{i0} , is calculated as the difference between expenditure needs and tax capacity from the base year:

$$SF_{i0} = E_{i0} - T_{i0}^*.$$

For relatively richer Autonomous Communities, for which the standard tax yield exceeds expenditure needs (e.g., the Balearic Islands and Madrid), the grant is negative and, as pointed out above, that amount is remitted from the Autonomous Community to the central government.

The most significant twist is that the Sufficiency Fund is not determined annually. For any year t subsequent to the base year, the amounts for the Sufficiency Fund transfers are calculated by applying to the base year results a growth index equal to the rate of growth experienced by the central government (or state) taxes equivalent to the ceded taxes (*Ingresos Tributarios del Estado [ITE]*). Therefore, the Sufficiency Fund transfer for the current year t is given by:

$$SF_{it} = SF_{i0} \cdot \frac{ITE_t}{ITE_0}.$$

The effect of this is that the revenue that Autonomous Community i would receive in the current year t (R_{it}) is equivalent to the sum of the actualized Sufficiency Fund and the actual yield from the taxes ceded (T_{it}).

Note that this is different from the “standard yield,” which is used only to calculate the Sufficiency Fund in the base year:

$$R_{it} = SF_{it} + T_{it} = SF_{i0} \cdot \frac{ITE_t}{ITE_0} + T_{it}.$$

The reliance of the equalization system on the computations of expenditure needs for a base year creates some serious issues. It seems correct to assert that, at the base year, the equalization system and the rest of the regional financing system guaranteed that all Autonomous Communities under the common regime had the funds required to finance all the service responsibilities devolved at a reasonably equal level. However, the same cannot be said for subsequent years. The actual level of equalization may gradually be weakened over time because, although the Sufficiency Fund evolves at the same rate for all Autonomous Communities, the measure of expenditure needs and the standard tax yield are likely to evolve at different rates. This is, in fact, what actually occurred in the early years of the application of the current system, when population growth was unevenly spread across the Autonomous Communities.

The system provides two instruments to correct this problem, although, so far, neither has been applied. First, the law requires periodic analysis of the impact of demographic changes in the Autonomous Communities on their expenditure needs. Second, because health care and education are defined as basic public services, with service standards fixed by the National Parliament (the catalogue of guaranteed sanitary benefits in health and obligatory education until the age of sixteen, and so on), the financing system is conceived to ensure that the regions have the necessary resources for their provision. Regional governments may receive additional funding to guarantee provision if the annual increase in public system users exceeds 3 percent of the increase in the national average. This additional funding would take the form of specific purpose grants or Basic Public Services Equalization Grants (*Asignaciones de Nivelación de Servicios Públicos Fundamentales*). Should these grants again be allocated to the same Autonomous Community within a five-year period, then the Sufficiency Fund must be adjusted to reflect the substantial change in expenditure needs of that regional government.²³

In addition to the equalization grants, under the overall objective of reducing regional disparities in income and wealth, the regions receive conditional grants that are intended to foster regional development. Examples of this type of grant are the Inter-territorial Compensation Funds (*Fondos de Compensación Interterritorial [FCI]*) and several grants from the EU budget, such as the European Regional Development Fund (ERDF).

Transfers to Local Governments

The current transfer system for local governments was last updated in 2004. It provides municipalities with unconditional grants that come directly from the central government's Ministry of Finance. Although the system of unconditional grants is ultimately enacted in a law from the National Parliament, the substance of that law is elaborated in a process of negotiation between the Ministry of Finance at the central level and the Spanish Federation of Municipalities and Provinces (FEMP), which represents all local governments.

The funds are distributed according to different formulas, which differentiate between large cities and medium and small municipalities.²⁴ In the case of the larger cities (those with a population exceeding 75,000 inhabitants),²⁵ the transfer is composed of two components. The first component involves revenue sharing on a derivation basis on three types of central government taxes: the personal income tax (with a sharing rate of 1.6875 percent), the VAT (with a sharing rate of 1.7897 percent), and excise taxes (with a sharing rate of 2.0454 percent).²⁶ The second component is the Complementary Fund (*Fondo Complementario*), which was added in the last reform of the transfer system to hold these municipalities harmless. For the base year, the Complementary Fund is calculated as the difference between the amount previously received in transfers²⁷ and the revenue sharing (calculated as in the first component). For any year t subsequent to the base year, the Complementary Fund is calculated by applying to the base year a growth index equal to the increase in central government taxes (ITE).

For all other municipalities, medium and small, the amount of the transfer fund, referred to as "sharing in central government revenues" (*participación en ingresos del Estado*), is distributed according to an index formula with three sets of variables: population, with an assigned relative weight of 75 percent; the inverse of the tax capacity, with a relative weight of 12.5 percent; and fiscal effort, with a relative weight of 12.5 percent. The pool of funds is adjusted every year according to the rate of growth in ITE.²⁸

This transfer system has been criticized from different angles.²⁹ For example, the distinction between the large municipalities and the rest lacks a clear rationale and transparency. In addition, this system lacks flexibility vis-à-vis the new problems faced by the country, such as the massive increase in the number of immigrants in some parts of the national territory, which has resulted in considerable increases in municipal (and regional) expenditures for social protection.³⁰ Several equity issues have arisen because of the out-migration from rural and mountain areas and the need to maintain facilities and services in those areas as well as in urban areas,

which have much higher population densities. In addition, it is only in a very indirect manner that the transfers to the local governments pursue an equalization objective.

The provincial governments benefit from a transfer scheme that is similar to that applied to large cities and that has the same two components: the Complementary Fund and revenue sharing on the personal income tax (at a rate of 0.9936 percent), VAT (with a sharing rate of 1.0538 percent), and excise taxes (with a sharing rate of 1.2044 percent).

SUMMARY AND THE WAY FORWARD

Spain has undergone a fast and deep process of decentralization since the late 1970s, thereby becoming one of the most decentralized countries in the world. This decentralization process, however, has been uneven. There has been more meaningful decentralization on the expenditure side than on the revenue side of subnational budgets. The regional governments (Autonomous Communities) currently represent 36 percent of total public spending, while local governments represent close to 13 percent. Together, these subnational governments play a fundamental role in the provision of the public goods and services that are closest to the lives of citizens and that most affect their welfare. For some observers, central government intervention in many areas that are the responsibility of subnational governments remains too high, reducing effective subnational autonomy.³¹ Nevertheless, overall, at least from the expenditure side of the budget, Spain has many of the features of many other federal systems, although formally it continues to be identified as a unitary country.

In comparison to other highly decentralized systems, the relative importance of local governments within the subnational public sector is low. Largely, this is because, in Spain, the responsibility for all education services, including primary and secondary education, is assigned at the regional level. However, the respective roles of regional and local governments have not been completely sorted out. There continue to be repeated calls from many quarters in the country to strengthen expenditure and revenue assignments to local governments and to proceed with a "second decentralization" reform process, following the mostly successful one involving regional governments. Many small municipal governments, with less than an optimal scale, represent the most important obstacle to going forward with these reforms.

The decentralization of tax sources has lagged behind expenditure responsibilities. However, this is not to say that, in Spain, subnational government revenue autonomy is very low. As we have seen, own revenues currently represent between 35 percent and 55 percent of total revenues among regional governments under the common regime, while in the case

of the two regions under the charter regime, almost all of their revenues could be interpreted as own revenues. In the case of local governments, revenue autonomy is higher than it is for regional governments under the common regime: their own revenues represent more than 60 percent of total municipal revenues. However, accountability and, generally, more fiscally responsible behaviour can be strengthened by increasing revenue autonomy and decreasing the dependence on tax sharing and transfers of subnational governments, especially in the case of regional governments under the common regime.

There are two fundamental options for increasing regional revenue autonomy. The first is to continue the current approach by increasing the allocated share of ceded taxes and raising or allocating normative powers over certain taxes such as the personal income tax, excise duties, or even, at some later date, the VAT.³² A second option would be to introduce completely separate taxes for regional governments cohabitating the same tax bases as the central government. In this approach, regional governments would have their own personal income tax, excises, or even a VAT or corporate income tax; legislative or normative power over these taxes could be regulated by national laws or could be left entirely up to the regional parliaments. This approach is essentially the one used in Canada and the United States.³³ The reform of the current revenue assignments would create the necessary fiscal or tax space for regional governments to introduce their own taxes. A system of separate taxes has some similarities with the current system of ceded taxes, but there are also important differences between the two. Perhaps the most significant difference is that, in the case of ceded taxes, the central government designs backup tax rates (*tarifas supletorias*) for the regional governments' use in case the latter do not design their own. This arrangement has, de facto, provided regional governments with few incentives to exercise their tax autonomy, and, to a large extent, it transforms ceded taxes more along the line of revenue sharing than along the line of real own taxes. Regional governments have found it much more attractive to bargain with the centre over the level of the ceded tax (for example, 50 percent rather than 33 percent) than to increase their own rates in order to raise any additional needed revenues. The use of the ceded tax scheme has helped to obscure regional government accountability. It may also be possible, along the same lines, to introduce some new taxes or to strengthen some existing ones at the regional level, such as in the case of environmental taxes, where some Autonomous Communities have already established an incipient presence.

An additional dimension of revenue autonomy involves tax administration. Greater involvement of the Autonomous Communities in tax collection and management is an avenue that several regional governments that are revising their Autonomy Statutes are currently considering. There have been

discussions and plans drafted to strengthen the regional governments' tax administration agencies; in some cases, the regional administrations would be put in charge of collecting all taxes in their own regions, including central government taxes, whether in partnership with the central tax administration agency or on their own. This would reproduce the arrangement currently in place in the two charter regions of Navarre and the Basque Country. Rolling out this model to the rest of the regions (i.e., those under the common regime) could bring increased interregional equity; it could also fragment the administration of the most important taxes, with losses in efficiency and likely increases in compliance costs. It is also argued that the complete decentralization of tax administration would increase the political risk of disintegration. A separate tax administration for separate taxes (personal income tax, etc.) at the central and subnational levels is another option.

Vertical imbalances remain an issue. Subnational governments have continued to complain about the lack of sufficient funding and to demand (and frequently receive) additional funding from the central government. Beyond the issues of whether subnational governments have been assigned adequate autonomous tax sources and how much they have been predisposed to use them (which is clearly quite decisive in resolving any issue of vertical imbalances), we note two things: first, after using an effective cost method, all regional expenditure responsibilities have been devolved by mutual agreement between the regional and central governments; second, it has not been shown that the evolution of central and subnational government revenues has resulted in any vertical imbalance that has been to the detriment of the subnational governments.

The incentives and behaviour of the subnational and central governments further muddle the issue of vertical imbalances. On the one hand, subnational governments have had the incentive to continue to behave strategically by asking for more revenue sharing and thus seeking to spread the costs of their spending decisions to all citizens in the country (rather than accepting the political cost of increasing the taxes paid by those residents in their own territory). This is just one more manifestation of the common pool problem. More important, it reflects the fact that, ultimately, subnational governments in Spain have been operating under a soft-budget constraint: the central government sees itself as directly implicated in the delivery of certain regional services, such as health and education, as well as certain local services. On the other hand, the central government has, in certain expenditure programs, sometimes taken *de facto* decisions involving unfunded expenditure mandates to the subnational governments. On other occasions, the central government has undertaken tax reforms that have had a significant impact on the revenues of these governments (e.g., reducing the yield of certain subnational taxes) without compensation or counterbalancing measures.

Horizontal fiscal imbalances will continue to exist in the near future. The current system of intergovernmental finance provides a reasonable level of equalization among regions under the common regime. However, the current formula for estimating the fiscal capacity and expenditure needs of different regions is in need of an overhaul. The funds dedicated to equalization and, therefore, the appropriate degree of equalization continue to be matters of hot debate in Spain. This is ultimately a political decision, with positions naturally taken according to who benefits and who pays. Beneficiary regions support a high level of equalization on the grounds of solidarity, while those regions with the highest fiscal capacity point to the disincentive and efficiency effects of high levels of equalization. Also, as we mention above, the system of local transfers continues to be the target of a variety of criticisms.

Transfer funding issues have been affected by the expansion of the EU to include ten new member states from Central and Eastern Europe, and this raises other issues for regional financing. Most important, this expansion implies the loss of European Structural Funds and other funds aimed at regional development, which currently benefit quite a few of the poorer Autonomous Communities.

The asymmetric treatment of common regime and charter regime regions is a thorny issue. The Constitution permits the existence of two financing systems with very different structures. However, the Constitution does not seem to allow for the results of the two systems to differ – that is, for Autonomous Communities with the same expenditure responsibilities to provide different levels of public services, depending on whether they receive funding under the common regime or the charter regime. Despite the interregional inequity implied by this situation, few new ideas have been proposed to address it, other than possibly replicating the charter regime in all regions. This would be far from desirable not only for the central authorities but also for anyone concerned with efficiency and equity. A desirable stopgap measure would be to make all regions, including charter regions, participate in the financing of the equalization grant system.

NOTES

* Financial support by the Spanish Ministry of Education and Science, Projects MEJ-04-SEJ2004-08253 (Carlos Monasterio) and SEJ2006-4444 (Julio López-Laborda and Jorge Martínez-Vázquez) is gratefully acknowledged.

1 The Autonomous Communities are highly diverse in terms of size, population, per capita income, and other factors. The largest is Andalusia, with a population close to 8 million, an area of 87,597 square kilometres, and a per capita income of 16,196 euros (in 2005). The smallest is La Rioja, with a population of 297,000, an

area of 5,000 square kilometres, and a per capita income of 22,326 euros. There are also large variations in size among municipalities, which range from large modern cities to very small rural municipalities.

- 2 There is an exception to this general principle in the case of the two Autonomous Communities with the “special regime” (Navarre and the Basque Country), in which municipalities – and, in the Basque Country, its own regional government – are financially dependent on the first tier of local government (i.e., the provinces).
- 3 From a different perspective, the Autonomous Communities represent more than 50 percent of general government employment.
- 4 See F. Pedraja, J. Salinas, and J. Suárez-Pandiello, “Financing Local Governments: The Spanish Experience,” in *Tax Reform in Spain: Accomplishments and Challenges*, ed. J. Martínez-Vásquez and J.F. Sanz (Cheltenham: Edward Elgar, 2007).
- 5 Provincial deputies, at the first tier of local government, are not directly elected but are designated by the municipal councils. The provincial deputies select one of their own as president of the Provincial Council.
- 6 This section and some other parts of the chapter draw upon J. López-Laborda and C. Monasterio, “Regional Governments: Vertical Imbalances and Revenue Assignments,” in *Tax Reform in Spain: Accomplishments and Challenges*, ed. J. Martínez-Vásquez and J.F. Sanz (Cheltenham: Edward Elgar, 2007).
- 7 For environmental policy, EU norms establish air and water quality standards, delimiting regional government as well as municipal responsibilities (n.b., municipal governments receive financial support from regional governments to meet these responsibilities).
- 8 For a discussion of this methodology, see J. López-Laborda and C. Monasterio, “Regional Governments: Vertical Imbalances and Revenue Assignments,” in *Tax Reform in Spain: Accomplishments and Challenges*, ed. J. Martínez-Vásquez and J.F. Sanz (Cheltenham: Edward Elgar, 2007).
- 9 See P. Drummond and A. Mansoor, “Macroeconomic Management and the Devolution of Fiscal Powers,” IMF Working Paper 2/76, 2002, on the general problem of macroeconomic management with a federal setting.
- 10 From 2001 to 2004, there was balance in the fiscal sector as a whole, and in 2005 it registered a surplus equivalent to 1 percent of GDP.
- 11 For the period 2007–09, a deficit will be allowed if the real growth rate of the economy is below the potential growth rate of 2 percent. For real rates of growth in the economy between 2 percent and 3 percent of GDP, budget balance will be required; for rates of growth above 3 percent of GDP, a budget surplus will be required.
- 12 The general fungibility of budgetary funds deprives this distinction on the causes of the deficit of any real economic meaning.
- 13 See C. Monasterio, “El laberinto de la financiación autonómica,” *Hacienda Pública Española* 163 (2002): 157–85, for a general discussion of autonomous financing.
- 14 There are some other minor deviations from the common regime in the case of the Autonomous Community of the Canary Islands, which, due to its geographical location, receives special treatment. However, the Canary Islands are typically

treated as part of the common regime. The two North African cities of Ceuta and Melilla also have a special status, which falls halfway between the position of a municipality and an Autonomous Community.

- 15 The standard assumption in the fiscal federalism literature is that some minimum degree of discretion over the structure of the tax is required (e.g., ability to change the tax rate) before we can consider it to be an own subnational government tax. See, for example, R. Bird, "Threading the Fiscal Labyrinth: Some Issues in Fiscal Decentralization," *National Tax Journal* 46 (1993): 207–27.
- 16 In the case of the Basque Country, tax autonomy is granted to the three provinces, or "Historical Territories," of Álava, Guipúzcoa, and Vizcaya. The "agreed taxes" in the Basque Country are administered and collected at the provincial level, with the regional government playing only a coordinating role. In this manner, the Autonomous Community is basically financed by transfers from the provincial governments. Note that this is not the case for Navarre because there the provincial and regional levels overlap perfectly.
- 17 The case of VAT and excise duties is quite complex. The tax yield collected by the regional governments is adjusted on the basis of estimates of consumption by the residents of each Autonomous Community. See I. Zubiri, *El Sistema de Concierto Económico en el contexto de la Unión Europea* (Bilbao: Círculo de Empresarios Vascos, 2000) for a complete explanation of these steps.
- 18 Some of the measures taken by the charter regional governments have been stricken by the European Court and by the Spanish Supreme Court because they were construed to represent public support of activities distorting economic competition. See I. Zubiri, *El Sistema de Concierto Económico en el contexto de la Unión Europea* (Bilbao: Círculo de Empresarios Vascos, 2000), 212–25.
- 19 See C. Wallich, ed., *Russia and the Challenge of Fiscal Federalism* (Washington, DC: The World Bank, 1994).
- 20 In its "Fiscal Regulations," the plenary session of the municipal council must decide, before the start of the fiscal year, which taxes are approved for implementation and within which margins, as specified by law. There is a third optional municipal tax on luxury expenditures, and this covers the use of hunting and fishing grounds. This tax has little revenue significance.
- 21 Data regarding vertical fiscal gaps was not available for Spain.
- 22 As we have seen above, the two regions under the charter regime receive no equalization grants. Actually, in their case, there is a negative transfer from these two regions to the National Treasury.
- 23 Special guarantees have been established for health care funding, including guaranteed increases that are at least equal to the rate of growth of GDP. In addition, revenue collections from the hydrocarbon retail sales tax, levied at the regional level, are formally tied to health (and environmental) spending.
- 24 See F. Pedraja, J. Salinas, and J. Suárez-Pandiello, "Financing Local Governments: The Spanish Experience," in *Tax Reform in Spain: Accomplishments and Challenges*, ed. J. Martínez-Vázquez and J.F. Sanz, (Cheltenham: Edward Elgar, 2007).

- 25 This group also includes the capital cities of all provinces and the capital cities of the Autonomous Communities regardless of their population size.
- 26 The allocation of revenues from consumption taxes is based on indirect methods that approximate relative levels of consumption expenditures.
- 27 This transfer used to be computed in a similar manner to the transfer system that, since 2004, has been used by the rest of the municipal governments.
- 28 The system of transfers for tourist municipalities with populations over 20,000 involves the two systems just described.
- 29 See, for example, F. Pedraja and J. Suárez-Pandiello, "La última reforma de la participación municipal en los tributos del estado. Un análisis cualitativo," *Papeles de Economía Española* 100 (2004): 77-92.
- 30 See I. Joumard and C. Giorno, "Getting the Most out of Public Sector Decentralisation in Spain," *OECD Economics Department Working Paper* 436 (2005): 8, 20.
- 31 See, for example, C. Viver Pi-Sunyer, "Finalmente, una amplia autonomía de baja calidad," *El País*, 6 September 2003.
- 32 This appears to be the route chosen by the regional governments (such as Catalonia) currently rewriting their regional constitutions (Autonomy Statutes) and negotiating with the central government.
- 33 Note that, fundamentally, the two Spanish regions under the charter regime have this sort of formal authority. In the charter arrangement, as in the common regime, there is no cohabitation of tax bases; however, in this case, the central government does not raise any of the taxes used by the regional governments. We should also note that this potential new arrangement could provide the basis for addressing the current asymmetry in revenue assignments between the regions in the common regime and those in the charter regime.