

**International Studies Program
Working Paper 06-11
January 2006**

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The Spanish Experience**

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Financing Local Governments: The Spanish Experience

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Introduction

Summarizing twenty five years of Spanish local public finance is not an easy task. In 1978, the new democratic Constitution completely changed the face of public administration in Spain. Until then, and apart from some minor, unsuccessful attempts at decentralization during the Second Republic in the early thirties of the last century, the model of governance was based on a pure version of Napoleonic centralism.

Nevertheless, the decentralization process initiated by the Constitution gave the regional governments (that is, created *ex novo*) a leading role. The aim of this process was to provide the regions with growing competences and responsibilities in relation

to expenditure assignments, and to a lesser extent, in revenue assignments. This new tier of government received major political and administrative support while local jurisdictions remained in the background from which they are, however, presently showing signs of emerging.

In 1978, Spanish local authorities managed around 13 percent of total public expenditure while, currently, this figure is scarcely 15 percent. Thus, little would seem to have happened during a period of almost three decades. Given the intensity of regional decentralization during this period,¹ these percentages would seem to point to stagnation in local governments. However, this is not quite the case. Actually, the relative importance of the public sector in the Spanish economy has increased considerably since the restoration of democracy to the extent that a welfare state, which already existed in neighboring countries, needed to be created from scratch. In fact, the ratio of total local government expenditure to GDP increased from 5.02 percent in 1980 to 6.15 percent in 2000, which shows that even if the relative weight of total local government expenditure in total government expenditure has not changed, the volume of local expenditure has significantly increased, since GDP has grown from €1,161 million in 1980 to €10,541 million in 2000 (see table 1).

Table 1. Some data on Spanish local finance

	1980		1990		2000	
	% GDP	% PAs*	% GDP	% PAs	% GDP	% PAs
Ordinary Expenditure	2.18	7.88	4.66	9.70	4.98	14.16
Investment Expenditure	2.84	68.16	1.60	22.07	1.17	23.21
Total Non-Financial Expenditure	5.02	14.30	6.26	11.32	6.15	15.30

Note: * Pas stands for Public Administrations (or Total Government Expenditures)

Source: Gago and Labandeira (2002)

Financing the increasing expenditure has often been controversial and led to conflicts between local governments and the central government, as the latter is the constitutionally responsible for guaranteeing the economic sufficiency of local governments. Although the search for an efficient and equitable financial system for local governments is still ongoing, the process to date has been shaped by six significant milestones.

1. Devolution of the Old Production Factor Taxes (PFT) (1979). The first major action in the field of local finance in democratic Spain was the devolution, to local authorities, of some of the old PFT eliminated by the central administration when it introduced a personal income tax². At that time, local governments were able to collect (but not to regulate) taxes on income arising from rural or urban properties and occupational taxes on commercial, industrial, professional, and artistic activities. The former category of taxes would develop, over time, into a property tax and the latter category into a business tax. These levies became the centerpiece of local finance and joined a whole range of small taxes with limited revenue-raising capacity, which were already available to the local authorities. These taxes were, however, rather revenue inelastic and incapable of responding to increasing pressure from citizens who, following the restoration of local democracy, were demanding more and better local public services. At the beginning, it was objectively very difficult to meet local residents' demands, given that the new democratic local administrations were reborn in difficult financial circumstances and overwhelmed by excessive expectations. Moreover, local governments were poorly equipped both in terms of their legal bases and qualified employees, to meet these new demands. If we also take into account the fact that assistance from the central government via transfers was limited, due to the need to modernize the Spanish economy and the building of a welfare state, it is

understandable that local governments began to incur debts as their own resources and state subsidies were insufficient to meet new expenditure needs. Compounding the problem was the fact that the newly elected local authorities were unwilling to frustrate citizens' expectations during a period of intense political and economic change.

In the face of an impending financial crisis, the central government reacted by adopting a series of extraordinary measures which culminated in the 1983 *Ley de Medidas Urgentes de Saneamiento y Regulación de las Haciendas Locales* (Act on Urgent Measures to Reorganize and Regulate Local Public Finance - hereafter, the AUM).

2. *Act on Urgent Measures to Reorganize and Regulate Local Public Finance (1983)*. The objectives of the AUM were twofold. On the one hand, public finance was to be rationalized, implicitly acknowledging that the poor financial situation of local authorities was caused by the structural deficiencies of the local finance system. Therefore, the AUM honored debts and made the State responsible for "actual debts" (as confirmed by audits of the town councils which availed themselves of the law). On the other hand, in order to avoid a repetition of financial difficulties in the future, the AUM tried to strengthen local taxation by conferring greater autonomy on local councils in the area of revenue collections, in particular enabling local governments to establish freely the rate of the property tax in urban areas, and by assigning, as a new local tax, the option of establishing a piggyback local income tax: a surtax (with a tax rate chosen by local councils) on the net tax liability of the state personal income tax.

The response to the AUM was different among town councils and adoption of the new financial tools was particularly uneven. Thus, at the end of 1986 local indebtedness was in overall terms greater than it had been prior to the AUM, reaching

worrying levels in some municipalities and demonstrating the limited success of the law. In any case, the AUM was given the coup de grace by two decisions of the Constitutional Court which invalidated the section of the law which allowed local authorities to set the rate of the urban property tax and the surtax on the personal income tax without any limitation. This was resolved later for the property tax by establishing a range of minimum and maximum rates. Nevertheless, the autonomy in setting the rate on the surtax on the personal income tax was never restored³.

3. *Accession to the EEC, Implementation of VAT, Abolition of the General Tax on Business Transactions (GTBT) and Changes in the Sumptuary Tax and Provincial Finance (1985)*. Before joining the European Economic Community, the core of indirect taxation in Spain was the GTBT, a multiphase sales tax, which was charged on the total value of sales (not value added) in each phase. This tax was technically very imperfect, because it created adverse differences in the taxation of goods and services according to the chain of production and distribution (the number of phases from the origin to the final consumer). Because of that, all countries interested in being part of the EEC were required to adopt the VAT as the only general indirect tax, and Spain was an exception. At the local level, the substitution of GTBT by VAT had significant consequences. Firstly, because Provincial governments were financed by a surcharge on GTBT and they also collected another indirect tax (Canon sobre la Producción de Energía – Energy Production Tax) that were both abolished. Secondly, there was a municipal tax on luxury expenditures (Impuesto sobre Gastos Suntuarios) that also was notably capped. In both cases, there was a compensation for lost tax receipts with general grants.

4. *Local Government Finance Act (1988)*. The enactment of the *Ley Reguladora de las Haciendas Locales* (law regulating local finance - hereafter the LGFA) initially

represented significant progress in the area of local financing. From a qualitative point of view it meant the end of the existing dependence-based model, whereas from a quantitative point of view, it brought new resources into the system to satisfy the needs identified on a daily basis. Later in this chapter, we set out a more detailed analysis.. For the moment, let us simply point out that the LGFA finally introduced revenue autonomy for local governments as it allowed them to establish the rates of local taxes (within some maximum and minimum bounds), which were simplified as they were reduced in number from ten to five. As far as transfers were concerned, the system was formula-based, establishing the total amount to be distributed among local governments which would be updated on an annual basis according to objective criteria. The transfer model has been revised since then every five years, both in terms of its amount and distribution criteria. This enabled local governments to calculate available external resources very accurately in spite of the highly critical judgments it received concerning the equity aspects of the model⁴. Lastly, the LGFA also allowed local governments to take on debt albeit within certain limits set in order to allow central government to coordinate macroeconomic policies.

5. *General Act on Budgetary Stability (2001)*. The practical implementation of the LGFA gradually led to the establishment of a “tax culture” and joint fiscal responsibility in the local sphere which were almost unheard of at the time. Authorities now turned directly to citizens for the resources required for their spending programs rather than “begging” for subsidies from other Public Administrations. However, all of the Spanish Public Administrations had to overcome many problems in order to comply with the macroeconomic targets imposed at the European Union level (such as the convergence of deficit, debt, interest rates and inflation rates) with a view to creating a Monetary Union where every national

currency would be replaced by the new “euro”. These difficulties led the central government to introduce the so called *Ley General de Estabilidad Presupuestaria* (General Act on Budgetary Stability – hereafter GABS). The explicit objective of this law was to increase budgetary restraints at every level of government, in particular, severely restricting access to credit so as to balance the public accounts on an annual basis where possible. To the extent that public debt had been mainly used to finance capital expenditure and that local governments are, above all, investing institutions (see Table 1), the adoption of this law in 2001 was a matter of concern for local managers because they were compelled to use alternative finance sources to maintain the desired levels of investment. The practical consequence of this was an increase in the tax burden (with associated political costs) or resorting to financial engineering and accounting tools in order to get around this new legislation. In the end, this decreased the transparency of public management⁵. In addition to the controversy raised by the introduction of the budgetary stability criteria, at that time the central government announced its intention, in the context of a wider reform of the LGFA, to eliminate the business tax – the second most important local tax in terms of its revenue raising power. This decision together with the *fait accompli* that local authorities were gradually assuming new competences (demanded by citizens) without any financial support exacerbated the uncertainty about local public finances.

6. *Act Reforming the LGFA (2002)*. Finally, in 2002 the LGFA was reformed and the amended Act forms the basis for current legal framework on local public finance which we will describe and assess in the rest of this chapter. For the time being, it should suffice to say that the new legislation dramatically affected each of the main sources of income for local councils.

Therefore, the next section examines the local tax system in depth in the context of the current Spanish framework. Section III reviews the model or rather the models for intergovernmental transfers, while Section IV considers debt recourse. In all cases we will describe the regulatory aspects from of the perspective of the theoretical principles of fiscal federalism. Finally, Section V will include some concluding remarks and loose ends to be considered in a very near future.

Local Taxation

At the present time, following the last local government finance reform examined in the previous section, the Spanish local tax system has the same number of taxes as established by the LGFA in 1988, but the main taxes have undergone substantial change. Specifically, Spanish local authorities levy five taxes: property tax (PT), business tax (BT), vehicles tax (VT), tax on buildings and tax on land value increase in urban areas. The first three are compulsory taxes to be collected by all local councils, whereas the other two are optional. In all cases local authorities are free to set tax rates within a legal range of maximum and minimum rates. However, together with these local taxes, municipalities may also collect fees and user charges (fees levied on the use of certain public services). These revenue instruments have grown in importance over the recent years. Table 2 shows the relative importance of these taxes within a period of five years, before (1998) and after (2003), the time of the last reform.⁶ We will examine each of these taxes separately.

The Property Tax (PT)

In accordance with the most conventional tax federalism theories, the property tax appears to be one of the most suitable taxes to provide a basis for local own source finance. In particular, it is argued that the location of the taxpayer is especially

relevant: we are dealing with a tax with a non movable tax base unlikely to be affected by emigration in the event the tax burden was high. The inability to export the tax burden beyond the boundaries of the beneficiary⁷ jurisdiction provides cost internalization under the benefit principle. In spite of this, there has been no shortage of controversy in the literature regarding the global effects of this tax on efficiency and equity. In particular, one of its most controversial aspects is its economic incidence: who bears the tax burden arising from this tax. There has been no agreement on this issue in the empirical literature⁸.

Table 2. Municipal fiscal revenue structure

	1998		2003	
	Thousands of €	%	Thousands of €	%
Property Tax (PT)	4,000.33	33.83	5,368.61	34.12
Vehicle Tax (VT)	1,265.56	10.70	1,802.73	11.46
Tax on Land Value Increase	667.55	5.65	1,053.70	6.70
Business Tax (BT)	1,640.45	13.88	1,241.87	7.89
Tax on Building	946.00	8.00	1,547.13	9.83
User Charges	3,303.79	27.94	4,720.75	30.00
Fiscal Revenue (*)	11,823.68	100,00	15,734.79	100.00

Note: (*) Excluding collection of extinguished taxes

Source: Directorate General of Community Funds and Territorial Funding

Following these guidelines, and as may be seen in table 2, the property tax seems to be the centerpiece of Spanish local taxation, contributing to one third of total tax revenues. In terms of its structure, the Spanish local property tax is mostly a standard property tax which falls on the administratively assessed gross value of immovable property in rural or urban areas⁹. So revenues depend critically on the assessment of immovable property and consequently on the swiftness with which price increases in immovable property (including new buildings) are recorded in the local tax registers in order to establish the appropriate tax base. In Spain “cadastral management” (the

administrative process consisting of an initial valuation and further revisions updating the assessed values of properties) falls outside the jurisdiction of local authorities. Actually, the Central Government is responsible for all cadastral management. This situation has given rise to continuous disagreements and disputes between administrations. Thus, local councils (especially the biggest) have been claiming the right to be involved in the cadastral management of this tax, given that they have as much at stake as the Central government in the census update. Furthermore they believe that, as they are closer to the ground, they are in a better position to understand the key components of the process (in particular the trends in property values). The Central Government, on the other hand, believes it cannot cease to set common valuation criteria for Spain as a whole and, consequently, the application of global rules can only be achieved if its own administrative bodies conduct all cadastral management.

A second controversial issue over this period is in relation to the alleged need to personalize the tax. This is a well known subject in the tax literature, according to which a pure tax on property turns out to be inequitable insofar as it is based on gross value without deducting debts and charges. This is a tax with a corporeal nature which does not allow for aspects such as family conditions, the health conditions of those liable to pay, or income level.¹⁰ In the Spanish case, this issue was dealt with in the recent amendment of the LGFA, by devolving competences to local governments enabling them to introduce new family-related tax relief (for instance, benefiting large families) or a surtax where dwellings are kept empty, in the pursuit of the non-fiscal objective of helping to mobilize these idle resources through their sale or rental. Nevertheless, some observers see these changes in the legislation as making the tax more complex with questionable effectiveness. These same observers have suggested

that this type of actions should be better channeled through expenditure policies, leaving the property tax exclusively as a revenue tool.¹¹

Beyond such controversies the local property tax seems to be a fully consolidated tax at the local level in Spain, and will undoubtedly continue to represent the main source of revenue to local governments.

The Local Business Tax (BT)

The second tax in order of magnitude was, until recently, the local business tax (around 14% of local tax revenues in 1998) as shown in table 2.

From a theoretical point of view, the local business tax was originally based on the benefit principle of taxation, presuming that there is a link on a proportional basis between the public services consumed by business and their productive activity.

However, in its practical implementation it may be carried out in several ways. International practice provided three approaches to taxation of economic activity at the local level, and each has different outcomes from the perspectives of equity and efficiency. The three bases are: i) *consumption*, this would involve taxing sales carried out within the municipality; ii) *income*, taxing income attributable exclusively to business profits in the area or all incomes received by citizens in the area; and iii) *use of production factors*, which could be made through differentiated tax rates in a hypothetical *property tax* on the business premises engaged in this activity or through *payroll taxation* (use of the labor factor) or through an index which weights the *various factors* used, meaning that the business would be taxed according to its use of the factors. The third criterion is the most difficult to design, as it is necessary to include labor and all fixed assets. This must be achieved according to rules that comply with the targets to be met, which may on the other hand hinder the application of the economic efficiency principle. In any case, the effective incidence of this

approach may be questionable. It would also be expected that the economic actors will try to shift the burden of taxation forward through higher selling prices of their production (goods or services) or backward through lower real wages for example, which shifts the tax burden onto one or more factor suppliers depending on market conditions (supply and demand elasticities of outputs and inputs). In addition in some cases the tax burden may be exported, or shifted outwards, to taxpayers outside the boundaries of the tax collecting jurisdiction.

The Spanish local business tax fits into the third option. It was defined in the 1988 LGFA as "...a direct tax with a non-personal nature and on the following taxable event: businesses, professional or artistic activities carried out in the Spanish territory whether or not in specific premises, whether or not classified in the tax schedule".

In real practice, the taxation of Spanish businesses by means of objective indicators, which do not always take into account taxable capacity, and with no regard to their income or profits, has made the business tax a particularly controversial tax. This tax has been strongly criticized by professional associations and politicians. It would seem that the extensive modifications to the way the tax is applied in the 2002 Act on Reform of the LGFA was a direct consequence of the business tax's unpopularity, magnified by purely political interests, as well pressure from specific interest groups¹². As a consequence of these changes, the new local business tax is only levied on organizations with an annual turnover higher than one million euros. In practice, this reform means that, in addition to a large number of previous taxpayers falling outside the scope of the tax (about 90% of those who paid the local business tax previously are now exempt), numerous Spanish local councils have been deprived of their previous business tax revenue. After the reform, the Central Government has

been forced to compensate those local governments with a new non-conditional transfer¹³.

However, the new regulations have not put an end to the controversy surrounding the business tax. Some authors still criticize it because it is unfair, as major groups of professionals and businessmen with a significant economic capacity no longer pay the tax. Others criticize its poor legal structure. In fact, various appeals have been lodged at the Spanish Constitutional Court on the basis that the current regulation discriminates against enterprises that still pay the tax. Consequently, and in spite of a 25 percent increase in the business tax rate, and beyond any changes to the new framework that may be decided by the courts, it seems obvious that the business tax is no longer a key component of Spanish local finances.

Other Taxes

The other Spanish local taxes have not been the subject of as much controversy as the previous two. In fact, the vehicle tax (the third compulsory tax) is a longstanding local tax that annually charged on the administrative value of cars and other vehicles. From time to time there has been a move to integrate it with the other taxes levied on cars (taxes collected by the regional governments or Autonomous Communities) with a view to reduce its compliance and administration costs¹⁴.

As far as the non compulsory (for local government use) taxes are concerned, the tax on building and the tax on land value increases in urban areas are taxes which aim to share with local councils the income derived from construction activities in general and urban development in particular. This has constituted a dynamic and important sector in the Spanish economy over the past several decades. Indeed, although in theory the revenues from these taxes tend to be erratic and less stable than the taxes described above, in practice they have brought in major complementary resources

basically to large town councils and to those with higher growth levels, particularly local authorities of regional capitals and tourist resorts.

User Charges

Finally, it is important to note a growing trend in recent years where municipalities charge users directly for publicly provided goods and services they consume. In fact, as economic theory states, where service users are fully identifiable (as services are divisible) and such services have no redistribution bias, the most efficient way to finance such services is to charge the users for the full cost of the service. Since a substantial volume of services supplied by Spanish municipalities meet these two characteristics, it is not surprising that fees and user charges have reached the level shown in table 2 (more than a quarter of tax revenue). Moreover, in light of forthcoming tighter restrictions introduced by the law on budgetary stability, there is likely to be a tendency to revive other taxes with a long tradition in the Spanish local government system such as special taxes which apply the profit principle to the funding of public investment. In practice these charges try to internalize a portion of the increase in the value of identified private properties produced as a consequence of the realization of public works in their proximity.

General Transfers to Local Governments

A Description of the Present System

Municipalities' sharing in central taxes (MSCT) is the main transfer of central public finances to local governments. It represents around a fourth of total non-financial local revenue though there are notable differences in relative importance depending on the size of the municipality. The MSCT is a non-conditional transfer with a global amount which is revised every five years. It changes within each five-year period

according to the change in nominal GDP, with a guaranteed minimum annual increase equal to the increase in the consumer price index (CPI). Once the funding of “special municipalities” (Madrid and Barcelona amongst others) are deducted from the general Fund¹⁵, the remainder is distributed among the different local governments according to a range of variables which include factors reflecting expenditure needs, revenue raising capacity and tax effort.

In fact, for the period 1999-2003 the MSCT was distributed according to the following criteria and weights:

- Need variables:
 1. 75 percent according to weighted population taking into account municipality size, using the following coefficients.

Number of inhabitants	coefficient
More than 500.000	2.80
From 100.001 to 500.000	1.47
From 50.001 to 100.000	1.32
From 20.001 to 50.000	1.30
From 10.001 to 20.000	1.17
From 5.001 to 10.000	1.15
No more than 5.000	1.00

2. 2.5 percent according to the number of school units whose building maintenance is a charge for municipal governments.
- 8.5 percent according to the (inverse) *revenue raising capacity* calculated by municipal taxes and charges.
 - 14 percent according to the tax effort calculated as a ratio of current to potential revenue of the most important municipal taxes (PT, BT, VT and TLVI)¹⁶:

In any case, a general minimum amount equal to that received during the last year of the previous five year period and additional funding consisting of a minimum grant (of approximately €100 per inhabitant) for municipalities with less than 5,000 inhabitants is guaranteed. This transfer complements municipal tax resources with a view to improving revenuesufficiency without an explicit equalization objective.

As indicated in the introduction, the 2002 Act reforming the LGFA changed the MSCT significantly. From a single general transfer system with all its nuances, there was a shift to a dual system which established a new model for calculating general transfers for the 1999-2003 quinquennium according (basically) to the size of the municipality. However, the new scheme is considered permanent because the five year revisions which characterized it have been removed. This parallels the new finance system arrangements for regional governments, which are also supposed to be permanent¹⁷.

A new scheme for municipalities with a *de jure* population equal to or higher than 75,000 inhabitants, and for some small local governments for administrative reasons (being the capital city of a province or of an autonomous regional community) identified as “*large municipalities*” has been introduced. This new scheme has been added to the distribution formula with multiple factors, which was in force in the previous quinquennium and which is still being applied to municipalities with small populations (“*small municipalities*”).

In the case of “*large municipalities*”, the general grant for each of them in the base year (2004) is made up of two components: on the one hand, “territorialized” shares in several central government taxes and, on the other, a Complementary Fund, which we will describe below:

- The “territorialized” shares are specific percentages of revenue from central government taxes not transferred to the autonomous regional communities such as: the personal income tax (1.6875%), VAT (1.7897%) and EU harmonized excise taxes (2.0454%). With regards to personal income tax, the allocation of local revenue is on a derivation basis assessed according to the net tax liability of residents in the municipality. The allocation of revenue from consumption taxes (general consumption tax and excises) follows a highly indirect procedure: firstly, it is related to the share of the consumption of the autonomous regional community (to which a municipality belongs) in the context of national consumption; and, secondly, according to the importance of the *de jure* population in relation to that in the autonomous regional community the locality belongs to.
- The second component, the Complementary Fund, is calculated (in the first year) for each one of the municipalities as the difference between the grant they received previously and the territorialized shares discussed above.

From a dynamic perspective, territorialized shares will develop in line with the collection of shared taxes - either the municipality’s tax revenue in the case of personal income tax and excise taxes on oil and tobacco or the general tax revenue of the nation in the case of VAT and all other excise taxes. They will also evolve according to dynamics of the autonomous community (to which the municipality belongs) compared to the national dynamics. The Complementary Fund will develop in line with the evolution of *National Tax Revenues* (NTR) minus revenues liable to be transferred to the autonomous regional communities, derived from personal income tax, VAT, and harmonized excise taxes.

For the other municipalities (*small municipalities*) the current distributive formula explained above is still applied but with some changes in relation to the previous five-year period (1999-2003). The pool of funds of the general grant is updated according to the NTR which replaces nominal GDP. The CPI is abolished as the basis for a guaranteed minimum increase. The provision of a minimum grant for municipalities with less than 5,000 inhabitants is also removed.

Once the pool of funds for the general grant has been determined, it is shared out according to a formula containing a range of variables which, as explained, try to include municipal differences in expenditure needs, fiscal capacities and revenue effort.

One of the two variables related to needs (school units) is removed in such a way that population is the only variable, with the same 75 percent. Once the higher population strata – to which the new transfer system is applied (*“large municipalities”*) – have been excluded, the others are adjusted under the LGFA demanding more competences for them. Some of them will have their weights increased. (See table).

Number of inhabitants	Coefficient (previous)
From 50,001 to less than 75,000	1.40 (1.32)
From 20,001 to 50,000	1.30 (1.30)
From 10,001 to 20,000	1.17 (1.17)
From 5,001 to 10,000	1.17 (1.15)
No more than 5,000	1.00 (1.00)

The *revenue raising capacity* variable now called *tax capacity* carries greater weight in the distributional formula (increasing from 8.5% to 12.5%) while the weighting of *tax effort* is reduced to the weight for revenue raising capacity

(decreasing from 14% to 12.5%). The Act defines neither the tax capacity nor the tax effort, a task entrusted to future Finance Acts. In the next section, we will explain and assess the definition of these variables in the last Finance Act.

There is a third system of transfers specifically for those municipalities within the group of “*small municipalities*” that are considered to tourist destinations. This is basically a hybrid system combining the “*small municipalities*” regime and the regime introduced for “*large municipalities*”¹⁸.

Assessment of General Transfers in the Light of Theory and Comparative Experience.

The purpose of this section is to assess the experience of local government in Spain in regard to the design of the transfer system. The theoretical precepts of fiscal federalism and comparative¹⁹ experience will provide the basis both for assessing progress and ways of improving the system of financing.

In fact, one of the main achievements of the implementation of the 1988 LGFA was undoubtedly the shift from a yearly assessment of the grant amount (which was therefore subordinate to other, more urgent, objectives of the Ministry of Finance) to a formula approach linking the pool of funds for transfers, subject to quinquennial revisions, to the change in the level of resources available to the Ministry of Finance, as in the case of the autonomous regional communities. Complying with the objective of a vertical rebalancing, some decisions such as a move to dynamic indices on magnitudes liable to be monitored by the central public finance²⁰ or to indices assessed on fewer resources²¹, and the abolition of quinquennial revisions should be criticized due to the uncertainty of results of the new system.

Not only do transfers play a role in achieving a vertical rebalancing, they also have an impact on the horizontal dimension. Thus, they must attempt to bridge the gap between expenditure needs and tax capacities among town councils. In addition to

the “non-conditional” character of the transfer, it seems appropriate to require clear objectives for the system which is expected to result into equilibrium between expenditure and fiscal capacities. It is difficult to deduce clear objectives for a dual (large and small municipalities) or even trinitarian (when there are touristic municipalities among the small ones) transfer system. As we have shown in another paper²², the design of the multiple-factor distributional scheme that is being implemented does not ensure financial equalization among municipalities. This means that there is a possibility for future reform which, given the changes in funding involved and the need to adjust to them, would require (if implemented) a transitional period. However, leaving structural elements such as tax capacity and effort unresolved and to be addressed in subsequent finance Acts will introduce uncertainty in this important piece of intergovernmental finance.

Among the factors which must be in a scheme distributing the general grant fund, there are two that are essential – those dealing with expenditure needs and with fiscal capacity. A third one reflecting the tax effort of the jurisdiction is debatable. In any case, in order to increase the transparency of the distributional scheme, the number of factors representing the dimensions above should be reduced to the minimum. Below we will examine each of them in the Spanish formula.

In terms of the factors used to measure local *expenditure needs*, the most important advances are in the representativeness and simplicity of the new methodology. Given the large number of Spanish municipalities (more than 8,000) and their heterogeneity, it seemed appropriate to move towards the highest degree of simplification (a single factor). In this context, population was the unquestionable candidate on the grounds of its (spatial and competence) representativeness, its relative easiness to calculate, and the difficulty of manipulating these data. The

definitive removal of the second factor (schools), whose weighting was halved in the previous quinquennium, is appropriate not only on simplification grounds but also because, nowadays, it is not relevant in terms of local expenditure responsibility (currently, the autonomous regional communities are responsible for them) and municipalities are in charge of a very small portion of expenditure (cleaning and surveillance).

But the essential issue when using the population as a variable representing local needs lies in the coefficients used to give different weights to municipalities according to size; especially the existing difference between the coefficients for the two strata with larger population (a coefficient of 2.85 for municipalities with more than 500,000 inhabitants is just about double the coefficient of 1.47 allocated to the stratum of municipalities with 100,000-500,000 inhabitants). It must be taken into account that the population variable represented 70 percent of the general transfer (during the 1994-1998 quinquennium). For this reason its financial consequences are important²³. The differences between these coefficients are not justified by greater expenditure responsibilities (in particular, there is no legal obligation to assign more competences to municipalities with more than 50,000 inhabitants). In addition, there is a lack of empirical basis to support the different coefficients; the sparse evidence in Spain does not support it.²⁴ Moreover, they are exaggerated from a comparative perspective. For example, the increase in the weighting of an inhabitant in a locality with 510,000 inhabitants compared to one with 120,000 inhabitants does not amount to 5 percent in Germany, while in Spain it is more than 90 percent. All other countries do not make any distinction by size, since population size already is the automatic adjustment. If there are no differences in expenditure responsibilities by size, then the only fact that would justify a higher weight coefficient for large municipalities would

be the presence of increasing costs or diseconomies of scale. But, the international evidence of the cost functions for public services is that unit costs for many services get pretty flat after a sharp decline reflecting increasing returns to scale up to 25,000 - 50,000 residents.

Firstly, the traditional lack of factors including the *tax capacity* as a distributive element of the allocation scheme is surprising. As explained above, an element of capacity index was introduced in the five year period 1999-2003 but was incorrectly implemented for several reasons. The main problem was that it identified fiscal capacity with actual revenues collected, thus introducing perverse incentives in the distribution formula (because there was the possibility of increasing the size of the transfers by decreasing tax rates and therefore tax collection, even though tax capacity had not changed at all). Other shortcomings lie in the fact that discretionary taxes for municipalities are included in the measure of fiscal capacity only for those municipalities that decide to make use of them. Consequently perverse signals are introduced again in the transfer system (by increasing the measure of tax capacity only for those municipalities levying optional taxes). The faulty design of the distribution formula is more evident when we focus on the clear contradiction of trying to reward tax effort of municipalities through the introduction of an independent factor for this end in the formula, and at the same time penalize, via a higher reading of fiscal capacity, those municipalities that have decided in favor of the implementation of optional taxes. Finally, income from user charges and other fees are included in tax revenue and fiscal capacity. However, the amount of this revenue is biased by the new ways of managing public services on a cost recovery basis similar to what is done in the private sector. From this perspective, these revenues (fees and charges) should not be included in the calculation of fiscal capacity.

Finally, the Finance Act for the 2004 financial year, which makes use of the authorization granted by the new LGFA, correctly defines fiscal capacity as the average tax base per inhabitant of the municipality in relation to its population stratum. However, several points need to be made about this definition. With regard to its scope, the Act falls short as it only makes reference to the Property Tax, while incorrectly omitting the other two compulsory taxes (business tax and tax on vehicles)²⁵. Moreover, the discretion of the municipalities to change the structure of these levies (beyond the tax rates) as provided by the 2004 reform must be taken into account when tax capacity is calculated..

As regards the *tax effort*, its use as an explicit variable of the distribution formula for general transfers is much more questionable. To start with, the transfer system should not discourage tax effort, and that will be accomplished with the proper definition and quantification of fiscal capacity. But, in the second place, there is no good fundamental reason why the transfer formula should stimulate effort. How much to tax should be left to the municipalities' collective decisions; there is nothing inherently superior to higher tax effort.

Another important issue is the calculation of the effort itself. In Spain, we start from a weighted sum of four taxes (the three compulsory taxes and the tax on land value increase in urban areas) bearing in mind actual revenues in relation to the maximum possible. The idea is clever, but the calculation has many deficiencies which have gotten worse following the last reform of the LGFA. In any case, the results obtained should reflect the concept we wish to measure - the tax effort. This is not easy to judge for the following reasons.

- There are no available data for every tax; therefore the maximum value of effort is always allocated to all municipalities with respect to vehicle tax and tax on land value increase.
- The result should not be susceptible to manipulation. Unfortunately, this is the case as long as the weightings in the calculation are internal (relevance in terms of revenue of each tax with respect to total revenue in the municipality).
- The last reform removes the Business Tax from some small municipalities (it should be remembered that big municipalities are excluded from the distributional scheme). In addition, its incidence is marginal in many others where it is still in force, which weakens the very concept of effort.

Updated data must be used, but data prior to the 2002 reform have been used to calculate municipal grants in 2004 in order to avoid some of the difficulties already mentioned. Thus, the variable does not seem to produce results in line with the concept which we are trying to measure. The final proof is that the formula itself contains specific limits on the value of the tax effort of the different municipalities.

All in all, we think that the justification for a tax effort variable in a distribution scheme makes sense when levying taxes or exercising legal capacity that has not been a long standing practice, and in any case its use should be temporary. From this perspective, this factor could be justified when establishing a new tax system derived from the 1988 LGFA but the passing of time and a significant and generalized exercise of legal capacity by Spanish municipalities makes it groundless in the distribution scheme. Its removal, which is advisable, would also mean a step towards higher simplicity and transparency of the grant system.

Let us now evaluate the grant applicable to the “large municipalities.” From 2004 onwards following the last LGFA reform, this grant is composed of territorialized shares plus a Complementary Fund. Two main points can be raised.

From a static perspective, if larger municipalities’ transfers are accepted as a starting point, we also accept the exaggerated weight coefficients applied to the largest municipalities. The approach raises an obvious problem present in territorializing any consumption taxes (both, general as the VAT and specific taxes, such as the excises). This problem is that it is impossible to use the traditional approach for apportioning part of the tax revenue according to relative consumption in the related territory because of the difficulty in assessing local consumption. In any case, territorialized shares continue to be transferred revenues and, as a consequence, they do not entail an improvement in autonomous principles.

On the other hand, from a dynamic perspective, the following considerations must be taken into account. Assuming the initial situation is correct (which is most unlikely), differences in funding from transferred incomes will arise insofar as one of the following two conditions among municipalities are met (actually both are likely to be met): the relative importance of each element (the various territorialized shares and the Complementary Fund) in the initial transfer is different and the dynamics of these elements are also different across municipalities. These differences, which could become significant throughout time, cannot be justified by assuming new expenditure responsibilities or by different tax effort among municipalities as these are simple transferred revenues. This situation will be particularly serious if we consider that the new MSCT will not be revised every five years as mentioned before.

In spite of the improvements in MSCT in the last few years, its current design presents a series of flaws that should be corrected. Introducing territorialized shares

will increase differences in financing between municipalities which will be added to the ones existing as a consequence of the exaggerated weights given to population in the largest municipalities. This may be considered a problem since the system is not designed to achieve horizontal equity among municipalities. Besides, there is no provision for the system to be revised every five years as before. The introduction of a true fiscal capacity index (restricted to PT) should be completed by including the rest of the compulsory municipal taxes. Finally, the tax effort index should be eliminated taking into account its inconsistent results and the consolidation of the municipal tax system, which will help to simplify an excessively complex transfer system.

Municipal Debt

Although local governments in Spain are basically suppliers of public goods and services, the need to make long term investments has often meant they have had to resort to borrowing to finance local projects. From a theoretical point of view, financing investments can be accomplished in two ways:

- Using money saved in each tax year - dedicating a share of tax revenues from one period to finance investment projects we wish to undertake ahead of time. This is sometimes known as the “pay-as-you-go” system (PAYG).
- Borrowing so that financing is spread over a period of time and financial obligations arising are met as the stream of profits from the investments made. This is known as the “pay-as-you-use” system (PAYU).

Debate is focused especially on the issue of intertemporal equity. Defenders of the PAYG system, and therefore critics of borrowing argue that, given that it is the current residents who decided to spend, it would be unfair to transfer the cost to future generations who have had no involvement in the decision. In effect, while the choice

between saving and borrowing is taken by individuals in the private sphere, in the sense that the costs assumed are internalized by the individuals themselves, the choice of governments generates external effects on future generations. In fact, the current generation has an incentive to try and avoid, via government borrowing, the costs arising from the public spending program. The probable result of this attitude would be an over-expansion of public spending beyond what would be optimal.

Nevertheless, there are also solid arguments in favor of the PAYU system from the viewpoint of intertemporal equity. Principally these are:

- Borrowing allows the payment of the costs of a project to be made at the same time as its benefits are reaped.
- The postponement of financing means that the cost per capita is reduced as the number of people benefiting from and paying for the service increases.
- Moreover, when there is inflation, greater income per capita in nominal terms would also produce a reduction in the charge per capita.
- Finally, and in entirely pragmatic and operational terms, the burden of financing arising from the PAYG system is excessively high, except for the case of small investment projects, making it impossible to finance most of the projects that are needed.

The issue of intertemporal equity causes an additional problem which arises from the possible transfer of the burden to future generations because of a decrease in capital formation. So, if we assume that there is full employment, increasing public services through borrowing, involves “crowding out”, i.e. transferring resources from the private sector to the public sector (funds loaned to the Administration are no longer available for the private sector) and this can be done either by reducing private consumption or reducing private investment. In the first case, the outcome will be a

reduction in the welfare of the current generation but in the second case, the welfare of future generations is reduced, as they inherit a lower stock of capital, although this reduction can be (more than) compensated by the increase in public capital.

These arguments based on criteria of intertemporal equity are not exclusively applicable to subcentral government tiers, but are equally valid for analyzing central debt. However, some problems of *intratemporal* equity are specific to the local sphere. These may arise as a consequence of inter-jurisdictional mobility as a response to borrowing policies. Actually, while central debt is mainly internal debt which is serviced basically by a country's residents, greater market opening in the local sphere means that a good part of the debt is external, in the sense that the holders of this debt are residents in other jurisdictions and, therefore, in the future transfers of income will be required between residents and non-residents. As a result, the existence of local public debt means that current residents have an incentive to emigrate in order to avoid facing future fiscal commitments to pay financial charges associated with this debt. The lower the costs of moving are, the greater this incentive will be. However, in the absence of asymmetries of information, with perfect mobility and if we assume free access to capital markets at a single rate of interest, it will be difficult to take such refuge. The reason for this is that fiscal obligations would be expected to be capitalized in property values such that any hypothetical purchaser who is aware that he is acquiring the property with an associated tax commitment which is expected to increase, would discount the current value of these taxes from the maximum he would be willing to pay for the property. As a consequence, if the potential emigrant attempts to sell his property, he would not be able to shift this cost onto the purchaser and would therefore bear the tax burden reducing his present and/or future consumption and providing a strong disincentive to inter-jurisdictional

mobility. At the same time, capitalization also affects profits arising from debt financed investments, which would operate in the opposite sense. The final outcome would therefore be that, according to the hypothetical situation above (perfect information, free movement, no access cost to capital markets and a single interest rate), PAYU and PAYG finance would be equivalent and there would be no incentive to emigrate. Less strict hypothetical criteria could lead to different conclusions as they would introduce arbitration factors which would alter inter-territorial equity.

In practice, the Spanish local government legislation has allowed recourse to credit, although the restrictions on this have varied over time²⁶. Historically speaking there have been three types:

- *Restrictions on intended use*, such that a local government may only borrow to carry out investment projects (the so called golden rule) or to cover temporary cash imbalances (or bridge financing).
- *Restrictions on implementation* such that contracting external debt or the issuing of public debt instruments require central government authorization.
- *Restrictions on amounts*, the reference criteria for this have been the most variable.

Focusing on the last of these restrictions, the objectives of quantitative limits on debt have been to safeguard the financial solvency of local governments and prevent undesirable uses of public credit. Alarm mechanisms have been established for this purpose together with the requirement for authorization by central government. Thus, the 1988 LGFA took as a reference the level of debt service or the *financial charges* arising from current debt (interests plus repayments of the principal) in relation to the local government's current revenues, so that when this indicator reached a value of 25 percent, the local government required authorization to carry out new credit

operations. The 25 percent level was therefore the “alarm level” for financial insolvency. Similarly, the LGFA prevented treasury operations for liquidity purposes and the like from being carried out when the amount exceeded 35 percent (subsequently lowered to 30 percent) of current revenues assessed in the previous financial year. This meant that in these cases borrowing was being used inappropriately in contravention of the restriction on intended use mentioned earlier.

Although the philosophy of quantitative restrictions was maintained for a long period of time, this has not been true for its implementation in practical terms. Therefore, the 1998 Act substantially amended the LGFA frames of reference, such that the relevant indicators became the existence of net negative savings and the fact that the current debt of the local government exceeded 110 percent of current revenues received. In the event that one of the cases described should arise, in addition to the requirement for central government authorization, local governments are required to present a financial restructuring plan to restore their position to less worrying levels and, in any event, lower than the levels which caused the alarms. In addition, municipalities with more than 200,000 inhabitants are allowed to substitute the authorization regime with a Budget Consolidation Plan approved by the Ministry of Finance or by the Regional Government which has, if appropriate, competence in this area, following a report from the aforementioned Ministry.

Finally, as we indicated in a previous section of this chapter, the introduction in 2001 of the legislation on budgetary stability had a serious impact on the ability of local governments to resort to credit as it obliged all Public Administrations to balance their budgets.

The legislation on budgetary stability which was adopted involved establishing a regulatory framework directed at ensuring budgetary discipline in order to comply

with macroeconomic objectives. This internal legislation on budgetary stability established the credibility of Spain's fiscal policy as is attested by the positive outcomes from the restructuring of our public finances. Although, as Kopits (2001) indicates, it is not a panacea, the adoption of legislation on budgetary stability (fiscal rules) should offer mechanisms enabling a reputation for fiscal discipline to be earned. As seen earlier, such a reputation has a high economic value, is difficult to achieve, and is easily lost.

An unavoidable initial assumption in developing the legislation on budgetary stability was the acknowledgment of the genuinely multi-jurisdictional character of our public finances, a factor of great complexity with far-reaching consequences for fiscal discipline. This leads to considering the legal framework of Budgetary Stability as an "internal stability Settlement," in line with the experience of certain countries with highly decentralized public sectors.

The General Act on Budgetary Stability (GABS, 2001) establishes the principles which should govern budgetary policy in Spain. The first of these, *budgetary stability*, is identified with a balanced budget or, where appropriate, a budget surplus, calculated on a national basis. The second principle involved is that of *multi-annual planning* which aims to achieve the realistic planning of public sector budgets, although it must always be compatible with the traditional annual budgetary principle which governs the approval and execution phases. The third principle, which is extremely important for the effectiveness of disciplinary mechanisms contained in the GABS, is *transparency*. This requires that the information which is important for verifying compliance with the principle of budgetary stability is adequate and correct as well as publicly available. The last principle contemplated in the GABS is *efficiency in the allocation and use of public resources*. This principle recognizes the

importance of accounting for macroeconomic aspects of budgetary stability and the microeconomic aspects of public management which impose an obligation, in a context of scarce resources, to manage according to standards of efficiency, quality and effectiveness. In our opinion, this acknowledgement fully justifies budgetary stability which has at times been deliberately derided as being simply “a numbers exercise”.

The measures in GABS make it mandatory for all agents involved in the state, regional and local government public sector budget process to include, in their budget and public spending rules, all the instruments and procedures that are necessary to achieve the objective of budgetary stability. To this end, the GABS legislation makes this a responsibility of the national government. Failure to comply with this objective, owing to exceptional situations of a deficit, is considered by the legislation but all such cases will require an explanation to be given as to their causes and proposed corrective measures. This is one of the Act’s incentive mechanisms reinforced by the principle of transparency - the threat of the deficit being made public knowledge.

The coordination of the budgetary activities at all levels of government is a responsibility of the national government. Before 31 March each year, the latter must set the budgetary stability target on a multi-annual basis covering the next three financial years on a rolling basis. The setting of multi-annual budgetary targets must be carried out in conjunction with the development, for the same time period, of a macroeconomic scenario in the Stability Program required by the European Commission. These targets, approved by the Spanish Parliament, will be assessed annually at the end of the financial year in a report made to the government before September 1st each year by the national audit commission.

With regards to the budget preparation process, the legislation on budgetary stability foresees a series of reform measures of different scope according to the competences assigned to each administration.

In the sphere of concern here – that of local government – the measures foreseen in the GABS are:

- A. The setting by the government, following a proposal from the Ministry of Finance, of the overall target for budgetary stability for local governments as a whole. The GABS assigns, to an organization called the National Local Government Commission, the role of the coordinating body which must be informed of these budget stability related activities. The Ministry of Finance is responsible for supervising and monitoring these budgetary activities and may demand any information necessary for this purpose.
- B. Local governments which do not comply with the budget stability target that has been set are obliged to prepare a medium term financial plan to correct the imbalance. This plan must be submitted to the Ministry of Finance as the supervisory body.

As a result, the laws on Budgetary Stability establish the basis for satisfying the principles of budgetary stability arising from the Stability and Growth Pact Settlement agreed at the EU Amsterdam Council of July 1997 for the different levels of government, therefore allowing the challenges facing our economy in the medium and long term to be met.

There has been no shortage of voices, both from the world of management and from the more strictly academic, questioning the need to apply this legislation strictly to local bodies²⁷. So, on the one hand, some people have stated that there is no need for it. This is on the grounds that the deficit and debt figures for local governments

prior to the introduction of the law indicated that the overall behavior of these authorities was characterized in general by relative austerity and responsible conduct with respect to the large macroeconomic targets arising from Spain's agreements with the European Union. In fact table 3 makes clear that there have been budget surpluses and financial charges were far below the figure of 25 percent of current revenue, a limit which had at one time been set as an indicator of the risk of insolvency.

Table 3. Deficit (€millions) and local financial charges (% costs/current revenue)

		1995	1996	1997	1998
<i>Municipalities</i>	Non-financial Deficit (-) or Surplus (+)	410.18	877.35	1,392.57	1,006.50
	Primary Deficit (-) or Surplus (+)	1,744.03	2,202.95	2,528.93	1,937.03
	Financial charges	17.22	17.26	17.25	12.25
<i>Other Local Governments</i>	Non-financial Deficit (-) or Surplus (+)	109.85	588.12	355.99	544.61
	Primary Deficit (-) or Surplus (+)	540.16	1,003.95	710.74	812.01
	Financial charges	-	-	-	-
<i>Total Local Authorities</i>	<i>Non-financial Deficit (-) or Surplus (+)</i>	<i>520.03</i>	<i>1,465.47</i>	<i>1,748.56</i>	<i>1,551.12</i>
	<i>Primary Deficit (-) or Surplus (+)</i>	<i>2,284.19</i>	<i>3,206.90</i>	<i>3,239.67</i>	<i>2,749.04</i>
	<i>Financial charges</i>	<i>14,77</i>	<i>14,87</i>	<i>14,38</i>	<i>11,12</i>

Source: Ministry of Finance

On the other hand, the proliferation of organizations created to implement the new forms of public management (autonomous bodies, municipal companies, consortia, etc.) may forewarn of the possible appearance of “creative” accounting mechanisms which tend to undermine the objective of transparency in financial management. To the extent that identifying budgetary stability with an absence of a deficit in practice implies a quantitative limit on the recourse to new credit operations with a ceiling marked by the repayment of existing debt, governments needing new resources to finance large investment projects may be tempted to use these methods. This would mock the spirit of the budgetary stability legislation and, more importantly, in our opinion, would obviate one of its principal virtues, which is the search for transparency of information. In the event that this occurs generally, and it is

still too early to verify this given the short time the Act has been in force, then the results of this well-intentioned legislation may be questionable.

Concluding Remarks

We began this chapter by highlighting the difficulty of summarizing 25 years of democratic local government in Spain in a few pages. Along the way we have described the successive reforms of the financing model and how they have affected local taxation, inter-governmental transfers and the opportunities for debt recourse, as the principal instruments used to finance an ever greater number of goods and services, while citizens make ever greater demands with respect to their quality.

Having reached this point, we would like to point out by way of a closing note one last aspect which presents an ongoing challenge to the process of decentralization. We are referring to what has come to be known as “second wave decentralization”. In this context, we should remember that, at the outset of the process following the adoption of the Constitution of 1978, the objective under discussion was that, at its conclusion, Central Government would manage only 50 percent of public spending, leaving 25 percent in the hands of the regional governments (the "Autonomous Communities") with 25 percent being managed by local governments. Compared to our neighboring countries, achieving these objectives would have placed Spain in the group of the most decentralized federal countries, even though it was clear from the beginning that the 50-25-25 target appeared to be inspired more by the magic of round numbers than reasoned economic and administrative analysis.

In fact, as the decentralization process has evolved, the management ability of the Autonomous Regional Communities has increased significantly and its volume of expenditure now easily exceeds 25 percent of total public expenditure, whereas local

spending has not changed significantly from the target that was implicitly set (50-25-25).

Seen in this way, it would appear that the significant decentralization process that followed the approval of the 1978 Constitution has stalled at the regional government level and has not reached or had a strong effect on the level of government nearest to the people. In this sense, there are some important nuances which should be taken into account both in the area of the structure of local government and in the broadening of its areas of responsibility.

In fact a simple analysis of the official competences reveals, without much effort, that there are several fields of activity where regional and local governments operate simultaneously. This is the case, for example, for cultural, tourism or urban planning activities. It is often said that an overlap of competences produces inefficiencies in the management of services, either because it causes unnecessary cost duplications or because this overlap prevent either administration from acting effectively as a consequence of a lack of coordination between them. These problems would apparently be solved if there were a clearer definition of competences so that the responsible authorities were identified explicitly and, in this respect, applying the *subsidiarity principle*, such that the more remote authority does not do what could be done by the closest, has been selected as the basic rule for action.

However, there is a risk that this type of analysis may be over-simplistic. In fact, there are many areas of activity where overlapping competences, far from having an adverse affect, actually improve performance. Examples of these are in the areas of infrastructure policies related to local development or the economies of scale which may be generated by regional coordination of public transport in metropolitan areas.

All in all, up to now, in addition to concurrent competences which have not always resulted in the development of cooperation mechanisms for managing public services for the benefit of citizens, local authorities have complained on many occasions about having to perform works which theoretically, in terms of the current legislation on local matters, do not fall within their remit. In spite of this, citizen pressure on the closest levels of government has meant that these governments have become more and more involved in performing certain tasks where regional governments were observed to be deficient, particularly with respect to activities related to social services and local development. This has occurred with no additional financing and has forced local governments to reduce the quantity or quality of their own services or, more often, to increase their level of debt.

The need to reallocate competences between the subcentral government tiers underlies the long list of grievances expounded in the Spanish Federation of Municipalities and Provinces and is behind the so-called *Local Agreement*. The *Local Agreement* results from a political commitment to decentralization from the regional government's management and powers to the Municipalities. Such entities are closer to the citizens' interests. It is aimed at enabling municipalities to have more management competencies and avoiding the overlap of authorities in a jurisdiction. The *Local Agreement* is based on the subsidiarity principle; this implies that the administration which is closer to the citizens must be responsible for a provision of services, more effective and less expensive in terms of public expenditure. Although it is true that in recent years certain legislative measures have been adopted in this regard – for example, expanding the sphere of responsibility of local governments in areas such as movement of traffic (traffic and road safety), public transport (both in terms of collective urban transport and taxis), the use, planning and management of

sporting facilities and activities, training and employment policies, the fields of provision for young people, environment, women, civil protection, social services, tourism or urban planning – these measures have not been accompanied by substantial increases in ordinary financing.

In any event, even in this upper range of competences it will, in practice, be difficult for activities managed by local governments to increase to 25 percent of public expenditure. Spain's neighboring countries, whose local authorities have achieved this ratio of expenditure and even higher have, as a common denominator, the fact that local authorities have responsibility for primary education. In practice, it therefore seems difficult for Spanish local governments to reach these levels unless their competences expand in this direction. Objectively speaking, this is very difficult unless an ambitious reorganization of the municipal sphere is undertaken to achieve minimum population groupings which take advantage of the economies of scale necessary to manage such an important service. Given the current fragmentation at the local level, the generalized decentralization of this type of competence would not make sense. Of course, it could be possible to have asymmetric assignments to the municipalities depending on their size and capacity, but a lot of political problems would arise in determining which municipalities might get additional competences.

At the present time, the current legislation gives the Autonomous Communities the power, albeit via a complex legislative procedure, to modify municipal boundaries and the creation and suppression of municipalities. As a result, a task which so far has not been undertaken, but which seems necessary if it is considered desirable to complete the decentralization process on the basis of the efficient provision of public goods and services, is to realign the territory and redefine the municipal map.

However, this involves overcoming inertias and local resistance which are for the most part unjustified from an economic point of view.

One way of advancing the process would be to initiate the transfer of competences to the most populated municipalities and the recently approved *Act on Measures to Modernize Local Government* has established the legal basis by providing for new forms of government for the most populous cities. Although we have a certain degree of skepticism about the effectiveness of some of the measures included in this law, known popularly as the *Big Cities Act*²⁸, we believe that introducing new forms of management for the most populated areas will facilitate legal access to competences such as civic safety, active employment policies, family policies, education or social services. In fact, it is likely that the progress of municipalism and the policies of proximity within the Welfare State may be considered as the principal objective of public management in future years. The assessment that citizens make about the way the decentralization process is developing will depend critically on the response to this challenge, while not forgetting, of course, the finance issue.

Notes

1. See Lopez Laborda and Monasterio (in this volume).
2. In the preconstitutional period, the main direct taxes existing in Spain were some *Production Factor Taxes* that charged individually the gross income arising from production factors. Concretely, there was a Tax on Capital Income (*Impuesto sobre las Rentas del Capital - IRC*), a Tax on Labour Income (*Impuesto sobre la Renta del Trabajo Personal - IRTP*), a Tax on Industrial Earning (*Impuesto Industrial - II*), a Tax on Urban Properties Income (*Contribución Territorial Urbana - CTU*) and a Tax on Rural Properties Income (*Contribución Territorial Rústica y Pecuaria - CTRP*). All them were collected by central government. IRTP was divided in two parts, an IRTP of dependent workers and an IRTP of independent workers. This last and II included a fix license quotas and a variable one related to the earning. The PFT devolved to local governments were CTU, CTRP, and the fix quotas of IRTP and II.
3. See Monasterio and Suárez-Pandiello (1998) for more details on the AUM, its changes and effects.
4. See Pedraja and Suárez-Pandiello (2003) for an extensive analysis of the model and its development.
5. So, an of this would be the public works made and financed by the private sector, which is who incurs in debt, differing the public financing in the time and becoming this, current expenditures in opposite to charges of debt. Another example is the translation of several fields of public management out of administrative controls, by conforming public or mixed enterprises which could operate in market conditions, avoiding thus the constraints of GABS.
6. At this time tax income was 45% of the total income of Spanish municipalities (49.97% if we exclude financial income)
7. See for example Oates (1972), Musgrave (1983) and King (1984)
8. See Hirsch and Rufolo (1990). Some recent contributions to this debate can be found in the pages of *National Tax Journal*. See Zodrow (2001), Brueckner and Saavedra (2001) and Fischel (2001).

9. The last reform included a new category of property (the so-called “property of a special nature”) including some with a controversial rural or urban assignation such as dams or toll motorways.
10. See, for example, the line of argument in the Layfield Report (1976) on the attempts to reform the British Property Tax. In the United States, many states and local governments have made use of the so called “circuit breakers,” which allow reduced assessment and/or rates for owning families with special conditions such as the elderly, low income, etc.
11. See for example Suárez-Pandiello (2003).
12. See Suárez Pandiello (2002).
13. We must remember that collections have fallen after reform to only 7.89 per cent.
14. Typically, the *Impuesto sobre Matriculación de Vehículos* that charges only one time the first matriculation or putting in service of vehicles.
15. These municipalities share the same percentage they had in MSCT in 1998; as a consequence, their transfer increases annually at the same rate as the nominal GDP (or CPI).
16. Besides, a limit to the effort is established in such a way that, for none of the municipalities, its value is not greater than five times the least value reached for the municipalities of the last population stratum.
17. However, flaws in the regional and municipal transfer system will bring about changes in the short run.
18. These municipalities have a share in some of the central government taxes in which “*large municipalities*” take part (excises taxes on oil and tobacco). The system will be favourable (unfavourable) for these municipalities when the revenue from these taxes is higher (lower) than the corresponding to NTR. It is controversial that tourist municipalities (those according to 51/2002 Act having a *de jure* population higher than 20,000 inhabitants and where the number of secondary residences is higher than that of first ones) should have a favourable legal treatment. On the one hand, they need a greater factor supply to attend to a higher number of inhabitants in certain periods of the year but, on the other hand, they have a higher fiscal base than the rest of municipalities. In any case, it seems clear that MSCT is not the appropriate instrument to do this.
19. For a comprehensive study of the major decisions which shall be taken in line with theory and experience, see Martínez-Vázquez and Boex (2000) and Bird and Smart (2002).
20. NTR compared to nominal GDP used in the five year period 1999-2003.
21. Current NTR is a narrower base than the one used in the five year period 1994-1998. The latter also included business taxes and Social Security tax, precisely those taxes with a higher increase in the last few years.
22. See Pedraja and Suárez-Pandiello (2003).
23. See Pedraja and Suárez Pandiello (2002) for information on differences in funding for the 1994-1998 quinquennium.
24. See Solé and Bosch (2003)
25. It must be borne in mind that, subsequent to the business tax reform, there are now more differences (in revenue-raising capacity) between municipalities where this distributional scheme is implemented because the above tax no longer exists in some of them.
26. About the borrowing limits in Spain and other European countries, see Dafflon (2002).
27. See, for example, Suárez Pandiello (2001).
28. See Suárez Pandiello (2003,b).

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