

**FISCAL FEDERALISM IN SPAIN.
THE DECENTRALISATION: AN UNFINISHED WORK**

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On the last two decades Spain has taken on an important decentralisation process which has concerned to wide fields of the public sector management. In particular, Central Government managed in 1975 (date of the death of general Franco and beginning of democratic transition) 85.07 % of the public expenditure, excluding Social Security. Twenty years later, in 1995, it only managed 58.84 %, in spite of having increased the weigh of the public expenditure from 16.41 % to 28.14 % of the GDP¹.

The task of decentralising this volume of expenditures has induced so much strong institutional tensions both, on the building of the constitutional framework and the development of the process rules and on the more pragmatic events of the daily management among the different implied governments. Those tensions have been especially hard in the field of the financing system.

I am going to destine this paper to critically summarise this process and the current situation about this. To do it, I will divide the work in four parts. First, I will briefly describe the general characteristics of the administrative Spanish system and I will try to remark which have been, in my opinion, the main determinants of the administrative and fiscal decentralisation process produced in Spain and its political and economic explanations. The second part will resume both models of financing the Autonomous Communities, which compose the new regional level of government “ex novo” introduced by Spanish 1978 Constitution and the most original contribution to the decentralisation process. Third part will summarise the local governments financing system. Mainly I will refer to municipalities financing, as principal instance, but I will do some brief reference to provincial and insular governments. Last, in the fourth part I will

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¹ Obviously, if we take into account the Social Security spending, those figures are considerably increased. In particular, Social Security expenditures were 9.66 % of GDP in 1975 and 19.09 % in 1995.

sum up the principal conclusions and I will notice about some “loose ends” to be take up in a next future.

1. -The decentralisation process. Theory and Policy.

Until 1978, the date when the current Spanish Constitution was approved, the Spanish Public Administration was essentially characterised by an exaggerated centralism where central government assumed control of practically all public expenditure.

The administrative structure until then rested on the division by provinces of the country made by Javier de Burgos in 1833 copying the napoleonic model. Nevertheless, the provincial level of government lacked of relevant responsibilities and this, linked to its political use during the dictatorship through the civil governors, made it to be converted into a simple instrument of the political designs from central government, searching inter-territorial uniformity.

The Democratic Constitution of 1978 has dramatically modified this situation by consecrating the principle of territorial *autonomy* and self-management. As I have announced earlier, the new Constitution has introduced a new level of government (Autonomous Communities, here in after ACs), based on common historical, cultural or economic characteristics which manage a set of political responsibilities accordingly to the traditional division of powers, this without changing the existing provincial model. So, they have been able to have their own legislative chambers, formed by members elected by the ballot box. They can also execute their own politics in matters that have been stated according to the Constitution and the respective Statutes of Regional Autonomy, and have their High Court of Justice.

The new autonomic structure was conceived, in the beginning as going along with the old provincial structure so that each AC should have to group together various bordering provinces. Meanwhile the already democratised provincial institutions (Deputations and Insular Councils) would for their own part in the decentralising network that would have the municipalities as the last link. But this process of decentralisation was not able to establish a harmonic well-balanced model of regional division. On the contrary, due to historical reasons jointly with different political aspirations at a territorial level, it was produced a rather casuistic regional model with conflicting functions and financial set-ups within the different ACs. Table 1

summarises the present state of territorial decentralisation in Spain, based on the three principal levels (central, regional and local).

TABLE 1

ADMINISTRATIVE DECENTRALIZATION IN SPAIN

FIRST LEVEL CENTRAL GOVERNMENT STATE		
SECOND LEVEL 17 AUTONOMOUS REGIONS (OR COMMUNITIES)	According to their	2 Foral Regime Communities (Navarra and Basque Country) with a particular more autonomous System
	financing system	15 Common Regime Communities with a general and essentially dependent of Central Government System
	According to their	7 High responsibilities Communities, which manage Education and Health Services (Andalucía, Basque Country, Canary Islands, Catalonia, Galicia, Navarra and Valencia)
	responsibilities	10 Low responsibilities Communities, which do not manage Education nor Health Services
	According to the number of Provinces in their territory	6 One-province Communities, where Provincial Governments do not exist and regional governments have assumed their responsibilities (Asturias, Cantabria, Madrid, Murcia, Navarra and Rioja) CONTINUA...

CONTINUACION ...		11 Multi-province Communities, where Provincial Governments exist and assume their own responsibilities
THIRD LEVEL LOCAL GOVERNMENTS	50 County Councils (Province Governments - Deputations and Islands-)	3 Foral Provincial Governments (Álava, Guipúzcoa and Vizcaya, in the Basque Country) with a special more autonomous financial system
		47 Common Regime Provincial Governments with a general and essentially dependent of Central Government financial system
	About 8000 Municipal Governments (City Councils)	

Source: SUÁREZ-PANDIELLO (1996)

Specifically, the first two (Central and AC) are more “political” levels, in the sense that they maintain the institutions that exercise the traditional distribution of power (legislative, executive and judicial), while the local level (provincial and municipal) completely lacks legislative and judicial institutions. More in particular, the central government has exclusive power in matters of defence, foreign affairs, economic stabilisation and social security with regard to pensions and unemployment subsidies. The central government also has responsibilities in public order, although it shares policing responsibilities with the regional governments of the Basque Country and Catalonia.

As for the regional level of government (AC), table 1 shows three types of grouping according to some remarkable facts. Firstly, we can classify those governments according to its responsibility number and dimension (map 1). In this sense there are seven communities with a size superior to the rest. Four of them (Andalucía, Catalonia, Galicia and Euskadi or Basque Country) has recognised the right to assume larger responsibilities range from the beginning of the autonomic process. Their justification relates to their status as “Historical” Communities, because they had their Statute of Autonomy from the thirties during the second Spanish Republic. The other three ACs with wide responsibilities have agreed to their present competence through an expansion, which has been achieved by a slower constitutionally designed

process. Table 2 summarises the main responsibilities assumed by both groups and table 3 shows a quantitative idea of this.

TABLE 2

LEVEL OF RESPONSIBILITIES OF AUTONOMOUS COMMUNITIES

Level of responsibilities		Responsibilities
HIGH	LOW	<p style="text-align: center;">COMMON</p> <ul style="list-style-type: none"> * Forestry, agriculture, livestock and fishing in internal waters * Town-planning and housing * Roads * Ports and airports without commercial activity * Hydraulic exploitation, channels and irrigation * Environmental protection * AC monumental patrimony, encouragement of culture and regional languages, libraries, museums and conservatories * Self-government institutions * Internal trade-fairs, sport promotion and tourism
		<p style="text-align: center;">EDUCATION</p> <ul style="list-style-type: none"> * Management of the education system at all levels <p style="text-align: center;">HEALTH</p> <ul style="list-style-type: none"> * Provision of medical and chemist assistance

Source: Monasterio and Suárez-Pandiello (1996).

Basically, the difference with regard to public expenditure between the two groups of ACs is that the Communities with a higher level of responsibilities assume more responsibility for Education and for Health, while, where in the rest of the ACs the Central Government is trying to face those needs. Anyway, there are certain differences even amongst the ACs that are regarded as having the same level of responsibilities, since the Statutes

that govern the responsibilities of each region have been adopted via different processes and individually ².

TABLE 3
QUANTITATIVE WEIGHT OF THE DIFFERENT A.C.
RESPONSIBILITIES (1993)

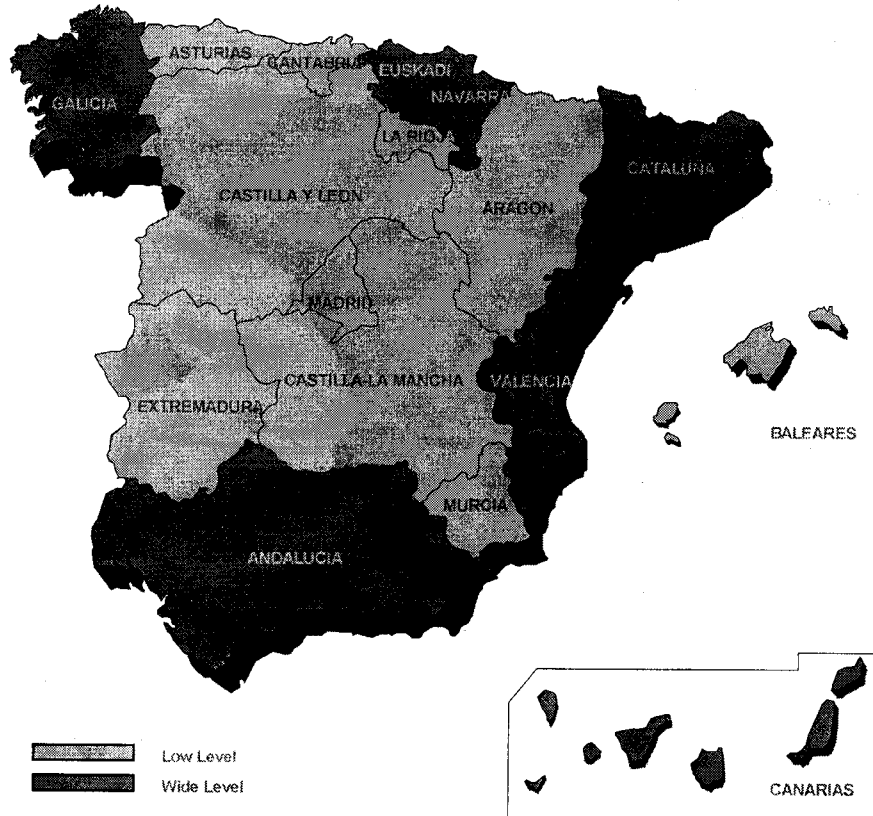
(Thousand of pesetas)

Responsibilities	Low	High	All Common Regime A.C.	% of total
Common	505.369.354	569.302.739	1.074.672.093	18,18
Education	985.123.696	1.297.263.618	2.282.387.314	38,61
Health	1.181.709.325	1.372.359.753	2.554.069.078	43,21
Total responsibilities	2.672.202.375	3.238.926.110	5.911.128.485	100

Source: Monasterio and Suárez-Pandiello (1996), pag. 61.

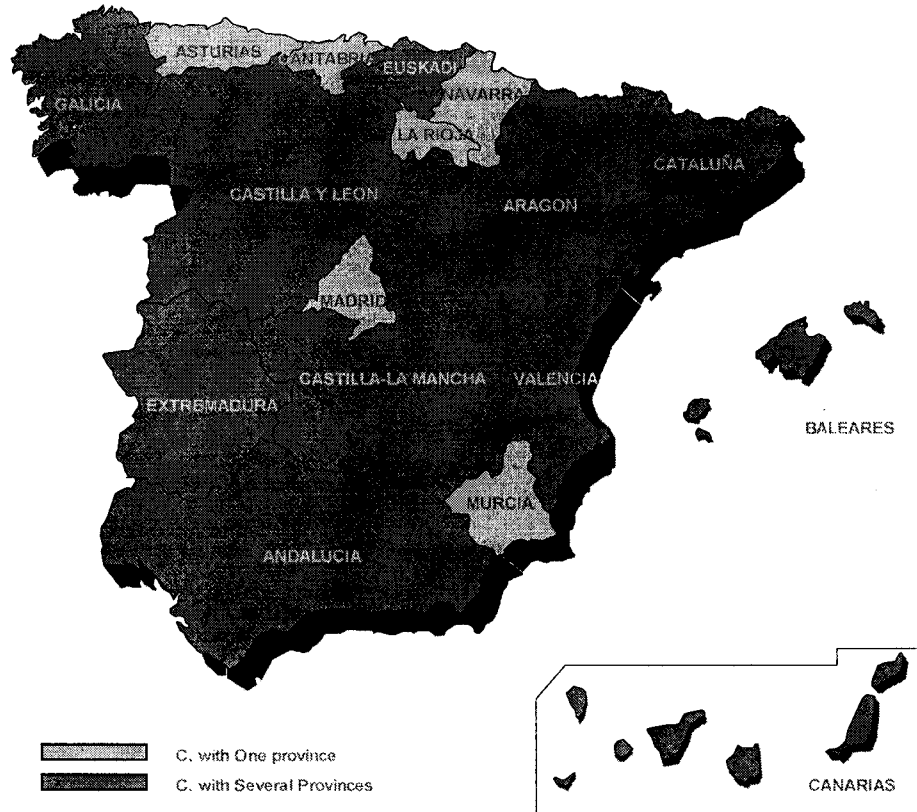
² At the moment, nevertheless, there is a process ongoing whereby ACs with the low level of responsibilities can take over responsibilities pertaining to health and education. Concretely, all the ACs has yet assumed the responsibilities in matters of universities and it is expected that at 1998 the transference process in education matters will be finished.

MAP 1
AUTONOMOUS COMMUNITIES
LEVEL OF RESPONSIBILITIES



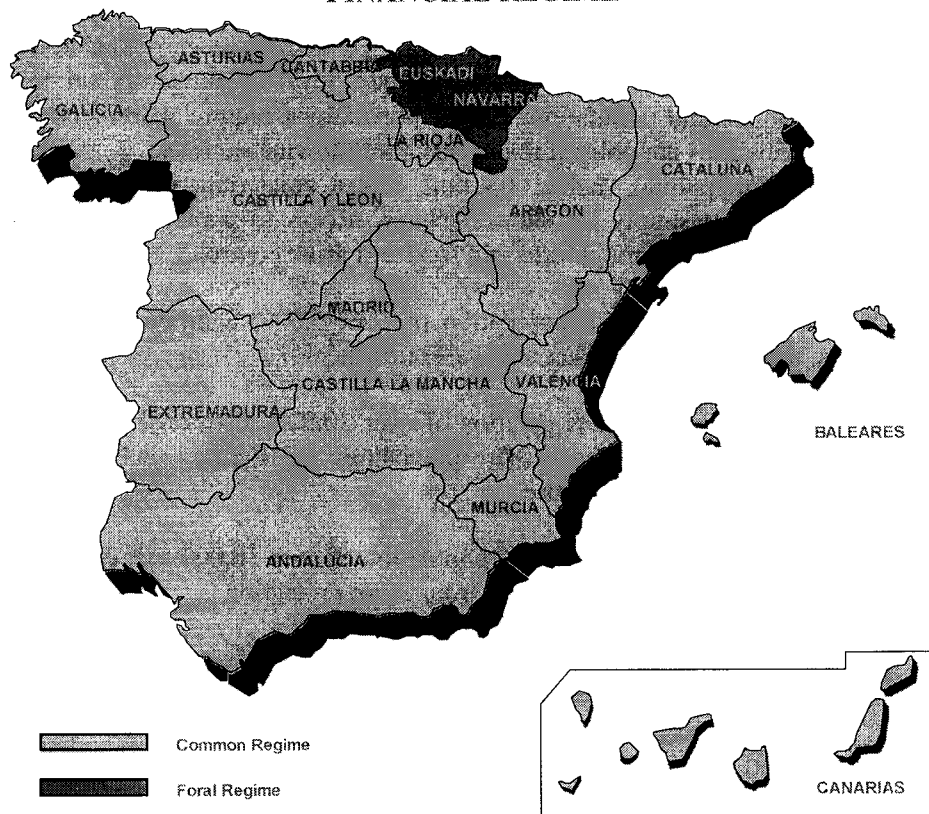
The second classification is based on the number of provinces that make up the ACs, where we must distinguish between the one-province or multi-province. That distinction is relevant in the sense that the one-province ACs assume the responsibilities and financial resources that previously, were given to the Provincial Deputations which have disappeared as territorial entities, so as to avoid administrative duplicity. On the contrary, the multi-province ACs have, constitutionally, to maintain the Provincial Deputations, as well as their responsibilities and their financial system, though some Statutes of Autonomy give the right to the AC to legislate in local matters.

MAP 2
AUTONOMOUS COMMUNITIES
NUMBER OF PROVINCES



Finally, the third classification looks at differences within financial systems, this having as a basis, the acknowledgement of historical constitutional rights for the Basque Country and Navarra. The particularities of this financial system will be taken up in later section.

MAP 3
AUTONOMOUS COMMUNITIES
FINANCIAL REGIME



At level of local government, the Spanish Public Administration is made up of two essential institutions. They are the Provincial Deputations (“Consejos” and “Cabildos” in the islands) and Town Councils or Municipalities, both constitutionally honoured institutions which have to be maintained, only with the exemption of the aforementioned disappearance of the Provincial Deputations in the case of the setting up of the one-province ACs. Nonetheless other types of organisms of local character can be created (Associations, metropolitan areas, consortiums, etc.) to deal with specific types of public services. Municipalities, both because of their number and for

being the nearest institutions to the citizens, are the principal leading part of the local public sector.

Though the Constitution provides for the division of powers between the State and the ACs but does not refer to the responsibilities corresponding to local governments. These powers are regulated in a particular Local Government Act, which establishes a minimum level of obligatory services per size of municipal population. Larger populations require more services. Thus, municipalities are obliged to provide the following services:

- a) In all municipalities: public lighting, refuse collection, road cleaning, drinking water supply to homes, sewage, access to population nucleus, paving of public thoroughfares and food and drink control.
- b) In municipalities with a population of over 5,000, additionally: public parks, public library, market and waste treatment.
- c) In municipalities with a population of over 20,000, also: civil protection, promotion of social services, fire prevention and fighting, public sports facilities and a slaughterhouse.
- d) Finally, in municipalities with a population of over 50,000 too: collective urban passenger transport and environmental protection.

Furthermore, the following responsibilities are given to Provincial Governments:

- a) Co-ordination of municipal services to guarantee an adequate level thereof.
- b) Legal, economic and technical aid to municipalities, particularly to those with reduced economic and management capacity.
- c) The provision of supra-municipal public services.
- d) Generally speaking, to foster and administer the specific interests of the province.

However, it should be made clear that in most cases, responsibilities are shared by the central government and the regional governments, as occurs in major roads and transportation, housing, social services and development policy. Similarly, the local governments intervene equally - to a certain extent - in the provision of these services. In turn, the regional, provincial and municipal governments share responsibilities in cultural activities and sports facilities. In a brief statistical annex, at the end of the paper, it can be found some quantitative details about the distribution of responsibilities and financial resources among the different levels of government in Spain.

Even so, if we have to label the origin of our fiscal decentralisation process, I think that “political” is the correct adjective. So as to understand it, it is necessary putting on the Spain in the second half of the seventies, just after General Franco’s death. It can be remembered how so many energies pushing for a political change were mixed in a moment of increasing political turbulence, due to the end of an authoritarian regime. Among those energies and related to our topic, perhaps the most important one was the political action of some very powerful nationalist groups existing in two specially relevant regions (Catalonia and Basc Country). Those groups, whose political fields went from the conservative right side to the radical left side, were linked by the common desire to reach a wide range of self-government, in order to manage each time larger responsibilities over its territories. Accordingly, the called “Estado de las Autonomías” (Autonomic State) was developed from the need of facing those demands without creating inadmissible territorial discriminations.

So, as against the economic arguments based on fiscal federalism theories³, as the known Barzel-Oates⁴ theorem, some problems have been generated in the evolution of the system due to its referred political origin and, more concretely, to the open character designed by the Constitution. Thus, there was an implicit agreement that at the end of the process Central Government only should have to manage around a 50 % of the public

³ See OATES (1972), KING (1984) or RUBINFELD (1987) for citing some works which have become classic.

⁴ Which was arguing for the superiority of decentralised provision of public goods under some general assumptions. See BARZEL (1969) y OATES (1972).

expenditure, the rest being managed -25% each- by ACs and Local Governments. Nevertheless, the lack of an explicit agreement about the ceiling of responsibilities to be reached by the ACs and also the concurrence of responsibilities in several levels of government has produced a lot of juridical conflicts and inefficient duplicities of bureaucratic organisms. Moreover, the financial system has been touched on those questions, and perhaps it has been there where the perception of those problems was biggest.

So, taking into account the principles of economic rationality, a financial system should have to be established consistent with the spending needs for each level of government, according with the volume of assumed responsibilities⁵. Therefore, the estimation of those needs and their determinants should be the basis on which a system of stable financing in dynamic sense would be built. However, in the Spanish case the evolution of the system has been strongly conditioned by political components, which have taken to maintain a special system of financing (foral) exclusively for two communities. Otherwise a financial schema has been perpetuated for the rest, based on revising it each fifth year, but only the allotment of the increments in financing on the previous "status quo" was subjected to discussion. Consequently, this outline has been based in good measure on "ad hoc" conditions and it have impeded the consolidation of a stable financing system. I will dedicate the following epigraphs to describe the foundations of the different financing systems.

2. - The autonomic financing models.

Moving towards a fiscal decentralisation has necessarily implied the provision of enough resources to sub-central levels of government in order to face a growing range of responsibilities. Concretely, it was necessary to create "ex-novo" a financial system for the ACs (new intermediate level of government) to satisfy their needs of expense, in view of the new responsibilities that were constitutionally attributed them. As I have previously indicated, historical and, mainly, political reasons, they made that two of the new ACs. (Euskadi and Navarre) were disrupted of the common or

⁵ As it is known, the more assumed principles of fiscal federalism suggest that sub-central levels of government be devoted fundamentally to provide public goods and services according with their jurisdictional size.

ordinary financing system and they maintain a special and more advantageous system for them (the foral regime). For the rest of the territories (the 15 remaining ACs), a new financing system was built on the base of a called *methodology of the effective cost*.

2.1. - The common regime system

It is habitual say that the Spanish financing system of the common regime ACs is integrated by three blocks of resources, they called *block of sufficiency*, *block of solidarity* and *block of autonomy*. This separation is useful, since it allows isolating the different objectives that are sought to cover with the several financial instruments, although the three blocks does not constitute independent compartments upon existing some interrelations among them.

a) The block of sufficiency

The so-called *block of sufficiency* contains the basic instruments of the system, it is to say, those with which the covering of the effective cost of the services transferred to the ACs should be guaranteed. Roughly, the *methodology of the effective cost* implied that the financial resources for the ACs after receiving the transfer of responsibilities from Central Government they should be enough in order to maintain the benefit of services previously made by Central Government to the same level of covering. In consequence, each responsibility should be valued (quantified or its effective cost calculated) and when it was transferred to an AC, it should be gone with enough instruments in order to finance it. In the practice, the lack of a reasonably developed system of costs accounting have made that the effective cost has become an “accorded cost” between the central and autonomous governments by means of bilateral agreements in mixed commissions of transfers.

Anyway, the revenues integrating the *block of sufficiency* have arisen until here from two sources, the *ceded taxes (CT)* and a *share on Central Government Taxes* (in Spanish, Porcentaje de Participación en Ingresos del Estado or *PPI*), by applying a percentage • on the Central Government tax revenues (*CGT*).

From the beginning, the management and the collection of a group of before centralised taxes have been given to the ACs of common regime. The

object was endowing them of any degree of financial autonomy, but the normative capacity about those ceded taxes was not ceded with. Ceded taxes were the Tax on Net Wealth, Inheritance and Gift Taxes, Property Transfer Tax, Stamp Duties and the Gambling Tax. In a first moment the Taxes on the Luxury Goods and other consumption taxes burdened in destination were also ceded to the ACs. However the disappearance of those taxes with the incorporation to Central Government of the Value Added Tax in 1986 has supposed a cutting in the fiscal bases of the ACs, and an increase of the dependence of the grants from the Central Government.

Thus, the shares on Central Government Taxes have come being in practice the real base of the system, due to their quantitative importance. However they did not take the form of territorial participation in the concrete collection of certain taxes, as it happens for example in the German case, but rather they appear like a system of unconditional grants.

At the beginning of the decentralisation process (transitory stage, until 1987), two important problems were brought up to the system by the direct link between those two financial instruments and the *effective cost (EC)* of the transferred services. On one hand, the equality

$$\alpha = \frac{EC - CT}{CGT}$$

implied that an increase on CT would automatically reduce the value of α . Thus, the ACs did not have any incentive to improve the management of the ceded taxes because the only purpose of α was to cover the effective cost of the transferred services⁶.

Otherwise, the methodology of the effective cost implied maintaining the services with a level of same covering to the prevailing before the decentralisation. Consequently, any AC wanting to improve this level of covering should make it by using other different sources of financing linked basically to the *block of autonomy*. We will see later those resources.

The knowledge of these problems led to the renovation of the prevailing philosophy. So, once the system of financing was established, it was disconnected of the effective cost and an automatic mechanism of

⁶ So, the Madrid AC was deprived at the beginning of the ceded taxes, since their presumed collection would overcome the effective cost of the transferred services.

evolution for the share in Central Government Taxes was instituted. To do it, the relevant criteria were set up on the basis of three general approaches. The first had a distributive character and weighed with positive sum diverse indicators of *expenditure needs* linked to the responsibilities that were assumed by each Community. The other two had a re-distributive quality and, to do it, a *fiscal effort* and a *relative poverty* variables respectively were weighed with zero sums⁷. The efficacy of the new mechanism was fixed in a five years period (1987-1991) to be revised at the end. The junction of these referred to the year 1986 was used to fix a percentage of participation in the Central Government taxes for each common regime AC. Starting from there, the amount that would correspond to each AC could be calculated for every year of the corresponding five years period according with the application of the following expression:

$$PIE_N = PPI_i \cdot ITAE^* \cdot IE$$

Where:

PIE_N was the amount we were looking for the year N.

PPI_i was the percentage of participation of i AC.

$ITAE^*$ were Structurally Adjusted Central Government Tax Revenues for the base year 1986 (in Spanish, *ITAE [Ingresos Tributarios del Estado Ajustados Estructuralmente]*). These are consisting of all the State taxes, including those used to finance the Social Security, and excluding ceded taxes to the ACs and those assigned to finance the European Union.

IE was the prevailing rate of evolution, knowing that as a general rule (variation in $ITAE$, as a general rule, with a maximum established in the evolution of nominal GDP and a minimum guarantee set in the inflation rate).

⁷ For a more detailed analysis see MONASTERIO & SUÁREZ PANDIELLO (1996).

$$IE = \frac{ITAE_N}{ITAE^*}$$

And as exceptions,

$$IE \leq \frac{GDP_N}{GDP^*}$$

And always .

$$IE \geq \frac{GEE_N}{GEE^*}$$

GDP was the nominal Gross Domestic Product and

GEE were the equivalent expenditures of Central Government, defined as the sum of the staff expenditures, the purchase of goods and services and the real investments carried out by Departments that had made relevant responsibilities transfers to the ACs.

The basic financing for the period 1987-91 was fixed in that way and that same philosophy has inspired the revision for the period 1992-96. Concretely slight modifications were incorporated for this new period, basically in relation with the indicators of the expenditure needs and in the total volume of revenue to be added to the system. The successive agreements of the system revision have been adopted into an advisory organism, created for the co-ordination between the Central Government and the Autonomous Governments. This organism is the denominated Council of Fiscal and Financial Politics (in Spanish, Consejo de Política Fiscal y Financiera or *CPFF*), and it is constituted by the ACs ministries of Finance and the Central Government ministries of Finance and Public Administrations. Once reached an agreement in this organism, this should be ratified by the Parliament before they're gone into effect.

As an example, table 4 shows the weights of the different indicators, which have been considered to distribute the PPI in the period 1992-96.

TABLE 4

**WEIGHT OF THE VARIABLES USED FOR DETERMINING THE PPI
FOR THE 1992-96 PERIOD**

Low Level of Responsibilities Communities

Population	64.00 %	
Insularity	0.40 %	
Surface area	16.60 %	
Geographical Dispersion	2.00 %	100 %
Administrative Units	17.00 %	
Tax Effort	1.82 %	
Relative Poverty	2.70 %	

High Level of Responsibilities Communities

Population	94.00 %	
Insularity	1.50 %	
Surface area	3.50 %	
Geographical Dispersion	0.60 %	100 %
Administrative Units	0.40 %	
Tax Effort	1.82 %	
Relative Poverty	2.70 %	

Furthermore, the main open to criticism element of the system was the lack of fiscal responsibility of the ACs. It could be easily deduced from the presented schema how the instruments to guarantee the financial sufficiency of these governments (therefore most of the resources) they remained them a very scarce capacity of autonomy to configure their mixes of revenues. Indeed, as I have previously indicated, after the tax cession the autonomous governments were who managed and who collected these taxes. However, the Central Government continued reserving the normative power on them, it is to

say the determination of tax bases, rates, exemptions and deductions. The consequence of this was a very strong financial dependence from the Central Government, which was considered negative both from the point of view of the effective autonomy as regards public management, and from that of the responsibility and the accountability in front of the citizens-voters. So, the conscience of this problem led to include the need of increasing the fiscal responsibility of the ACs in the financing agreement for the 1992-1996 period, and thus the task of studying the question was delegated in a working group. As a consequence of this, on October 7, 1993, the ACs allowed it in the Personal Income Tax (IRPF) for the 1994 and 1995 tax years. As the end of 1995 had approved no definitive system, the share was extended until 1996, with the same criteria applicable as in 1995.

The financial effects of sharing were neutral in 1993, since the sharing is conceived as a deposit made on account of the general or PPI grant:

$$PPI_{O93}^i - 0.15 IRPF_{93}^i = PPI_{N93}$$

Where, PPI_{O93}^i = PPI according to the old system, in 1993 in Community i .

$IRPF_{93}^i$ = Resources proceeding from the tax liability of the personal income tax (IRPF) in 1993 in Community i .

PPI_{N93}^i = New PPI in 1993 in Community i .

The previous relationship was conditioned by the fact that in 1993, $PPI_{O93}^i > 0.15 IRPF_{93}^i$. Since the ACs of Aragón, Balearic Islands and Madrid did not meet this condition, the percentage share was set at 10% in Aragón and 5% in the Balearic Islands and Madrid.

As of 1993, the evolution of the new share (PPI_N) continues to depend on the same variables that prevailed at that time. On the other hand, the evolution of the share in IRPF depends on the real growth of the amounts payable of this tax declared by the residents of each Autonomous Community. However, and to make sure that the new financing system did not spawn winners and losers, maximum and minimum limits were set on growth in variations of the resources derived from the new financing system. This means

that with this new system, all the Communities will have greater resources, and those that make a greater tax effort through IRPF will derive greater benefit from the change, albeit with a maximum limit.

Anyway, the progresses in matters of fiscal responsibility with the share on the Income Tax were very insufficient. Because there was Central Government who continued having the ability of fixing tax bases and rates, this new financial instrument became in practice another kind of unconditional grant. It was at the end of April 1996, just after the last national elections, when the winning party -Partido Popular (PP)- and the Catalan nationalist party -Convergència i Unió (CiU)- have established an agreement to deeply reform the regional financing system in matter of fiscal responsibility. Concretely, it will be possible to increase the AC percentage share in the Personal Income Tax until 30%. In addition, the most important thing, the ACs will have tax powers to establish basic elements of the ceded taxes, such as the rate and the deductions, including in this the power to modify the tax rates on their share on income tax⁸.

b) The block of solidarity

Once guaranteed the cover of the effective cost of the assumed responsibilities, it was understood that it was necessary to face the existing disparities in the endowment of stocks of public capital along the territory, which was generating important inequities on the people living in the poorest regions. To do it, and to cover the called level or *block of solidarity*, there were established some principally conditional grants linked to investment projects. Among those, the most important one is the called *Interterritorial Compensation Fund*, whose endowment is made taking as a basis the 30% of the civil investment budget of the Central Government. Now, this Fund is only distributed among the poorest Autonomous Communities, which are whose per capita income do not reach the 75 % of the European Union mean. The distribution criteria include population (87.5%), migratory balance (1.6%), unemployment (1%), surface area (3%) and population dispersion (6.9%). Furthermore, as distribution is made following the above criteria, the result is

⁸ For a more detailed exposition of the changes related to the autonomic share on the income tax, see ZABALZA (1994), PEREZ (1995) or BOSCH, SUAREZ PANDIELLO & ESPASA (1996).

corrected as a function of the inverse of income per inhabitant of each region and those living in the islands. More specifically, the FCI distribution formula is as follows⁹:

$$ICF_i = \left[\left(0.875 \cdot \frac{P_i}{\sum P_i} + 0.016 \cdot \frac{MB_i}{\sum MB_i} + 0.01 \cdot \frac{U_i}{\sum U_i} + 0.03 \cdot \frac{Sr_i}{\sum Sr_i} + 0.069 \cdot \frac{NP_i}{\sum NP_i} \right) Q + 3.624 \cdot \left(\frac{P_i}{\sum P_i} - \frac{GDP_i}{\sum GDP_i} \right) Q \right] I_i$$

Where,

ICF_i is Community i 's share in the Interterritorial Compensation Fund,

P_i is the population of Community i , in mean values of the last five years,

MB_i is the migratory balance of Community i , defined by the mean of the internal migratory balance plus the mean of outbound migration for the last ten years, taking zero value if $MB_i > 0$.

U_i is the number of unemployed in Community i , in mean values for the last available five years,

Sr_i is the surface area of Community i ,

NP_i is a measurement of population dispersion, defined as the number of nucleus of population per square kilometre in the territory of Community i ,

GDP_i , in average values for the last available five years,

I_i is the correction factor for the insularity variable corresponding to Community i , so that the amount corresponding to the Autonomous Community of the Canary Islands by virtue of the rest of the criteria

⁹ A wide revision of the principles and the time evolution of the IMF can be seen in BIESCAS et al. (1992). For a more summary version, MONASTERIO & SUAREZ PANDIELLO (1996), Chapter 6.

increases by 63.1%, whereas the amount for the other Communities falls proportionately and,

Q is the total volume of ICF to be distributed.

Other main financial instruments obtained by the ACs to cover solidarity objectives are the *Investment Agreements* between central and autonomic governments (essentially matching grants) and the *European Structural Funds*. Besides, in the Spanish regulation there exists too another financial instrument, the called *Especial Assignations of Equalisation*, from the Central Government budget, whose theoretic mission must be to cover strong insufficiencies in the provision of essential public needs detected into a territory. The reality is that this instrument never has been implemented.

c) The block of autonomy

Finally, it is possible that any community would want to improve the level of covering of the services provided by itself, by increasing the quantity or by improving the quality. To face those desires, the Spanish system includes some financial instruments linked to the called block of autonomy. Those instruments are the called *own taxes*, different of the ceded taxes, the *surcharges* and the *borrowing*. The own taxes are limited by strong conditions, which in practice made very difficult their use. Concretely those limitations are

- Avoiding double taxation, it's to say, do not tax bases yet taxed by the central government.
- Avoiding too fiscal exports, so, do not tax income nor goods out of the Autonomous Community, and
- Maintaining the unity of the interior market, or do not obstructing the free factors and commodities traffic.

With those limitations, the main taxes which have been created by the ACs were several taxes on concrete gambles (in particular, 8 ACs have established a Tax on Bingo), taxes on Under-productive Land (created by 3

ACs, with non-only fiscal objectives) and some kind of environmental taxes. Anyway, the financial weight of the own taxes of ACs is very small.

With respect to surcharges, it is possible to fix them on the central income tax, and on the ceded taxes with two limitations: do not modify the nature of the taxes on which are set up and do not reduce the tax collection of the central government. For instance, if we want to fix a surcharge on the central income tax, the personal and progressive character of that tax must be preserved, and this surcharge can not be deducted of the central tax. In practice, any community has never established any surcharge, due perhaps to the lack of political incentives to do it in moments of increasing tax pressure at both central and local levels. All communities have yet preferred to cover their autonomic desires by borrowing, which has become the only virtual instrument of true income autonomy.

However, some apparently severe restrictions have been put about the capacity of the ACs to borrow, in order to avoiding some eventual macroeconomic problems linked to the expansion of autonomic debt. Among this, we can point out three:

- A limit of destination. ACs only can borrow to destine it to investment projects or to cover transitory (less than a year) treasury needs.
- A maximum quantitative limit. The sum of all the financial charges (interests and amortisation) linked to borrowing can not exceed the 25 % of their current income.
- A need of direct authorisation. ACs must be explicitly authorised by the Central Government to borrow in foreign capital markets (foreign currency) and to put into circulation autonomic public debt securities.

In practice, some ACs have sometimes avoided the two first limits with none penalty. Moreover, the increasing use of borrowing by ACs along the last decade, joined to the need of observing the convergence criteria in order to build the European Union, have made necessary new limits to the autonomic debt and deficits. To do this, a new agreement was reached about, because which all the ACs accept to fix a top limit to their annual debt and deficit and, in exchange, Central Government takes charge of automatically

approving all borrow operations for which its authorisation is legally necessary¹⁰.

2.2. - The “foral regime” system

Until here, I have summarise the main points related to the financing system of the “common regime” ACs. Otherwise, the essence of the other system (“foral”) is the reversal of the scheme of financial relations between the central government and the common region ACs. Unlike the dependence of the common regime ACs on grants (the result of their traditional scant financial autonomy), the “foral” system is based on an agreement whereby the respective “foral” territories take charge of the main taxes of the State tax system. There are the so-called *Concierto*, in the Basque Country, and *Convenio*, in Navarra. Those ACs not only use these to finance the responsibilities they have taken on, but also have a margin of financial resources to transfer an amount to the central government as a way of payment for State services provided in the ambit of the respective “foral” territories. These are the Quota -in Spanish, *el Cupo*-, as it is known in the Basque Country, or Contribution, in Navarra¹¹. Nevertheless, their own management of the “agreed taxes” logically means a higher degree of financial autonomy. Improvements in the management of these aforementioned taxes would in turn create possibilities of improving services to the “foral” governments, because the quota is not linked to their receipts.

A vertical tax imbalance is produced between levels of government as a result of their matching their respective tax powers with expenditure requirements, in accordance with the current system of responsibilities. Consequently, the “foral” territories have a greater taxing capacity than would really be necessary for the financing of their responsibilities, which is exactly the opposite in the case of the common regime ACs. This explains why the flow of grants between levels of government goes from the central

¹⁰ A more detailed analysis of this point, and, in general, of the regional and local debt can be seen in ALVAREZ CORBACHO, MONASTERIO & SUAREZ PANDIELLO (1997).

¹¹ Note that the differential sphere of the foral system refers exclusively to revenue (financing system). Regarding expenditure, both the Basque Country and Navarra are Autonomous Communities with a high level of responsibilities as we showed in chapter 2 (see Table 3).

government to the common regime ACs, in one case, and in the other, from the “foral” territories to the central government.

The systems of privileges applied in the Basque Country and Navarra are essentially similar. Nevertheless, there are certain small differences between them. Perhaps the most significant one is arising from the different character of the two ACs. So, it is important be aware of the real “foral” authorities, who have tax powers, are the provincial governments (Historical Territories, in constitutional terminology). Due to this, the scheme of internal relationships in the Basque Country entails a degree of complexity that does not occur that in Navarra. The reason is this last is a one-province Community, where the province as a separate administration has disappeared, and their responsibilities having been assumed by the Autonomous Community.

Concretely, the tax and financial relationships between the Basque Country and the Central Government are based on a pact (the Economic Arrangement or, in Spanish, *Concierto Económico*). From this, the organs pertaining to the “foral” system of the so-called Historical Territories (Basque Provinces) of Álava, Vizcaya and Guipúzcoa, deal with the management of the “agreed taxes”. According to the provisions of the Economic Arrangement, attributing not only management responsibilities to the competent “foral” system organ, but also tax regulatory capacity can effect the agreement on each tax. In this case it would be dealing with “agreed taxes” (*impuestos concertados*) through the autonomous regulations and “those agreed” through common regulations. Anyway, the “agreed taxes” include all the Central Government taxes, except the special taxes (excises)¹², social security contributions (payroll taxes) and import taxes.

Later on, the Basque Country’s favourable vertical tax balance derived from the Economic Arrangement is subsequently adjusted through payment of the Quota, conceived as a contribution to non-assumed general State responsibilities. Since the services provided by the State in the Basque

¹² Recently a new agreement was made, which includes too excises in the “agreed taxes” with the Basque Country.

Country depend at all times on the power sharing in force during the period in question; the Quota is adjusted when a transfer of power takes place.

Besides what might be termed the external fiscal relationships of the Basque Country, articulated by means of the Quota, there is also an important flow of internal fiscal relations. These take the form of grants from the “foral” system provinces (the holders of the Arrangement) towards the Autonomous Community of the Basque Country and the Basque municipalities. Obviously, in the case of Navarra, those internal relations are limited to the links with Navarra municipalities.

Furthermore, apart from the “agreed taxes” (or grants received from the “foral” provinces in the Basc Country), theirs main resources, the foral regional governments are also financed by other revenue, they receive in its capacity as Autonomous Community. For instance, specific grants for financing health and social services, grants from the European Structural Funds, income property and from borrowing are other sources to finance foral ACs¹³.

3. - The local governments financing system.

As we outlined previously, the structure of Spanish local governments comprises two levels, provincial and municipal. In practice, only the municipal governments can collect their own taxes, albeit being closer to citizens. The provincial are absolutely dependent of the grants from other levels of government (excepting the possibility of fixing a surcharge on the municipal business tax), especially after the introduction in the central sphere of VAT (in 1986) which took away some important provincial tax receipts¹⁴. Evidently this does not affect the foral ACs whose structure of income is completely different, by having the above-mentioned “agreed tax system”. In the statistical annex, some quantitative and qualitative information can be found about the differences in revenues of all “common” regime and “foral” regime governments.

¹³ For a more technical a complete explanation of the foral system see ZUBIRI & VALLEJO (1995), MONASTERIO & SUAREZ PANDIELLO (1996) or BOSCH, SUAREZ PANDIELLO & ESPASA (1996).

¹⁴ Those provincial taxes were the surcharge on the old Business Trading Tax (multi-phasic tax) and the Tax on the Production of the Electric Power.

Putting the core on municipal governments, after the reform of their financial system in 1988, local sufficiency is based on two basic financial mechanisms similar to the components of the block of sufficiency in the common regime ACs system. Those instruments are the *own taxes* and a *share in central government taxes*. Furthermore, Spanish local governments can access other resources such as those derived from the exploitation of their own property, as well as resorting to credit. The own taxation of Spanish municipalities is based on the availability of three compulsory taxes, which have to be collected by all the municipalities, two voluntary ones and a third (voluntary) which remains from the old financing system. The compulsories are the Property Tax, the Business Tax and the Motor Vehicles Tax. The voluntaries are the Tax on Increment of Urban Land Value and the Tax on Buildings, Plants and Works. The last is the earlier called Tax on Sumptuary Expenses, which at the present only tax the private exploitation of hunting and fishing grounds. In all the cases, the municipal governments are able to fix the tax rate between some upper and lower limits; the top rate depends on the range of population in the municipality (greater rate as greater population). In practice this system gave to municipalities more fiscal autonomy than the called Autonomous Communities. Concretely, the municipal governments obtain roughly the 50% of their financial resources from taxes, while the common regime ACs collection hardly reaches the 15% (both including fees and user charges).

Spanish municipalities enjoy a broad degree of autonomy for the purposes of raising their own taxes (roughly 60% of the total). Although, the fact that the central government reserves the main tax concepts as far as collecting power is concerned (Income Tax, Value Added Tax...) makes the introduction of a powerful system of grants indispensable to guarantee the constitutional principle of sufficiency. In Spain, this system is based mainly on a general grant which often receives the somewhat confusing name of *State Revenue Sharing* (in Spanish, *PIE-Participación en Ingresos del Estado*), and whose design is very similar to that of the Tax Sharing Percentage (PPI) obtained by the Autonomous Communities (ACs). What both sharing (autonomous and local) have in common is that in practice they are general and unconditional grants from the State and they are not sharing in the territorial collection of State taxes. Nevertheless, there is an important difference between both of them. Even although there is no difference

between them as regards the freedom to dispose of the resources, there is a difference in the determination of the amount, since the bases for determining the latter are different, and therefore involve implicit and different distributive consequences.

Anyway, there are an additional difference between the sharing of the ACs and those of the municipalities. This is that while each AC has its own percentage, determined in accordance with the criteria analysed above, the share of municipalities is constituting an overall fund for all of them¹⁵, which in a second phase is distributed amongst the 8,000 municipalities, on the basis of other specific criteria.

More specifically, once the basic conditions of the system have been defined for a determined time period (five years), the definitive quantity will be established in accordance with the Central Budget Act. In 1988 an initial definitive financing was set for the municipalities. This was used to calculate the percentage share they will be entitled to in the course of the five-year period, according to norms analogous to those established for the ACs, which means that the same base (Central Government taxes) and the same rules of evolution are fixed. This is how the share of the municipalities in the Central Government taxes for the year N (PIE_N) is defined,

$$PIE_N = PPI \cdot ITAE^* \cdot IE$$

where:

PPI is the percentage share of the municipalities (as a whole).

ITAE* are Structurally Adjusted Central Government Tax Revenues (yet defined) for the base-year.

IE is the prevailing rate of evolution (variation in ITAE, as a general rule, with a maximum established in the evolution of nominal GDP and a minimum guarantee set in the inflation rate).

The only difference in the rate of evolution (IE) with regard to the one used for the ACs is the fact that the minimum guarantee (variation in

¹⁵With the exception of the big metropolitan cities (Madrid y Barcelona) which have an independent share.

Equivalent Central Government Expenditure - *GEE*) is replaced by the increase in the consumer price index (inflation) between the periods considered. The reason is the use of the *GEE* has no sense at municipal level due to the different nature of its spending powers. The Local Finance Act is therefore seen to guarantee automatism in the granting of the main source of general grants.

Once the overall sum of the *PIE* has been set, it must be distributed amongst the different municipalities. Once again, the Local Finance Act draws from the Central Budget Act for fixing specific criteria, even when a series of general rules are established. The practical embodiment of these distribution criteria implemented by successive Central Budget Acts takes the form of three basic points¹⁶:

1. The special treatment afforded to the municipalities of Madrid and Barcelona is maintained, which entails guaranteeing an increase in their financing outside the general fund, by the application of the prevailing rate of evolution to their financing. Furthermore, a special compensation is introduced for municipalities integrated within the metropolitan area of Madrid and those that comprised the metropolitan area of Barcelona.
2. Each municipality is guaranteed a minimum financing which consists of a standard increase on the previous year's (excluding the compensations mentioned in the preceding paragraph).
3. The remaining *PIE*, once the above quantities have been deducted, is distributed amongst the municipalities in accordance with the three general criteria provided for by the legislation, to wit:
 - 70% depending on the number of inhabitants in each municipality, pondered by a series of coefficients as per strata of population, being the top 2.85 for the municipalities greater than 500,000 inhabitants and the bottom 1 for those lesser than 5,000.
 - 25% depending on the number of inhabitants, pondered according to the average tax effort of each municipality in the year prior to the revenue-sharing year, and

¹⁶ For a more detailed and critical analysis see SUAREZ PANDIELLO (1996).

- The remaining 5% depending on the number of General Basic Education school units, both Pre-school and Special, existing in public centres where the property belongs to the municipalities, or depending on the upkeep and maintenance expenses payable by them.

As I have said earlier, beyond this incomes, Spanish municipalities can also obtain recourses through other sources, such as specific grants, interest on its own patrimony, share of the ACs income, fines and public or private loans.

4. - FINAL COMMENTS

As we have seen up to this point Spanish General Government has experimented over the last decade with an important process of decentralisation that has resulted in an increase of almost 25 percentage points by the participation of sub-central bodies in the management of public expenditure. Such decentralisation could be qualified as orthodox from the point of view of expenditure, given that sub-central finance is fundamentally dedicated to allocation objectives.

From the point of view of income the fiscal decentralisation in Spain also respects to a high degree the directive lines on the theory of fiscal federalism, where the main decentralised taxes were on bases with little capability of inter-jurisdictional mobility (Personal and Real Property Taxes for example). Taxes more related to re-distributive or stabilising activities were not decentralised (Income Tax or Corporation Tax for example)¹⁷ with the exception of foral regime. But the system chosen in Spanish case was leaving some loose ends, which need to be dealt with. For instance, the Spanish system gave little incentive to the fiscal co-responsibility above all on the level of ACs. Certainly, the possibility that these had to relate their tax demands to their needs of expenditure were minimal. So, the regulation of ceded taxes was carried out at central level (not even the rates could be changed) and the requirement of non-assessment of taxable factors already submitted to the central taxation largely was restricting the possibilities of creating new taxes. From this point the only unexplored path until now has been the application of surcharges as an option to fiscal co-responsibility. This

¹⁷ See MUSGRAVE (1983)

fact was creating a dangerous asymmetry in the distribution of political costs and benefits derived from public actions, where the sub-central levels was benefiting from the popularity originated from a larger quantity and quality of services given without falling into the cost that taxation demands suppose. This generalised non-fulfilment of the fiscal equivalence principle (Olson, 1969) seemed unalterable in the Spanish system of fiscal federalism where the autonomic surcharges continue unused¹⁸. A try of overcoming this was made with the last Agreement of ACs financing, by including as a new ceded tax a portion of the Income Tax and by giving to the ACs some normative powers about the ceded taxes (Income Tax too). At the same time, the total volume of general grants (PPI) is strongly reduced. So ACs will be compelled to assume a much greater level of fiscal responsibility (they will win in *autonomy*), but the *solidarity* principle could be damaged.

Otherwise, the differences in expenditure per inhabitant and the financing between the territories of foral regime and the ones of common regime are unacceptable from the point of view of fairness. The existence of territories that are fiscally privileged could create important elements of tension in the consolidation of the process of decentralisation, where financial reactions are unpredictable. In this way it is essential to reduce the complexity of the financial system of the sub-central governments, reducing the number of instruments of financing and giving them a more permanent character, to avoid a process of continuing negotiation between levels of government, with the consequence of political tension.

Finally, there are so many discrepancies that have arisen about the criteria of distribution of inter-territorial grants, mainly the ones related to local level¹⁹. From a theoretical point of view, it seems reasonable that the general or unconditional grants should bridge the existing gap between the needs of expenditure and the fiscal capacity of the subsidised entity. It seems

¹⁸ In this sense some theories could be a subject of contrast, such as the one explained by GROSSMAN (1989). According to it, after the abandonment of fiscal equivalence principle there underlies a political agreement, which is not necessarily explicit, between central government and the sub-central ones of exchanging grants by votes.

¹⁹ See for example SUAREZ PANDIELLO (1996)

also fair to incorporate some measure of fiscal effort in order to encourage the taking on of fiscal responsibilities or costs of popularity by those aforementioned entities. In this sense, an appropriate measure of the needs of expenditure is essential to design a correct mechanism of distribution, the same way that the analysis of the historical determinants of expenditure²⁰ would help to improve the formulas.

In order to conclude I only want to mention two things that are always flying over the Spanish debate about our fiscal federalism system, its building and their limits.

Firstly I want to shift the readers the idea of Spanish process of decentralisation is yet today an uncompleted and essentially unstable system due in my opinion to its origin has been mainly political more than economic. I take the view that the nationalist desires of two specially important regions (Catalonia and the Basc Country) and the need of replying those aspirations without generating strong inequities with the other territories were the original stones of the autonomic state. Moreover, the lack of explicit political agreements about the arrival point (the top of responsibilities to be assumed by the ACs at the end of the process) has moved all this in a framework of severe uncertainty, which has gone delaying the final of the process. However, certainly with partial agreements, it was possible to decentralise a very important amount of the public sector (20 % as a mean and close to 30% in some communities) in a very short time, which is, in my opinion, a positive point.

From a more technical point of view, and referring only to the financial system, it is important to remark that periodically it emerges an important debate in relation to the trade off between the two main principles that would must be preserved - the autonomy principle versus the solidarity principle. This occurs every 5 years, when the system has to be revised and I have noted how historically the regional financing was in practice and paradoxically very few autonomous and very dependent to central grants. The last reforms have tried to strongly modify this aspect by transferring to the ACs more normative powers on the ceded taxes, and by adding to those a

²⁰ For the Spanish case, there can be seen MONASTERIO & SUAREZ PANDIELLO (1989), BOSCH & SUAREZ PANDIELLO (1994) and BOSCH & SUAREZ PANDIELLO (1995).

share on the Income Tax. However, this change is producing at the present a very hard debate, which yet has been displaced to jurisdictional field (to the constitutional court) by some of the poorest communities. In essence, those governments are qualifying this reform as unfair, because the richest regions could collect more income with lesser tax rates, and moreover, the cession of a share of the income tax to the ACs will reduce the central government income to redistribution purposes. In opposite, the rest of the communities support the new system by arguing that it increases the fiscal co-responsibility. As the two positions become quite politically incompatible, a question can be made about whom finally will win and which will be the true financial system in the future. For the moment, the question is opened, and as Bob Dylan said the answer is blowing in the wind.

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