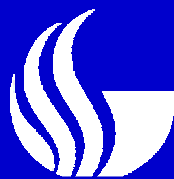


# International Studies Program

Working Paper 05 -12  
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Julio López Laborda  
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Georgia State  
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# *Vertical Imbalances and Revenue Assignments in Decentralized Spain*

**Julio López Laborda and Carlos Monasterio Escudero\***  
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## **1. INTRODUCTION**

This chapter provides an overview of the key issues in public economics arising from the process of territorial decentralisation that has taken place in Spain since the restoration of democracy and the Constitution of 1978, and which resulted in the emergence of the “Autonomic State”.

The first section focuses on the assignment of competencies between central and regional levels of government and explains in some detail the methodology used to quantify the “effective cost” of the services devolved to the Autonomous Communities (hereinafter ACs). We have paid special attention to health services, which is the most significant item for regional budgets in quantitative terms.

The second section deals with revenue assignment, transfers and borrowing, and describes the two systems established to finance regional expenditure. These are the

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“common system” (*régimen común*) applied in the majority of the ACs and the “charter system” (*régimen foral*), which is based on the historical rights accorded to the Basque Country and Navarre. The last section appraises the decentralisation process and notes some emerging issues of debate.

## **2. ASSIGNMENT OF COMPETENCIES TO THE AUTONOMOUS COMMUNITIES**

### ***2.1 Initial assignment of competencies***

The decentralisation of public sector in Spain began with the democratic Constitution of 1978, which recognises the right of the Autonomous Communities to regional self-government.

This process resulted in the emergence of the “Autonomic State”, which is essentially similar to a federal State, with which it shares a number of common features (Aja, 1999: 31-39):

1) The fundamental division of competencies between central and regional government is settled at the constitutional level.

2) Legislative and executive offices in the Autonomous Communities (Parliament and President) are elective and officeholders are accountable to the regional electorate alone.

3) Disputes between central and regional government are handled by the Constitutional Court.

The Autonomic State is formed by seventeen Autonomous Communities, in addition to the Autonomous Cities of Ceuta and Melilla (see Figure 1), which are highly diverse in terms of size, population and other factors. Table 1 provides a summary of population, area, income levels, number of local jurisdictions (provinces and municipalities<sup>1</sup>), the year the Statute of Autonomy (a sort of regional Constitution for each AC) was enacted, the level of devolution at the time each AC was founded, and the

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<sup>1</sup> In Spain, the term “province” refers to a tier of local government grouping a number of municipalities within certain geographical boundaries. Its main purpose is thus to assist the municipalities with the performance of their functions.

applicable financing system. We shall return to the latter two features later on in this paper.

The design of Spanish devolution allots the distribution of competencies between the central and the regional level of government to the Constitution, which nevertheless sets out only general principles in the matter of revenue assignment.

Over time, the ACs have taken on responsibility for the provision of a wide range of regional public goods and services which specifically impact the well-being of people living within their territory. These include town and country planning, housing, public works, regional transport and infrastructure, farming, environment, culture, tourism, sport and so on, as well as health and education, the two basic public services provided by the Welfare State. Originally, and for historical reasons, only a small group of ACs were granted powers in education and health matters. This led to a distinction between “high level Communities” (i.e. those with a high level of devolved competencies) and “low level Communities”. Though certain minor differences persist (e.g. only some Communities have powers for the administration of the prison system and the police), it may fairly be said that all of the ACs nowadays have substantially the same competencies.

The competencies assigned to the central government, meanwhile, are related with economic stability, income and wealth redistribution and the provision of national public goods and services, that is, those that affect all of the citizens of Spain equally, such as international relations, defence, customs and tariffs, foreign trade, the currency system, basic regulation of the financial, banking and insurance systems, the bases and coordination of general economic planning, public finances and debt, basic Social Security legislation and funding, national public works, infrastructure and transport, and so on.

Central government is currently responsible for approximately 50 percent of total public expenditure, the ACs some 35 percent and local government institutions around 15 percent.

The ACs do not exercise their powers within a framework of complete freedom. While they have exclusive competencies in some areas (such as regional public works,

infrastructure and transport) without intervention from any other tier, their actions in others are subject to restrictions of differing intensity.

In some cases, such as environmental and farm policy, EU Directives determine minimum environmental quality standards and the kinds of crops that may be grown. The most significant limitations, however, refer to services such as healthcare and education. Although managed by the ACs, these are shared competencies and the central government establishes the basic conditions for the provision of the service, the rules governing access by users and other matters that cannot be altered by regional governments. These restrictions are intended to ensure that the conditions of the service remain essentially the same nationwide. Within this framework, the ACs have the power to enact specific regional laws applicable within their territory, manage the service and improve the conditions under which it is provided. They cannot, however, lower basic standards.

It is important to note here that all of the competencies assigned to the ACs, with the sole exception of the institutions of self-government (regional government and parliament) which represent a minimal part of total AC expenditure, are devolved from services that were formally provided out of central government budgets and were transferred to regional budgets after decentralisation. Consequently, the cost of the services transferred is a key issue, which we shall consider in the next section.

## ***2.2 Valuation of competencies and effective cost method***

Decentralisation of the public sector involves rather more than simply demarcating the competencies transferred to the new regional governments. It also requires an accurate assessment of the cost of each service and the allocation of the relevant financial resources to the Autonomous Community concerned to ensure provision is properly funded.

Figure 1. The Spanish Autonomous Communities



**Table 1. Key characteristics of the Autonomous Communities**

AUTONOMOUS COMMUNITY	POPULATION 1-1-2004 (1)		AREA (1)		GDP 2003 (1)		Per capita GDP 2003 (1)		PROVIN- CES	MUNICI- PALITIES (2)	APPROVAL OF STATUTE	INITIAL LEVEL OF COMPETEN- CIES	FINANCING SYSTEM
	Population	%	Km. <sup>2</sup>	%	Thousands of €	%	€	Index					
								Average = 100					
Andalusia	7.687.518	17,80%	87.597	17,31%	101.136.409	13,62%	13.709	75,29	8	769	1981	HIGH	LOFCA
Aragon	1.249.548	2,89%	47.720	9,43%	22.962.774	3,09%	19.726	108,34	3	730	1982	LOW	LOFCA
Asturias	1.073.761	2,49%	10.604	2,10%	16.226.551	2,19%	15.521	85,24	1	78	1981	LOW	LOFCA
Balearic Islands	955.045	2,21%	4.992	0,99%	18.552.348	2,50%	21.965	120,63	1	67	1983	LOW	LOFCA
Canary Islands	1.915.540	4,43%	7.447	1,47%	30.863.449	4,16%	17.006	93,40	2	87	1982	HIGH	LOFCA
Cantabria	554.784	1,28%	5.321	1,05%	9.391.318	1,27%	17.681	97,11	1	102	1981	LOW	LOFCA
Castile-La Mancha	1.848.881	4,28%	79.463	15,70%	25.477.676	3,43%	14.673	80,59	5	916	1982	LOW	LOFCA
Castile and León	2.493.918	5,77%	94.223	18,62%	41.572.359	5,60%	16.956	93,12	9	2247	1983	LOW	LOFCA
Catalonia	6.813.319	15,77%	32.114	6,35%	135.901.060	18,31%	21.601	118,63	4	945	1979	HIGH	LOFCA
Valencia	4.543.304	10,52%	23.255	4,60%	72.332.347	9,74%	17.314	95,09	3	541	1982	HIGH	LOFCA
Extremadura	1.075.286	2,49%	41.634	8,23%	12.794.973	1,72%	11.812	64,87	2	382	1983	LOW	LOFCA
Galicia	2.750.985	6,37%	29.574	5,84%	39.503.352	5,32%	14.439	79,30	4	315	1981	HIGH	LOFCA
Madrid	5.804.829	13,44%	8.028	1,59%	129.702.431	17,47%	24.392	133,96	1	179	1983	LOW	LOFCA
Murcia	1.294.694	3,00%	11.313	2,24%	18.445.403	2,48%	15.826	86,92	1	45	1982	LOW	LOFCA
Navarre	584.734	1,35%	10.391	2,05%	12.607.800	1,70%	23.098	126,86	1	272	1982	HIGH	CHARTER
Basque Country	2.115.279	4,90%	7.234	1,43%	47.045.371	6,34%	22.719	124,77	3	250	1979	HIGH	CHARTER
La Rioja	293.553	0,68%	5.045	1,00%	5.562.569	0,75%	20.584	113,05	1	174	1982	LOW	LOFCA
Ceuta/	74.654	0,17%	19	0,00%	1.186.090	0,16%	15.471	84,97	0	1	1995/		
Melilla	68.016	0,16%	13	0,00%	1.043.518	0,14%	15.279	83,91	0	1	1995		
TOTAL	43.197.648	100,00%	505.987	100,00%	742.307.798	100,00%	18.208	100,00	50	8.101			

Source: Spanish National Statistical Institute, *Instituto Nacional de Estadística* (1), Public Administration Ministry, *Ministerio de Administraciones Públicas* (2), and the authors.

LOFCA: Ley Orgánica de Financiación de las Comunidades Autónomas (Autonomous Communities Financing Act)z

The cost of devolved services was calculated in Spain using the “Effective Cost Method”, which is based on the following criteria:

1) Users of public services should not suffer changes in the level of provision due to the devolution of competencies from central to regional governments. This requires transferring all the human and material resources used and required for the provision of the service from central to regional governments.

2) The financial sufficiency of both tiers of government (the level devolving the service and the level assuming the new competency) must be assured and increments in public spending avoided. This requires removing the expenditure item from the central government budget in an amount equal to the funding received by the Community concerned.

The volume of spending associated with the competencies transferred was quantified by valuation commissions formed by representatives of central government and of the AC concerned. These “Mixed Transfer Commissions” (*Comisiones Mixtas de Transferencias*) agreed to the value of the devolved competencies mainly on the basis of budget data. Competencies cannot be devolved unless the AC is in conformity with this valuation.

The importance of the effective cost method to the structure of AC finance can hardly be overstated, since the application of the method determines the total volume of resources funded. Consequently, any discussion of ACs finances and respect for the principle of sufficiency will always be tantamount to a debate over the appropriateness of the effective cost method.

In essence, the effective cost method seeks to establish the monetary value of each competency by identifying all costs that will be incurred by the AC affected as a result of the devolution of the service. This is the key figure if the AC is to continue the service at the same level of provision as central government prior to the transfer.

Table 2 shows how the effective cost of a competency  $j$  for an Autonomous Community  $i$  ( $EC_{ij}$ ) is calculated on the basis of the sum of costs, less fees charged to users of the service.

**Table 2. Quantification of the effective cost of devolved services**

$EC_{ij} = DC_{ij} + IC_{ij} + RI_{ij} + NI_{ij} - F_{ij}$
<p>DC<sub>ij</sub>: Direct costs incurred in the provision of the service. These comprise wages and salaries, and current purchases of goods and services by the agencies directly providing the service.</p>
<p>IC<sub>ij</sub>: Indirect costs. These comprise wages and salaries, and current purchases of goods and services by agencies that do not directly provide the service to end users but are responsible for support functions, planning and coordination.</p>
<p>RI<sub>ij</sub>: Replacement investment. Capital expenditure required to maintain the stock of public assets transferred under the same conditions of use.</p>
<p>NI<sub>ij</sub>: New investment. Capital expenditure intended to increase the stock of public assets (this component was not included in the calculation of the effective cost until 1995)</p>
<p>F<sub>ij</sub>: Fees charged to users of the service in accordance with the benefit principle</p>

Source: the authors.

As Table 2 reflects, the method involves the calculation of the *net effective cost*, because fees charged to partially fund the service transferred (*F<sub>ij</sub>*) are deducted from the total cost of provision. This procedure seems appropriate because the logic of the benefit principle requires that the provider of the service decide the level of fees charged. Thus, the transfer of services also implies the transfer of revenues where these arise from the application of the benefit principle.

The effective cost comprises only current and capital expenditure, excluding financial charges in respect of public debt servicing (interest and repayment) and transfers.

The exclusion of financial charges associated with public debt is absolutely logical because in devolving the competency for a service, the central government also transfers the stock of public capital required for provision, but retains the stock of public debt issued to fund the same. It would therefore be inappropriate to include the effective cost of interest charges or debt repayments.

Transfers, meanwhile, are excluded because the logic of the effective cost method requires that those associated with redistribution should remain the competency of central government.

This criterion, however, ignores the crucial distinction between public provision (public funding for a service which is made available to the consumer without charge per unit consumed) and public production (public funding for a service directly produced by the public sector, contracting the necessary inputs).

Public production in fact seems to be the only alternative considered in the effective cost method. If this were not the case, transfers to private sector providers of public services would have to be considered in the calculation of the cost of the services transferred.<sup>2</sup>

The methodology used to calculate the effective cost of services suffers from certain problems, including the following:

1) The absence of a reliable source of data for the application of the methodology. This is due to the lack of public sector cost accounting and the fact that budget accounting methods are designed for expenditure control rather than the measurement of the cost of services. Thus, the effective cost method results in a *negotiated cost* rather than an *assessed cost* of services. Central government enters the negotiations leading to the quantification of the effective cost with a certain advantage due to the asymmetry of information available to the parties, because it has prior management experience and data. The process of devolution and valuation of transfers may be viewed as a recurring game where the ACs have gradually acquired experience in successive rounds of negotiations, starting from an initial situation in which central government had a clear information advantage.

As we have explained, the effective cost of the service depends on central government expenditures immediately prior to devolution. In these circumstances, there is a clear temptation to adjust budgets downward in the year prior to the transfer. Such underbudgeting certainly creates problems for central government in its last year

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<sup>2</sup> In recognition of this, funds associated with grant maintained private educational establishments were included in the 1992 reform of the regional finance system.

providing the service, but it offers the advantage of lowering the transfer of funds that must be made to the ACs in subsequent years, which amply offsets any such difficulties.

The attractions of such a manoeuvre only increase where overall transfer of a major competency (such as education or health) is concerned.

2) The effective cost refers to the moment of transfer, and the expense associated with central government provision of the service is calculated at the level prevailing *in each region* at that time. As a result, two similar ACs could simultaneously obtain the devolution of (say) education but each be assigned differing, possibly even widely diverging, effective cost.

3) Given that regional finances were carved out from the existing national exchequer, it would seem reasonable for this process to have covered both the assets and liabilities of central government. Since the carve-out concerns *what there is* and not *what there should be* in the central government exchequer, the effective cost could have included a share of the deficit (a part of the stock of debt) in respect of the competencies transferred, but it did not. A part of the accumulated central government debt would thus have been allocated to the improvement of the services devolved to the ACs, and the question therefore arises whether a portion of this outstanding debt should not also be decentralised together with the services. Placing the public assets associated with the services transferred in the hands of the ACs without simultaneously transferring that part of the stock of debt that might rationally be associated with such assets is not without its consequences. In the first place, the debt burden came to represent an increasing share of the central government budget, which at the same time shrank as a result of the transfers. The other outcome was that the ACs maintained their borrowing capacity intact with the full course left to run up to the established ceilings. This, of course, provided a certain incentive to borrow further.

Despite these criticisms, it must be recognised overall that the effective cost method did provide an effective basis for the orderly devolution of a significant volume of competencies from central government to the ACs without causing excessive budgetary tensions. Based on an analysis of the decentralisation process in terms of the available alternatives, it must be allowed that it would have been far from easy to proceed in any other way given the weaknesses inherent in the original accounting data.

### 2.3 The devolution of health services

In Spain, as in the majority of federal countries, the decentralisation of health services has been rather limited (Banting and Corbett, 2002: 16-25) and to a great extent the goal has been to ensure territorial equality in the quality of healthcare.

This is, then, a shared competency, where the level of healthcare coverage (universal in the case of Spain), the list of guaranteed medical services and general funding are decided at the central government level. The regional governments, on the other hand, are responsible for the delivery of healthcare to the citizen within their own territory and the distribution of health funding among hospitals and clinics. At the same time, they have the power to expand the list of guaranteed services, though they must seek additional financing from the regional taxpayer.

There are two reasons for the special treatment of health services within the range of competencies devolved to the ACs. In the first place, health is by some way the largest of the ACs' expenditure programmes, normally representing between 40 and 50 percent of total spending (Table 3). In addition, the rate of growth in health expenditure exceeds that of GDP growth and the outlook is for strong upward pressure in the future due to the aging of the population.

Secondly, health services were fully devolved to all of the ACs only very recently (2002) and were funded through a system of conditional grants that lay outside the general financing system<sup>3</sup>. Health competencies in fact continue to display certain peculiarities even after 2002, insofar as the ACs are required to guarantee a minimum increase in spending.

Until the general devolution of health competencies to all of the ACs, funding was provided through a separate system of specific grants, so that the amount received by each region represented a part of the total health budget in proportion to the regional population entitled to receive healthcare (Monasterio, 2002: 165-166). Unlike other competencies, then, the effective cost method was not used for health service finance, which was assessed rather on the basis of an explicit criterion of equity in the allocation of resources, i.e., equality in terms of *per capita* spending.

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<sup>3</sup> This was the case for the common regime ACs but not for the charter regime ACs, where health financing is included in the special arrangements we describe in the next section.

Over time, one of the main problems for the financing of the healthcare system has been the growth in spending, which in most years outstrips GDP growth. Expanding pharmaceutical expenditure has been a cause of particular concern, because it represents a higher percentage of total health expenditure in Spain than in other countries of the European Union or in the USA.

Nevertheless, it cannot be denied that health indicators are good in Spain, with long life expectancy, a reasonable hospital network and a more or less universal public health system reaching 99.4 percent of the population in 2000 (European Observatory on Health Care Systems, 2000).

In view of the high level of health coverage, concerns about rising health spending in the future are based mainly on the aging of the population (which raises *per capita* use of the health services) and the higher cost of care resulting from the introduction of new medical technologies and medicines, which are not only more effective but also more expensive.

For this reason, special guarantees have been established for healthcare funding, even though these services have formed part of the general “common regime” AC financing model since 2002. These include:

1) Guaranteed increases in healthcare funding at least equal to percentage GDP growth between 2002 and 2004. This guarantee resulted in additional expenditure of € 210 million in 2002 and is likely to be extended beyond 2004.

2) Healthcare is defined as a basic public service and funding will be reviewed in those ACs where the annual increase in public system users exceeds 3 percent of the increase in national average. Where applicable, these ACs may receive specific purpose grants to improve regional healthcare services, the so-called “Basic Public Services Equalisation Grants” (*Asignaciones de Nivelación de Servicios Públicos Fundamentales*). A similar guarantee is also applied to the education service.

In addition, the collection of the hydrocarbons retail sales tax, which is levied at the regional level, is tied to health spending.

The final goal pursued through the above measures is to ensure adequate funding for an expenditure item that absorbs almost half of regional budgets and is a basic public service for the Welfare State. This funding must be sufficient to guarantee the national

list of health services nationwide and to provide the ACs with a margin to improve the service. The ACs are supposed to obtain additional resources by raising those taxes over which they have control. To date, however, only few ACs have availed themselves to the chance of raising the hydrocarbons retail sales tax for this purpose. These groundbreakers are Madrid (in 2002), Asturias and Galicia (in January 2004) and Catalonia (July 2004).

**Table 3. Autonomous Community Health Expenditure Indicators, 2002**  
(€'000 and %)

Autonomous Community	1. Total spending – all competencies	2. Total health spending	% Health spending (2/1)	Devolution of health services
Andalusia	12,918,377.92	5,401,165.42	41.81	1984
Aragon	2,306,090.03	986,297.47	42.77	2002
Asturias	1,992,620.35	901,628.36	45.25	2002
Balearic Islands	1,332,388.68	612,060.14	46.28	2002
Canary Islands	3,195,461.64	1,274,100.67	39.87	1994
Cantabria	1,114,478.55	492,407.07	44.18	2002
Castile-La Mancha	3,254,504.96	1,339,768.18	41.17	2002
Castile and Leon	4,783,475.14	1,941,595.28	40.59	2002
Catalonia	11,230,690.90	4,860,026.70	43.27	1981
Valencia	6,778,431.90	3,045,965.02	44.94	1988
Extremadura	2,172,560.12	839,507.47	38.64	2002
Galicia	5,172,261.91	2,100,252.67	40.61	1991
Madrid	8,675,745.43	3,788,044.69	43.66	2002
Murcia	1,897,040.16	835,604.27	44.05	2002
La Rioja	555,480.49	244,485.05	44.01	2002
<b>Total ACs (common regime)</b>	<b>67,369,608.19</b>	<b>28,662,909.46</b>	<b>42.55</b>	

Source: Ministry of Finance (2004) and the authors.

### 3. REVENUE ASSIGNMENT, TRANSFERS, AND BORROWING<sup>4</sup>

Having quantified the cost of the services devolved to the ACs, the next step is to assign them their own resources to finance expenditure needs. The Constitution of 1978 establishes two basic systems for the funding of the ACs, the “common” system applicable to all of the ACs except the Basque Country and Navarre, and the “special” or “charter” system applicable to the latter based on their regional charters<sup>5</sup>. These systems

<sup>4</sup> For a more detailed analysis see Monasterio and Suárez-Pandiello (1998).

<sup>5</sup> The Autonomous Community of the Canary Islands includes certain special features due to its geographical location, although it forms part of the “common” system. The two North African cities of

differ widely both in terms of structure and outcomes, and we therefore discuss each separately.

### 3.1 *The common system*

The design of the common system was originally established by the Autonomous Communities Financing Act, 1980 (*Ley Orgánica de Financiación de las Comunidades Autónomas –LOFCA*), which was comprehensively reformed in 2001. Consequently, the common system is also commonly referred to as the LOFCA system. The Act establishes the basic principles of the system, while specific applications are settled by the Autonomous Communities Fiscal and Financial Policy Council (*Consejo de Política Fiscal y Financiera de las Comunidades Autónomas, CFFF*), the bi-partite body responsible for the coordination of financing at the central and regional levels. The CFFF assesses the evolution of regional finances on a regular basis (in principle once every five years) and makes any necessary changes. The most significant reviews took place in 1986, 1992, 1996 and 2001. The need for five-yearly reviews of the financing system was removed in 2002 when all of the ACs reached the ceiling for the devolution of competencies.

Initially (end of the 1970s and early 1980s) the common financing system worked in the following manner. The net effective cost of the  $j$  devolved competencies was calculated for each Autonomous Community  $i$ :

$$EC_i = \sum_{j=1}^n EC_{ij} \quad i=1, \dots, 15 \quad [1]$$

This cost was financed by way of lump-sum general grants. Hence, the total funding received by the AC was:

$$R_i = EC_i \quad [2]$$

This model had two main weaknesses. In the first place, the effective cost method failed to ensure that the ACs would be able to provide the devolved services on a roughly equal basis, allowing them rather to continue the former central level provision. This level, however, may differ widely from provision in other ACs.

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Ceuta and Melilla also have a special status, which is halfway between the position of a municipality and an Autonomous Community.

The second weakness is that the system of funding was based exclusively on grants, thwarting the effective action of two basic criteria for decentralisation: the principle of financial autonomy, which requires that a jurisdiction should be in a position to decide the level and mix of its revenues and spending; and the principle of accountability, in accordance with which the cost of providing regional public goods and services should be borne by the beneficiaries for reasons of efficiency.

Both central government and the ACs were aware of these two problems, and the subsequent evolution of the common financing system has consisted of gradual efforts to correct the resulting weaknesses, using the tools that the own LOFCA anticipated.

It was first agreed as early as 1986 to replace the effective cost method with a quantification of regional spending based on indicators that would more accurately reflect the *expenditure needs* of each AC, in other words the costs incurred by each AC in order to provide the same level of public goods and services as other ACs. The indicators currently applied and their relative weightings are shown in Table 4. These cover three blocks of competencies -health, social and other services. Population is the indicator with the highest weighting.

Despite this use of indicators in the quantification of regional spending, however, effective cost remains decisive for the determination of the ACs' expenditure needs. This is because all of the regional financing reviews approved by the CPFf included the condition that no AC would be assigned lower revenues than it had hitherto received.

**Table 4. Criteria applied in the quantification of common system Autonomous Communities' expenditure needs (since 2002)**

CRITERION	OTHER SERVICES	HEALTH	SOCIAL SERVICES
Population	94%		
Area	4,2%		
Dispersion	1,2%		
Island territory	0,6%	0,5%	
Protected population		75%	
Population > 65		24,5%	100%
Total	100%	100%	100%

Source: the authors.

The financing instruments used for regional spending have also changed. The system of funding based exclusively on general purpose grants was soon abandoned and replaced (1982-1984) with “ceded taxes” (*tributos cedidos*) and the “sufficiency fund” (*fondo de suficiencia*, referred to as “sharing in State revenues”, *participación en los ingresos del Estado*, until 2002), two revenue sources that were more in line with theoretical recommendations and the experience of other federal states.

Ceded taxes are established and regulated at the central level, which assigns certain competencies to the ACs. Until 1997 these competencies comprised only collection and administration of the tax. The ACs were not given any powers to regulate the taxes ceded, and the system should therefore properly be described as a tax sharing arrangement rather than own taxes. Since 1997 certain regulatory competencies have been devolved for certain ceded taxes, allowing the Autonomous Community in question to set the tax rate and establish tax credits and allowances. In line with the literature (see, for example, Bird, 1993) these may be defined as own regional taxes, as long as the AC concerned has discretion to set the tax rate.

Table 5 enumerates the taxes ceded to date with a description of the competencies assigned to the ACs with regard to tax collection, administration and regulation. The last column of the table classifies these taxes from an economic standpoint as own taxes or tax sharing arrangements. Central government retains all powers over the collection, administration, and regulation of corporate income tax, the tax on insurance premiums, import duties, payroll taxes and non-resident taxes.

Concerning the personal income tax, the tax schedule is divided into separate central and a regional tax schedules. The central government schedule, which is equal to 67 percent of the total tax, is allocated at the central level, while the regional schedule, equal to 33 percent is allocated to each AC. The ACs may maintain this tax schedule, in which case they will receive 33 percent of the total tax take, or they may increase or reduce the rate (as well as establishing their own tax credits) in which case the take would be either higher or lower than 33 percent.

**Table 5. Taxes ceded to Autonomous Communities under the common system**

TAX	COLLEC-TION	ADMINI-STRATION	REGULATION	CLASSIFI-CATION
Personal Income Tax	33%	NO	Tax schedule and tax credits	Own tax
Tax on Net Wealth	100%	YES	Threshold, tax schedule and tax credits	Own tax
Inheritance and Gift Tax	100%	YES	Allowances, tax schedule, tax credits, administration and collection	Own tax
Capital Transfer Tax, Taxes on the raising of capital, and Stamp Duties	100%	YES	Tax rates, tax credits, administration and collection	Own tax
Gaming Taxes	100%	YES	Allowances, taxable base, tax rates, administration, collection and inspection	Own tax
Vehicles Excise (registration)	100%	YES	Tax rates	Own tax
Hydrocarbons Retail Sales Tax	100%	YES	Tax rates, administration, collection and inspection	Own tax
Value Added Tax, VAT	35%	NO	NO	Tax sharing
Excise Duties (alcoholic beverages, tobacco and petrol)	40%	NO	NO	Tax sharing
Electricity Tax	100%	NO	NO	Tax sharing

Source: López-Laborda (2004).

The tax yield that each AC should obtain by making the same tax effort as the others (the “standard tax yield”) is calculated for each tax ceded. To the extent that this yield may be insufficient to meet expenditure needs, the system guarantees a genuine equalisation grant (the sufficiency fund) to cover the difference between expenditure needs and fiscal capacity. The sufficiency fund is a lump-sum unconditional grant.

Let us now consider how the sufficiency fund is determined. The CPFF establishes a “base” year for the system and calculates the expenditure needs of each Autonomous Community,  $E_{i0}$  and the standard yield for the ceded taxes,  $T_{i0}^*$ . The sufficiency fund,  $SF_{i0}$ , is calculated as the difference between expenditure and taxes:

$$SF_{i0} = E_{i0} - T_{i0}^* \quad [3]$$

In some Autonomous Communities (e.g. the Balearic Islands and Madrid) the standard tax yields may exceed their expenditure needs. In such cases, the grant is negative and the amount is redirected from the AC to central government.

The sufficiency fund is not determined annually. For any year  $t$  subsequent to the base year, the amount is calculated by applying to the base year fund the rate of growth in State taxes equivalent to those ceded to the ACs (*Ingresos Tributarios del Estado, ITE*):

$$SF_{it} = SF_{i0} \cdot \frac{ITE_t}{ITE_0} \quad [4]$$

Consequently, the revenues that Autonomous Community  $i$  would receive in year  $t$  would be the sum of the sufficiency fund and the actual yield from the taxes ceded (not the standard yield, which is used only to calculate the sufficiency fund in the base year):

$$R_{it} = SF_{it} + T_{it} = SF_{i0} \cdot \frac{ITE_t}{ITE_0} + T_{it} \quad [5]$$

Based on the above, it may fairly be said that the common system of regional financing guarantees that all of the ACs will receive the funds they require to finance the services devolved at a reasonably equal level. However, it is no less true that the equalisation procedure may gradually be weakened over time, insofar as the sufficiency fund evolves at the same rate for all ACs, while the expenditure needs and the fiscal capacity of each AC are likely to evolve at different rates. This issue has become particularly important since 2002, the year in which the need for five-yearly reviews of the financing system was eliminated, as explained above<sup>6</sup>.

The taxes ceded and the sufficiency fund make up what might be called the “basic financing model”. However, the ACs also have certain additional resources that can be used to provide more or better services than would be affordable through this basic model.

For example, they may establish genuine regional taxes and surcharges (or “truly” regional taxes, according to Bird, 1993: 213). In contrast to the ceded taxes, the ACs have full powers of collection, administration and regulation in such cases. There are,

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<sup>6</sup> As explained in Section 1.3, an AC may receive a “Basic Public Service Equalisation Grant” when the annual increase in education or healthcare services users exceeds 3 percent of the increase in the national average. Should this grant be allocated again to the same AC in a period shorter than five years, then the sufficiency fund must be adjusted to reflect the substantial change in the AC’s expenditure needs.

however, strict bounds to this power. Suffice to say that the Autonomous Communities Financing Act (LOFCA) prevents the ACs from trespassing on the terrain already occupied by central government and municipal taxes. This limitation explains why the ACs have established so few regional taxes (basically environmental and gaming taxes), and why the tax yield is so small.

The ACs also receive conditional grants intended to foster regional development, with the goal of reducing differences in income and wealth. Examples of this type of grant are the Interterritorial Compensation Funds (*Fondos de Compensación Interterritorial, FCI*) and certain revenues obtained from European Union budget, such as the European Regional Development Fund (ERDF).

Table 6 shows the structure of ACs' non-financial revenues in 2003. Own revenues (comprising ceded and genuine regional taxes) represent 35 percent of regional non-financial revenues. If tax sharing formulas (which are based on the derivation principle and, so are closer to own revenues than transfers) are included, this share rises to almost 60 percent. Conditional grants, meanwhile, represent less than 15 percent of Autonomous Communities' non-financial revenues.

Finally, the ACs may run deficits and borrow. This source of financing is, however, subject to certain restrictions. In the first place, debt may only be used for investment purposes. Secondly, annual repayments of principal and interest may not exceed 25 percent of the AC's current revenues. Thirdly, all AC borrowing is coordinated with central government borrowing, and certain operations (foreign credit and regional public debt) are subject to central government approval.

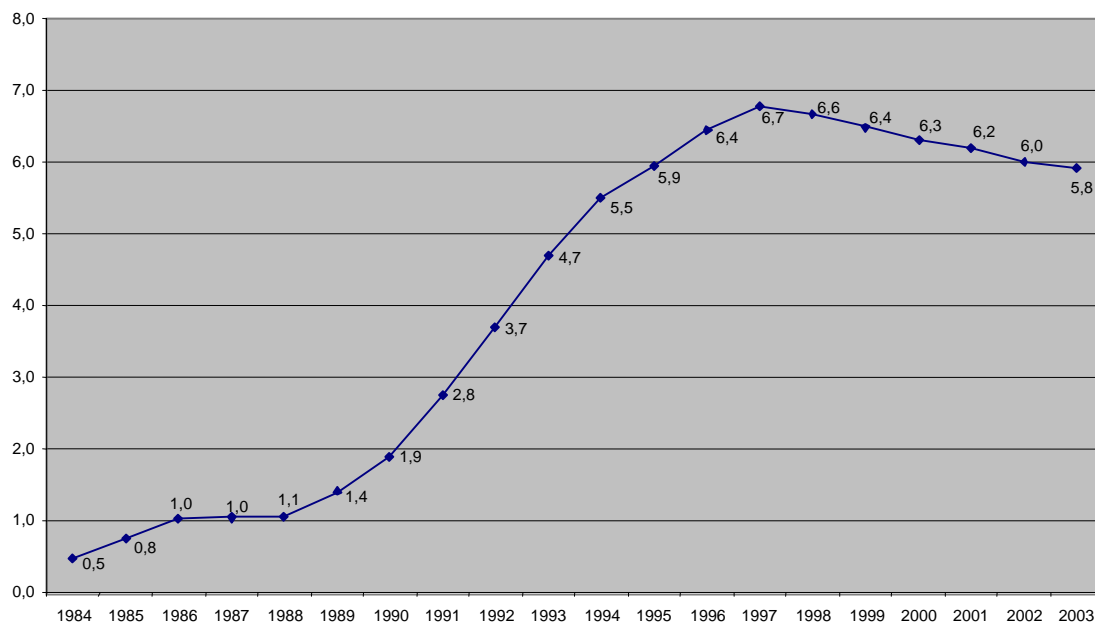
As shown in Figure 2, the ACs have made increasing use of debt since 1992. Many reasons have been advanced to explain this behaviour, such as the insufficiency of the revenues generated by the "basic model" the limited scope for genuine regional taxes and surcharges to play a role in the improvement of services, and the familiar phenomenon of the "fiscal illusion" associated with debt financing. As explained in the first section of this chapter, a certain incentive for regional indebtedness was built into the system because the ACs were not assigned a part of the deficit related with devolved competencies.

**Table 6. Percentage structure of common regime Autonomous Communities' non-financial revenues per 2003 budgets**

<b>OWN REVENUES</b>		<b>35</b>
Regional taxes, surcharges, fees, charges, public prices and others		3.32
Personal Income Tax	15.21	
Net Wealth Tax	1.25	
Inheritance and Gift Tax	1.76	
Capital Transfer Tax, Taxes on the raising of capital, and Stamp Duties	9.10	
Gaming Taxes	1.53	
Vehicle Excise	1.35	
Hydrocarbons Retail Sales Tax	1.48	31.68
<b>TAX SHARING AND GRANTS</b>		<b>65</b>
<i>Tax sharing</i>		22.87
Value Added Tax, VAT	14.94	
Excise Duties	7.93	
<i>General purpose grants</i>		27.65
Sufficiency fund	27.65	
<i>Specific purpose grants</i>		14.49
Interterritorial Compensation Funds	1.05	
Other central and other agents grants	4.39	
European Union transfers	9.05	

Source: the authors.

**Figure 2. Evolution of the common and charter regime Autonomous Communities' stock of debt in relation to GDP (%)**



Source: Bank of Spain, *Statistical Report*.

In 1992 central government and the Autonomous Communities recognised the need for coordination to achieve the fiscal convergence objectives established in the Maastricht Treaty. The resulting agreement gave rise to the Budgetary Consolidation Scenarios (*Escenarios de Consolidación Presupuestaria, ECP*), which set annual limits on the deficit and debt of each AC.

Compliance with the Budgetary Consolidation Scenarios has been uneven, with some ACs observing and others repeatedly breaching their terms. The greatest virtue of these arrangements has certainly been their contribution to restraining the growth of regional debt in aggregate terms. As Figure 2 clearly shows, the growth rate slowed after 1992, and since 1997 the debt / GDP ratio has even fallen.

Since 2003 the Budgetary Stability Act has created a new scenario in which the Spanish public sector as a whole is required to maintain a balanced budget or achieve budget surpluses.

In this new context, central government sets budgetary stability targets for the ACs as a whole over a three-year period, subject to a report from the CPFF. The CPFF is also responsible for establishing the stability targets for each individual AC, and if agreement proves impossible, every AC is required to pass and implement a balanced or surplus budget.

If any Community breaches these rules in the approval or settlement of its budget, it is required to prepare a medium term economic and financial correction plan. In such cases, central government approval is required for all regional borrowing operations. Finally, if breaches by any AC result in or contribute to non-compliance by Spain with its obligations under the European Union Stability and Growth Pact, the AC is required to assume the attributable part of any liability that may arise.

Undoubtedly, budgetary stability legislation represents a challenge for the ACs. It limits their access to borrowing and they may be forced to reduce the level of services provided to their citizens, improve the management of public spending or raise taxes. ACs could also circumvent fiscal rules using off-budget financing and other “creative techniques”. There is some evidence about the use of this kind of instruments: the debt issued by regional-owned companies has raised from 0.6 percent of the GDP in 1995 to the 1.3 in 2003.

### 3.2 *The charter system*

The charter financing system applies to Navarre and the Basque Country. Specifically, it is called the *Convenio* in Navarre and the *Concierto* in the Basque Country, both terms referring to the regional financing arrangements currently governed by the “Economic Agreement between the State and Charter Community of Navarre Act”, 2003 (*Ley del Convenio Económico entre el Estado y la Comunidad Foral de Navarra*) and the “Economic Agreement with the Autonomous Community of the Basque Country Act”, 2002 (*Ley del Concierto Económico con la Comunidad Autónoma del País Vasco*).

In contrast to the common financing system, the charter system is not based on the assignment of specific revenues to fund a given level of spending. The chief feature of the charter system is that it provides the regions concerned with close to the maximum fiscal autonomy. Both the *Convenio* and the *Concierto* basically recognise the capacity of the charter regions to establish and regulate their own fiscal system provided that the free movement of persons, goods, services and capital is ensured.

In essence the charter regions are financed exclusively through tax revenues called “agreed taxes” (*tributos convenidos* in Navarre and *tributos concertados* in the Basque Country). The charter regions (more precisely the provinces or “Historical Territories” of Álava, Guipúzcoa and Vizcaya in the Basque Country) have wide powers over these revenues, which are in general considerably greater than the powers of the common regime ACs for “ceded taxes”. Table 7 details the taxes concerned using the same structure as Table 5. The only taxes currently outside the charter regime are import duties and payroll taxes.

In contrast to the common regime regions, then, the charter regime ACs have full powers over all personal and corporate income taxes. The regional finance departments also control the main indirect taxes, comprising VAT and excise duties<sup>7</sup>, although only to the extent of administering the tax without regulatory powers. This is mainly due to the restrictions established by European rules governing the harmonisation of indirect taxes.

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<sup>7</sup> The case of VAT and excise duties is highly complex, because the tax yield collected by the AC (which depends on regional value added in the case of VAT) has to be adjusted to obtain the yield finally corresponding to the regional government, which is based on consumption by the residents of the AC (See Zubiri, 2000: 39-40).

**Table 7. Agreed taxes assigned to the charter regime regions**

TAX	COLLEC-TION	ADMINI-STRATION	REGULATION	CLASSIFI-CATION
Personal Income Tax	100%	YES	Full	Own tax
Tax on Net Wealth	100%	YES	Full	Own tax
Inheritance and Gift Tax	100%	YES	Full	Own tax
Corporate Income Tax	100%	YES	Full	Own tax
Non-Resident Income Tax	100%	YES	Full for permanent establishments	Own tax
Capital Transfer Tax, Taxes on the raising of capital, and Stamp Duties	100%	YES	Full, with some exceptions	Own tax
Gaming Taxes	100%	YES	Full, with some exceptions	Own tax
Vehicles Excise (registration)	100%	YES	Tax rates, declaration and payment forms and payment periods	Own tax
Hydrocarbons Retail Sales Tax	100%	YES	Tax rates, declaration and payment forms and payment periods	Own tax
Value Added Tax, VAT	100%	YES	Tax declaration and payment forms and payment periods	Tax sharing
Excise Duties (alcoholic beverages, tobacco and petrol)	100%	YES	Tax declaration and payment forms and payment periods	Tax sharing
Electricity Tax	100%	YES	Tax declaration and payment forms and payment periods	Tax sharing
Tax on Insurance Premiums	100%	YES	Tax declaration and payment forms and payment periods	Tax sharing

Source: López-Laborda (2004).

In practice, the charter ACs have made wide use of their regulatory powers in tax matters, generally to reduce the tax burden. For example, corporate income tax depreciation allowances are more generous than in the common regime ACs and tax credits for investment and job creation are higher, while tax rates in general are lower.<sup>8</sup>

In light of Table 7, and given the level of incomes in the Basque Country and Navarre, it is evident that the charter regime ACs do not require additional grants to finance their expenditure needs, which are adequately covered by their tax revenues. Indeed, these ACs actually make annual transfers to the central government, the Basque

<sup>8</sup> Some of these measures have been challenged by the European Court and by the Spanish Supreme Court, which has viewed them as regional public aid distorting competition (Zubiri, 2000: 212-225).

*quota* and the Navarre *contribution*, to help fund the cost of national public goods or, to put it another way, those matters over which central government retains competencies (citizens under the common regime ACs help to finance the cost of national competencies through non-ceded taxes: a 67 percent in the personal income tax, a 100 percent in the corporate income tax, a 65 percent in the VAT, and so on). Basically, the quota (for the purposes of simplicity we shall apply this term both to the Basque quota and to the contribution made by Navarre) is calculated as follows.

The share in the cost of national public goods,  $G$  attributable to each charter territory is based on the “imputation index”, which is basically a relative income function. The imputation index is 1.6 percent for Navarre and 6.24 percent for the Basque Country.

Since the State collects certain revenues in the charter regions (non-agreed taxes and non-tax revenues) and a part of central government expenditure is financed through the deficit, a distinction is made between the Gross Quota,  $GQ$ , and the Net Quota,  $NQ$ , calculated as the gross quota less all revenues obtained by the national exchequer in the charter AC. The amount of the Gross Quota in the “base” year for charter Autonomous Community  $f$  is as follows:

$$GQ_{f0} = i_f \cdot G_0, f = \text{Navarre, Basque Country} \quad [6]$$

where  $i_f$  is the imputation index for charter Autonomous Community  $f$ , and  $G_0$  represents national public goods in the “base” year. Let us call revenues not covered by the financing agreements  $TN$  and the deficit  $D$  (a surplus would operate in the oppositedirection). We may now calculate the value of the Net Quota, which is the amount actually transferred by the regional finance departments to the central Finance Ministry as follows:

$$NQ_{f0} = i_f \cdot G_0 - i_f \cdot TN_0 - i_f \cdot D_0 = i_f \cdot [G_0 - (TN_0 + D_0)] \quad [7]$$

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

$$NQ_{ft} = NQ_{f0} \cdot \frac{IE_t}{IE_0} \quad [8]$$

Hence, the revenues received by Autonomous Community  $f$  in year  $t$  will represent the difference between the tax yield actually obtained from agreed taxes,  $T_f$ , and the amount of the quota:

$$R_{ft} = T_{ft} - NQ_{ft} = T_{ft} - NQ_{f0} \cdot \frac{IE_t}{IE_0} \quad [9]$$

As in the common financing system, the above outline represents only the “basic model” for charter AC funding. The Basque Country and Navarre also have other sources of revenues with which to fund their competencies, such as taxes, surcharges, borrowing, etc.

There can be no doubt that the charter system scores highly from the standpoint of the principles of financial autonomy and accountability. The charter ACs finance all expenditure out of their own revenues, in contrast to the common regime ACs, and this brings them closer to the situation in the world’s most fiscally decentralised countries, such as the United States, Switzerland and Canada.

Other issues, however, do not come out so well. In the first place, the greater financial autonomy of the charter ACs provides an incentive for asymmetric tax competition between these regions and the common regime ACs. For example, if a charter AC decides to implement tax measures to attract firms from other regions, the common regime ACs are unable to react, because they do not have regulatory powers over corporate income tax.

Secondly, comparison of the structure of the common and charter financing systems shows that an equal level of tax effort will provide the charter regime ACs with higher revenues than the common regime ACs to finance the same competencies. To put it another way, the common regime ACs have to levy higher tax rates on their constituents to provide the same standard of regional-type public services.

An explanation for this difference is that the charter system is so designed that citizens resident in these ACs fund the cost of regional public goods and the respective share of national public goods out of their taxes. The citizens of the common regime ACs on the other hand *also* finance equalisation grants (the sufficiency fund) allowing those

ACs with low fiscal capacity or high expenditure needs to provide the same level of regional public goods and services as the other ACs.

#### **4. AN APPRAISAL: WHAT DOES THE FUTURE HOLD?**

To conclude, let us reflect on the key features of the decentralisation process that has taken place in Spain since the end of the 1970s and consider some emerging areas of debate:

1. The view that Spain has undergone a very fast and intense process of public expenditure decentralisation is widely held, but none the less true for that. The ACs currently handle 35 percent of total public spending and participate in the provision of the public goods and services that are closest to the lives of citizens and most affect their well-being. The level of decentralisation is similar to that found in the classic federal states, and it is therefore an error to continue to include Spain among the centralised or unitary States, as is generally the case in the literature. From both the institutional and the financial standpoint, Spain is a genuinely federal country.

Local government in Spain has less weight than in other decentralised states. To some degree, it could be explained by the fact that in these countries (e.g. the United States, Canada and Switzerland) education is devolved down to the local level, while in Spain it remains at the regional level. Nevertheless, there is considerable insistence on the need to strengthen local competencies and financing in a “second decentralisation” process following the successful consolidation of regional government.

Probably the sharpest criticism of the Spanish decentralisation process comes from those who believe that the autonomy achieved by the ACs is of poor quality, wide though it may be (Viver, 2003). Central government intervention in all areas of the Autonomous Communities’ competencies is intense (even in matters reserved exclusively for the ACs), and in practice this substantially reduces their ability to adopt their own policies. According to these authors, the resulting system is closer to an administrative than to an authentically political autonomy. If this is the case, as indeed it seems to be, a key task for the immediate future will be to *guarantee that ACs are allowed to exercise their competencies without undue interference from the central government.*

2. In every review of the common financing model, the ACs have complained that the system does not assure them sufficient funding, and that central government should assign additional resources. There are various reasons for these demands. On the one hand, an element of strategic calculation pervades the conduct of the ACs, which have sought to push the cost of their spending decisions over to all of the citizens of the country rather than accepting the political cost of increasing the taxes paid by those resident in their own territory (the classic “common pool problem”). It should be remembered here that all of the competencies held by the ACs were devolved after they had accepted the effective cost appraisal in the “Mixed Transfer Commissions”.

However, it is also true that the central government sometimes takes decisions that have a significant impact on the revenues of the ACs, such as changes in the tax system that reduce the yield of the taxes ceded, or the requirement that the ACs undertake certain expenditure programmes.

The satisfactory development of any federal state such as Spain requires that *all levels of government act in accordance with the principle of federal or constitutional loyalty* derived from the Constitution and expressly enshrined in the LOFCA. Consequently, the ACs cannot shift the financial consequences derived from the exercise of their powers either to central government or to other ACs, nor can central government ignore the impact of its actions for regional finances.

3. The decentralisation of public revenues has lagged considerably behind expenditure. However, own revenues currently form a significant part of Autonomous Community finance, representing 100 percent in the charter regime Communities and between 35 and 60 percent in the common regime ACs.

Any further efforts to strengthen autonomy and accountability will mean *expanding the scope of common regime ACs own revenues, and at the same time reducing dependence on grants from the central government*. There are few options open, however. The expansion of the percentage allocation of certain ceded taxes might be considered, for example, or the devolution of regulatory powers over certain indirect taxes such as excise duties or even at some later date Value Added Tax. Another possibility would be to strengthen environmental taxes at the regional level, where the ACs have already established an incipient though scattered presence.

4. The financing system guarantees a reasonable level of equalisation between the common regime ACs. Thus, if two Autonomous Communities require the same tax effort from their citizens, the system ensures that both will also be in a position to provide a reasonably similar level of devolved public goods and services should they so wish.

*The appropriate degree of equalisation* is a matter of permanent debate in Spain and will certainly continue to be so in future, hotting up if anything. The ACs that are the beneficiaries of the grant system support a high level of equalisation on the grounds of solidarity, pointing to Germany, Australia and Canada by way of example. However, those ACs with the highest fiscal capacity have come to demand a system based on the resources generated in each region and a lowering of equalisation between territories, appealing to the principle of efficiency (as in the United States and Switzerland).

5. The Constitution permits the existence of two financing systems with very different structures. The common regime is based on taxes ceded by central government and grants from the sufficiency fund, while the charter regime is based on a regional tax system with bottom-up grants.

What the Constitution does not permit, however, is that the results of the two systems should differ, so that ACs with the same competencies provide different regional public goods and services depending on whether they receive funding under the common or charter regime.

This is an emerging issue in the debate over the evolution of the Spanish regional State. On one side are *those who favour the extension or generalisation of the charter regime* to the common system ACs. On the other, are the supporters of *measures aimed at bringing the results of the charter regime into line with those of the common regime* without changing its special nature. The solution to this dilemma is highly related to the one of the debate concerning equalisation.

6. The expansion of the European Union to include ten new member States from Central and Eastern Europe also raises issues for regional financing.

The first and most important of these will be the loss of European Structural Funds and especially those aimed at regional development, which currently benefit more than a few of the Autonomous Communities of Spain. Given the low income levels of the

new member States and the decision to freeze the EU budget at 1.24 percent of the Union's GDP, regional aid will be switched toward the countries of the East from 2006.

The loss of such regional development funds, as well as the need to constrain borrowing and deficits in accordance with European rules governing public finance and the Spanish Budgetary Stability Act, could jeopardise investment and the improvement of regional public capital stock. The effect is important because the ACs are the main Spanish public sector investors, currently making around 40 percent of total public investment.

As explained above, these restrictions represent a challenge for regional governments, which will either have to improve their management of spending or raise taxes on their constituents.

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