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# The new framework for the Spanish regional (autonomous) governments

*The author of this article is Pablo Hernández de Cos of the Research Department.*

## 1. INTRODUCTION

Fiscal decentralisation has been one of the distinctive features of the Spanish public sector in recent decades. Decentralisation commenced with the approval of the Spanish Constitution in 1978. This enabled the regional (autonomous) governments (RGs) to be set up and reformed the territorial organisation of the State. Since then, responsibilities for managing certain services have gradually been transferred from the State to the RGs and the arrangements for financing these responsibilities have been developed.

The design and implementation of fiscal policy in Spain, meanwhile, has been governed since the mid-1990s by the need for budgetary consolidation, first, to qualify for Stage Three of Economic and Monetary Union and, subsequently, to comply with the Stability and Growth Pact, whereby all EU countries must ensure that their budgetary positions are close to balance in the medium term.

The need to reconcile these two elements (fiscal decentralisation and budgetary consolidation), has highlighted the usefulness of developing rules of fiscal discipline that bind the different levels of government, as well as creating a regulatory environment for the RGs that ensures a degree of financial autonomy consistent with the level of spending responsibilities assumed.

It is against this background that two pieces of legislation have recently been approved by *las Cortes* (the Spanish parliament). These are, the Budgetary Stability Law (1), which, inter alia, strengthens the mechanisms for co-ordination between the State and the RGs, so that the latter more closely participate in the general macroeconomic stability objectives, and the new arrangements for financing the ordinary-regime RGs agreed by the Fiscal and Financial Policy Council (CPFF) in July 2001, which contain significant changes to the previous financing arrangements (2).

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(1) Law 18/2001 of 12 December 2001 on general budgetary stability and Organic Law 5/2001 of 13 December 2001, which supplements the general budgetary stability law.

(2) This agreement has been enshrined in Organic Law 7/2001 of 27 December 2001 amending Organic Law 8/1980 of 22 September 1980 on the financing of the regional governments (LOFCA), and in Law 21/2001 of 27 December 2001 regulating the fiscal and administrative measures of the new arrangements for financing the ordinary-regime regional governments and towns with statutes of autonomy.

This article analyses the content of both pieces of legislation and their implications in terms of the institutional environment within which the RGs operate. Section two describes the legislation and section three assesses it. The article ends with a section of conclusions.

## 2. THE NEW AGREEMENT FOR FINANCING THE RGS AND THE BUDGETARY STABILITY LAW

The development of regional government, in the case of the ordinary-regime RGs, commenced with the creation of pre-autonomous entities and continued with the approval, in 1980, of the Organic Law on the Financing of RGs (LOFCA), and of the respective autonomy charters. Subsequently, the five-year agreements on financing arrangements signed within the CPFF have been the basis for the development of the system of regional government. The latest of them, reached in July 2001, established new arrangements for financing the ordinary-regime RGs, which came into force on 1 January 2002 and which, unlike the previous arrangements, are intended to be a definitive model.

These arrangements are based on two fundamental elements: first, determination of the resources corresponding to each RG in the year taken as the base year (1999) (see Table 1); and, second, definition of the rules governing the future level of the resources of each RG.

To determine the first of these elements, the overall spending needs of the RGs are established in accordance with the revenues they received in the base year (3) and with the amounts allocated to a set of supplementary funds with various objects (4). The spending needs so defined are divided up among the RGs on the basis of certain distribution criteria (5), among which the relative population variable is the most relevant. Subsequently, the tax resources that will be available to the RGs to finance their spending are defined and the amount they would have been in the base year is estimated. Finally, the so-called sufficiency fund is fixed. This covers the difference between the spending needs and the tax-raising capacity of each

RG in the base year and therefore enables the system to be closed (6). This ensures that the total resources of each RG in the base year are equal to its previously defined spending needs, thereby fulfilling one of the requirements of the new agreement (7).

From this year, therefore, the RGs receive percentages of the annual receipts from the assigned taxes and the sufficiency fund, the amount of which shall vary according to the criteria set out below. The figures for the base year, on which the new agreement is founded, are not currently available, however.

As regards the rules for the future levels of resources, it is established that the sufficiency fund shall be increased annually in accordance with the rate of growth of state tax revenues (ITE) (8) (9). At the same time, to avoid the accumulation of large disparities in the revenue raising capacity of the different RGs, two rules have been established to regulate their revenues. First, the rate of growth of revenues of the so-called general block of common responsibilities (see Table 1) of each RG shall not exceed by more than 75% the average rate of growth for all the RGs (10). Second, the growth rate of these same revenues in those RGs whose income per head is less than 70% of the average income per head of the ordinary-regime RGs, shall not be less than 120% of the average rate of growth of all the ordinary-re-

(6) The sufficiency fund consists of a transfer from the State to the RG, where the latter's spending needs exceed its tax-raising capacity in the base year, or, in the opposite case, a transfer from the RG to the State.

(7) In addition, so-called minimum guarantees are established whereby an RG cannot receive, in respect of spending blocks (general common responsibilities fund, the fund to relieve low population density, the general health fund and the social assistance fund), an amount less than it would have received under the previous arrangements.

(8) These include the State receipts, excluding those that are assignable, from personal income tax, VAT and excise duties. In the event that the sufficiency fund is negative (because the spending needs of the RG are less than its tax-raising capacity), the negative transfer that the RG concerned must make shall change in line with the tax revenues of that RG (regional ITE, which includes the receipts in the territory of the RG, without exercise of regulatory powers, in respect of personal income tax, VAT and excise duties), provided that the rate of growth of the regional ITE is less than that of the national ITE.

(9) The sufficiency fund established for the base year will likewise be subject to review in the event of transfer to the RG of new services and/ or assignment of taxes.

(10) In the event that this percentage is exceeded by any RG, its resources shall be reduced to the limit set, provided that the reduction made as a consequence of this rule shall not exceed 22.791% of their initial level. Also, when the RG to which the adjustment is applied has more than 10% of all the population centres existing in the ordinary-regime RGs, the excess over 75% of the average rate of growth shall be multiplied by 0.49 to obtain the amount of the adjustment.

(3) These revenues come from the general common responsibilities fund, the general health fund and the social assistance fund

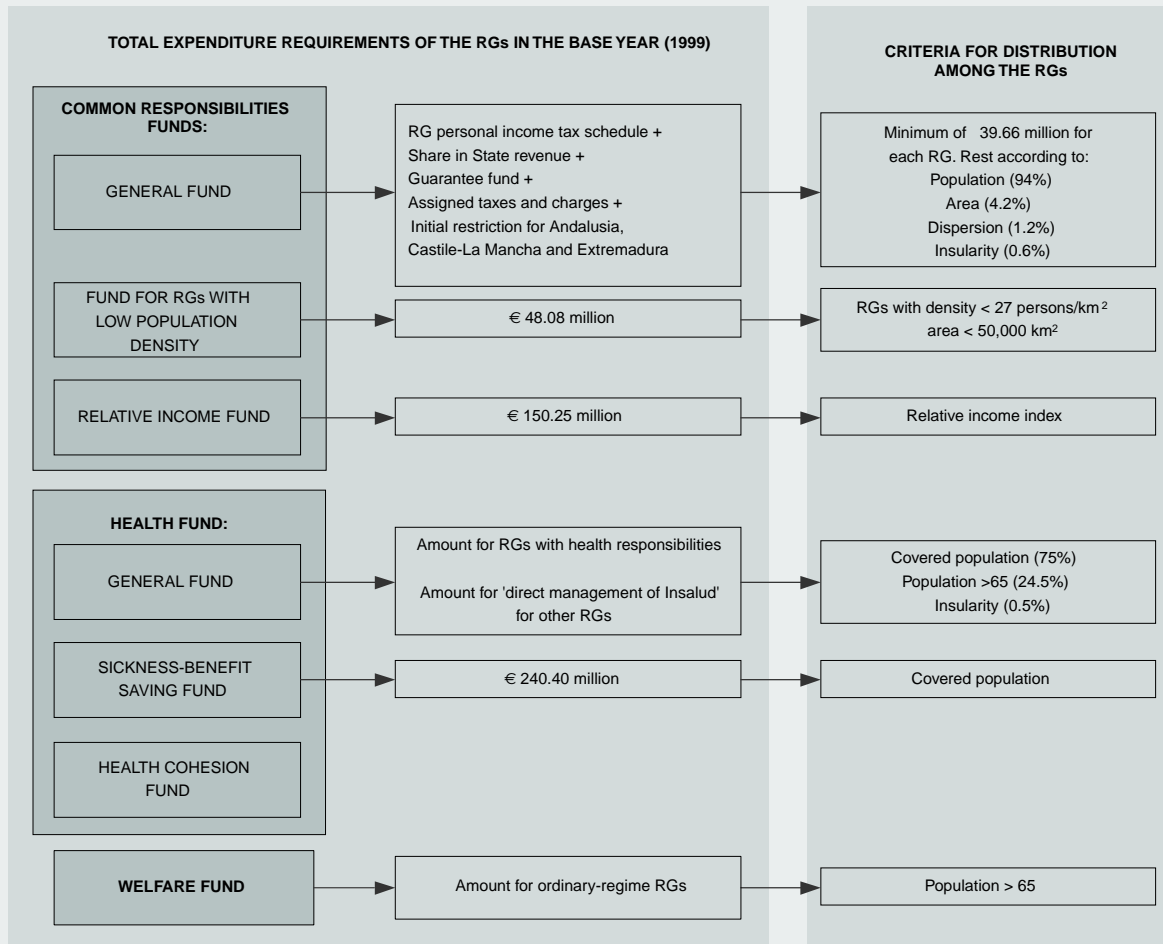
(4) These are the fund for RGs with low population density, the relative income fund, the sickness benefit saving fund and the health cohesion fund.

(5) The distribution criteria vary from fund to fund.

TABLE 1

**Determination of the resources corresponding to each regional government in the base year**

**DETERMINATION OF THE GUARANTEED EXPENDITURE IN THE BASE YEAR**



**SOURCES OF FINANCING OF THE SYSTEM IN THE BASE YEAR (G=T+S)**



gime RGs (11). In addition, a rule is established whereby RGs shall allocate to health spending (12) at least the initial financing established for this item, increased in line with the growth rate of the national ITE, so that all the resources of the financing system are tied to compliance with this requirement. Finally, during the first three years that the agreement is in force, the state shall ensure, for those RGs that have assumed health responsibilities, that the resources allocated to this item grow in line with nominal GDP.

Various features of the agreement should be noted. First, the financing of health and social services is included within the overall financing system (13). Second, the weight of territorially based tax resources in the financing of the RGs is increased. In this respect, the percentage of personal income tax assigned is raised to 33% and, in addition, 35% of the net receipts from VAT, 40% of those from excise duties on manufacture (14) and 100% of the duty on electricity, of the new duty on the retail sales of hydrocarbons and of the duty on certain means of transport are assigned (15). Moreover, the new system extends the regulatory powers of the RGs with regard to assigned taxes (see Table 2). The most important modification relates to personal income tax; the RGs are still able to set their own schedule, subject to the sole restriction, under the new system, that it is progressive and retains the same number of brackets as that of the State. Regulatory powers are not granted, however, over VAT and excise duties (16), except in the case of the duty on certain means of transport, where the RGs have the power to modify the rate within certain limits, and the new duty on hydrocarbons. Finally, the State guarantees for

minimum growth of the financial resources received by each RG are abolished, subject to the exceptions indicated for health spending during the first three years the agreement is in force and to the rules for adjusting revenues.

The new agreement also covers certain aspects of the channels of financing that remain outside the system. First, it establishes so-called levelling payments, whose purpose is to ensure a minimum level of provision of health and education services. In the event of a deviation of more than three percentage points (17) from the national average annual percentage increase in the number of pupils of school age or in the covered population (18), negotiations shall be initiated to analyse the appropriateness of allocating such levelling payments. Second, the Inter-territorial Compensation Fund (19) is maintained, subject to two changes, namely to give Ceuta and Melilla access to these funds and to enable them to be used to finance not only investment spending but also the current spending associated with such investment. Finally, investment agreements and programme contracts are maintained.

The agreement does not establish procedures to co-ordinate central and regional finance departments in relation to general macroeconomic objectives. However, these issues are addressed by the Budgetary Stability Law. The macroeconomic co-ordination between the different levels of government has, until now, been based on the rules in the LOFCA which restrict the RGs' capacity to borrow (20) and which require them to present to the government (through the CPFF) an annual borrowing programme. Once this programme has been agreed, all of the transactions contained therein are automatically authorised by the State (21).

(11) For RGs whose income per head is between 70% and 75% of the average income per head, the average rate of growth of their financing shall be no less than 30% of the average rate of growth of all the ordinary-regime RGs. For those between 75% and 82%, this percentage is 22%.

(12) Excluding that part corresponding to the sickness benefit saving fund.

(13) Under the previous system, health was financed outside the financing system for the RGs. The Social Security Treasury Department was the recipient and distributive centre for all the resources, even in the case of RGs to which this responsibility had been transferred (see Gordo and Hernández de Cos (2000) for more details).

(14) Duties on beer, wine and fermented beverages; duty on intermediate products and on alcohol and derivative drinks; duties on tobacco products and the duty on hydrocarbons.

(15) These percentages shall be applied to the net receipts obtained by the State in each region, the criterion for distribution among the RGs being the territorial consumption indices published by INE.

(16) According to the preamble of Law 7/2001 of 27 December 2001 which introduces the new Financing Agreement, EU tax harmonisation prevents the RGs having fiscal responsibilities, at least in the case of VAT and special duties on manufacture.

(17) One percentage point when the area of the region exceeds 90,000 km<sup>2</sup>.

(18) In this case, the covered population shall be age-weighted.

(19) Law 22/2001 of 27 December 2001 regulating the Inter-territorial Compensation Funds.

(20) These restrictions are, first, that credit transactions with a maturity of less than one year shall be used to cover temporary cash requirements. Second, credit transactions with a maturity of more than one year, whatever their form, shall comply with the following requirements: a) the entire amount of the credit shall be used to finance investment spending; and b) the annual amount of the repayments plus interest shall not exceed 25% of the current revenues of the RG. Third, the RGs shall require State authorisation to enter into credit transactions abroad, to issue debt and for any other recourse to public credit.

(21) This programme can be modified while it is being implemented by the RG, by means of a new proposal to the Government. Moreover, the State itself may suspend the programme as a precautionary measure in exceptional circumstances that may hamper the financial policy of the Treasury or involve an imbalance between the level of external and domestic borrowing.

TABLE 2

## The regional governments' regulatory powers over assigned taxes

Tax	% assigned	Scope of regulatory powers
Personal income tax	33	They can regulate the rate schedule, the only limitation being that it must be progressive and have the same number of brackets as the State one. Possibility of establishing deductions for personal and family circumstances, non-business investment and based on the application of income. The 15% deduction for investment in a habitual residence is divided into two tranches. The 5% regional one can be modified by the RGs by up to 50%.
VAT	35	No regulatory powers have been granted.
Wealth tax	100	They can set the level of the tax-free allowance and the rate schedule, without limitation, and create such deductions and allowances as they wish, while respecting those of the State.
Tax on inheritance and gifts	100	They can create reductions in the tax base for mortis causa and inter vivos transfers, while maintaining those of the State. They can regulate the rate structure without limitation. They can establish the amount and coefficients applicable to estates without limitation. They can create deductions and allowances, while respecting those of the State.
Tax on property transfers and documented legal acts (stamp duty)	100	As regards transfers of property for consideration, they can regulate the rate charged on the transfer of personal and real property and on the creation and transfer of real rights, other than collateral ones, moreover, and on the rental of personal and real property. In relation to documented legal acts, they can regulate the rate charged on notarial documents. They can create deductions and allowances, while respecting those of the State, but only in those areas where they have regulatory capacity over the rate of charge.
Tax on gaming	100	They can regulate exemptions, the tax base, the rate schedule, fixed charges, allowances and accrual.
Excise duties on manufacture (a)	40	No regulatory powers have been granted.
New duty on retail sales of hydrocarbons	100	In the case of petrol and diesel fuel, the RGs can increase it by up to €10 per 1000 litres in 2001 (€17 in 2003 and €24 in 2004). For agricultural diesel fuel and heating oil, by up to €2.5 per 1000 litres (€4.25 and €6 in 2003 and 2004, respectively). For fuel oil, up to €0.4 per tonne (€0.7 and €1 in 2003 and 2004, respectively).
Duty on electricity	100	No regulatory powers have been granted.
Vehicle registration duty	100	They can adjust the rate schedule, subject to certain limits.

(a) Duties on beer, wine and fermented beverages, intermediate products, alcohol and derived drinks, tobacco products and hydrocarbons.

These co-ordination mechanisms were strengthened, from 1992, following the publication of the Spanish Convergence Programme, with the signing of the so-called Budget Consolidation Scenarios (ECP) by the State and each RG. These established the maximum deficits and debts permitted for each RG, as determined by bilateral negotiations (22).

The Budgetary Stability Law, with effect from 2002, has modified some of these co-ordination mechanisms, since it stipulates that each RG shall comply with the principle of annual budg-

etary stability, defined as the need to maintain a balanced budget or surplus. In the event of failure to do so, the RG shall justify the situation of financial imbalance and draw up an economic/financial plan to correct the situation, which must be approved by the CPFF.

### 3. ASSESSMENT OF THE NEW FRAMEWORK FOR THE REGIONAL (AUTONOMOUS) GOVERNMENTS

The above-mentioned legislative changes define a new framework for relations between the State and the RGs, characterised by a higher degree of financial autonomy for the RGs and a stricter co-ordination mechanism, which requires the RGs to participate in the general macroeconomic objective of budgetary stability.

(22) In March 1995, following the revision of the Convergence Programme, the ECP commitments were also revised, with the limits being set for the period 1995-1997. Finally, the latter were again changed with the approval of the first Stability and Growth Programme in December 1998.

These measures are assessed below in the light of a number of criteria considered essential for the smooth operation of decentralised systems of government, namely: uniformity, stability, generality, financial autonomy, fiscal co-responsibility, sufficiency of resources, inter-territorial solidarity, co-ordination and transparency. A definitive assessment of the Financing Agreement will need to be made, however, when the figures on which it has been based become available.

The financing model approved introduces a uniform system for all the ordinary-regime RGs. This uniformity should be considered desirable as, from the viewpoint of economic rationality, the persistence of different levels of powers and financing regimes does not seem justified. Accordingly, within the State, only the specific-status RGs have a different financing system. Moreover, the new system is, by nature, definitive and stable, in contrast to the high degree of instability of the previous five-year agreements, which is appropriate given the conclusion of the process of transferring spending powers from the State to the RGs. Obviously, as recognised in the agreement, this will not prevent the future introduction of modifications that may be considered necessary in the light of experience with the new system.

Also notable is the significant advance entailed by the integration of health financing in the overall regional financing arrangements. In this respect, when health, like other public services, became financed solely through State transfers under the provisions of the Social Security System Consolidation and Rationalisation Law, which came into force in 1997, it did not seem justified for health financing to remain separate from the rest of regional financing. In relation to health spending, however, the new model establishes a significant special feature in that it requires the RGs to assign annually to the financing of health services at least the base-year amount increased in line with the growth of the national ITE, with all the resources of the system being subject to compliance with this rule. Thus, although health is integrated in the overall system of financing, this spending has a different treatment from that of other spending items. Indeed, the establishment of a minimum rate of growth for this component of public spending seems to preclude effective measures being introduced to curb its recent growth trend. This minimum rate of growth is also equal for all the RGs, irrespective of any differences that may arise in the future behaviour of the variables determining the level of health spending in the RGs.

From the standpoint of the financial autonomy of the RGs, the new system reduces their

dependence on State transfers and broadens their tax structure, thereby correcting the lack of synchrony between spending decentralisation and the system for financing the RGs, the former being more developed than the latter. Moreover the degree of financial autonomy will be more similar across the RGs, since the distribution of consumption across regions is more even than the distribution of income and, as indicated in the previous section, higher decentralisation percentages have been set for VAT and excise duties (the taxes most closely linked to consumption) than for personal income tax.

Meanwhile, the choice of VAT and excise duties as assignable taxes, involves a change from the previous tendency for tax decentralisation to affect mainly wealth and income taxation. This decision should be seen in the context of the loss of weight of direct taxation in total public revenues and the increase in that of indirect taxation. This shift in the sources of financing has, in the past, given rise to certain problems of financial insufficiency for the RGs. These have been resolved by various devices (e.g. the establishment of guarantees), which reduced the incentives for the RGs to use their regulatory powers, thus eliminating fiscal co-responsibility. In relation to health spending, however, this type of guarantee has been retained, albeit temporarily, since, as indicated, the new model establishes that the State will guarantee that the minimum rate of growth of financing allocated to this expenditure shall be equal to the nominal rate of growth of GDP during the first three years of the financing system.

The new agreement increases the degree of fiscal co-responsibility, partially widening the regulatory powers over personal income tax and the other assigned taxes (excluding VAT and excise duties), and eliminating the guarantees for the rate of growth of personal income tax. In this respect, the diversification of the taxes assigned to the RGs reduces the need for these guarantees, since revenues will be less dependent on the behaviour of a particular tax. Following the elimination of the guarantees, the RGs will therefore have to assume the risk of revenue losses associated with these taxes.

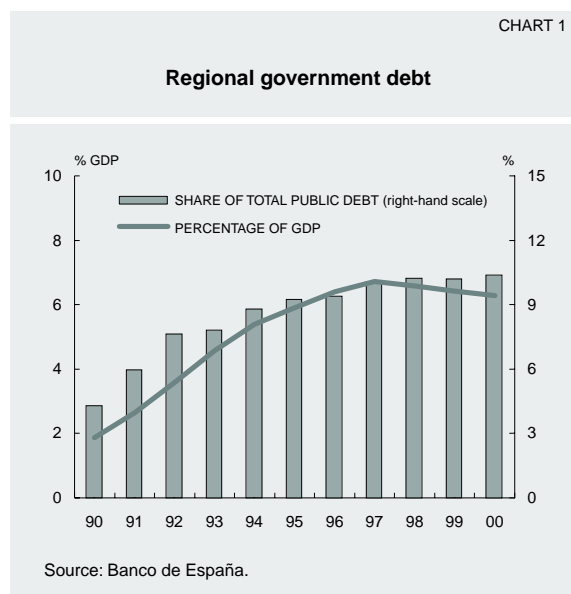
With respect to the financial sufficiency of the RGs, the system ensures that the volume of resources will be at least equivalent to that received under the previous financing model. However, the choice of a single year to calculate the revenue-raising capacity of the assigned taxes and the sufficiency fund for each RG may introduce distortions into the structure of financing in the base year that may be extended into the future. Indeed, tax receipts in a particular year are necessarily subject to tem-

porary disturbances, which may partly be cyclical and which may not be uniform across the RGs. Meanwhile, the level of the sufficiency fund is also affected by the base year chosen, as it is calculated as the difference between the spending requirements and revenue-raising capacity in that year, so that if the latter is exceptionally high, the amount of the fund will be below the desired level and vice versa.

The new model establishes two mechanisms to ensure inter-regional solidarity. The first is the sufficiency fund which, owing to its method of calculation in the base year ensures a trade-off between its per-capita level and the income per capita of each RG. Moreover, the decision to link the size of the fund to the growth of State tax revenues enables the revenue effects of specific shocks to a particular region to be partly offset. Given that the weight of this fund is negatively related to income, a larger part of the revenues of lower-income RGs will be guaranteed by the growth of the total income of the economy. The second element of inter-territorial solidarity is provided by the adjustment mechanisms. These limit the effects of the differences in the growth of the different regions on tax receipts and, therefore, on the level and sufficiency of the public services provided. These rules are also strengthened by the so-called levelling payments and, of course, by the Inter-territorial Compensation Fund.

In any event, the degree of solidarity of the new system depends on a complex set of factors. The application of criteria for the distribution of the resources that differ from one block of responsibilities to another, the establishment of a minimum amount to be received by each RG, the setting of minimum guarantees which mean that, for each block of spending, each RG must receive at least the amounts received under the previous system in the base year, and the existence of various funds that supplement the general ones (the fund for RGs with low population density, the relative income fund, the sickness benefit saving fund, the health cohesion fund) and of resources that remain outside the system (basically, the Inter-territorial Compensation Fund and European Union funds) are all involved in determining the inter-regional solidarity in the new system.

From the standpoint of transparency, the present formulation of the agreement does not resolve some of the problems that have been detected as the regional project has been developed in relation to the availability of statistical information on the regional governments. The application of the new system involves a further reduction in the number of transactions channelled through the State, the only agent,



up until now, that has supplied regular information on its budget outturn. There is therefore a risk of loss of information on the activities of general government in Spain.

The progress made in decentralising public expenditure and the financing of the RGs has required, as indicated, the institution of mechanisms for macroeconomic co-ordination between the State and the RGs. Until now the limits set for the borrowing and deficits of the RGs have generally been respected. In fact, borrowing by the RGs has not reached worrying levels, although it is on a rising trend (see Chart 1). Nonetheless, the aforementioned mechanisms may not be sufficiently strict in a setting of activity growth channelled through the RGs. In this respect, the procedures in force do not provide a precise definition of the co-ordination rules, nor is there any agency responsible for supervising compliance. In the event that limits are breached there are no sanctioning mechanisms. Meanwhile, the restrictions on borrowing set in the Budget Consolidation Scenarios are the result of bilateral agreements between each RG and central government, without there being any apparent objective criteria for their determination. They are not public in and they are capable of revision. All this may give rise to a sub-optimal set of incentives.

The entry into force of the budgetary stability law could resolve some of these shortcomings. In particular, the law establishes a single non-negotiable limit for all the RGs, requiring them to keep their budgets in balance or surplus. The net lending/net borrowing to which the aforementioned limit refers is defined in accordance with the European System of National and Regional Accounts, so that a defined accounting principle

is stipulated. Also, within regional and local government, the principle of budgetary stability is applicable to corporations and public-law establishments reporting to the RGs. Finally, a procedure has been introduced for those cases in which there is a deficit, requiring the RG at fault to draw up an economic/financial plan to correct it. A sanctioning mechanism has also been established insofar as if, as a result of this imbalance, Spain infringes its obligations under the Stability and Growth Pact, the RG concerned shall assume the responsibility arising from such breach. In addition, the law provides that the authorisation of the State to the RGs to enter into credit transactions and to issue debt shall take into account the achievement of the targets, so that, the use of this power of authorisation is expressly highlighted as an incentive mechanism for achieving the targets.

From the standpoint of the balanced budget target, it should be taken into account that the growth of the resources of the RGs is more dependent on the business cycle following the entry into force of the new financing agreement since, as discussed above, it has increased the weight of tax revenues in their total financing and the financial guarantees for the growth of their resources have disappeared. Accordingly, achievement of the annual balanced budget target requires the RGs to maintain fiscal surpluses at times of economic expansion, to enable them to absorb the foreseeable decline in tax resources during economic slowdowns and to avoid the need for pro-cyclical discretionary measures.

Finally, it should be remembered that an essential element in the appropriate implementation of any fiscal decentralisation programme is a guarantee of information transparency in relation to the activities of regional and local government. In the Spanish case, this need for transparency is, if possible, even greater owing to the size of the spending and tax responsibilities assumed by the RGs relative to the activities of the public sector as a whole. In this respect, the Budgetary Stability Law provides for the creation of an information centre to supply data on credit transactions, the issuance of debt and other recourse to credit or risk assumed by the RGs. Nonetheless, it is also necessary to ensure the periodic publication of information on the activities of the regional governments on

the same conditions as information is currently provided by central government, so that fiscal decentralisation does not lead to a reduction in the information available and the various activities of the public sector can be effectively monitored.

#### 4. CONCLUSIONS

The regional financing agreement and the Budgetary Stability Law came into force on 1 January 2002, establishing a new framework for the RGs and their relations with the State. On one hand, the RGs now have a uniform, stable and comprehensive financing system that increases their financial autonomy and the level of fiscal co-responsibility. On the other hand, and in response to the significant level of revenue and spending responsibilities assumed by the RGs, mechanisms have been put in place to ensure that they participate fully in fiscal consolidation and in complying with the obligations under the Stability and Growth Pact.

As in the case of the State, the maintenance of a balanced budget will require the RGs to achieve sufficiently large surpluses in times of economic boom, since their resources depend to a larger extent on tax receipts and will, therefore, be more sensitive to the business cycle. However, under the new model, the RGs are in a better position to adjust their revenue to their desired spending.

Against this background, given the importance that the activity of the RGs will have and the relevance of the principle of transparency in ensuring that public-sector activities are controlled, it would seem necessary to make improvements to the budgetary information mechanisms of the RGs, in order to guarantee periodic publication of information on their activities on the same conditions, and with the same detail and periodicity, as that currently provided by central government.

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