FISCAL COORDINATION IN SPAIN

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Rome, 10 July 2008
1. **THE FISCAL DECENTRALIZATION PROCESS**

1. The Spanish public sector has experienced very important changes in the last 30 years, both in quantitative and in qualitative terms. One of those relevant changes is the high degree of decentralization that has been reached in the country.

2. The process of fiscal decentralization began in Spain at the end of the 1970s and above all it can be explained by historical and cultural reasons rather than economic factors. One of those reasons was the need to consolidate Democracy. That’s why the beginning of this process has been identified with the Spanish Constitution of 1978. In fact, the process was carried out under the legal framework established by the Constitution.

3. This legal framework led to the formation of 3 levels of government: central, regional and local. The regional level is formed by 17 regional governments, the so-called Comunidades Autónomas or *Self-governing Communities*. On the local level there are over 8,000 municipalities.

4. Certainly the main characteristic of the Comunidades Autónomas is their political, administrative and fiscal autonomy. Each Self-governing Community has its own Parliament and his own government. They are both completely independent of any national body.

**Expenditure assignments**

5. The Constitution establishes a number of attributions that can be assumed by the different regions if they want to. But in some cases the distribution of competencies between Central government and regional governments is not quite clear, making it difficult to distinguish if some competencies are exclusive to the regional governments or they could be shared with the Central government. As a result, not every region in Spain has exactly the same competencies and attributions, although they tend to be quite similar. In fact, nowadays there are few differences between them.

6. In general terms the regional and local governments provide public services which are closer to the citizens, such as education, health, housing, etcetera.
For instance, education and health amount to almost 60% of the total expenditure managed by the Self-governing Communities. Another 12% are economic affairs such as infrastructures, agriculture and so on.

7. At the local level the share of the different public services is more balanced. Almost 60% of the total expenditure is devoted to public order and security, housing and community amenities, recreation and cultural activities, social services, environmental protection (such as waste management, waste water management), etcetera.

8. Finally, the central administration has competencies in the general public services, (such as foreign affairs, foreign economic aid, public debt transactions, transfers to the other levels of government, transfers to the European Union), as well as military and civil defence, and social protection.

An ongoing process

9. Although fiscal decentralization in Spain has been an ongoing process in the last few decades, we can distinguish 3 main stages.
10. The first stage began in 1978 and it finished in the middle eighties. In this period most of the transfers to the regions were carried out, except for education and health services for a number of Self-governing Communities. At the end of this period the Self-governing Communities roughly managed 20% of the total public expenditure.

11. Later, from 1985 to the end of the nineties, the share of the Self-governing Communities was stabilized at 25%.

12. More recently, in 1999 began the so-called “third decentralization stage” which included the transfer of health and education services to the Communities that had not assumed those competencies at that point.

**Figure 2**

**Fiscal decentralization**
Percentage of the total public expenditure

13. As a result of this process, nowadays almost a half of the public expenditure is managed by regional and local governments, while the share of the Central administration hardly goes over 20% of the total public expenditure.
International comparison

14. Spain has reached a high degree of decentralization. In fact, Spain has become one of the most decentralized OECD countries, not only if we make comparisons to unitary countries, but also taking into account the federal ones.

15. The fiscal decentralization has been more intensive in the expenditure side, creating a dependence on the central government to obtain the necessary funding for the implementation of the expenditure policies. Of course, this is a common practice that happens in most of decentralized countries.

16. As a result, tax responsibility of territorial administrations is not sufficiently developed. The consequence is that regional Parliaments do not use the full extent of their taxing powers, with perhaps the exception of introducing tax credits or lowering tax rates. This reluctance to use full powers suggests a lack of fiscal accountability on the part of regional governments.
Table 1
Decentralization in a number of OECD countries
Sub-national government's share both in general government expenditures and revenues

<table>
<thead>
<tr>
<th>PUBLIC EXPENDITURES</th>
<th>Low decentralization (&lt; 20%)</th>
<th>Middle decentralization (&gt; 20% &lt; 40%)</th>
<th>High decentralization (&gt; 40%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Low decentralization (&lt; 20%)</td>
<td>Greece Portugal France</td>
<td>Belgium Netherlands Norway United Kingdom</td>
<td></td>
</tr>
<tr>
<td>Middle decentralization (&gt; 20% &lt; 40%)</td>
<td>Japan Germany Finland Austria Italy</td>
<td></td>
<td>Denmark Sweden Spain</td>
</tr>
<tr>
<td>High decentralization (&gt; 40%)</td>
<td></td>
<td></td>
<td>United States Canada</td>
</tr>
</tbody>
</table>

Source: OCDE, Intergovernmental transfers and decentralised public spending (2006)

2. RELEVANT ISSUES

17. Several issues can be highlighted in regard to decentralization processes. First, it is usually argued that fiscal decentralization leads to a higher level of public expenditure of the general government. It could be explained by some reasons. For instance, in the first stages of a decentralization process the expenditure assignments are not clearly defined and as a result some public services can be partly provided by both central and regional governments at the same time.

18. Another concern widely argued about decentralization is the difficulty to keep the public deficit under control, as a consequence of the fiscal autonomy of each administration.
19. Those issues are closely connected with a third topic: the gap between sub-national income and expenditure shares.

20. Another important risk about fiscal decentralization is the horizontal equity. This is a problem linked with the territorial dimension of the different regions and their abilities to generate fiscal resources. As long as there are regions which have less population or less income per head than others, it is essential to articulate a fiscal compensation system.

21. Another basic problem to be solved is how to evaluate and quantify the volume of funding that subnational governments need for providing a specific public service. Once the competence is transferred from the central government and the evaluation is fixed, potential changes in the initial circumstances and subsequent difficulties can take place. These kind of problems are related to the difficulty to evaluate the public service that is going to be transferred. It is not guaranteed that the services received can be financed at a minimum level provided in every region of the country.

3. THE SPANISH EXPERIENCE

22. Firstly, regarding the level of public expenditure, fiscal decentralization in Spain has been accompanied by a decrease in the size of the public sector. In the last 15 years the general government’s expenditure has fallen by almost 10 points of the GDP. In fact, nowadays Spain is one of the countries with lowest level of public expenditure in EU. So it can be concluded, looking at the Spanish experience, that decentralization does not always lead to a larger public sector.

23. Furthermore, Spain’s economy has managed to develop an intense decentralization process and, at the same time, it has recorded a successful performance in public finances in the same period. In 1995 the Spanish public deficit was indeed one of the highest of the European Union. Since then fiscal outcomes have improved year by year and in 2005, for the first time in 30 years, for the first time in our Democracy, the public accounts recorded a surplus of 1.1% of the GDP. This trend continued in 2006 and 2007. In 2006 the surplus amounted to 1.8% of the GDP. Last year the surplus was over 2% of the GDP.
24. One of the most important achievements in the last few years has been the sharp declining of the public debt ratio. Since 1996 gross debt ratio has gone down over 20 points of the GDP and is currently around 35% of GDP, one of the lowest levels in the EU.

25. As a consequence of the former data, nowadays Spain is one of the countries of the EU with better fiscal stance. While in 1995 the Spanish public deficit was one of the highest of the European Union, nowadays Spain is one of the few countries with public surplus. In addition to this, the debt ratio is one of the lowest of the EU, far below the reference value of 60% of the GDP.

26. These outcomes in fiscal consolidation have been made possible by the confluence of three main circumstances:

   - **Strong growth.** Spain has recorded 12 or 13 years with annual rates of growth over 3%.
   
   - **Lower interest rates.** This period was also coincident with a European context of low interest rates.
   
   - **Expenditure control.** Finally, the budgetary policy was managed with a remarkable expenditure control. The most interesting outcome was the absence of budgetary deviations.

27. To summarize, it can be concluded that the decentralization process in Spain has not jeopardized the achievement of a sound fiscal path.
Fiscal coordination in Spain

Figure 4
Decentralization process and public expenditure in Spain

![Chart showing the decentralization process and public expenditure in Spain. The x-axis represents years from 1988 to 2005, and the y-axis represents the sub-national governments' share in general government expenditure and the total expenditure as a percentage of GDP. The chart illustrates the increasing trend of sub-national governments' share in general government expenditure and the decrease in total expenditure as a percentage of GDP over the years.]

Figure 5
Decentralization process and fiscal consolidation in Spain

![Chart showing the decentralization process and fiscal consolidation in Spain. The x-axis represents years from 1988 to 2005, and the y-axis represents the regional governments' share in general government expenditure and the surplus or deficit as a percentage of GDP. The chart illustrates the increasing trend of regional governments' share in general government expenditure and the decrease in surplus or deficit as a percentage of GDP over the years.]

Assymetry between expenditures and revenues
28. The sub-national governments in Spain managed almost a half of the total public expenditure but they only collect one third of the total revenues. On the other hand, it should not be forgotten that an essential principle in any decentralization process is the interterritorial solidarity. This principle usually requires compensation transfers from the Central government. As a consequence, a certain degree of vertical unbalance can be used to finance those transfers which will help to reduce wealth differences among regions.

**Figure 6**
Sub-national gov's share in general gov expenditure and revenue

<table>
<thead>
<tr>
<th>Expenditures</th>
<th>Revenues</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subnational governments</td>
<td>Central Government</td>
</tr>
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</table>

**Fiscal autonomy**

29. At this point it is useful to analyze the fiscal autonomy of the regions. We can define the fiscal autonomy of sub-national governments as the share of their own revenues in total revenues. This rate varies in Spain in a range between 30% to 100%. In other words, grants and subsidies are an important source of revenue for sub-national governments. On average, the Self-governing Communities still depend on over 30 or 40 % on transfers from the central government, but there are important differences between the regions.

30. This situation leads to two main consequences:
- first, a lack of fiscal accountability in the sub-national governments

- and, second, the little use made by the regions of their legal fiscal powers over those taxes whose revenue is shared with the Central government.

31. It is obvious that there is a permanent tension between the Central State’s desire to control certain financial and expenditure policies, and the growing demand of regional governments for greater competencies over expenditure, and consequently greater freedom of decision over revenues. Thus tax matters have become the core of the debate in the process of decentralization in Spain. In fact, recently, central and regional governments have agreed on the need to update the financial framework in order to reflect properly on the regions’ increased taxing and spending powers and also to increase their fiscal accountability.

**Figure 7**
Regional governments revenues (2005)

*Eighteen budgets and one fiscal policy*

32. Although fiscal policy is designed by the central government, there are 17 budgets (corresponding to the seventeen regions) that are no responsibility of
the central government and they have relevant effects on the fiscal policy. On the other hand, our fiscal supranational framework is the Stability and Growth Pact. So the role of supranational and subnational bodies has taken on a great importance, and it is a double limitation to the central government when it comes to defining their medium-term fiscal policy. Accomplishing the European Pact and implementing a prudent fiscal policy could be difficult in a highly decentralized country if the fiscal discipline requirements are not applied to all public administrations at the same time. Otherwise, pressure from financial markets would be exercised by these administrations leading to negative effects on interest rates, prices and economic growth.

The role of the Central State

33. So the Central government has a key role when defining and establishing ways to guarantee:

- Firstly, a minimum level of provision of the same public services for every region of the country, so that every citizen would be provided with similar public goods and services.

- Therefore, the Central State should create the mechanisms to ensure cohesion and solidarity between regions and, at the same time, provide the regional governments with enough funding to develop their competencies.

- In addition to this, the Central government should foster internal stability pacts which ensure fiscal discipline in every public administration.

4. THE FISCAL RULE

34. According to this role it was quite useful and necessary to design a fiscal framework in order to ensure budgetary discipline as well as to ensure co-ordinated budgetary action by all public administrations and consequently the internal and external economic stability.

Principles
Fiscal coordination in Spain

35. The national rule in Spain was passed by the Parliament at the end of 2001. The so-called Budgetary Stability Law includes the general principles that must govern the behaviour of all public administrations in order to achieve the objective of budgetary stability. Those principles are:

- **Stability.** This principle was defined in the former Law as a balanced or surplus situation according to the definition set out in the European System for National Accounts.

- **Multiyear planning.** The Stability Law establishes that the preparation, approval and implementation of the budgets for the public sector will be framed in a multiannual scenario compatible with the principles of annuality by which budget approval and implementation is governed.

- **Transparency.** The budgets must contain sufficient and suitable information to permit the verification of their adaptation to the principle of budget stability, as well as the fulfilment of the budget stability objective and the observance of fiscal obligations by the community standards in matters of national accounting.

- **Efficiency.** Public expenditure policies must be established taking into account the economic situation and the fulfilment of the budget stability objective and will be implemented by means of an efficacy, efficiency and quality-driven public resources management.

*Main drawbacks of the 2001 law*

36. The former Law entered in force in 2002 and its effective implementation was quite positive in some aspects. In brief, it was a great step forward in the improvement of the budgetary discipline. A budgetary discipline even more demanding than that one established in the Stability and Growth Pact. Nevertheless, it was criticized for several reasons:
- The stability principle did not consider the general economic situation of the country. The rule was criticised for the possibility of introducing a pro-cyclical bias in the conduct of fiscal policy.

- In the first year of implementation of the Law, several Self-governing Communities broke their passed objectives. A possible underlying reason could have been that some of them didn´t believe in a Law that they understood as an imposition.

- Finally, there was a lack of involvement of the Self-governing Communities in the decision making process.

**The reform of the stability law**

37. For these reasons, the economic authorities decided to reform the Stability Law. The main goal was to ensure continuing sound fiscal management in a decentralised framework, while maintaining the stabilising role of public finance.

38. The reform was passed in May of 2006 and the new Law came into force on the First of January 2007. It retains the simplicity of the former Law and has fairly broad support from the regions because of its increased flexibility. The main goals of the reform were:

- To maintain fiscal balance over the business cycle. This is the more significant aspect of the reform. The new rule has improved the stabilising function of the fiscal policy by evaluating the cyclical position of economy and taking into account the expected real growth rate in comparison with the potential one.

- To make the budgetary stability compatible with the improvement of the productivity.

- In order to combine respect for financial independence with general economic policy objectives the Law promotes the participation of the Self-governing Communities in the decision making process of the stability objectives.
39. The reformed Stability Law has been backed by strong political commitment. It reflects the consensus between central state and the regional governments that an appropriate domestic fiscal rule could provide the basis for sound and sustainable budgetary developments and contribute to accomplish the objectives of the national fiscal framework. From then on relationships between different levels of government had been based on cooperation, dialogue and negotiation.

**Main fiscal discipline mechanism**

40. According to the reform, the main mechanisms of the fiscal rule in Spain can be summarized by the following.

41. Firstly, the preparation and execution of budgets by the public administrations will be carried out within the budgetary stability principle. This principle is defined as a fiscal balanced situation throughout the economic cycle.

42. The Spanish Parliament will pass the budget stability objectives for the next three financial years. These objectives are passed both in terms of all the public administrations and for each one of them.

43. According to the objective established for the Central Administration, the Government dicedes upon an expenditure limit for the following year. This expenditure limit cannot be overrun while preparing the Budget for the following year.

44. Within this limit, a contingency fund is allocated in a separate chapter of the Central State budget in order to attend to non-discretionary needs which could not be foreseen in the initially passed budget but which may appear during the financial year. This fund will amount to 2 per cent of the former limit.

**Stability over the economic cycle**

45. With the new rule the stability objective becomes more flexible. In brief when economy is in an expansive phase a surplus will be demanded, while in a phase of recession or low growth it will be possible to have a small deficit. Every three years, the central government will publish two growth thresholds
that will determine the required stability objectives for the Central State, the Autonomous Communities and a number of Local Administrations. The more essential aspect is the report which will determine the cyclical position of the economy. This report is prepared by the Ministry of Economy and Finance, taking into account the forecasts of the European Commission and the European Central Bank.

46. The objectives are fixed as a percentage of the GDP within a range of possible values depending on growth developments:

- If the report foresees a growth above the higher threshold (initially set at 3 per cent) the objective would be a surplus.

- If the report foresees a growth less than the lower level (initially set at 2 per cent) the objective might be a deficit with the limit of 1% of the GDP. This limit is distributed as follows:
  
  - 0.20% of the GDP for the Central government:
  
  - 0.75% of the GDP for the ensemble of the Autonomous Communities.

  - 0.05% of the GDP for the Local governments.

  - Finally, if the report foresees a growth between the two thresholds, the objective will be, at least, a fiscal balance.

47. The main objective of this rule is to avoid any discretion decisions.
Figure 8
Stability over economic cycle

Procedure for setting the budgetary stability objective

48. The stability objectives have to be passed by the Parliament in the first half of each fiscal year.

49. The setting of the objectives for the ensemble of the Self-Governing Communities requires a prior report by the Tax and Financial Council of the Self-Governing Communities. This Council is the coordinating body between the Central State and the Self-Governing Communities for financial matters.

50. The procedure is as follows:

- Within the first half of every year, the Central Government, by means of an Agreement of the Council of Ministers, at the proposal of the Ministry of Economy, and following the report of the Tax and Financial Policy Council of the Autonomous Communities and of the National Commission of Local
Administration in terms of the scope thereof, will establish the budget stability objective for the following three exercises, both for the public sector overall and for each one of the groups of agents included in it.

- The agreement of the Council of Ministers containing the budget stability objective will be sent to Parliament with the report on the economic cycle. Successively, and following the corresponding Plenary debate, the Congreso de los Diputados (Spanish House of Commons) and the Senate will approve or reject the stability objective proposed by the Government.

- If on approval by the House of Commons the stability objective were rejected by Senate, the objective will be put to a further vote in the House, and will be approved if ratified by a simple majority.

- Once the Government has approved the budget stability objective the Ministry of Economy and Finance and the representatives of each Autonomous Community will negotiate, bilaterally, the budget stability objective corresponding to each one of the Autonomous Communities.
Deficit for investments

51. In addition to the stability objectives, the public administrations may present a deficit in the years when it is to be put to funding increases in investment in programmes targeting productive activities, including those targeting research, development and innovation.

52. This is an exceptional rule, meaning that each project must be authorised by the Ministry of Finance. It falls to the Ministry of Economy and Finance, on the basis of the general criteria established, in its respective sphere of action, by the Tax and Financial Policy Council of the Autonomous Communities and the National Commission of Local Administration to authorise the investment programmes of the autonomous communities and the local authorities, for which purpose the contribution of such projects to improving the productivity of the economy and the level of borrowing of the autonomous community and local authority will be taken into account.

53. In any case, at least 30 per cent of the investment program must be funded with the gross savings of the proposing administration.

54. Finally, the maximum deficit for that investment is 0.5 per cent of the GDP.
Aggregate deficit

55. As a result of the former rules, the most unfavourable situation according to the law would be a cyclical deficit of 1 per cent, to be distributed between the Administrations in compliance with the law, and an additional 0.5 per cent for productive investments as we have just seen.

56. It is remarkable that the maximum deficit that could be reached for the general government as a whole continues providing a wide margin to meet the Stability and Growth Pact.

Monitoring and enforcement

57. According to the Law each public administration has autonomy to all the procedures and regulations needed to meet budgetary stability. Despite this principle of fiscal autonomy, the National Government is responsible for monitoring and ensuring the compliance with the budgetary objectives. The regulation is as follows.

58. It falls to the Government of the Nation, without prejudice to of the competences of the Tax and Financial Policy Council of the Autonomous Communities, to guarantee the application of the principle of budget stability throughout the public sector area.

59. Before 1 October of every year, the Minister for Economy and Finance will send the Government a report on the degree of fulfilment of the budget stability objective for the previous year, as well as of the cyclic evolution of the year in course and any deviations from the initial forecast contained in the report on economic cycle.

60. The Minister for Economy and Finance will inform the Tax and Financial Policy Council of the Autonomous Communities and the National Commission of Local Administration, in their respective areas of competence, on the degree of fulfilment of the budget stability objective in the previous year.

61. If a risk of non-fulfilment of the budget stability objective is appreciated, the Government of the Nation may formulate a warning to the Administration in question. Once this warning has been formulated, the Government will inform
the Tax and Financial Policy Council of the Autonomous Communities, if the
warning is given to an Autonomous Community, and the National Commission
of Local Administration, if it is a Local Organisation.

62. Non-fulfilment of the stability objective consisting of a deficit above the one
set will require the formulation of an economic and financial plan for
rebalancing within a maximum term of three years. To assess the degree of
fulfilment of the budget stability objective of each one of the public agents, the
real evolution of the economy in the budget year will be assessed with regard
to the initial forecast contained in the report on economic cycle.

63. Fulfilment of the stability objective will be taken into account in the
authorisation of credit and debt offering operations of the Autonomous
Communities and of the local authorities.

64. The public administrations failing to fulfil the obligations contained in the Law
or in any agreements which, in its implementation, were adopted by the
Ministry of Economy and Finance or by the Tax and Financial Policy Council
of the Autonomous Communities, cause or contribute to non-fulfilment of the
obligations taken on by Spain vis-à-vis the European Union as a result of the
Stability and Growth Pact, will assume, in the part ascribable to them, the
responsibilities derived from any such non-fulfilment.

65. Finally, the Central State will neither assume nor be answerable for the
commitments of the autonomous communities, of the local authorities nor the
entities linked to them or reporting to them, without prejudice to the mutual
financial warranties for the joint conduct of specific projects.

**Actions taken in case of non-compliance**

66. The exceptional situations of budgetary deficit must be justified by explaining
the reasons which have led to it and identifying the income and expenditure
related to it. A mid-term economic and financial plan will have to be prepared
in order to correct this situation within the next 3 fiscal years. In the case of
the Central Government this plan must be submitted to the Parliament. In the
case of Autonomous Communities, the Tax and Financial Council of the Self-
Governing Communities will assess the effectiveness of those plans
concerning the Communities.
Finally, the assessment about the compliance of the budgetary stability objectives will take due account of the real performance of economy with respect to the forecasts in which the objectives were based on.

5. TO SUMMARIZE

68. Spain has experienced an intense process of decentralization during the last 30 years. As a result Spain has become one of the most decentralized OECD countries.

69. Though the decentralization neither has led to a larger public sector nor has jeopardized the fiscal consolidation, there are some matters to be discussed. Firstly, the Self-governing Communities still depend on over 30% on transfers from the Central government. Secondly, fiscal policy is designed by the central government but there are 17 regional budgets that are not the responsibility of the Central government and that has a relevant effect on the fiscal policy.

70. The Central government has a key role to foster national stability pacts which ensure fiscal discipline at each level of government. The national rule in Spain (the Stability Law) was approved in 2001 and it was amended in 2006. This rule has reinforced the commitment to sound finances and it is fully aligned with the amended (revised) SGP.

71. The new rule has also improved the stabilising function of the fiscal policy. The Law obliges the public administrations to register surpluses in periods of high growth. Limited deficits are allowed in periods of low growth. Finally, fiscal discipline is also pursued by fostering greater consensus and involvement in setting the budget targets from all sub-sectors.

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