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Sharing Taxes and Sharing the Deficit in Spanish Fiscal Federalism

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1. INTRODUCTION

The economic downturn occurring in Spain since 2008 has created different sources of stress for fiscal federalism. Among other things, the crisis has brought to the forefront the vast differences in income and indebtedness among Autonomous Communities as well as the unpredictable impact of the economic crisis on their financing system. It is now the subject of discussion among policy makers and analysts as to what extent the Central Government may limit indebtedness of Autonomous Communities or force them to increase their tax pressure (for example by modifying personal income tax rates) in order to curb the deficit. The underlying debate is whether the debt/deficit limits will end up promoting a re-centralization process of public spending first, and of authority later. It could be argued that the speed at which the decentralization process in Spain has developed has been too fast in order to be adequately “digested” by the institutions. A rebalancing of powers, taking into account the obvious centralization force of entering the European Union, cannot be completely ruled out.

This debate became more intense, and interesting, during the months of July through December 2011. Four legal or regulatory changes happened that have substantially transformed the framework of Spanish fiscal federalism in probably more ways than I will be able to convey in this short paper: first, in July the Government amended the Stability Act (a Law to curb the deficit) in order to establish a debt ceiling for the central government. Then, also in July the Constitutional Court decided on the constitutionality of the Stability Act, which had been contested since it was first approved, in 1997². Third, on September 2nd, 2011 article 135 of the Spanish Constitution was reformed in order to include a debt and deficit ceiling. Fourth, on September 28th the European Union approved a new set of regulations (the so-called *Six Pack*³), designed to make the Stability Pact substantially stricter⁴. Finally, on

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² Opinion 134/2011, of 20 July 2011 (all the Court’s Rulings are publicly available at www.tribunalconstitucional.es).

³ See: http://ec.europa.eu/economy_finance/economic_governance/index_en.htm (access 16.11.2011).

⁴ I have dealt with this reform at: “Estabilidad Presupuestaria y Reforma Constitucional”. *Revista Española de Derecho Europeo* (Civitas), *Revista Española de Derecho Europeo*, March 2012 (forthcoming).

December 9th 2011, a reform of the Treaties was announced, which is bound to limit the deficit to a maximum of 0.5 per cent⁵.

Spain has undergone a complicated process of fiscal decentralization in a relatively short time span. From a fully centralized country in 1978, it was divided into seventeen Autonomous Communities by 1982. At the same time, an arduous process of regime change (from Franco's 1939-1975 dictatorship to the approval of a Constitution in 1978 and the entry in the European Union in 1986) brought about substantial legislative reform. This also meant introducing a new tax system.

From a fiscal federalism perspective, the high vertical fiscal imbalance (VFI) with which Communities started off in 1982 has been (partially) resolved by transfers (both conditional and unconditional) as well as mechanisms of sharing taxes. Since 1997 this includes sharing the personal income tax, what in practice means that Communities perceive a percentage (currently 50 per cent) of the revenue accrued in their territory and may also establish the tax rates to be applicable in their territory introduce new tax credits or increase/decrease those established by the Central government. Fourteen years on since that system, which was partially amended in 2002 and 2010, was implemented it is possible to assess its results from different perspectives: has VFI decreased? Have Communities become more fiscally responsible?

The aim of this paper is to present a frozen image of the current Spanish system of fiscal federalism, in light of the tensions that the economic situation, has brought about. With this purpose, I will first broadly offer an outline of how decentralized Spain actually works, and how the decentralization process was brought about. Then I will focus on how the financing system works for most Autonomous Communities. Finally, I will attempt a preliminary analysis of the recent constitutional reform. A main conclusion of this paper is that fiscal federalism in Spain is, in fact, a work in progress.

2. THE SPANISH “ESTADO DE LAS AUTONOMÍAS”

2.1 Becoming a Democracy

The existence of Spain as a country, was the result of a long process that combined several kingdoms. One important step towards the creation of Spain was the unification by marriage of the Kingdom of Castilla with the Kingdom of Aragón in the late 15th century⁶. More recently, on November 20th 1975 Francisco Franco (the last

⁵ There is no official draft version, but the EU fiscal draft has been leaked and can be found in these pages: <http://www.openeurope.org.uk/research/100112fiscalpactdraft.pdf>, access 16.01.2012), and here: <http://www.telegraph.co.uk/finance/financialcrisis/9026142/The-EU-fiscal-draft-treaty-in-full.html> (access 20.01.2012).

⁶ In the early 1700s, King Felipe V, with the so-called “Decretos de Nueva Planta,” abolished the political and administrative autonomy of Aragón, Catalonia, Mallorca and Valencia, in order to centralize and unify political power. It is interesting to note that the very special political and economic organization of the three provinces of the Basque Country and of Navarra, the “fueros,” partially survived this centralizing attempt by the Spanish kingdom. The reasons are linked to the support that these provinces provided to the King in his political conflicts. The special arrangement for these provinces allowed them to keep a wide range of autonomy, with a semi-independent fiscal authority that prevailed until the mid-1800s. Although they lost some of their political autonomy in the late 1800s, they kept a special fiscal

Spanish dictator in power since 1939), died. Three years later, on the 6th of December 1978, Spaniards voted in favour of as of 2011 the longest lasting Constitution in their history. On the first of January 1986, Spain became a Member of the European Union. In less than ten years, Spain was radically transformed.

A salient element of the Spanish transition towards democracy is that it took place without any major breakthrough or revolution. In fact, what happened in Spain was more what has been often called a “legal revolution”⁷, characterized by two elements:

First, the existing legal framework -the set of laws approved under the Franco regime, was taken as a departure point. There was a prevailing political will to achieve a maximum degree of consensus among Spain’s political and social forces. Following this principle of respect for legality, beginning in 1976, a government designated by the King of Spain (Juan Carlos I), still under the laws of the Franco regime, first initiated a series of legal reforms that made it possible to exercise previously prohibited political rights (among other things, the Communist Party was legalized) and, subsequently, held free elections under these new laws. Finally, in a third phase, the new Constitution was ratified.

A second element was the constitutional consensus: the political will to seek a maximum degree of consensus among the diverse political and social forces in Spain on the basic aspects of the process, an agreement not only on decision-making procedures, but on the decision themselves.

One of the challenges of the new democratic era was the regional question. Solving it was intimately linked to attaining democracy, as consensus could not be obtained without the nationalist or autonomist movements. A decentralization process would also make it harder for Spain to undergo changes that would result in a new dictatorship. Simply put, it is harder for a Coup d’Etat to be successful when power is substantially decentralized. As López Guerra put it “with the creation of regional governments in the autonomous communities, power centres independent of the majority party have developed. These help to establish the balance of power so necessary in a country like Spain, which has such scant democratic tradition”⁸.

arrangement that prevailed until Franco's Dictatorship, and that for Navarra and Álava even remained (to a certain extent) during that very centralized period.

⁷ See Borrajo Iniesta, I.: “Adjudicating on Division of Powers: the Experience of the Spanish Constitutional Court”, in Andrew Le Sueur (ed.), *Building the UK's New Supreme Court: National and Comparative Perspectives*, 2004, pp. 149 et seq.

See also: López Guerra, L.: ‘The development of the Spanish ‘State of Autonomies’ 1978-1992. At: JJ. Kramer (Hrsg.): *Föderalismus zwischen Integration und Sezession*. Baden-Baden: Nomos Verlagsgesellschaft, 1993; and López Guerra, L.: ‘Regions and Nationalities in Spain: the autonomous communities’. At: G. Färber; M. Forsyth (hrsg.): *The Regions -Factors of Integration or Disintegration in Europe?*. Baden-Baden: Nomos Verlagsgesellschaft, 1996.

⁸ López Guerra, L.: “National and Regional Pluralism in Contemporary Spain”. At (R. Herr; J. H. R. Polt, Eds): *Iberian Identity, Essays on the Nature of Identity in Portugal and Spain*. Institute of International Studies, University of California, Berkeley, 1989, p. 28.

2.2 The Design and the Functioning of the “Estado de las Autonomías”

2.2.1 Deciding on a model

One of the main challenges to design a coherent decentralization system in 1975 was the fact that the intensity of regional identity differs greatly from one region of Spain to another. Article 2 of the 1978 Constitution even distinguishes between “regions” and “nationalities”. The difference between these terms is not always clear, but the fact that the Constitution uses these two words reflects that regional identity and sentiments regarding autonomy are stronger in some regions than in others. Historically, Catalonia and the Basque Country have most actively sought a higher degree of autonomy and political identity. In contrast, other regions such as Extremadura or Murcia have only later on shown a desire for greater political autonomy. This varying intensity of regional sentiments is clearly reflected in the type and strength of local political parties. In both Catalonia and Basque Country specifically nationalist regional political parties have won majorities in the respective community governments⁹. It is important to note that the Spanish case shows that it is not only political motivations, or economic incentives, that drive decentralization, but a number of closely intertwined factors¹⁰.

In this context, it was difficult to decide which was to be the final model of decentralization. The solution finally adopted was akin to an asymmetric federalism system, at least in its initial design. The Constitution met the challenge by not defining the new system, but by establishing a procedural framework instead. Thus, what the Constitution does is to establish an “optional autonomy system” (the so-called ‘*principio dispositivo*’) which entails the possibility of asymmetry, as it does not force decentralization¹¹.

Soon after the Constitution was ratified, almost all of the regions expressed a desire to obtain the higher degree of autonomy, seeking the same powers as those granted to Galicia, Catalonia and the Basque Country. Granting the higher degree to all regions at once would have necessitated the immediate creation of a federal system, and Spain’s administrative and political structure made that impossible or at least impractical. It took then three years, and an attempted *Coup d’État* in 1981 (23 February) for the political parties to finally agree on a regional structure for the country. Seven regions would immediately attain the higher degree of autonomy (Catalonia, Galicia, the Basque Country, Andalusia –which held a referendum to choose this- Valencia, the Canary Islands and Navarra. The other ten chose the lesser degree of autonomy.

⁹ Another significant feature of the Spanish political system is the coexistence in parliaments of both political parties organized nationwide and regional parties which are nationalist. Furthermore, there have always been separatist movements or parties that seek the total independence of the region-autonomy. See: López Guerra, L.: “National and Regional Pluralism in Contemporary Spain...cit. pp. 20 et seq.

¹⁰ See the sophisticated model proposed by León-Alfonso, S.: *The Political Economy of Fiscal Decentralization. Bringing Politics to the Study of Intergovernmental Transfers*. Barcelona: Instituto d’Estudis Autònoms, 2007, pp. 59 et seq.

¹¹ López Guerra, L.: “El modelo autonómico”. *Revista Catalana de Derecho Público, Autonomies*, n. 20/1995, p. 171.

This process has given rise to a form of State that, albeit still not quite defined, probably falls, together with Belgium, Germany, Austria and the United Kingdom, into the category of a “decentralized State”. However, when one takes a closer look at the broad scope of decentralization in Spain and at the authority gained by the Communities over the past twenty years, one has to conclude that – and this has become quite a controversial issue – Spain is, in practice if not in legal form, a federal state¹².

One of the most important features of this model of State is its asymmetry. There are two reasons why the State of Autonomies is asymmetrical:

The first lies in the procedural framework established by the Constitution. The original idea of the framers of the Constitution was that some Communities with past experience of self-government should be given the opportunity to become fast laners from the beginning, while the rest would have to start by being slow laners. Hence the second transitional provision of the Constitution, which establishes fast access to autonomy for those Communities which had approved self-government statutes in the past (ie during the Second Republic). These were to be Catalonia, the Basque Country and Galicia, which had not only had brief access to autonomy in the years of the Republic but also had more or less in common a strong nationalist sentiment fuelled by the existence of different languages. In the end, however, seven Communities became fast laners: in addition to the aforementioned three, Andalusia, Navarra, Valencia and the Canary Islands adopted the higher level of autonomy. The other ten Communities remained with a lower level of autonomy until 2002, when they ‘caught up’ with the fast laners.

The second explanation for asymmetry lies in the recognition of the historic rights of some regions, enshrined in the first additional provision of the Spanish Constitution. This has resulted in the Basque Country and Navarra having a much greater level of authority, especially in fiscal matters. The first type of asymmetry can be categorized as *de facto* or *transitory*; it refers only to the initial process, but does not prevent all Communities from eventually gaining access to the same level of authority. The second type is embedded in the Constitution, and of a much more controversial nature.

2.2.2 The legal structure (and challenges) of the devolution process

The process by which Autonomous Communities were formed is relatively easy to explain. Certain groups of provinces, provided that they have common historical, cultural and economic characteristics, have the right to decide whether they want to become an AC (section 143 of the Constitution). If they decide to do so, they then have to choose which matters they want to be in charge of. In other words, this is autonomy “*à la carte*” or a “cheese platter” system.

¹² This has been a highly contested area among Spanish constitutional scholars. It has been pointed out that there is no general theory of what the “Estado de las Autonomías” is (in this regard Aja Fernández, E.: *El Estado autonómico. Federalismo y hechos diferenciales*. Madrid: Alianza Editorial, 1999, pp. 33 et seq). Furthermore, not only different countries, but also different fields –economics, political sciences, law- bestow different meaning to what the word *Federal* means and should entail. See: Beer, S. H.: “A Political Scientist’s View of Fiscal Federalism”; en: AA.VV. (Ed.: Oates, W. E.): *The Political Economy of Fiscal Federalism*. Toronto: Lexington Books, 1997, pp. 21 et seq.

In fact, the Constitution does not assign explicit authority to Communities, but affords them the possibility of taking authority over a group of matters listed in sections 148 and 149. It does, however, reserve special functions for the State. Thus, for example, the State is in charge of “regulating the basic conditions to ensure the equality of all Spaniards in the exercise of their rights and the fulfillment of their obligations” (Section 149.1.1^a), and is assigned exclusive authority for “coordination of the economy” (Section 149.1.13^a)¹³.

Despite the existence of two lists of areas of authority in the Constitution – those for Communities to choose from, and those for the State to undertake – the design does not end there, as section 149.3 establishes a series of provisions that could eventually change the actual distribution of authority. Thus, Communities may take on the authority not expressly assigned to the State by the Constitution and the State may take on the authority not taken on by Communities. In the case of a conflict over which tier should be assigned a given matter, the laws enacted by the State will prevail over the Communities. Lastly, section 149.3 establishes that the laws of the State will at any rate be supplementary to the Communities’ (eg in the case of legal gaps or loopholes, or where an AC’s regulation is incomplete or unclear). This last provision has been the object of much controversy, as the Constitutional Court has radically changed its interpretation to avoid its use as an indirect means for the State to retrieve authority from Communities. This change of the Court’s case law took place in Opinions 118/1996 and 61/1997.

The Constitution also allows the State to control Communities in some cases (eg Sections 150.3, 153 and 155). In practice, these provisions have never been invoked. Instead, the numerous conflicts have been solved – or are in the process of being solved – through politically negotiated agreements.

One relevant feature of the Constitutional design of the State is the strong role that the State is bound to play in the distribution of authority. This can be explained by the co-existence of the principle of autonomy and the principle of unity. They are both expressed in Section 2: ‘The Constitution is grounded on the indissoluble unity of the Spanish Nation... and guarantees and recognizes the right to autonomy of its regions...’. This apparent oxymoron has been the subject of many decisions of the Constitutional Court, which has repeatedly stated that it is within the unity of the State that autonomy can find its being.

From a legal perspective, Communities “assume” or take on their authority via a Statute of Autonomy (“*Estatuto de Autonomia*”)¹⁴, which acts as the supreme norm, or effective constitution, of each Community. Statutes have a legally complicated double status: they are both the maximum norm of a region and a Government’s law, as they are also subject to the Constitution (and to the Constitutional Court’s scrutiny). This double nature explains why a reform of a Statute needs to be approved both by the central Parliament and by the Autonomous Communities. In the case of “fast lane” Communities (those that accessed this status earlier), there must also be a referendum in the Community. Potentially, this system could have led to a fully asymmetrical

¹³ See Borrajo Iniesta, I.: “Adjudicating on Division of Powers: the Experience of the Spanish Constitutional Court...cit. pp. 151-157.

¹⁴ Again, Borrajo Iniesta, I.: “Adjudicating on Division of Powers: the Experience of the Spanish Constitutional Court...cit. pp. 152 et seq.

federal system. In practice, a completely asymmetrical system was never considered desirable, and a set of political agreements and laws contributed to *harmonize* the levels of authority of Communities. Today, all Communities have a similar degree of responsibility, the main differences lying in the financing systems (*foral* vs. *Common system*, as we will see). The result is a system very similar to a Federation.

Between 2006 and 2009 most Statutes of Autonomy were reformed. While most of the reforms merely reflected what already was a reality, in some cases the reforms have been highly contested. Such was the case of the Catalan Statute that was challenged before the Constitutional Court and was the object of severe political turmoil. On June 28th 2010, the Spanish Constitutional Court ruled that part of the Catalanian Statute of Autonomy¹⁵ is unconstitutional¹⁶. While from a formal perspective Catalonia has the same powers as the other Communities, it has traditionally played a leading role in the devolution process. This explains why many other Communities (such as Andalusia or Valencia) had reformed their Statutes partially following the Catalanian model. Their laws are also affected now. In a very long ruling (the longest ever in Spanish history, with almost a thousand pages), the Court struck down 14 of the 113 articles that the People's Party (PP) argued were unconstitutional, while reinterpreting a further 23 articles¹⁷.

Fiscal federalism, normally a contested area, was barely touched by the Court's Ruling. This is partly explained by the fact that the current financing model of Autonomous Communities, which entered into force in January 2010, via a Central Government law¹⁸, closely followed some of the provisions of the Catalanian Statute.

In effect, the Court has merely softened some sections of fiscal federalism, such as the obligation for the Centre to invest in Catalonia, or the obligation to transfer certain taxes, which according to the Court are within the authority of the Centre and cannot be unilaterally determined by Communities.

2.2.3 Institutional elements of the system: the roles of intergovernmental agreements, the Senate and the Constitutional Court

1. Bilateral and multilateral agreements have played a very important role in the assignment of authority. Multilateral agreements have coexisted with bilateral agreements and have served to greatly unify the policy competences of the Communities. The role of political agreements has also been very relevant in the process of allocation of resources between the different tiers of government. This is

¹⁵The Statute is available in English: http://www.parlament-cat.net/porteso/estatut/estatut_angles_100506.pdf.

¹⁶Note that the decision to strike down a Statute of Autonomy is unprecedented in Spanish Democracy, but then so are the rest of the elements surrounding it: a Court deciding with only 10 out of its 12 members, as one passed away and another (Pablo Perez Tremps) was recused, and one of the worst political rows in recent history. The Court was divided and had been unable to agree on a ruling for almost 4 years. Finally, in June 2010 the much expected ruling was approved by a majority of 6 to 4.

¹⁷As interesting as the list of articles annulled, or even more, are the areas that were declared valid, as some of them were also largely contested. Among other, the duty to know the Catalan language (sections 34 or 50.5) was merely softened by adding that it shall not imply a prohibition to use the Spanish language or an obligation to use Catalan.

¹⁸Ley 22/2009, de 18 de diciembre, por la que se regula el sistema de financiación de las Comunidades Autónomas de régimen común y Ciudades con Estatuto de Autonomía y se modifican determinadas normas tributarias.

quite a politicized issue in Spain that has been the cause of much stress between the state and some Communities (especially Catalonia and the Basque Country). There are two major types of agreements, which are closely related: agreement between different political parties and negotiations between the State and the Communities (both bilateral and multilateral).

The process usually unfolds as follows: First, a multilateral agreement between the State and all the Communities is reached. This is done in the Finance and Tax Policy Council (*Consejo de Política Fiscal y Financiera*), where the finance ministers of all Communities and the state are represented. Once an agreement has been approved, bilateral agreements with the state are signed. This is done in the “Mixed Commissions” (*Comisiones mixtas*)¹⁹.

This agreement system serves to give weight to the Communities’ opinions on the allocation of resources. It has been broadly criticized, however, for its lack of transparency, as the agreements take place behind closed doors and the results are only partially made public, which results in a restriction of democracy²⁰.

2. Autonomous Communities are represented at the Senate, which operates as a second Chamber that revises legislation. However, so far the Senate is only in theory a representative Chamber of the Communities. The main cause for this lays in two reasons: First, the fact that most senators are elected by universal suffrage from provincial voting districts, while only a minority (46 out of 253) are appointed by the Parliaments of the Autonomous Communities. Thus, according to section 69 of the Constitution and section 165 of the Law of General Elections (Organic Law 5/1985, June 19th), there are four Senators per Province that will be elected directly by citizens. Then, every Community may choose one Senator, plus one more for every million inhabitants in the Community. Second, the Senate has very limited powers in making State laws. One of the proposals on the Socialist government agenda when it entered into power in 2004 was the reform of the Senate. This was never attained. A strong Senate would promote multilateral action, and some Communities still prefer to relate to the centre on a bilateral basis. This is certainly the case for Catalonia and the Basque Country.

3. Finally, the rulings of the Constitutional Court have played, and still play, a significant role in the definition of authority in the Statutes of Autonomies²¹. Taking into account that the vast majority of the matters listed in the Constitution are actually shared between the Central Government and the Communities, it is not hard to

¹⁹ See J. Ramallo Massanet and J.J. Zornoza Pérez: “El Consejo de Política Fiscal y Financiera y las Comisiones mixtas en la financiación de las Comunidades Autónomas, *Papeles de Economía Española* 83 (2000).

²⁰ In fact, not all CPFF agreements are published (see a full list of those that are available at: <http://www.meh.es/es-ES/Areas%20Tematicas/Financiacion%20Autonomica/Paginas/Acuerdos%20del%20Consejo%20de%20Politica%20Fiscal%20y%20Financiera.aspx>).

See this argument, referring to the Canadian system but perfectly applicable to the Spanish case at: Smiley, D. V.: *The federal condition in Canada*. Toronto: McGraw-Hill Ryerson Limited, 1987, pp. 20 et seq; Cameron, D.; Simeon, R.: “Intergovernmental Relations and Democracy: An Oxymoron if There Ever Was One?”. AA.VV.: (Eds.: H. Bakuis; G. Skogstad): *Canadian Federalism: Performance, Effectiveness and Legitimacy*. Don Mills: Oxford University Press, 2002, pp. 278 et seq and 282.

²¹ Borrajo Iniesta, I.: “Adjudicating on Division of Powers: the Experience of the Spanish Constitutional Court...cit. pp. 157 et seq.

imagine that this has been a source of permanent conflict between these two tiers of government. The Court, as the only body competent to resolve such conflicts, has undertaken a very important task in the evolution of the Statutes of Autonomies²². Of course this role has been reinforced by the “unfinished” nature of the different provisions regarding regional autonomy established in the Constitution, and by a certain ‘didactic’ tendency of the Court to fully explain and thus to clarify the rules governing the Statutes of Autonomies. Moreover, the Court has often ruled in favour of the Communities, which in the first years of the decentralized model was almost revolutionary in a country with such a long tradition of centralization²³. However, it is probably time that it played a secondary role in the shaping of the State of Autonomies, in favour of a stronger role for the Senate. At present, the following statement dating back to 1998 is still true: “it is becoming almost routine in Spain to discuss any Law of certain importance in two forums, a first debate in the Parliament, and a second, and decisive one, in the Constitutional Court”²⁴. In fiscal federalism matters, there have been many relevant Constitutional Court’s Opinions that have reinforced the Communities’ spending power, declared void AC taxes because they were similar to State or municipal taxes and asserted the right of Communities to establish taxes, provided they do so in matters that fall within their scope of competence²⁵.

2.3 Rethinking the model after the financial crisis?

The financial crisis has brought to the forefront different structural problems in the Spanish State of Autonomy, namely the growth of indebtedness in Autonomous Communities²⁶ and their inability to fully develop a sound revenue system by using the taxing powers that they have.

A recentralization of authority, an unthinkable idea until not long ago, has been proposed by different politicians, including those from the PP (People’s party), which now holds since November 2011 an absolute majority at the State level.

3. FINANCING AUTONOMOUS COMMUNITIES

There are currently two systems to finance Autonomous Communities, the “common system” and the “foral regimes” (also known as “cupo” or “quota”; the regimes applied to Basque Country and Navarra). I will focus on the first in this paper, with only some limited references to the foral regimes.

²² López Guerra, L.: “The Spanish Constitutional Court and Regional Autonomies in Spain”, in: D’Atena (Ed.): *Federalism and regionalism in Europe*. Napoli: Editoriale Scientifica, 1998.

²³ López Guerra, L.: “The Spanish Constitutional Court and Regional Autonomies in Spain...cit.

²⁴ López Guerra, L.: “The Spanish Constitutional Court and Regional Autonomies in Spain...cit. p. 263.

²⁵ Among the leading Constitutional Court’s cases (not available in English), see: SSTC 37/1987, de 26 de marzo; 186/1993, de 7 de junio; 49/1995, de 16 de febrero; 289/2000, de 30 de noviembre; 168/2004, de 6 de octubre; 179/2006, de 13 de junio y AATC 417/2005, de 22 de noviembre y 456/2007, de 12 de diciembre (all available at the web site: www.tribunalconstitucional.es).

²⁶ Pointed out, recently, by CUENCA, A.: “Estabilidad presupuestaria y endeudamiento autonómico”. *Cuadernos de Derecho Público*, May 2012.

3.1 Taxing Democracy and Financing the Decentralization Process

It is not an exaggeration to say that until the late 1970s Spain did not have a *Tax system* as such, at least not one that was generally implemented (the levels of tax fraud under Franco's dictatorship cannot be overstated) or that followed the general structure of the tax systems of other OECD countries. The first modern personal income tax (PIT, hereafter) was established in 1978, as was the first corporation income tax (CIT, hereafter). The tax reform undertaken between 1978 and 1985 entailed a substantial increase of the tax pressure. Tax revenues in fact quadrupled between 1975 and 1980²⁷ and yet it was generally accepted by citizens, at least measured by the fact that there was no tax revolt. It can be argued that most taxpayers footed the bill as part of the price to pay for democracy.

Part of the reform of the tax system was a direct consequence of joining the European Union, which was also of paramount importance for Spain²⁸. Finally, and at the same time, Spain underwent a decentralization process between 1978 and 1982 that ended up with seventeen Autonomous Communities²⁹. One of the most striking aspects of Spain's decentralization is the speed at which it has developed, as can be seen below.

Table 1: Decentralization in Spain (public spending)
(% share of total public expenditure)

	1982	1996	2009
Central Government	53	37.5	20.9
Social Security ³⁰	32.5	29.2	29.9
Autonomous Communities	3.6	22.3	35.6
Municipalities	10.6	11.6	13.6

Part of the process of creating a tax system in Spain entailed substantially reforming its tax administration. This process took some years and it was finalized with the creation of a new administrative body in 1990 the National Tax Collection Agency (*Agencia Estatal de Administración Tributaria*, AEAT hereinafter), which is in charge of collecting the main taxes of the system, including the PIT, CIT and the Value Added Tax (VAT).

²⁷ OECD: "Revenue Statistics: Spain", OECD Tax Statistics (database).
doi: [10.1787/data-00253-en](https://doi.org/10.1787/data-00253-en) (Accessed on 30 May 2011).

²⁸ See in this regard: C. Closa and P. M. Heywood, *Spain and the European Union*, Palgrave Macmillan, 2004 (as the authors argue, entering the EU was Spain's main project).

²⁹ Andalusia, Aragon, Asturias, the Balearic Islands, the Basque Country, the Canary Islands, Cantabria, Castilla-La Mancha, Castilla-Leon, Catalonia, Extremadura, Galicia, Madrid, Murcia, Navarre, La Rioja, and Valencia. Basque Country and Navarra have broader tax powers than the rest of the regions. In the case of the Basque country, these powers rest in the provincias (Álava, Guipúzcoa and Vizcaya) that hold tax powers to regulate the Corporate Income Tax Law and the Personal Income Tax, among other taxes. The attribution of tax powers rests on a mixture of domicile and source, so that for instance regional tax provisions will apply when a company is domiciled in those territories but only if at least 25 per cent of its turnover is also derived there (unless turnover is lower than €7 million).

³⁰ Social Security is controlled by the central Government, but it is a separate entity from a budgetary perspective.

Box 1: National Tax Collection Agency: the big numbers

- The Agency³¹ had a 2009 budget of €1,414.3 million and a total of 27,755 employees.
- The total number of registered taxpayers is 47,999,499, of which: 1,682,509 are registered as small companies (revenue does not exceed € 8 million), 5,154,706 are individual business people and professionals and 41,477 are large companies.
- The AEAT's results of 2009 were a total net collection of €144,023 million for a public collection cost of 1% of revenue collected
- The number of tax returns processed in 2009 for the main taxes of the system (i.e., in terms of revenue) were:
 - o Personal Income Tax: 19,467,138
 - o Corporation Income Tax: 1,389,514
 - o Value Added Tax: 3,525,821
 - o Excise Duties: 9,130,549

Source: the author and *Memoria AEAT 2009*³²

3.2 Outline of the System: Taxes and Transfers

1. It is commonplace in the fiscal federalism literature to refer to “Vertical Fiscal Imbalance”, abbreviated as VFI³³ as the situation that arises when one tier of government – usually the Central Government – has a greater power to obtain revenues than it actually needs for the exercise of its assigned level of authority, while the other – usually sub-national governments – is in the opposite situation. This creates an imbalance that must be resolved in order to guarantee to the sub-national governments the autonomy required for the exercise of their authority. Ultimately VFI needs to be addressed in order to protect the citizen's right to obtain the services they pay for via taxation. This means that at least *some* distribution of resources needs to take place following a decentralization process.

The problem is easily understood and conflicting parties – the State and sub-national governments – normally agree that it must be resolved and that the allocation of resources must be “re-balanced”. Conflict usually arises when deciding which of the different possible solutions should be used. VFI imbalance can be solved either through transfers from the State or through a reassignment of taxation powers. In practice, a mix of the two will be used, so that most sub-national governments receive financing in the form of both transfers and own taxes. When sub-national governments receive financing almost exclusively in the form of transfers, an incentive is created to spend those monies in a less responsible way. The idea is simple and similar to the ‘moral hazard’ problem. It is easier for governments to spend money when (a) they do not shoulder the political burden of having to raise it (ie establishing or raising taxes),

³¹ The Agency collects all taxes, including ceded taxes (and only included taxes created by the Autonomous Communities, which are really minor).

³² Latest available complete data, at: AEAT Report 2009, “Key figures for 2009”, pp. 7 et seq. Available online (English version): www.aeat.es.

³³ Also known as *fiscal mismatch*, “*fiscal gap*” o del “*revenue gap*”; See: Oates, W. E.: “An Economist's Perspective on Fiscal Federalism”, at (Ed. Oates, W. E): *The Political Economy of Fiscal Federalism*. Toronto: Lexington Books, 1977, p.. 16; Boadway, R. W.; Hobson, P. A. R.: *Intergovernmental Fiscal Relations in Canada*. Canadian Tax Papers, no. 96. Toronto: CTF, 1993, pp. 28 et seq and 77 et seq.

and (b) there is no need for them to explain to voters/taxpayers the relationship between monies raised and monies spent. In other words, the situation creates a lack of accountability that may not be advisable. This has been, and to a certain extent still is, the situation for common-system Communities.

Horizontal fiscal imbalance (HFI) will arise when there are significant differences in income and thus public resources among sub-national governments³⁴. Resolving this imbalance may also mean better addressing citizen's rights to their services, but it is much harder to solve than VFI. In particular because an increase of sub-national taxation systems will normally make HFI more obvious (richer regions also have higher taxing capacity). Both VFI and HFI have been present in the debates about the Communities' fiscal responsibility, which have become one of the main issues in the relationship between the State and the Communities. Since early on, the transfer of at least *some* taxation powers to such sub-national tiers of government, so that they have fiscal responsibility "at the margin"³⁵, has been considered essential in order to reinforce a certain level of political autonomy.

2. As stated above, one feature of the Spanish fiscal decentralization model is the radical asymmetry that exists between two groups of Communities. On the one hand, the financing systems applicable to the two *foral* Communities are known as *Concierto* (Basque Country) and *Convenio* (Navarra) systems³⁶. The main characteristic of this kind of system is that it entails a maximum level of taxation autonomy, which means these two Communities have powers to pass legislation, with only few limitations³⁷, on two of the main taxes of the Spanish fiscal system. Because the Central Government is still responsible for the provision of some public functions or services within the territory of these two Communities, it is entitled to receive a certain sum of money from them, known as the "*cupo*" (quota).

In contrast, the so-called 'common system', which applies to the other fifteen Communities, is the opposite of the *cupo*. The main difference lies in the fact that, under the common system, the Communities have more limited taxation powers, which results in a greater financial dependence upon the Central Government. Hence, (still) most of their revenues are provided by the Central Government, in the form of transfers³⁸.

³⁴ See Boadway, R. W.; Shah, A.: *Fiscal Federalism: Principles and Practice of Multiorder Governance*. Cambridge, 2009; Boadway, R. W.; Hobson, P. A. R.: *Intergovernmental Fiscal Relations in Canada...cit.* pp. 30-32.

³⁵ Heald, D.; Geaughan, N.: 'Financing a Scottish Parliament', in S. Tindale (ed), *The State and the Nations*. London: Institute for Public Policy Research, 1996, pp.167-83. Boadway, R.: "Intergovernmental Fiscal Relations: The Facilitator of Fiscal Decentralization", *Constitutional Political Economy*, vol. 12, no. 2, 2001, pp. 93-121.

³⁶ Both these terms (*concierto* and *convenio*) translate into English as 'agreement'.

³⁷ Such limitations are established in the laws regulating the *Convenio* and *Concierto*, and basically refer to the need to maintain a certain level of harmonization with the State's tax system. They are, however, established in quite broad terms, which for example allow the Basque Country to establish corporation tax credits that differ broadly from those of the State. See: Ruiz Almendral, V.: "The Asymmetric Distribution of Taxation Powers in the Spanish State of Autonomies: the Common System and the *Foral* Tax Regimes". *Regional and Federal Studies*, (Editorial: Routledge, Frank Cass Journal, Vol. 13, no. 4, Winter 2003 (pp. 41-66); Monasterio Escudero, C.; Zubiri Oria, I.: "Dos ensayos sobre financiación autonómica". Fundación de las Cajas de Ahorro, 2009.

³⁸ Ruiz Almendral, V. *Impuestos Cedidos y Corresponsabilidad Fiscal*. Tirant lo blanch, 2004.

The mere existence of such asymmetries has been, and still is, the cause of much political discussion. The Constitution in its first supplementary provision states that “the Constitution protects and respects the historical rights of the *foral* territories”. However, it is unclear whether this provision actually calls for totally different financing rules. It has also been argued that it is not feasible to maintain such asymmetry in the long term as this will have a negative impact on the efficiency of the system. It would lead to increasingly divergent tax systems³⁹. Furthermore, and more worryingly, this system ends up entailing that they do not share the full cost of the centrally provided services, which also implies their citizens are enjoying higher per capita public spending than the rest of the country⁴⁰.

In fact, it is not the legal design but the way it has been implemented which has resulted in a situation where the current Basque Country and Navarra do not fully cover the central governments costs (both within the territory and as a pro rata share of other costs) relative to them. In that regard, C. Monasterio has pointed out that “As a way of decentralizing the Public Sector, the Foral System is a clear example of Asymmetrical Federalism, since Foral Finance can apply tax measures which the rest of Spanish Autonomous Communities cannot use. From the perspective of Fiscal Federalism, the Foral System gives great tax autonomy to Sub-central Finance, but as a result the Central Government has almost no tax devices. Today, this system presents serious problems regarding the contribution to national public goods financing and the cooperation to economic stabilization. In quantitative terms, analyzing financial relations between the Foral System of Basque Country and Central Government as a whole, the paid amount underestimates by more than 2500 million euro a year the appropriate contribution from Foral Finance for period 2002-2006”⁴¹. It is important to underline the relevance of this imbalance that is only sustainable, in economic terms, because Navarra and the Basque Country only represent 8 per cent of the national GDP. Taking into account that the above mentioned 2500 million figure is quite close to reality⁴², it represents about 0.25 per cent of Spanish GDP. Whether this imbalance can survive the current economic situation in Spain is yet to be seen. Furthermore, the Cupo regime has created certain tensions with European Union Law, as a miscalculation of the Cupo, together with sometimes lower rates for corporate income taxes in the Basque country has been deemed by some to be to the benefit of Spain vis-à-vis other EU countries⁴³.

³⁹ García-Milá, T.; McGuire, T. J.: “Fiscal Decentralization in Spain: An Asymmetric Transition to Democracy”. (Bird, R. ed): *Subsidiarity and Solidarity: The Role of Intergovernmental Fiscal Relations in Maintaining an Effective State in Diverse Countries*. Washington: World Bank, 2003.

⁴⁰ See: Ruiz Almendral, V.: “¿Vuelta a la casilla de salida? El concierto económico vasco a la luz del Ordenamiento comunitario”. *Revista Española de Derecho Europeo*, n. 28/2008 (499-528). Castells, A.: “Autonomía y solidaridad en el sistema de financiación autonómica”. *Papeles de Economía Española*, no. 83/2000; Monasterio Escudero, C.; Zubiri Oria, I.: “Dos ensayos sobre financiación autonómica”. Fundación de las Cajas de Ahorro, 2009.

⁴¹ See Monasterio Escudero, C.: “Federalismo fiscal y sistema foral. ¿Un concierto desafinado?”. *Hacienda Pública Española / Revista de Economía Pública*, 192-(1/2010): 59-103. To date, this is the most thorough analysis of the current foral regime, which if not in design, is quite problematic in its practical implementation, and largely unfair.

⁴² High ranking Spanish officials from the Ministry of the Treasury (Hacienda) all coincide in this reality.

⁴³ Ruiz Almendral, V.: “¿Vuelta a la casilla de salida? El concierto económico vasco a la luz del Ordenamiento comunitario”. *Revista Española de Derecho Europeo*, n. 28/2008 (499-528); Palao Taboada, C.: “State Aid and Autonomous Regions: The ECJ’s Ruling in the Basque Country case”. *Bulletin for International Taxation*, may/june 2009.

3.3 Sharing Taxes

1. The Spanish Constitution (sections 133 and 157) bestows taxation powers upon the fifteen Communities⁴⁴. In accordance with the recognition of autonomy, or, stated more accurately, the recognition of the right to be autonomous, the Spanish Constitution grants Communities “financial autonomy for the development and execution of their authority” (art. 156)⁴⁵. Apart from stating this principle of financial autonomy, the Constitution establishes a list of resources that will constitute the Communities’ income. This list includes almost all kinds of possible existing resources. Thus, they may obtain revenues from: ceded taxes; surtaxes on existing Central Government taxes; their own taxes; public debt; and transfers (section 157.1).

However, it also allows the Centre to approve a special “organic” law (*ley orgánica*) regulating both how the resources listed in section 157.1 will be distributed among Communities and the limits on the exercise of their financial power on the resources (i.e. whether and to what extent they may create new taxes, etc)⁴⁶. This implies that the Central Government is given the power to both limit and control the financial autonomy of the Communities. In fact, soon after the Constitution was ratified, the *Special Law for the Financing of the Autonomous Communities*, Law 8/1980 (*Ley Orgánica de Financiación de las Comunidades Autónomas* – hereafter, the LOFCA) was approved. The role of the LOFCA is central in the system of financing Autonomous Communities. Some authors have in fact spoken of a “de-constitutionalization” of the system, since the LOFCA replaces the Constitution in

⁴⁴ See Rodríguez Bereijo, A.: “Constitución Española y Financiación Autonómica”, at *La financiación Autonómica*. AELPA, Tecnos, 2010, pp. 25 et seq.

Section 133

1. The primary power to raise taxes is vested exclusively in the State by means of law.
2. Self-governing Communities and local Corporations may impose and levy taxes, in accordance with the Constitution and the laws.
3. Any fiscal benefit affecting State taxes must be established by virtue of law.
4. Public Administrations may only contract financial liabilities and incur expenditures in accordance with the law.

⁴⁵ Section 156

1. The Self-governing Communities shall enjoy financial autonomy for the development and exercise of their powers, in conformity with the principles of coordination with the State Treasury and solidarity among all Spaniards.
2. The Self-governing Communities may act as delegates or agents of the State for the collection, management and assessment of the latter's tax resources, in conformity with the law and their Statutes.

⁴⁶ Section 157

1. The resources of the Self-governing Communities shall consist of:
 - a) Taxes wholly or partially made over to them by the State; surcharges on State taxes and other shares in State revenue.
 - b) Their own taxes, rates and special levies.
 - c) Transfers from an inter-territorial compensation fund and other allocations to be charged to the State Budget.
 - d) Revenues accruing from their property and private law income.
 - e) Interest from loan operations.
2. The Self-governing Communities may under no circumstances introduce measures to raise taxes on property located outside their territory or likely to hinder the free movement of goods or services.
3. Exercise of the financial powers set out in subsection 1 above, rules for settling the conflicts which may arise, and possible forms of financial cooperation between the Selfgoverning Communities and the State may be laid down by an organic act.

designing the main structure of the financing of the Autonomous Communities⁴⁷. The Constitutional Court has also stressed this role of the LOFCA (Opinions 179/1985, 68/1996, 183/1988, among others) even if it has also underlined the relevance of the Statutes of Autonomy in the definition of the financing system (Opinion 31/2010) *within the framework of the LOFCA*⁴⁸.

The LOFCA imposes severe limits on Communities' capacity to create new taxes. The most important limitation is the prohibition of double taxation (article 6.2 and 3), which prevents AC taxes from being similar to taxes created by the Central Government and the Municipalities. However, this limitation has been largely offset by the sharing taxes system, put into place in 1997, so that in practice, Communities have substantial taxing powers.

The original limitation of their tax powers has an obvious explanation; when the Constitution (1978) and the LOFCA (1980) were approved, both Municipalities and the Central Government had already established taxes on most of the possible sources of revenues, which has left little tax room for Communities. In fact, some of the attempts of Communities to establish their own taxes were declared unconstitutional by the Constitutional Court, on the basis of sections 6.2 and 6.3 of the LOFCA⁴⁹. A recent reform of article 6.3 of the LOFCA has considerably eased the limit⁵⁰. But so far Communities have not created any new taxes. It is not always clear whether it is the limitations on establishing new taxes or the unwillingness to withstand the political consequences of increasing the tax burden that has deterred Communities from creating new taxes, but the traditional existence of such limits underlines the importance of intergovernmental transfers in Spain. When the level of tax autonomy is so low, the possibilities for Communities to obtain their own resources are scarce, hence the need for transfers from the Centre. This situation also explains the substantial imbalance between the common-system Communities spending autonomy – which has been strongly supported by the Constitutional Court (case 13/1992, among other) – and their limited power to raise their own revenues.

2. There is a widespread view that to achieve a fundamental decentralization of powers, the sub-national tiers of government must be able to raise revenues in addition to the Central Government transfers they receive. That view holds that the transfer of at least some taxation powers to sub-national tiers of government is essential in order to achieve a certain level of political autonomy. This inspired the reforms undertaken

⁴⁷ This idea at: Palao Taboada, C.: "La distribución del poder tributario en España". *Crónica Tributaria*, n. 52/1985, p. 184; Medina Guerrero, M.: *La incidencia del sistema de financiación en el ejercicio de las competencias de las Comunidades Autónomas*. Madrid: CEC, 1992, p. 342.

On the other hand, when the Constitution was approved there were no Autonomous Communities, so it would have been difficult to perfectly outline their financing system.

⁴⁸ The relationship between the LOFCA and the Statutes cannot be fully established ex ante. It depends on what type of authority the LOFCA and the Statutes are dealing with. For example, in the case of limits to taxes, the Constitution does bestow the LOFCA the authority to establish the limits within which autonomous Communities may operate.

⁴⁹ Organic laws, such as the LOFCA, that refer to how authority is distributed in Spain have a particular status in the process before the Constitutional Court in the sense that they serve as an element to determine the constitutionality of a given measure. This explains that a law passed by an Autonomous Community establishing a given tax will be deemed unconstitutional if it is contrary to the LOFCA.

⁵⁰ Article 6.3 was modified in 2009 (via this law: *Ley Orgánica 3/2009, de 18 de diciembre, de modificación de la Ley Orgánica 8/1980, de 22 de septiembre, de Financiación de las Comunidades Autónomas*) in order to make it easier for Communities to establish their own taxes.

in 1996, when there was a fundamental change in the financing system of Communities along these lines. Some taxes traditionally belonging to the Centre, and including the personal income tax, were transformed into shared taxes (ceded taxes or *impuestos cedidos*) in 1997, substantially increasing the taxing powers of Communities. Subsequent reforms in 2002 and 2009 have further increased Communities' powers over these taxes⁵¹.

The main goal of these reforms was to make Communities more involved in the establishment of taxes and thus more directly accountable to their taxpayers for the monies they spend. Simply put, the reforms consist of the sharing of some tax room that until then had been occupied solely by the Centre. This has been done through a type of resource called a 'ceded tax'. Until 1997, ceded taxes were Central Government taxes whose yield was granted to Communities according to the taxes paid within each AC's territory (derivation principle). Due to powers delegated by the Centre, Communities had also taken on the responsibility for administering and collecting these taxes. Ceded taxes were, therefore, virtually a kind of transfer, by which some of the taxes 'owned' and until 1997 regulated exclusively by the Centre accrued to, and were administered by, the Communities. They differ from transfers in that the Communities may receive a 'bonus' in some cases. Thus, if the actual yield of the tax is greater than what had been forecasted by the central government, the AC receives the difference. If the yield is less than the forecast, the Community still receives the initially forecasted amount. However, an increase of the yield may or may not be a consequence of better tax administration; for example, it may be merely due to economic conditions⁵². Therefore, this bonus only partially serves as an incentive for Communities to administer ceded taxes more efficiently. On the other hand, the Communities' decision-making powers over these kinds of taxes were, previously, almost non-existent.

⁵¹ The latest reform, which entered into force on January 1st 2010 (although most of its provisions actually extended their effects retroactively, to 1 January 2009) is regulated in the Law 22/2009 (Ley 22/2009, de 18 de diciembre, por la que se regula el sistema de financiación de las Comunidades Autónomas de régimen común y Ciudades con Estatuto de Autonomía y se modifican determinadas normas tributarias) For a general outline (in English) of how the system works and the different outcomes see, by the author: Ruiz Almendral, V.: "Fiscal Federalism in Spain: the Assignment of Taxation Powers to the Autonomous Communities". International Bureau of Fiscal Documentation. European Taxation, vol. 42, no. 11, November, 2002. Ruiz Almendral, V.: "The Asymmetric Distribution of Taxation Powers in the Spanish State of Autonomies: the Common System and the *Foral* Tax Regimes". Regional and Federal Studies, (Editorial: Routledge, Frank Cass Journal, Vol. 13, no. 4, Winter 2003 (pp. 41-66).

More recently, see: Bosch, N. y Durán, J.M.: "The financing system of Spanish regions: Main features, weak points, and possible reforms", en Bosch, N. y Durán, J.M. (Eds.): *Fiscal Federalism and Political Decentralization. Lessons from Spain, Germany, and Canada*, Chentelham: Edward Elgar, 2008, pp. 3-24 Gimeno, J.: "Tax assignment and regional co-responsibility in Spain", at Bosch, N. y Durán, J.M. (Eds.): *Fiscal Federalism and Political Decentralization. Lessons from Spain, Germany, and Canada*, Chentelham: Edward Elgar, 2008, pp. 74-106. López-Laborda, J., Martínez-Vázquez, J. y Monasterio, C. (2007): "The practice of fiscal federalism in Spain", en A. Shah (Ed.), *The Practice of Fiscal Federalism: Comparative Perspectives*, Quebec: The Forum of Federations McGill-Queen's University Press, pp. 287-316. Martínez-Vázquez, J.: "Revenue assignments in the practice of fiscal decentralization", en Bosch, N. y Durán, J.M. (Eds.): *Fiscal federalism and political decentralization. Lessons from Spain, Germany, and Canada*, Chentelham: Edward Elgar, 2008, pp. 27-55. See a thorough outline of the current system at: Zabalza, A. and J. López-Laborda (2010), "El Nuevo Sistema de Financiación Autonómica: Descripción, Estimación Empírica y Evaluación", *Working Paper* No. 530. Madrid: FUNCAS. (<http://www.funcas.es/Publicaciones/InformacionArticulos/Publicaciones.asp?ID=1593>).

⁵² See a critic at Monasterio Escudero, C.; Zubiri Oria, I.: "Dos ensayos sobre financiación autonómica...cit.

Ceded taxes thus changed substantially following the 1996 reform (which entered into force in 1997). The reassignment of taxation powers resulting from the shared taxes mechanisms constitutes the most important tax reform since the State of Autonomies became a reality. Under the new system, common-system Communities have substantially increased their taxation powers. Although the gap between the powers of the *foral* and common-system Communities remains quite large, it has certainly been reduced by the reform. If the tendency continues, the possibility that the two systems end up converging should not be completely ruled out. Such convergence derives mainly from the common-system Communities' newly acquired taxation powers.

Until 1997, only *foral* Communities could pass legislation and control some of the main taxes of the system (such as the personal income or the corporate income taxes). Since then, common-system Communities have gradually gained access to most important tax bases (and rates), excluding corporate income taxes. Although the gap is still wide, considering that common-system Communities can only regulate certain aspects of some of these taxes while *foral* Communities may regulate most elements of the said taxes except for certain aspects, the tendency is towards a degree of convergence. However, when we compare the powers that the common-system and *foral* Communities hold on the main taxes of the taxation system, it is clear from the following table that a profound asymmetry prevails.

Communities may now regulate certain aspects of the personal income tax, the wealth tax, the death and gift taxes, stamp duty and gambling taxes. The use of those powers by Communities is entirely another story. In fact, because Communities do not actually use their powers, at least not extensively, I submit that ceded taxes often work, *in practice*, as a type of transfer. Technically of course, in budgetary terms, they are classified as Communities own taxes. It is the lack of fiscal responsibility, or generally the lack of interest shown by Communities to actually employ their taxing powers to increase their revenues that make them similar to a transfer.

Until 2009, if an AC failed to do so or decided not to exercise such powers, there would be no consequences; the Central Government would continue to regulate every aspect of these taxes in that AC, so it would not lose any revenue by failing to legislate. If an AC were to decide to pass legislation modifying the above-mentioned authorized aspects over any ceded tax, it could do so by enacting legislation which would then substitute for Central Government law, in those areas where the AC has the authority to legislate.

The way that this option was structured – and the fact that the Central Government still guarantees to Communities lump-sum grants allocated on the basis of historical shares in its transfers, *regardless of whether they exercise their powers or not* – served to create a strong disincentive for Communities to use their new taxation powers.

Starting in 2011 the Central Government does not regulate the *ceded* part of the tax any longer. Hence “lazy” Communities will lose their revenue if they fail to legislate. This was a central government's initiative, as no Community has asked for this. It is supposed to reinforce fiscal responsibility, if only by *forcing* Communities to exercise their powers. However, most Communities have (even with the current crisis) merely

used their powers to copy the Central Government's legislation in the same exact terms, which is why I submit that ceded taxes remain a form of transfer.

Table 2: Autonomous Communities powers on ceded taxes (2009)

Ceded Taxes	AC share (%)	Administration	Legislative Powers that Communities <i>must</i> assume
Personal income tax	50	State	Tax rates (must have same number of tax brackets as the State tax) Tax credits, under certain conditions Personal deductions
<i>Wealth tax (repealed in 2009, reestablished in 2011)</i>	<i>100</i>	<i>Communities</i>	<i>Tax rates</i> <i>Minimum threshold</i> <i>Tax credits</i>
Succession and gift taxes	100	Communities	Deductions (mainly, for family circumstances) Tax rates Deductions and tax credits Tax administration regulations
Taxes on transfers and official documents	100	Communities	Tax rates Tax credits Tax administration regulations
Gambling taxes	100	Communities	Exemptions Taxable base Tax rates Tax credits Tax administration regulations
Value added tax	50	State	None
Excise duties	58	State	None
Tax on wine	58	State	None
Tax on electricity	100	State	None
Tax on vehicles	100	Communities	Tax rates (under certain limits)
Special tax on gas	100	Communities	Tax rates (under certain limits) Tax administration regulations

3.4 The Functioning of the System: Transfers and Ceded Taxes

To a large extent, the financing of common-system Communities is based upon need, not purely fiscal capacity⁵³. Thus, it can be argued that their enhanced tax room on ceded taxes is not sufficiently taken into account in the sense that no penalization is envisaged when Communities decide not to exercise their powers or not to increase their tax pressure when they need extra revenue (as opposed to incurring extra debt). In fact, the Communities have mostly used their powers on ceded taxes to create new

⁵³ A recent, thorough, outline of the Spanish system of intergovernmental transfers can be found at: Zabalza, A.; López-Laborda, J.: "The new Spanish System of intergovernmental transfers". International Studies Program Working Paper 11-03 February 2011, Andrew Young School, Georgia University (at <http://aysps.gsu.edu/isp/files/ispwp1103.pdf> (accessed 27.12.2011)).

fiscal benefits⁵⁴. This is bound to change with the new debt and deficit limits, as explained below.

Table 3: Comparison of legislative powers of common-system and *foral* Communities

Main Taxes in Spain	Legislative Powers that <i>foral</i> Communities may assume	Legislative Powers that common-system Communities must assume
Personal income tax	Total regulation of the tax	Tax rates (must have same number of tax brackets as the State tax) Tax credits, under certain conditions
Corporation income tax	Total regulation of the tax	None
Tax on income of non-residents	Regulation of the tax only in the case of permanent establishment in the <i>foral</i> territory	None
Wealth tax	Total regulation of the tax	Tax rates Minimum threshold Tax credits
Death and gift taxes	Total regulation of the tax	Deductions (mainly, for family circumstances) Tax rates Deductions and tax credits Tax administration regulations
Taxes on transfers and official documents	Total regulation of the tax	Tax rates Tax credits Tax administration regulations
Gambling taxes	Total regulation of these taxes	Exemptions Taxable base Tax rates Tax credits Tax administration regulations
Value added tax	None	None
Excise duties	None	None

The transfers received by the Communities have traditionally been based upon need. In the early 1980s, and according to the LOFCA, the cost of the devolved powers would be calculated and a given amount would then be transferred to the Communities. In reality, the cost was calculated, but transfers were also the subject of intense negotiations which took place in bilateral commissions (between the Centre and each AC). These would meet behind closed doors and agree on a certain amount. The reason for this is that the then existing accounting systems of the Central Government were inadequate for such calculations, so the actual cost of the transferred services was never actually determined. This continuous negotiation was also the subject of sharp criticism. Apart from the lack of democracy argument, seen above, from a financial perspective it was deemed to create inequalities as, eventually,

⁵⁴ On the personal income tax, see: Ruiz Almendral, V.; Vaillancourt, F.: "Choosing to be different (or not): personal income taxes at the sub-national level in Canada and Spain". *Papel de Trabajo del Instituto de Estudios Fiscales*, n. 29/2006, pp. 1-37.

those Communities whose bargaining position was weaker would get less money to exercise the powers that fall within their scope of authority⁵⁵.

The new financing system for Autonomous Communities that entered into force in 2009⁵⁶ was approved at a difficult economic conjuncture for Spain. With the end of the housing bubble and the abrupt end of construction activity, national unemployment hit 20 per cent (July 2011 data), and according to official reports, there is no real hope for recovery before two or three years⁵⁷.

The 2009 system follows the traditional formula applied since 1997, by which the total financing that a Community needs (or is entitled to) is calculated and then different resources are added to arrive at the figure. Roughly put, there are two general sources of revenue that stem directly from the financing system established by the central government. These two sources are a mix of transfers and revenue from ceded taxes – both taxes administered by the Centre and the Communities. Other revenues that Communities may have, such as those deriving from own taxes, are not part of the formula. This is, or should be, an advantage, to the extent that Communities may increase their own revenues by establishing new taxes. However, the political cost of such a measure has generally prevented own taxes from being a significant source of revenue.

The said two sources are the following⁵⁸: revenues that are received on an annual basis and revenues that are received periodically, and adjusted once all the data is known. The first group is formed by ceded taxes which are administered by Communities. The second, much larger, type of source is a mix of ceded taxes revenue (which are administered by the central government) and transfers that intend to equalize revenues on the basis of different needs criteria (population, age of population, etc). The second source may be negative or positive, that is, a Community may be forced to return part of the revenue obtained from the Central Government from the lump sums (*Fondo de Garantía* and *Fondo de Suficiencia Global*) of transfer schemes that are designed to equalize the fiscal capacity of Autonomous Communities. In July 2011 the Consejo de Política Fiscal y Financiera and the Ministry of Economy publicly announced the final data of tax revenues for 2009 (the first year this new system was applied). Because of the crisis, tax revenues, in particular in income taxes, have considerably decreased, which has resulted in the need for many Communities to pay back to the Central Government part of the transfers they received as an advance.

The financing formula first determines the amount that each Autonomous Community is entitled to receive in a given fiscal year. That needed amount or “total financing” (the law calls it “*Necesidades Globales de Financiación*” -NGF) is established for each Community (see below, Table 4).

⁵⁵ León-Alfonso, S.: *The Political Economy of Fiscal Decentralization. Bringing Politics to the Study of Intergovernmental Transfers*. Barcelona: Instituto d’Estudis Autònoms, 2007.

⁵⁶ The system was established by two laws: Organic Law 3/2009, which reformed the LOFCA and the above mentioned Law 22/2009.

⁵⁷ See the latest report from the Ministry of Finance in Spain, at: <http://serviciosweb.meh.es/apps/dgpe/TEXTOS/SIE/siepub.pdf>.

⁵⁸ Santiuste Vicario, A.: “La aplicación práctica del sistema de financiación de las Comunidades Autónomas de régimen común regulado en la Ley 22/2009, de 18 de diciembre”. *Presupuesto y Gasto Público*, 62/2011, pp. 101-117.

The figure will depend on a number of factors, a main one being what the Community had been receiving before (what revealingly is called “total Status Quo”, Table 4), but also other elements such as how scattered the population is or whether the Community has an own language that deserves to be protected (Catalonia, Galicia, Valencia and Balearic Islands fall in this group). The goal is that all the services that are now rendered by the Communities (and in particular the most expensive, Health and Education, which in 2001 became almost entirely the Communities’ responsibility) can continue to be rendered with roughly the same standards as before, as well as with a minimum across the country.

This is actually a consequence of article 149.1.1^a of the Spanish Constitution, which mandates the Central Government to regulate “*basic conditions guaranteeing the equality of all Spaniards in the exercise of their rights and in the fulfillment of their constitutional duties*”. Furthermore, the Constitution also mandates that certain equality (not uniformity) must be achieved and that the Central Government is in charge of guaranteeing that equality at least at the margin. While Section 137 establishes that “*The State is organized territorially into municipalities, provinces and the Self-governing Communities that may be constituted. All these bodies shall enjoy self-government for the management of their respective interests*”, Section 138.1 establishes that “*The State guarantees the effective implementation of the principle of solidarity proclaimed in section 2 of the Constitution, by endeavoring to establish a fair and adequate economic balance between the different areas of the Spanish territory and taking into special consideration the circumstances pertaining to those which are islands*”. Furthermore: article 138.2 states that “*Differences between Statutes of the different Self-governing Communities may in no case imply economic or social privileges*”. According to section 139 “*All Spaniards have the same rights and obligations in any part of the State territory*”. The financial consequences of these provisions are contemplated in article 158 of the Constitution, which establishes that “*1. An allocation may be made in the State Budget to the Self-governing Communities in proportion to the amount of State services and activities for which they have assumed responsibility and to guarantee a minimum level of basic public services throughout Spanish territory*” and that “*2. With the aim of redressing interterritorial economic imbalances and implementing the principle of solidarity, a compensation fund shall be set up for investment expenditure, the resources of which shall be distributed by the Cortes Generales among the Self governing Communities and provinces, as the case may be*”.

These constitutional mandates are reflected in the different types of transfers designed into the system⁵⁹. I will dedicate the following lines to the general outline of the system, leaving out the specifics of the different funds, as well as the special equalization scheme that results from article 158.2, which is regulated in a specific law⁶⁰.

⁵⁹ See, in detail: Zabalza, A. and J. López Laborda, “The new Spanish system of intergovernmental transfers”, *International Tax and Public Finance* (2011) 18: 750-786.

⁶⁰ The “Compensation Funds” are regulated in the Law 22/2001, (*Ley reguladora de los Fondos de Compensación Interterritorial*).

Table 4: Global financing needs (*Necesidades Globales de Financiación*)

Community	Total “Status Quo”	Resources to keep the Welfare State	Scattering of Population	Low density of population	Special language (Catalan, Galisian...)	Total additional resources	Global financing needs
	(1)	(2)	(3)	(4)	(5)	(6)=(2)+(3)+(4)+(5)	(7)=(1)+(6)
Cataluña	15.214.740,10	951.399,58	0,00	0,00	97.957,56	1.049.357,14	16.264.097,24
Galicia	5.729.107,75	163.004,20	34.093,79	0,00	45.956,43	243.054,42	5.972.162,17
Andalucía	14.904.227,64	778.962,05	0,00	0,00	0,00	778.962,05	15.683.189,69
Principado de Asturias	2.273.533,55	46.396,98	7.864,75	0,00	0,00	54.261,73	2.327.795,29
Cantabria	1.401.128,34	54.157,82	1.052,33	0,00	0,00	55.210,15	1.456.338,49
La Rioja	703.737,89	42.875,18	0,00	2.073,69	0,00	44.948,87	748.686,76
Región de Murcia	2.392.718,45	211.455,96	0,00	0,00	0,00	211.455,96	2.604.174,41
C. Valenciana	8.288.774,94	717.237,29	0,00	0,00	61.642,56	778.879,85	9.067.654,79
Aragón	2.855.957,50	136.777,65	0,00	9.006,07	0,00	145.783,72	3.001.741,22
Castilla-La Mancha	3.924.816,60	245.155,03	0,00	13.986,25	0,00	259.141,28	4.183.957,88
Canarias	3.466.475,27	302.230,38	0,00	0,00	0,00	302.230,38	3.768.705,64
Extremadura	2.322.230,82	48.591,86	0,00	7.436,00	0,00	56.027,86	2.378.258,68
Illes Balears	1.718.400,14	173.418,91	0,00	0,00	31.297,08	204.715,99	1.923.116,14
Madrid	12.106.808,68	878.796,65	0,00	0,00	0,00	878.796,65	12.985.605,33
Castilla y León	5.411.011,21	149.540,45	6.989,13	17.497,99	0,00	174.027,56	5.585.038,77
Total CC.AA.	82.713.668,89	4.900.000,00	50.000,00	50.000,00	236.853,63	5.236.853,63	87.950.522,52
Melilla	8.317,03	6.550,00	0,00	0,00	0,00	6.550,00	14.867,03
Ceuta	9.416,99	9.150,00	0,00	0,00	0,00	9.150,00	18.566,99
Total Ciudades	17.734,02	15.700,00	0,00	0,00	0,00	15.700,00	33.434,02

Going back to the “Global Financing Needs” (GFN), the 2009 system added new elements to the formula, making it a very expensive system⁶¹. Before then, only an updated “status quo” would be taken into account. The new system attempts to link the GFN to different criteria that may significantly make the provision of services, in particular Health and Education, more or less expensive. With that purpose, new specific funds have been added to the formula. These funds are to be distributed unevenly among Communities, depending on how much they need. That specific need is assessed through a mix of criteria. Thus, elements such as population, its age distribution, the total surface of the Community and how scattered the population are taken into account just to determine the GFN or amount every Community should achieve. These new funds are revealingly named “Resources to keep the Welfare State”.

⁶¹ As pointed out at Zabalza, A.; López-Laborda, J.: “The new Spanish System of intergovernmental transfers...cit.

The distribution of the GFN among Communities can be seen in Table 4⁶²:

A second step of the system is to define what types of resources will form part of the Global Sufficiency Fund (see Table 5).

Table 5: Global sufficiency fund for 2009

Autonomous Community	Global Financing Needs 2009	Taxing Capacity 2009 (ceded taxes)	Transfers from a Guarantee Fund 2009 (Health, mainly)	Global Sufficiency Fund 2009
	(1)	(2)	(3)	(4)=(1)-(2)-(3)
Cataluña	16.264.097,24	15.672.639,50	-1.455.227,31	2.046.685,05
Galicia	5.972.162,17	4.342.099,98	880.601,61	749.460,57
Andalucía	15.683.189,69	11.645.015,53	2.659.014,15	1.379.160,01
Principado de Asturias	2.327.795,29	1.973.957,92	88.428,98	265.408,38
Cantabria	1.456.338,49	1.167.410,33	-55.714,21	344.642,37
La Rioja	748.686,76	577.042,01	21.555,66	150.089,10
Región de Murcia	2.604.174,41	2.146.073,99	365.363,65	92.736,77
C. Valenciana	9.067.654,79	8.308.737,90	739.427,70	19.489,20
Aragón	3.001.741,22	2.680.403,38	-37.110,51	358.448,35
Castilla-La Mancha	4.183.957,88	3.120.427,22	724.008,93	339.521,73
Canarias	3.768.705,64	1.712.326,07	1.752.613,99	303.765,58
Extremadura	2.378.258,68	1.430.744,00	556.138,29	391.376,39
Illes Balears	1.923.116,14	2.341.634,13	-230.154,58	-188.363,42
Madrid	12.985.605,33	15.416.043,39	-3.180.398,76	749.960,70
Castilla y León	5.585.038,77	4.462.342,12	486.978,91	635.717,75
Total CC.AA.	87.950.522,52	76.996.897,49	3.315.526,50	7.638.098,53
Melilla	14.867,03	0,00	0,00	14.867,03
Ceuta	18.566,99	0,00	0,00	18.566,99
Total Ciudades	33.434,02	0,00	0,00	33.434,02
Total General	87.983.956,54	76.996.897,49	3.315.526,50	7.671.532,55

The current system establishes that those resources will be formed by two large groups: first, the yield of ceded taxes (*Tributos cedidos* -TC) and an equalization transfer (Fund to guarantee essential public services or *Fondo de Garantía de Servicios Públicos Fundamentales* –FGSPF).

A second type of transfer will cover a possible gap when TC + FGSPF does not cover the Global needs. So there are two possible outcomes (as can be seen in the following table):

⁶² Source for all the following tables: Ministerio de Economía y Hacienda (July 2011); document named “Liquidación de los recursos del sistema de financiación de las comunidades autónomas de régimen común y ciudades con estatuto de autonomía y de las participaciones en los fondos de convergencia autonómica, regulados en la ley 22/2009, de 18 de diciembre, correspondientes al ejercicio 2009” and in particular de Annex Tables. All available at: <http://www.meh.es/es/Estadistica%20e%20Informes/Estadisticas%20territoriales/Paginas/Informes%20financiacion%20comunidades%20autonomas2.aspx>.

Table 6: Communities with per capita GDP lower than 90 per cent of the average (thousands of euro)

Autonomous Community	GDP 2007 (thousands of euro)	GDP 2008 (thousands of euro)	GDP 2009 (thousands of euro)	Population 2007	Population 2008	Population 2009	Average GDP per capita Last 3 years	Communities that will benefit
	(1)	(2)	(3)	(4)	(5)	(6)	(7)=[(1)+(2)+(3)]/[(4)+(5)+(6)]	
Cataluña	197.166.994	202.695.024	195.644.827	7.166.031	7.270.468	7.288.071	27.411,67	
Galicia	54.107.607	56.220.304	54.857.447	2.728.772	2.738.098	2.737.034	20.134,97	<90% average
Andalucía	144.949.006	148.915.411	142.994.677	7.989.013	8.105.608	8.177.351	17.998,50	<90% average
Principado de Asturias	22.936.864	23.736.703	22.725.577	1.058.743	1.059.089	1.057.145	21.858,16	
Cantabria	13.347.745	13.888.906	13.346.291	567.088	573.758	577.885	23.612,15	
La Rioja	7.762.984	8.037.214	7.843.401	309.360	313.772	316.341	25.166,87	
Región de Murcia	27.100.446	28.164.464	27.182.448	1.392.368	1.430.986	1.452.150	19.283,66	<90% average
C.Valenciana	102.478.051	105.833.509	101.793.151	4.824.568	4.950.566	5.019.138	20.961,13	
Aragón	32.906.696	34.071.768	32.497.506	1.286.285	1.306.631	1.318.923	25.429,46	
Castilla-La Mancha	35.729.134	36.857.370	35.784.888	1.951.388	2.001.643	2.037.756	18.089,68	<90% average
Canarias	41.734.525	42.907.188	41.258.418	2.019.299	2.061.499	2.085.980	20.415,87	<90% average
Extremadura	17.502.561	18.176.031	17.922.048	1.076.695	1.079.725	1.081.012	16.556,53	<90% average
Illes Balears	26.142.863	27.196.542	26.404.893	1.028.635	1.058.668	1.074.949	25.217,57	
Madrid	186.500.419	193.049.514	189.782.158	6.112.078	6.245.883	6.300.460	30.513,41	
Castilla y León	56.620.354	58.128.174	56.388.618	2.492.034	2.506.454	2.510.631	22.790,58	
Total	966.986.249	997.878.122	966.426.348	42.002.357	42.702.848	43.034.826		

A first outcome is when the total amount that a Community needs is smaller than the sum of TC and FGSPF. In this scenario, the Autonomous Community will need to return part of the revenue received. This will normally happen to the richest Communities. This has happened in 2009 to Catalonia, Cantabria, Aragon, Balearic Islands and Madrid (respectively, they have had to return 1,455; 55; 37; 230 and 3,180 million euro). The reason is the high yield of their ceded taxes, which is explained because these are the richest Communities (which means richer taxpayers).

A second possibility is that the Community is not able to cover all its needs by TC and FGSPF. In this case, the second fund –Global Sufficiency Fund/*Fondo de suficiencia global*- will be applied. This has happened to the rest of Communities, with Andalusia receiving 2,659 million euro and, on the other end, La Rioja receiving 21 million euro (column 3)⁶³. The Global Sufficiency Fund therefore only applies as a “closing element” of the system.

⁶³ See complete data at Table 2.11, “Anexo numérico 2009”, at <http://www.meh.es/es-ES/Estadistica%20e%20Informes/Estadisticas%20territoriales/Paginas/Informes%20financiacion%20comunidades%20autonomas2.aspx>

This means that, to a certain extent, the system also provides for inter-regional equalization, with richer Communities partly financing poorer Communities. This is also often contested. Of course any tax system –and the current financing model is largely based on taxes– as well as any redistribution or equalization scheme will produce that result. Whether or not it should be accepted is another matter, and the ultimate answer, largely ideological⁶⁴.

In 2009, new specific balancing transfer systems were introduced. The new types of transfers were intended to equalize AC public revenues and guarantee the provision of “essential public services”, or services related to Education, Health and other Social Services (support for the elderly, etc.). The cost of these transfers has considerably increased, especially in Communities where immigration growth has been quantitatively relevant (such as Madrid and Catalonia, among others).

This final set of transfers is designed to further equalize resources between Communities, not on the basis of the authority that they have but on the basis of a number of elements that set them at a disadvantage. These two “Convergence Funds” (*Fondos de convergencia*) are the “Cooperation Fund” (*Fondo de cooperación*) and the “Competitiveness and Compensation Fund” (*Fondo de competitividad y convergencia*). The criteria that set the relevant amounts revolve around the per capita income, scarcity of population, growth of population and per capita tax capacity (which is a criterion not unrelated to income).

As can be seen in Table 6, taking the most revealing indicator, the per capita income⁶⁵, six Communities have benefited from the “Cooperation Fund”, as they had a per capita income “less than 90 per cent of the average”; see following table (Galicia, with a per capita income of 20,134 euro, Andalusia, 17,998, Murcia, 19,283, Castilla La Mancha, 18,089, Canary Islands, 20,415 and Extremadura, 16,556. By contrast, the richest Communities, in terms of per capita income, are Madrid (30,513), Catalonia (27,411), La Rioja (25,166), Aragón (25,429) and the Balearic Islands (25,217).

When the final results of the system for 2009 were revealed last July 28th, 2011, as all the final data on the yield of the different taxes was ready, it turned out that all Communities will need to return to the Central Government part of what they had been receiving during 2009, 2010 and part of 2011. Simply put, the explanation mainly lies in the way taxation revenues have plummeted and that some of the needs were overestimated. This resulted in ACs receiving an overestimation of tax revenues which is why the following table (Table 7) shows tax revenues as “negative”.

⁶⁴ Furthermore, it is debatable whether financing the poorer is not in fact in the richer Communities’ self interest, since the poorer may then be in a better position to grow and contribute to the general growth.

⁶⁵ The per capita income taken into account for the purpose of this fund is the average of three years: 2007, 2008 and 2009.

Table 7: Final results of the financing system (2009)

ACs	1.PIT revenues	2.VAT revenues	3.Excise revenues	4.Transfer from the Guarantee Fund	5.Global Sufficiency Fund	6.Final results 2009 resources	7.Global convergence funds	6 + 7	9.Advanced funds received by ACs	10. Compensation Wealth Tax	Final result
	(1)	(2)	(3)	(4)	(5)	(6)=(1)+...+(5)	(7)	(8)=(6)+(7)	(9)	(10)	(11)=(8)-(9)-(10)
Cataluña	-893.434,26	-1.252.917	-62.527,67	559.214,78	732.953,94	-916.710,42	936.740,46	20.030,04	2.495.631,41	2.507,09	-2.478.108,45
Galicia	-74.686,46	-450.323	9.511,17	224.634,78	-1.198.572,99	-1.489.436,53	242.788,07	-1.246.648	353.747,09	196,60	-1.600.592,15
Andalucía	-474.622,75	-1.116.762	-59.865,36	618.589,43	-2.957.522,80	-3.990.184,08	308.562,00	-3.681.622	954.397,49	1.419,96	-4.637.439,54
Principado de Asturias	-57.508,81	-197.606	806,89	85.185,86	-394.516,81	-563.639,52	90.926,32	-472.713	115.202,07	149,34	-588.064,62
Cantabria	-34.312,35	-103.245	378,08	44.514,75	-231.059,88	-323.724,70	16.195,79	-307.528,91	56.670,90	26,72	-364.226,53
La Rioja	-37.606,11	-50.394	193,45	24.668,98	-104.864,74	-168.002,52	0,00	-168.002,52	34.898,30	74,09	-202.974,92
Región de Murcia	-109.948,10	-167.616	-17.370,48	107.231,47	-271.285,98	-458.989,74	150.976,89	-308.012,84	273.846,83	114,96	-581.974,63
C. Valenciana	-604.899,09	-696.362	-73.448,17	378.500,84	-441.114,18	-1.437.323,24	634.026,61	-803.296,63	903.460,44	462,35	-1.707.219,43
Aragón	-128.233,02	-225.540	-9.155,82	107.137,69	-345.096,80	-600.888,79	32.645,72	-568.243,07	153.316,97	86,68	-721.646,72
Castilla-La Mancha	-61.184,16	-217.909	-14.652	166.382,78	-714.515,05	-841.878,59	76.320,53	-765.558,06	267.840,91	295,85	-1.033.694
Canarias	-123.715,29	0,00	3.809,67	164.891,21	-959.090,40	-914.104,81	69.199,92	-844.904,89	256.961,54	490,53	-1.102.356,96
Extremadura	-10.744,51	-140.370	9.585,45	88.459,88	-694.966,16	-748.035,81	102.503,83	-645.531,99	118.777,70	68,62	-764.378,31
Illes Balears	-96.634,97	-360.201	-26.651	82.860,53	224.054,50	-176.573,70	327.163,05	150.589,35	328.571,13	396,03	-178.377,81
Madrid	-834.258,59	-1.174.106	-10.912	455.094,54	601.420,14	-962.762,58	762.328,68	-200.433,89	1.130.029	5.759,87	-1.336.223,38
Castilla y León	-111.930,37	-388.110	-7.158	208.158,95	-1.066.230,60	-1.365.270	210.485,55	-1.154.785	284.270,78	125,02	-1.439.181,09
Total CC.AA.	-3.653.718	-6.541.468	-257.457	3.315.526	-7.820.407	-14.957.525	3.960.863	-10.996.662	7.727.623	12.173,70	-18.736.459
Melilla	0,00	0,00	0,00	0,00	1.762,77	1.762,77	5.250,00	7.012,77	8.260,00	0,00	-1.247,23
Ceuta	0,00	0,00	0,00	0,00	3.810,86	3.810,86	5.850,00	9.660,86	10.500,00	0,00	-839,14
Total Ciudades	0,00	0,00	0,00	0,00	5.573,63	5.573,63	11.100,00	16.673,63	18.760,00	0,00	-2.086,37
Total General	-3.653.718,83	-6.541.468	-257.457	3.315.526,50	-7.814.834,18	-14.951.952	3.971.963	-10.979.988	7.746.383,17	12.173,70	-18.738.545

4. SHARING THE DEFICIT

4.1 Economic Situation and Growth of Deficit and In-Debtment

The current economic crisis has forced Spain to adopt a number of measures that should prevent the need for a European bail-out⁶⁶. With a 20 per cent unemployment rate and a total deficit larger than the agreed ratio to GDP in the European framework, to name just two indicators, further measures may be needed.

Even if Spain does not have a debt / deficit problem greater than other EU members, there is a strong credibility problem, which is the main reason why the system should be reformed.

A mild reason for optimism is that foreign direct investment (FDI)⁶⁷ is slowly beginning to grow again, after falling sharply in 2009. In fact, in 2010 there was an increase of 41.5 per cent, with a total volume of €23,415 million. However, it is

⁶⁶ Among the most controversial, a decrease of public servants salaries of between 5 and 15 per cent and the increase of the general rate of the Value Added Tax from 16 to 18 per cent.

⁶⁷ See latest official data at: "Note on 2010 inward FDI data – Investment Registry, March 2011", available at:

<http://www.investinspain.org/icex/cma/contentTypes/common/records/viewDocument/0,,,00.bin?doc=4469127> (access on 27.June.2011).

important to note that the main element behind that FDI increase was operations in the Spanish holding regime (“*Entidades de Tenencia de Valores Extranjeros*” or ETVE), which increased by 174 per cent and were worth €11,778 million⁶⁸.

The current main indicators of the Spanish Economy⁶⁹ can be found below:

Table 8: Annual data and forecast for Spain (2 June 2011)

	2006 ^a	2007 ^a	2008 ^a	2009 ^a	2010 ^a	2011 ^b	2012 ^b
GDP							
Nominal GDP (US\$ bn)	1,235.90	1,444.00	1,600.20	1,468.40	1,409.90	1,529.40	1,454.80
Nominal GDP (€ bn)	984	1,054	1,088	1,054	1,063	1,119	1,152
Real GDP growth (%)	4	3.6	0.9	-3.7	-0.1	0.9	1.3
Expenditure on GDP (% real change)							
Private consumption	3.8	3.7	-0.6	-4.3	1.2	0.7	1.3
Government consumption	4.6	5.5	5.8	3.2	-0.7	-1	-1.6
Gross fixed investment	7.2	4.5	-4.8	-16	-7.6	-1.9	2.8
Exports of goods & services	6.7	6.7	-1.1	-11.6	10.3	8.6	3.7
Imports of goods & services	10.2	8	-5.3	-17.8	5.4	4.3	2.7
Origin of GDP (% real change)							
Agriculture	5.4	5.4	-2	-0.6	-1.2	0.3	0.3
Industry	2.9	1.3	-1.5	-9.8	-1.4	1	1.5
Services	4.4	4.4	2	-1.4	0.3	0.9	1.2
Population and income							
Population (m)	44.7	45.2	45.5	45.8 ^c	45.9 ^c	46.1	46.3
GDP per head (US\$ at PPP)	29,213	31,266	31,488	30,643 ^c	30,782 ^c	31,446	32,610
Recorded unemployment (av; %)	8.5	8.3	11.4	18	20.1	20.6	19.7
Fiscal indicators (% of GDP)							
General government budget revenue	40.4	41.1	37.1	34.7	35.7 ^c	35.9	36.3
General government budget expenditure	38.4	39.2	41.3	45.8	45.0 ^c	42.7	42
General government budget balance	2	1.9	-4.2	-11.1	-9.2 ^c	-6.8	-5.6
Public debt	39.6	36.1	39.8	53.2	60.1 ^c	67.1	69

^a Actual. ^b Economist Intelligence Unit forecasts. ^c Economist Intelligence Unit estimates.

Source: The Economist, Intelligence Unit⁷⁰

4.2 The Stability and Growth Pact and the Spanish “internal” Pact

1. Naturally, and particularly since 2008, the debate about the deficit limits and the debt ceiling has grown exponentially. Although Spain implemented severe deficit restrictions in 1997 and 2001, following the European Stability and Growth Pact, the

⁶⁸ This regime is a preferential tax treatment regime, bestowed to non-residents. It is currently regulated in articles 116-119 of the LCIT, it was introduced in the nineties, reformed in 2003 and then again by the Law 35/2006, of 28 November with the obvious purpose of capturing foreign capital.

⁶⁹ The main investors in Spain in 2010 were: The Netherlands (21.4% of the total), France (18.5%) and the United Kingdom (16.5%), which together accounted for 56.4% of total investment. Practically all foreign investment in 2010 came from OECD countries (95.1%). The two main areas of FDI in 2010 were Transport (€1,983 million) and Real Estate (€1,980 million), both these sectors accounted for 17% of the total FDI. By Autonomous Community, the three leading regions by inward FDI were Madrid, Catalonia and Andalusia (€ 4,986, 3,952 and 1,140 million respectively), or 42.8%, 34% and 9.8% of total gross inward FDI.

⁷⁰ Source:

<http://country.eiu.com/article.aspx?articleid=1568148141&Country=Spain&topic=Economy&subtopic=Charts+and+tables&subsubtopic=Data+and+charts%3a+Annual+data+and+forecast>, accessed on 27.June. 2011).

The Economist uses a number of different sources: OECD, Main Economic Indicators; Banco de España, Boletín Estadístico; Instituto Nacional de Estadística (INE); IMF, International Financial Statistics.

economic crisis has brought to the political forefront a debate that was almost non-existent outside expert circles.

In 1992 the Treaty of Maastricht made the limitations on debt (60 per cent) and deficit (3 per cent) a prerequisite to enter the “third phase” of the common currency. The 1997 “Stability and Growth Pact” (SGP) and several Rulings by the Commission set strict rules, which until 2005 included sanctions, for those Member States that did not comply with the limitations. The Pact reflected a widespread consensus, consolidated during the late 1980s and 1990s, on the wisdom of curbing excessive deficits. While the tendency towards excessive deficits is almost a structural feature of democratic governments, when they occur, a number of disadvantageous economic consequences are bound to ensue, such as higher interest rates or a higher debt burden that will have to be passed onto future generations by means of higher taxes, social security fees, etc. On the other hand, public expenditures tend to consolidate and to grow, while a sometimes organized resistance to pay higher taxes curtails the possibilities of revenue growth⁷¹. Of course, the main problem is also part of the solution, which is that the best way to secure compliance in policy is a genuine belief from policy-makers. But even if governments and decision-makers share this conviction, the question at stake is why would governments comply if the costs of failing to do so can be transferred to the whole EU. This explains the codification of the Pact.

The Stability and Growth Pact addressed the concerns about budgetary discipline in the Economic Monetary Union (EMU). Such concerns were originally expressed by the “stronger” European economies, thus reflecting a certain distrust of the poorer, southern, economies (namely, Spain, Portugal, Ireland and Greece). The need for rules to ensure Member States’ budget stability has been considered essential for the attainment of an EMU, but it is also generally regarded as a sound principle, or guideline, for a growing economy⁷².

It is, however, not a neutral position, for it reflects a consensus on how economic policy should be established⁷³. The consensus seems to point to the reduction of public spending as the main way to reduce the deficit. However, it has been soundly argued that it is not public spending, but the growing limitation in increasing taxes (taxing capacity) that causes problematic deficit⁷⁴.

⁷¹ Rotte, R.: “The political economy of EMU and the EU Stability Pact”, en: Baimbridge, M.; Whyman, P. (Eds): *Fiscal Federalism and European Economic Integration*. London: Routledge, 2004, pp. 50 et seq.

⁷² Buti, M.; Franco, D.: *Fiscal Policy in Economic and Monetary Union. Theory, Evidence and Institutions*. Cheltenham/Northampton: Edward Elgar, 2005, pp. 8.

⁷³ Cameron, D. R.: “On the Limits of the Public Economy”. *Annals of the American Academy of Political and Social Science*. Vol. 459, Government and Economic Performance, 1982, pp. 47 et seq. Specifically on the EMU see: Snyder, F.: “EMU Revisited: Are We Making a Constitution? What Constitution Are We Making?”, at: AA.VV. (Eds.: Craig, P.; Búrca, G. De.): *The evolution of EU Law*. Oxford: Oxford University Press, 1999, p. 418.

⁷⁴ Cameron, D. R.: “Taxes, Spending and Deficits: Does Government Cause Inflation?”. Lindberg, L. & Maier, C. (Eds): *The Politics of Inflation and Recession*. Washington D. C.: Brookings Institution, 1985, pp. 234 a 239, y pp. 252 a 259. See a critic at: WOLFE, D. A.: “Politics, the Deficit and Tax Reform”. *Osgoode Hal Law Journal*, vol. 26, n. 2/1988, pp. 351 et seq.

On the other hand, there is a strong case to avoid a democratic deficit, which would ensue when future generations are forced to foot the bill of present spending⁷⁵. This “intergenerational equity” argument is present in all Stability reports presented by the Commission.

Furthermore, there is still, and will continue to be for years to come, the fundamental and unresolved question of the bifurcation of monetary policy and economic policy⁷⁶.

2. In 1997, Spain introduced what has been informally labeled “internal stability pact”⁷⁷ by establishing strict deficit limitations in budgetary policy. In practice, this radically changed how the Central Government’s budget was designed and applied and the question of in-debtment slowly began to creep into financing agreements with Autonomous Communities⁷⁸. But the economic growth that ensued did not help the debate, after all there was not much deficit and in-debtment was low. Hard times spurred the debate and shaped it. In fact, the 2009 reform of the financing system did partially revolve around the deficit issues, even if no significant measure or sanction was implemented.

This has partially changed recently. On July 6th (2011) and by Royal Decree (*Real Decreto-ley*)⁷⁹, the Central Government substantially limited the deficit that the Centre and municipalities may incur, actually establishing a ceiling for public spending; that is, a total maximum spending, related to their deficit limits. On July 27th, all Autonomous Communities agreed to pass laws to limit public spending, which should mirror the said Royal Decree. In the same meeting, it was approved to set the stability objective for Autonomous Communities (that is, the allowed deficit) a 1.3 per cent for 2012, 1.1 per cent for 2013 and 1 per cent for 2014. Finally, the Communities of Andalusia, Extremadura, Balearic Islands and Valencia presented “rebalancing plans”, which were accepted by the Ministry of Economy⁸⁰.

⁷⁵ This argument, among other, at Elliott, E. D.: “Constitutional Conventions and the Deficit”. *Duke Law Journal*, n. 6 (december), 1985, pp. 1089-1090.

⁷⁶ Joerges, C.: “States without a Market? Comments on the German Constitutional Court’s Maastricht-Judgement and a Plea for Interdisciplinary Course”. *European Integration Online Papers* (EioP), Vol. 1, n. 020/1997 (disponible en: <http://eiop.or.at/eiop/texte/1997-01920htm>), pp. 8 y 9. By the same author, see: “The Market without a State? The “Economic Constitution” of the European Community and the Rebirth of Regulatory Politics”. *European Integration Online Papers* (EioP), Vol. 1, n. 019/1997.

⁷⁷ The laws that contain the “internal pact” are: *Ley Orgánica 5/2001, de 13 de diciembre, complementaria a la Ley de Estabilidad Presupuestaria* and *Real Decreto Legislativo 2/2007, de 28 de diciembre, por el que se aprueba el texto refundido de la Ley General de Estabilidad Presupuestaria*. The European “Pact” was approved by a Resolution of the European Counsel (17 June 1997).

The Stability laws were highly contested and it was challenged before the Constitutional Court that decided on this issue in its opinion of 20 July (STC 134/2011), declaring them consistent with the Constitution. Of course after the reform of art. 135 CE this is now clear too.

⁷⁸ See Ruiz Almendral, V.: *Estabilidad presupuestaria y gasto público en España*. La Ley-Wolters Kluwer, 2008.

⁷⁹ *Real Decreto-ley 8/2011, de 1 de julio, de medidas de apoyo a los deudores hipotecarios, de control del gasto público y cancelación de deudas con empresas y autónomos contraídas por las entidades locales, de fomento de la actividad empresarial e impulso de la rehabilitación y de simplificación administrativa*.

⁸⁰ We have left out of this paper the analysis of the situation of municipalities. In fact, their current debt represents 3.3 % of the GDP. See data for municipalities at: www.eell.meh.es.

Table 9: Stability objectives (deficit projections) for 2012-2014

	2010	2011	2012	2013	2014
Central Government	-5.7	-4.8	-3.2	-2.1	-1.5
Autonomous Communities	-2.8	-1.3	-1.3	-1.1	-1.0
Municipalities	-0.5	-0.3	-0.3	-0.2	0.0
Social Security	-0.2	+0.4	+0.4	+0.4	+0.4
Total deficit	-9.2	-6.0	-4.4	-3.0	-2.1

4.3 The Reform of Article 135 of the Spanish Constitution: Possible Consequences for Fiscal Federalism in Spain

1. On August 23rd, 2011, President Zapatero announced before Parliament a possible reform of the Constitution in order to include a deficit limit. This came as a surprise to virtually everyone, but since the other large party (People's Party –*Partido popular*) also agreed, on August 26th a formal proposal was presented before Congress. According to the Spanish Constitution, because this article does not touch any of the main elements of the text (fundamental rights, the Crown, the outline of the State of Autonomies)⁸¹ its reform may be undertaken by special (60 per cent) majority of the Parliament and without referendum. On September 2nd, barely two weeks after it was first announced, the article was modified.

The new article 135 of the Constitution does several things:

First, it refers to the principle of stability as regulated in the Treaty for the Functioning of the European Union (TFUE), to which the article also refers. Section 135.1 establishes that “*all public administrations will follow the principle of budget stability*”. Section 135.2 states that “*The Central Government and the Autonomous Communities may not incur a structural deficit higher than that established by European Union. An Organic law [that is, a law that needs absolute majority for its approval] will establish the maximum structural deficit permitted to the Central Government and the Autonomous Communities. Local entities [mainly municipalities] must have totally balanced budgets*”.

The inclusion of the principle of stability is not a radical change or an innovation of our law system, at least to the extent that it was already mentioned in the TFUE, which is part of Spanish law. But it does ease the coordination between Spanish budgetary principles and European ones, which has been highly contested. It also makes it easier

⁸¹ This reform will follow article 167 of the Spanish Constitution:
Section 167

1. Bills on constitutional amendments must be approved by a majority of three-fifths of members of each House. If there is no agreement between the Houses, an effort to reach it shall be made by setting up a Joint Committee of an equal number of Members of Congress and Senators which shall submit a text to be voted on by the Congress and the Senate.
2. If approval is not obtained by means of the procedure outlined in the foregoing subsection, and provided that the text has been passed by the overall majority of the members of the Senate, the Congress may pass the amendment by a two-thirds vote in favour.
3. Once the amendment has been passed by the Cortes Generales, it shall be submitted to ratification by referendum, if so requested by one tenth of the members of either House within fifteen days after its passage.

to impose these limits to sub-national entities without the constant claim that it may limit their autonomy.

Second, the reform also limits debt, not just the deficit. Thus, section 135.3 establishes that the total in-debtment may never be higher than that established in European law. Again, not a radical reform but good news that it is now enshrined in the Constitution.

Third, the reform does have elements of flexibility:

A first element is that the numbers will be established in an Organic Law, which is easier to change than the Constitution. It has been announced that this law will be approved before the June 30th, 2012, and that there is already agreement (between the two main political parties) on its content. According to press releases (as reliable as they can be) the new Organic Law, to be approved before next 30 June 2012 will establish a maximum deficit of 0.4 per cent for the total public Administrations (that is, not only Central Government but also Communities and Municipalities) in the year 2020 (the German reform, which is being closely followed, set a deficit ceiling of 0.35 per cent for 2015).

A second element of flexibility also follows closely the German constitutional reform. Thus, the new section 135.4 establishes that the deficit and debt limits may only be infringed in cases of *“natural catastrophes, economic recession or situations of extraordinary emergency that are beyond the central Governments control”* such circumstances will need to be assessed and the breach of the deficit/debt limits approved by an absolute majority of Congress.

Third, the new section 135.5 establishes the minimum content that the future organic law is to have. Such law will need to develop the principle of stability as well as establish how Autonomous Communities and Municipalities may participate in the process of distributing the deficit and debt threshold among the different entities. The law will then set how the “pie” of total deficit and debt is distributed among the entities, as well as set the method by which such limits will be calculated. Finally, the law will need to establish the possible sanctions to be applied to those entities that do not comply with the limits.

Fourth, the new section 135.6 is directed to Autonomous Communities that must adopt the pertinent legislation, or modify the existing legislation if that is the case, in order to comply with the new article 135.

2. At this stage, and without knowing what the organic law will actually look like (it will not be approved before June 30th 2012), the following reflections can be made:

First and foremost, the article is a substantial change in comparison to the old article 135⁸², which merely established the obligation to always repay the interest and capital

⁸² The old text stated:

Section 135

1. The Government must be authorized by law in order to issue Public Debt bonds or to contract loans.
2. Loans to meet payment on the interest and capital of the State's Public Debt shall always be deemed to be included in budget expenditure and may not be subject to amendment or modification as long as they conform to the terms of issue.

of the State's Public Debt, a matter that was then, and still is, for that part has not been modified, completely outside the democratic debate. Even if both the Government and the Parliament "forgot" to include the necessary credits to repay the public debt in the budgetary document, they would still be automatically included.

It is remarkable, in my view, that article 136 has not been amended. This article refers to the Auditing Court (*Tribunal de Cuentas*), a totally independent body, accountable only before Parliament that is in charge of "*with auditing the State's accounts and financial management, as well as those of the public sector*" (136.1)⁸³. It should have been further empowered to also control the new debt and deficit limitations.

Second, from a political perspective, the decision has been harshly criticized because it seems to have been dictated by Germany. Indeed, opposition leader Mr. Mariano Rajoy proposed a similar measure a year ago, which was rejected by the ruling party without further discussion. The fact that it has been proposed in the last month before the Parliament was dissolved⁸⁴ also sends a message of hastiness that is not a good precedent.

Third, it could be argued that the content of the new article is not so new taking into account that the stability principle already exists in the TFEU and that the "internal stability pact" already established the deficit limits for all public entities. However, even if the final text of the Organic Law does not differ greatly from the existing laws, there is a fundamental difference in the importance that the principle acquires.

Fourth, a classical argument employed by those who oppose the stability principle has been that it runs counter to the principle of equity in the distribution of public moneys, as established by article 31.2 of the Spanish Constitution ("*2. Public expenditure shall make an equitable allocation of public resources, and its programming and execution shall comply with criteria of efficiency and economy*")⁸⁵. Already many political commentators have expressed that worry, and the new government the People's Party (PP), in power after 20 November 2011, has publicly stated that the new article must mean less public spending. This is one view; another one is that the reform does not

⁸³ Section 136

1. The Auditing Court is the supreme body charged with auditing the State's accounts and financial management, as well as those of the public sector.

It shall be directly accountable to the Cortes Generales and shall discharge its duties by delegation of the same when examining and verifying the General State Accounts.

2. The State Accounts and those of the State's public sector shall be submitted to the Auditing Court and shall be audited by the latter.

The Auditing Court, without prejudice to its own jurisdiction, shall send an annual report to the Cortes Generales informing them, where applicable, of any infringements that may, in its opinion, have been committed, or any liabilities that may have been incurred.

3. Members of the Auditing Court shall enjoy the same independence and fixity of tenure and shall be subject to the same incompatibilities as judges.

4. An organic act shall make provision for membership, organization and duties of the Auditing Court.

⁸⁴ Parliament will be dissolved on September 26th. General Elections will take place on November 20th.

⁸⁵ Many Spanish commentators have made this point, that the stability notion both limits public spending and that it makes its distribution less equitable; among others: Aliaga Agulló, E.: "El proceso de asignación de los recursos públicos en la futura Ley General Presupuestaria". *Revista Española de Derecho Financiero*, n. 120/2003, p. 655; Martínez Giner, L. A.: "El principio de justicia en materia de gasto público y la estabilidad presupuestaria". *Revista Española de Derecho Financiero*, n. 115/2002, p. 471. I have maintained the opposite view in: Ruiz Almendral, V.: *Estabilidad presupuestaria y gasto público en España*. La Ley-Wolters Kluwer, 2008, pp. 153-162.

necessarily diminish public spending, but then the tax revenues must be raised. Spain currently has substantially lower tax pressure than most other European countries from the “euro-area”, more so if the fact that the welfare state is well extended and implemented (with free and universal Health care and Education, among others) is taken into account.

**Table 10: Total tax revenue as percentage of GDP
(Euro countries)**

	1965	1975	1985	1995	2000	2007	2008
Austria	33,9	36,6	40,8	41,4	43,2	42,1	42,7
Belgium	31,1	39,5	44,3	43,5	44,7	43,8	44,2
Denmark	30,0	38,4	46,1	48,8	49,4	49,0	48,2
Finland	30,4	36,6	39,8	45,7	47,2	43,0	43,1
France	34,1	35,4	42,8	42,9	44,4	43,5	43,2
Germany	31,6	34,3	36,1	37,2	37,2	36,0	37,0
Greece	17,8	19,4	25,5	28,9	34,0	32,3	32,6
Ireland	24,9	28,8	34,7	32,5	31,3	30,9	28,8
Italy	25,5	25,4	33,6	40,1	42,2	43,4	43,3
Luxembourg	27,7	32,8	39,4	37,1	39,1	35,7	35,5
Netherlands	32,8	40,7	42,4	41,5	39,6	38,7	39,1
Portugal	15,9	19,1	24,5	30,9	32,8	35,2	35,2
Slovak Republic					34,1	29,4	29,3
Slovenia				39,2	37,5	37,8	37,2
Spain	14,7	18,4	27,6	32,1	34,2	37,3	33,3

Source: OECD Tax databases⁸⁶

Fifth, this reform will surely shape the debate and future reforms of the financing of public entities (Autonomous Communities and Municipalities). Just last July (2011), the Constitutional Court decided on the first of many cases on the Stability Laws, that many Communities claimed, limited their fiscal autonomy in a way that was contrary to the Constitution. In its decision 134/2011, of July 20th, 2011, the Court clearly states both that the Central Government has the authority to impose debt and deficit limitations to Communities and Municipalities, and that those limits are a consequence of the European legal framework. I submit that that ruling has paved the way for the current reform of article 135.

A possible outcome is that Communities may start to exercise their tax powers on ceded taxes in a more substantial way. This may mean more fiscal responsibility but also larger levels of regional differences. All that in a country where, even though officially decentralized, there is a generalized sentiment among citizens by which certain things –such as the provision of fundamental services but also tax pressure - must remain the same or similar in all the territories⁸⁷.

⁸⁶ Source, OECD database (free access:
http://www.oecd.org/document/60/0,3746,en_2649_34533_1942460_1_1_1_1,00.html).

⁸⁷ Often, differences in salaries of public servants among Communities, or tax pressure, attract press attention and more often than not, angered comments by politicians contrary to such differences.

5. CONCLUSIONS

The decentralization process in Spain has been remarkably swift and, generally speaking, quite successful. Authority has been devolved to Communities in an orderly fashion and this new tier of government has been well accepted by citizens.

Nonetheless, far too many issues remain unresolved. Among others, the level of fiscal responsibility is insufficient. Despite the significant reallocation of taxation powers, the system is still largely based on the assessment of need by the Central Government and the allocation of funds according to that need. Furthermore, and to a large extent the basic formula of the system guarantees funds to Communities without sufficiently taking into account their fiscal responsibility, whether they decide to establish new taxes or increase tax pressure in order to obtain more funds, and regardless of whether they control their indebtedness and deficits. Indeed, the law prescribes that all Communities shall receive an amount sufficient to finance their authority. If a Community decides to increase or decrease the tax burden of its ceded taxes, this will be reflected in the total budget received from the Centre, which will then vary accordingly. However, there is no effective mechanism to incentivize Communities to exercise their taxation powers, as they still obtain the revenue of ceded taxes, even when they do not actually regulate any aspect of them. That is, the financial incentive for Communities to use their powers over those ceded taxes that they control is weaker than the political incentive not to increase the tax burden on their citizens. In fact, a substantial amount of revenue is already guaranteed from ceded taxes they do not control. This partially explains why most of them have preferred to establish tax credits and tax benefits, as opposed to increasing the tax burden. They have, so far, only increased taxes in the cases of gambling taxes, capital transfers tax and stamp duty.

Furthermore, the financing system does not sufficiently take into account the EU Stability Pact constraints. Although Spain has adopted a kind of “internal stability pact”, the sanctions are not credible enough and Communities are able to run large deficits while reducing their tax burdens. It seems as if the financing of Communities was designed (still) without fully taking into account the European context. Of course the new article 135 of the Constitution may serve to change that, but it is too early to tell.

If a crisis can be viewed as an opportunity, the current one may bring about two theoretically opposite results: a larger decentralization of revenues, in the form of greater fiscal responsibility and a re-centralization of services, as a result of severe spending cuts by Autonomous Communities.

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