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KEY ORGANISATIONAL CHOICES FOR FINANCING REGIONAL GOVERNMENTS IN DEMOCRATIC SPAIN

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Abstract

How much power to tax do really enjoy the seventeen new regional governments created in democratic Spain? What other sources of income do they dispose of? Which rules have been implemented for regulating their tax and non-tax sources of income and how are these rules influencing the behaviour of relevant political agents? These are the questions addressed in the present paper. Although no econometric estimation has to my knowledge been provided yet, the arguments and figures provided indicate that the political mobilization and the overspending incentive generated at this level of government must be considered key factors in any explanatory model of the surprising path of growth and development registered in Spain since the mid 1980s. Physical and human capital stocks increased at a spectacular rate so as to substantially narrow the gap, in comparison to European standards, that had been generated over the previous forty years of dictatorship. Public deficits and outstanding public debt remained under control. Spanish per capita real GDP soared from 2,536 Euros in 1980 to 19,456 in 2004.

Keywords: *Multi-level Government, Power to Tax, Financial Rules, Intergovernmental Relations, Political Mobilization, Overspending Incentive.*

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I. Introduction

How much, if any, power to tax do regional governments enjoy in democratic Spain? What other sources of income do they dispose of? Which rules have been implemented for regulating their tax and non-tax sources of income? How are all these organisational rules influencing the behaviour of relevant political agents? These are basic questions to be answered in the present article.

As known, the institutional organisation of government in Spain has undergone a radical transformation since the approval of the 1978 Constitution. From a highly centralized and authoritarian political regime in which there were only two levels of government (central and local), Spain has moved to a democratic and three-level political system (central, *regional*, local) in which many organisational changes have taken place, including those resulting from its membership in the European Union. Because some of these changes have been analyzed elsewhere,[1] the present article will only focus on the rules governing regional governments tax and non-tax sources of income. However, a few introductory comments may be helpful.

The first one refers to history. As history matters and culture transmits values and aspirations, several nationalist parties emerged rapidly during democratic transition in some singular regions or "nationalities" such as Catalonia and Basque Country. Some of these nationalist political leaders participated from the very beginning in negotiations culminating with the approval of the new Constitution and its rules for multilevel policy governance. This, in part,[2] explains why these rules have generated a complex and flexible system for multi-level government that has also evolved through time and that tends to operate very much like a competitive federal system although it was not called so in the Constitution.[3] "State of autonomous communities" *(Estado de las Autonomías)* was the name used for deliberately demarcating it from both traditional federal systems and centralized ones.

Second, although social norms and behavioural-shared principles are not the central focus of this paper, it can be introductorily mentioned here that the commitment problems so frequently found in some Latin American politics have not been very relevant in Spanish politics since democratic transition.[4] Although the organisational rules here investigated have led to a permanent political bargaining process between representatives at different levels of government, and even if the Constitutional Court was very active during the 1980s, political representatives have usually paid much attention to the basic behavioural norms that become dominant in repeated and evolutionary games. Of course, many political confrontations have existed between leaders from all parties and regions, and also inside parties, as it is the case everywhere as cooperation and competition, as well as distributive issues, are central aspects of democratic politics.[5] However, besides all this political tension and hard bargaining, a minimum level of mutual trust has characterized the policy arena so as to minimize the said commitment problems. The new political leaders that emerged at all levels did not see each other in politics just for one legislature and, in fact, many of them have remained in politics for fifteen or twenty years as no limitation exist. They have been forced to interact recurrently, and have paid much attention to the benefits of having a reputation of trustworthiness. They were all fearful of entering a route of political confrontation similar to the one that ended with the Civil War that took place from 1936 to 1939. Many of those who were political leaders during the eighties, were children in the thirties, some with personally devastating experiences. That is another example of how history matters, not only because of the usual path-dependence arguments, but also because it influences social norms and shared values and attitudes.[6]

Third, two political parties that are present in all regions are succeeding each other in most sub central executives, as it has also happened in central government after March 14th, 2004.[7] This has also introduced more stability for intertemporal agreements and policies to be carried out. These political parties in Spain are powerful and stable organisations with democratic and decentralized governance structures at sub central levels that are mainly financed through the central budget according to their electoral results. Therefore, the permanent bargaining already mentioned has usually taken place not only under a stable and well-enforced overall institutional environment but also under stable social and behavioural norms enforcing the pacts finally reached.[8] The decentralising reforms implemented by the social-democratic central governments from 1982 to 1996 have not been reversed, but instead, were advanced by the new Popular Party[9] central governments since 1996 till 2004. Though marginal institutional changes have been implemented from time to time in the organisational rules here investigated, institutional stability has been a salient characteristic of the said institutional framework for financing regional governments in Spain.

Fourth, it is also helpful to mention in this introductory section that the decentralisation of policy tasks and expenditures to regional governments advanced rapidly, as Table 1 shows. Three years after the approval of the 1978 Constitution, regional governments only managed 2.9 percent of total public expenditures. In 2004 they

TABLE 1

PUBLIC EXPENDITURE BY LEVEL OF GOVERNMENT IN SPAIN AS A PERCENTAGE OF THE TOTAL(*)

	1981	2004
Regional Governments	2.92	30.90
Central Government	87.30	56.00
Local Governments (**)	9.74	13.18
Total	100.00	100.00

Source: Ministry of Public Administrations.

(*) Initial budgets. Expenditures coming from social security funds are attributed to the level of government that manage them. Each level also includes expenditures managed by their respective government agencies. Lend-Repay is not included.

(**) Municipalities, Provincial Governments and other Local Governments.

managed 30.90 percent. If we also take into account that total public expenditure in Spain has experienced a significant and rapid growth over those years,[10] there is clear evidence of the high degree of decentralisation achieved in policy tasks. Just in twenty years, regional governments became responsible, on average, for an amount of policy tasks and expenditure quite close to that of traditional federal countries such as Germany or Switzerland.[11] Because the new institutional setting for regional self-governance was designed and initially implemented at the late seventies there is no doubt that "economic growth" cannot be considered an explanatory factor for the said institutional changes and decentralisation process here investigated. Over those years the Spanish economy was suffering from the severe economic crises that took place since 1974 to 1985.[12] Although no econometric estimation has been provided yet, the arguments and figures here provided will show that the overspending incentive and the political mobilisation generated at the regional level of government by the new rules must have been key factors for the surprising path of growth and development registered in Spain since the mid 1980s.

Because Municipalities already existed before democratic transition and they have experienced only minor changes concerning the tasks they are responsible for, the local level of government will not be addressed here. The purpose of the present paper is to concentrate only on the more salient features of the new institutional setting for regional self governance created in Spain.

Fifth, it must be also mentioned that the specific decentralisation model implemented in Spain benefited from the previous existence of an economy that was mainly organized under market rules, even if many policy controls and regulations were in place and had to be progressively eliminated since the very beginning, particularly after the so-called *"Pactos de la Moncloa"* and the central elections that took place in June 1997. Many other reforms in markets and economic sectors with positive consequences on growth took place between 1978 and 1986, but they cannot be addressed here, as we cannot deal either with those economic reforms implemented since 1986 for successfully being a part of the common European market and the European Monetary Union. It must be pointed out, however, that it is in the polity where those reforms are made. This also adds new value to the Spanish system of multilevel political governance created after 1878. Of course, many other organisational reforms have also been implemented in public management procedures at all public administrations levels.[13]

With all this in mind, the present paper examines which organisational rules have been set in place for regulating regional governments tax and non-tax sources of income and how are these rules influencing economic performance in the country. In Section II these basic rules are examined. Section III shows the relative weight of external and internal sources of income by regional governments and compares the situation with that of the Länder in a traditional federal country such as Germany that has also experienced major institutional reforms as a result of European integration and that includes, as it is the case in Spain, a small number of regional/state governments. Section IV addresses the issue of consequences and provides the arguments by which the said organisational rules for financing regional governments in Spain must be considered key factors in any explanation of the surprising path of growth and development registered since the eighties. In the concluding section the main ideas of the paper are emphasized and some questions about the future are posed.

II. The Basic Rules Allowing Regional Governments to Get Tax and Non-tax Income

The 1978 Spanish Constitution explicitly mentions that governments at the "regions and nationalities"[14] *should* have sufficient financial autonomy in order to guarantee them an appropriate degree of autonomy in exercising their functions. However, it was ten years latter through the 1988 Law on the Financing of the Autonomous Communities (L.O.F.C.A.) that the rules of a general financial system applying to them was firstly defined and passed at the Central Parliament[15] ones (the Basque Country and Navarra). The Law gave to the *Fiscal and Financial Policy Council* (F.F.P.C), a body composed of representatives of the central government and the regional governments, the role of coordinating and deciding on future reforms of the rules contained in such a financial system. Several reforms have been carried out since then, but the one made through the Law 14 of December 27, 1996 (which reformed the L.O.F.C.A. as well as the Law of Ceding Central Taxes), represented a watershed.

This law gave the regional governments a limited regulatory capacity over all the so-called *ceded taxes* that they had never previously enjoyed. More recently by the Law 7 and Law 21 (both passed on December 27, 2001), new taxes, as well as some new regulatory capacities, were also ceded to them as indicated in Table 2.[16]

Although these ceded taxes are mainly regulated by central government, the yields so collected are automatically at *regional* governments' disposition for an unconditional use, and no bargaining with central government is needed. The revenue so obtained is considered as own tax revenue for those governments, and so is classified in the IMF tables that will be shown next.

Besides the said ceded taxes, regional governments may also create their *own taxes* according to the rules specified in the updated LOFCA. Because severe constraints are imposed,[17] few regional taxes have been created, and some of these have been declared non-constitutional by the Constitutional Court. These *own taxes* include taxes on bingo games, taxes on underemployed property, taxes on preserves for hunting, taxes on water, taxes on oil-bearing fuels, and some ecological taxes. Altogether they provide an amount of revenue much lower than the one provided by ceded taxes. According to the 2002 Regional governments' budgetary figures, about a 70.62 percent of their own tax revenue usually comes from ceded taxes.

The *surcharges* they may add on some central taxes and others (surcharge on Personal Income Tax, etc.), and the fees, rates and prices charged for governmental services complete the regional governments sources of own income according to the LOFCA rules. *Grants* received from different sources (conditional and unconditional grants coming from several Funds, investment agreements, etc.) and the income received through *borrowing* constitute their external sources of income in the prevailing organisational setting.

TABLE 2

TAXES TOTALLY OR PARTIALLY CEDED TO SPANISH REGIONAL GOVERNMENTS(*)
AND REGULATORY CAPACITIES ATTRIBUTED TO THEM

General Property Tax	Ceded the 100% of tax revenues. Management by regional government. Regional governments may regulate the tax rate structure and the minimum property that is exempted.
Inheritance and Gift Tax	Ceded the 100% of tax revenues. Management by regional government. Regional governments may regulate the tax rate structure and the reductions applicable on property bases.
Property Transfers and Stamp Taxes	Ceded the 100% of tax revenues. Management by regional government. Regional governments may regulate the tax rates.
Gambling Tax	Ceded the 100% of tax revenues. Management by regional government. Complete regulatory capacity by regional governments.
Personal Income Tax (Law 14, 1996 and Laws 7 and 14, 2001)	Ceded the 33% of the regional PIT bases. Management by central government tax agency. Regional governments may settle the *complementary tax rate structure* to be applied to the 33% of regional PIT bases. This structure must have the same divides as the central rate structure and also be progressive. They may add new family, personal and other deductions besides the ones settled by Central Government.
New taxes ceded through the laws 7 and 21, 2001	
Taxes on Tobacco, Alcohol and hydrofoils	Ceded the 40% of tax revenues. Management by central government tax agency. No regulatory capacity by regional governments.
Taxes on Electricity, Motor Vehicles, and retailing particular fuels	Ceded the 100% of tax revenues. Management by regional government. No regulatory capacity by Regional governments.
Value Added Tax	Ceded the 35% of tax revenues. Management by central government tax agency. No regulatory capacity by regional governments.

Source: Own made through the Law 14 of December 27, 1996, and Law 7 and Law 21 both of December 27, 2001.

(*) Except for Basque Country and Navarra that enjoy a special *foral* financial system.

III. The Relative Weight of External and Internal Sources of Income

If those are the basic rules governing the taxing powers and other sources of income by regional governments, how much money do they receive from each source? The figures of Table 3 provide us an overall look at the relative magnitude of the income they obtain by comparison to the situation existing in a traditional federal country such as Germany that, as already indicated, includes, as it is the case in Spain, a small number of state governments and has also experienced major institutional reforms as a result of European integration.

Table 3 clearly indicates that *regional* governments in Spain receive a substantial proportion of revenue through the grants coming from superior levels of government: a 57.28 percent in 2000. By contrast, grants received by the Länder account for only 16.16 percent of the total revenue in 2000. Whereas in Germany this percentage has remained stable over the last fifteen years, in Spain it reached a 70.25 percent in 1988. These National Account figures admit no contest, even if they do not show the positive effects on the regional governments own tax revenue resulting from the few more taxes partially or totally ceded to them for 2002 and following years already indicated in Table 2.[18]

This comparative external dependency that regional governments confront to as a result of the financial rules in place manifests also in the fact that they may only vary the yields obtained from their own tax sources (ceded taxes and own taxes) in a limited way. As mentioned earlier, most of these yields have come from ceded taxes that are mainly subject to central regulation. Of course, they do not participate in regulating central taxes. Nor for the moment.[19] This financial external dependency looks even grater if we consider that the Law on the Financing of the Autonomous Communities (LOFCA) has always settled limits to the regional government borrowing as source of income. These limits became more severe after the 18/2001 *General Law for budgetary stability* and the 5/2001 *Complementary Law for Budgetary Stability*, both passed at Central Parliament.[20] Table 4 shows

TABLE 3

REVENUE FOR REGIONAL-STATE GOVERNMENTS IN SPAIN AND GERMANY
(Year 2000. % of the total. National accounts)

	Spain	Germany
Grants	57.28	16.16
Own tax and non-tax revenue	37.29	81.38
Borrowing	5.43	2.46
Total	100.00	100.00

Source: Own made through International Monetary Fund 2005 Report. Figures of public domain.

that regional governments contributed to the total outstanding debt in a very low proportion over those years. Roughly speaking, the central government has contributed over the period nine times more than regional governments. Total debt has also been in Spain under the European average as it is shown in Table 4. Annual public deficits have remained also under control over the period. Regional governments contributed moderately to the total deficit that has also remained around the European average, as figures of Table 5 show.

TABLE 4

GENERAL GOVERNMENT OUTSTANDING DEBT IN SPAIN
(% of the GDP-National Accounts)

	1991	1996	1998	2001	2004
Regional Governments	2.7	6.3	6.2	6.4	6.2
Local Governments	4.1	4.0	3.5	3.0	2.9
Central Government	37.3	55.9	51.6	46.0	37.2
Social Security Funds (*)	0.6	0.6	0.3	0.2	0.1
ALL GOVERNMENTS in Spain	44.7	66.8	63.2	55.6	46.4
EU AVERAGE (Euro zone)	57.4	76.1	73.8	68.3	69.8

Source: Bank of Spain Statistics Bulletin. Figures of public domain.
According to the European excessive-deficit protocol.
(*) Central government decides this debt.

TABLE 5

ANNUAL PUBLIC DEFICITS IN SPAIN
(% of the GDP-National Accounts)

	1991	1996	1998	2001	2004
Regional Governments	–1.4	–0.6	–0.4	–0.6	0.0
Remaining Levels of Government(*)	–3.0	–4.4	–2.6	+0.1	–0.1
ALL GOVERNMENTS in Spain	–4.4	–5.0	–3.0	–0.5	–0.1
EU AVERAGE (Euro zone)	–4.4	–4.3	–2.1	–1.8	–2.8

Source: Bank of Spain Statistics Bulletin. Figures of public domain.
According to the European excessive-deficit protocol.
(*) Includes Central and Local levels, plus Social Security Funds.

The said low power to tax and high financial external dependency of regional governments does not necessarily mean that their executive branches have had little money and a low degree of discretion for pursuing their policies.

If we remember that total public expenditure in Spain amounted to a 24.9 percent of GDP in 1974 whereas in 1992 it already amounted to a 48 percent, and that the regional governments' share in this huge increasing pie also grew spectacularly as indicated in Table 1, it is already evident that a permanent and successful struggle for policy tasks and for grants has characterized intergovernmental relations in Spain since the 1980s, because regional governments have enjoyed almost no power to tax.

GDP figures also show the significant increase in resources those governments have been managing. The total income (conditional and unconditional, including borrowing) for which they have been responsible amounted to 6.45 percent of Spanish GDP in 1988 whereas in 2001 it reached 11.69 percent. Figures in constant Euros provided in Table 6 are also very much informative. Even if around a fifty per cent of their total income has usually come from conditional appropriations linked to specific collaborative or agreed projects, regional governments have disposed of a huge and increasing amount of unconditional financial resources for pursuing their own policy objectives. Yes, there has been a spectacular increase in resources. There is no mistake in the figures in constant Euros provided in Table 6.[21]

TABLE 6

CONDITIONAL AND UNCONDITIONAL FINANCIAL RESOURCES
OF REGIONAL GOVERNMENTS IN SPAIN(*)
(1995 constant Euros)

	Unconditional income	Conditional income	Total income
1988	11,099,889,269 (45.5%)	13,030,304,760 (54.5%)	24,130,194,029 (100%)
1993	15,328,262,259 (39%)	23,974,974,300 (61%)	39,303,236,559 (100%)
1999	29,880,456,935 (53.52%)	26,275,259,910 (46.79%)	56,155,716,845 (100%)
2001	33,646,003,266 (53.05%)	29,777,188,560 (46.95%)	63,423,191,826 (100%)

Source: Ministry of the Economy and Finances.
(*) Except the two *foral* ones. Ceuta and Melilla autonomous cities are not included.

IV. On the Consequences Derived from the New Institutional Setting for Regional Public Finances

So, which consequences can be attributed to this institutional setting that regulates the Spanish regional governments' tax and non-tax sources of income? The two most salient issues are, no doubt, the strong political mobilisation and the permanent overspending incentive generated at this level of government. As a result, the physical and human capital gaps created over the forty previous years of dictatorship, by comparison to the European standards, have been rapidly shortened. Although no econometric estimation has to my knowledge been provided yet and several other factors[22] have had a positive impact on growth, this mobilisation and overspending generated must have been key factors for the surprising path of growth and development registered in Spain since the mid 1980s.

Concerning political mobilisation, as it is well-acknowledged the existence of an asymmetry between spending responsibilities and tax revenue-raising capabilities of sub central governments inevitably generates an overspending incentive on the part of these governments. This is because the gap generated will have to be filled using a complex system of intergovernmental grants coming from upper levels of government rather than by raising regional taxes. This bias meets the favour of both organised groups and people in general at the regional level because political regional representatives may show themselves in regional mass media (including the public regional TV channels they are usually responsible for) as working hard to secure money to carry out their policies for increasing economic and social development in the region.

Getting public infrastructure built by private building companies and paying for this with central grants received is a salient aspect of such an institutional setting. The same is true for other policies sub central governments implement in order to ensure re-election in their autonomous electoral processes. This is what has happened in Spain because no budgetary constraint has, in fact, existed upon these regional governments till the latter 1990s and half of the said grants have been of an unconditional nature as indicated in Table 6.

Although rooted in a similar incentive, this political mobilisation and overspending cannot be appropriately explained through the so-called "flypaper effect" that is pointed out in the traditional grants in aid public finance literature, mostly referring to the USA case.[23] Firstly because the Spanish regional governments enjoy almost no independent power to tax. And secondly because central government leaders have not usually disposed of a full discretion to decide the amount of grants to be transferred to sub-national governments. In order to form a majority in the Central Parliament moderate nationalist political party representatives at this Parliament (particularly those from the moderate Catalan nationalist party, and also those from the Basque nationalist party) have often played a pivotal role. The Spanish central government has often been empowered because it has had the support of one or more of these nationalist parties that have been the dominant party at their respective territories since the very beginning after democratic transition, sometimes enjoying an absolute majority in their regional legislative chambers. The general financial system in place and the amount of grants being transferred to regional governments have always been the result of multiparty negotiations. Nationalist party leaders have always profit from their pivotal position for advancing decentralisation one way or another.[24] Their attempts to obtain revenue raising powers have been much less successful as we saw in previous sections.[25]

Because regional governments were successful in achieving more and more policy tasks and financial resources, and because there were so many gaps to be addressed after forty years of dictatorship, by comparison to European development standards, the political mobilisation and the overspending incentive generated at this regional level by the rules here investigated must be considered key factors in any explanation of the substantial close of the said gaps that has taken place in Spain over the last quarter of the twentieth century.

Spanish per capita GDP went from 2,536 euros in 1980 to 19,456 in 2004, according to National Statistics Bureau (INE) figures. All regions benefited greatly. People employed went from 11.8 millions in 1980 to 17.9 millions in 2004. Private and public capital stocks (economic and social infrastructures) increased at a spectacular rate. New school buildings, ports enlargements, new public hospitals, new buildings for the Courts, new industrial estates with facilities for new firms settlement, new accesses and facilities in public beaches for helping to attract more tourists, new universities, etc., are some examples of these infrastructures for which all regional governments are now responsible for. Central government also invested in other infrastructures under their responsibility such as national highways and routes, airports, Spanish satellites, etc. Tortosa-Ausina (2001, p. 183) shows that the capital stock in Spain increased a 75.8% in real terms over the first twenty year of democracy, that is, at an average annual rate of 3.75% in real terms.[26] Many concrete examples could be mentioned here, but let me just indicate that whereas in 1980 there were only two Public Universities in the Valencian Community, at present times there are five. The three new ones, with their own and new facilities, have been built by regional government and they already rank even higher than the older ones in many aspects in the official teaching and researching rankings that are being elaborated. In Andalucia there are now ten Universities. As capital transfers to firms have also been a part of the said regional governments' public spending,[27] there is no doubt that a spectacular increase in the physical and human capital stocks of the Spanish economy has taken place over those years.

Although a negative assessment based on efficiency considerations is usually made when authors analyse the said overspending incentive or sub-national governments "tax non-responsibility", particularly when referring to long-established democracies,[28] the arguments and figures here provided lead to a different assessment as already indicated.

In those general analyses it is often asserted that when sub central governments have enough power to tax their constituents for performing their tasks, these political leaders, as well as constituents and organised groups, are collectively forced to balance the total benefits and costs, as well as their distribution, of governmental policies in a way that is not the case under a system where bargaining for central grants becomes a main tool for obtaining income. There is no doubt that efficiency problems concerning the use of common pool financial resources are higher in sub central politics when higher is the importance of the intergovernmental grant system. This has been the case in Spain because political leaders at all regions have usually been immersed in hard multi-party negotiations for grants with central government leaders since the very beginning as they have always enjoyed almost no independent tax power as previously indicated. When money comes from outside, less care is paid on to how it is finally spent.[29]

Because so much money has been spent by regional governments in Spain in such a short period of time (most of this money coming from "external" sources of revenue), those considerations are relevant here if a comparative assessment of potential alternative uses of these public expenditures and their consequences is to be made. This is, nevertheless, a controversial task because it requires that we take into account the hypothetical alternatives existing during those years. As such it is beyond the scope of this paper. If this task were to be accomplished, however, it should be taken also into account that all efficiency gains obtained in the working of the polity because of the said more balanced, and collectively reached, consideration of the benefits and costs of policy actions at the regional level must be compared with the efficiency losses that might also result from the assignment of a full power to tax to these sub central units. Among these efficiency losses it might be mentioned here the one derived from the generalized disregard that would surely come out of the positive and negative external effects some sub central policies have for other neighbouring regions. As it is well known, this spill-over problem is partially corrected in all western democracies by the conditional grant system. Grants in all western democracies also produce, in fact, beneficial impacts on regional solidarity and regional welfare because several central funds exist whose money is allocated as grants among sub central governments according to more or less quantitative ratios of underdevelopment. So, the equity losses generated by eliminating grants as a source of income should also be taken into account because equity is collectively assessed in positive terms, as the principles of regional solidarity and redistribution usually settled in constitutions reflect.[30] The gains derived from a cutting in central grants to induce a slowdown in sub central expenditures in order to accomplish macroeconomic stabilisation ratios under central government responsibility, an instrument that is in fact used, would be also lost if sub central governments were not dependent on grants.

However, the purpose of this paper is not to deal with these and other efficiency and equity distortions that might arise as a consequence of decentralising the power to tax to sub central units of government.[31] And it is so because the Spanish decentralisation process has been very much asymmetrical with very little power to tax being transferred.

By comparison to the forty previous non-democratic years, the settlement of general electoral rules in 1978 had, no doubt, a significant impact with regard to the mobilisation of all political agents in searching for economic and social needs to be solved as a way to ensure re-election. What the asymmetrical decentralisation to the regional level and the financial system examined added in this respect was, firstly, more frequent elections run by regional candidates who were closer to the issues to be dealt with and to the affected groups of regional constituents. And, secondly, it added a new, strong incentive to work hard in order to ensure re-election by finding local and regional opportunities for public action because it was not necessary to increase taxes over regional constituents for implementing new policy projects, but to successfully bargain for more grants at upper levels. If these new governments had been forced to increase their own taxes on regional constituents as a main source of revenue, a different path would have resulted.

Because the central taxes whose revenues are totally or partially ceded to regional governments still are managed and collected by the Central Tax Agency, and because those other taxes that are partially or totally regulated and managed directly by these regional governments are few and of little significance, it can be stated that the aforementioned new institutional setting has not caused any relevant increase in those transaction costs derived from tax compliance. A unified form exists for each tax, except in the case of the two *foral* communities. Of course, no competition between those governments to attract tax bases by reducing tax rates (mainly on business) have taken place, except in some minor, insignificant and already solved cases affecting the said two *foral* communities.[32] No tax race to the bottom has, then, occurred. And the same is true for those other efficiency and equity distortions that frequently arise from tax competition strategies by sub central units of government when they independently control personal, corporate or other direct and indirect taxes as previously mentioned.

The said overspending incentive has not either generated an exploding situation. Total public expenditure in Spain in relation to GDP has remained under the European Union average. The same is true if the Spanish regional governments' expenditures are compared with that of the German Länder, for example.[33] And even if public expenditure on health, education and social security by all levels of government increased very much over those years, they still are under the EU average. In 2000 they were, for example, about ten points lower in Spain than in Germany in relation to the GDP according to comparable National Accounts IMF figures (23.32 percent of GDP in Spain versus 33.56 in Germany).[34]

Not only deficits and outstanding debt remained under control as shown in previous Tables 4 and 5, some other positive effects for efficiency and growth could also be emphasized if other aspects of the Spanish model of decentralisation were taken into account. Although this transcends the purpose and space attributed to this article, it can be just mentioned that this model has also produced a strong incentive to innovation in public management procedures and policies, which is often invoked to support decentralisation of some policy tasks. Initiatives developed by a political team at a regional executive (concerning both spending initiatives as well as organisational innovations in regional public sector organisations) were imitated by other regional executives. The special report on Spain published in the leading The Economist in December 1996 is very much ilustrative as providing straitforward quantitative evidence on those issue is not an easy task. A more recent special issue in The Time on Spain entitled "*Spain takes on the world*" emphasizes similar mobilisation aspects.[35]

The same is true for the improved control of public sector management achieved in Spain as a result of the specific model of decentralisation and financing implemented.

And this is so, first because members of regional executives and their teams of vice-ministers, general directors, etc. are only responsible for regional bureaus and not for all public administrations in the country. Activities to be supervised become less, and closer again to people in charge. Purposes can be achieved, in principle,[36] with greater public sector efficiency.[37] And secondly, because once the total amount of grants has been negotiated for a budgetary year, all gains derived from costs saving strategies in the management of regional public sector organisations remain under regional executives control, what also creates new incentives. Horizontal accountability has therefore increased substantially over the period as a result of the strong incentives examined here. Vertical accountability also increased significantly as seventeen new democratic political processes were created.[38]

V. Concluding Remarks

The arguments and figures provided allow for a straightforward conclusion. Contrary to what many general analyses of intergovernmental relations predict when referring to long established democracies, I have argued that, because of their consequences on political behaviour, the governance structure investigated here must be considered a key factor in any explanation of the surprising path of growth and development registered in all regions over the last quarter of the twentieth century in Spain. The new rules have contributed to substantially close the public and private capital gaps (economic and social infrastructures), in comparison to European development standards, that had been generated over the previous forty years of dictatorship. Physical and human capital stocks increased at a spectacular rate so as to substantially improve the competitiveness of the Spanish economy.

Although regional governments in Spain have been enjoying an increasing amount of their own tax revenue, they have been very much dependent on grants. Borrowing has also been centrally controlled to a large degree and, in fact, most of their own tax revenue has come from the so-called *ceded taxes* over which they only have limited regulatory capacities. The taxes they independently regulate and manage are insignificant. This institutional setting has therefore generated an overspending incentive and a strong political mobilisation at the regional level because it has not been necessary to increase taxes over constituents for implementing new policy projects, but to bargain for more grants at higher levels. Although the system was designed when the Spanish economy was suffering from the severe economic crises that took place from 1975 to 1985, the Spanish GDP could increase substantially on average since the mid eighties. As western modern taxes were also settled at the central level from the beginning of democratic transition, an increasing amount of tax revenue has been collected over the years for financing government policies at all levels, particularly at the regional one. No relevant budget constraint has, in fact, existed over those years. Most of this public income has come from the increase registered in the Spanish tax revenue in relation to GDP (from about a 18 per cent in 1978 to more that 35 per cent in 2000 and following years). Moreover, Spain has also been receiving as public income from the European Union budget an average of 1.2 percent more each year in net terms since its membership in 1986. Public deficits and outstanding public debt have remained under control. As indicated, horizontal and vertical accountability, as well as policy innovation, increased also as a result of the asymmetric and competitive model of decentralisation implemented.

All these are conclusions about the past, of course. However, might these positive consequences remain for another twenty or twenty five years? The institutional approach employed here, because it is a situational one, clearly conveys the idea that consequences are always situational dependent variables. And it is also evident that situational circumstances are changing significantly at present in Spain. Once these new circumstances are considered, it is unclear that, if unchanged, the organisational structure for regulating regional public finances examined here will continue to play a key role in propelling growth as it has done in the past.

First of all, as the aforementioned gaps are gradually being narrowed, less and less positive value can be attributed to the overspending bias. A new external budget constraint is also in place since the late 1990s, because the so-called "European Stability and Growth Path" settled limits to public deficit and outstanding public debt of the EMU member countries. These new constraining rules have already been influencing intergovernmental relations in Spain over the last recent years. Total public expenditure in relation to GDP has been going down in Spain as a result since the late 1990s, as previously mentioned.

However, this is not all concerning new circumstances, because new claims for greater financial autonomy have emerged in several regional political processes. Moreover, the new ten states that joined the EU in 2004 will get most of the European Funds after 2007, as already agreed at the last European Council held under the UK presidency in December 2005. This will result in a significant financial cut for most Spanish regional governments. New political disputes are also emerging because regional governments have to respond to the increasing demand for health and education services stemming from the significant increase in the number of immigrants settling in their territories. New financial resources are claimed for those regions with a higher level of immigration if the quality of these services has to be maintained or improved.

If circumstances change significantly, and participants are not able to modify those affected institutional arrangements, then consequences of prevailing institutional settings may drastically change. This is why analysing the past is always easier than predicting future performance when human affairs are considered. Looking at these past years however, it seems evident to me that it must not be by chance that a salient issue in the political agenda of the new government in office after March 14, 2004, is the reform of the territorial organisation of government and the general financial system investigated here. Committees formed by representatives from all political parties have already been created at several regional legislative chambers to start the process of reforming their respective self-government Statutory Laws. The debate on how to reform the general financial system has also started at the *Fiscal and Financial Policy Council.* Whether or not these very recent changes in institutional an non-institutional circumstances may slow down the current "rise of the nation" is an issue that transcends the scope and space assigned to this paper.

Notes

1 See Toboso (2005a).
2 Colomer (1998) deals with this and other causal factors from a very illuminating institutional game theory perspective.
3 For similar statements see Elazar (1998, p. 21), and Peces-Barba (2002, p. 73).
4 For the Argentina case see Saiegh and Tommasi (1999) or Tommasi, Saiegh and Sanguinetti (2001). See also the very much cited articles by North (1993a), Weingast and Marshall (1988), or Weingast, (1989).
5 See Colomer (1990, chaps. 10 and 15) for an institutional analysis of the political and military tension created by main players during the failed military coup that took place in February 1982, or the political tension created by the successful general (not only labour) strike that took place in December 1988. NIE analyses on distributive consequences of institutional arrangements can be found in Knight (1992), Libecap (1989), Williamson (1996a), (1996b) and (1997), Dixit *et al.* (1998).
6 On this see North (1994), and North (2005, chaps. 3 and 4).
7 The first turning in central government took place in 1982 when the social-democratic party (PSOE), under González leadership, won general elections. The second one took place in 1996 when victory went to the side of Popular Party and Aznar. And the third one occurred after March 11th, 2004, when the social-democratic party won general election again, this time with Rodriguez Zapatero.
8 On the economic consequences of stability in formal and informal institutional structures see North. (1990, chap. 12), and Williamson (1996c).
9 Of a centrist/conservative political orientation.
10 Total public expenditure amounted to a 24.9 per cent of Spanish GDP in 1974, whereas in 1992 it already amounted to 48 percent. This percentage started to go down since 1992 and it is now arround the 40 percent in National Account figures.
11 Toboso (2005a) shows that the German Länder managed 25.59 percent of total public expenditure in 2000 whereas in Spain regional government managed 16.93 percent, according to comparable IMF national accounts figures.
12 See Garcia Delgado (1990). As straighforward figures showing the magnitud of such an economic crises, it can be mentioned that the unemployment rate went from 3 per cent in 1974 to 21.5 per cent in 1985, according to Statistics National Bureau.
13 They all have been very pro-market ones in the line of the so-called new public management. See, for example, the analysis by Cabases Hita *et al.* (2003) on how efficient are public hospitals.
14 This two different terms were explicitly used in the 1978 Constitution in an attempt to settle that some regions "were more than regions", that is, that they had time ago an independent political history from the common history most others had at those years. This still is a controversial issue in the Spanish politics. In this paper the term *regional* government or *autonomous* government are indistinguishly used as a shortcut to mention the government of both regions and nationalities.
15 The rules of the LOFCA apply to all regional governments except for the two so-called "foral" ones. "Foral" relates to the *fueros*, that is, to some traditional political privileges once awarded by a King to a city or region. In order to reach general conclussions that might be of interest from an international point of view, the particularities affecting these two autonomous communities in the north of Spain (Basque Country and Navarre) will not be addressed here.
16 At present, the process of reforming Staturory Laws that has been initiated by the approval of the Valencian and Catalan ones will surely culminate with a new step in attributing taxes and regulatory capacities to these governments.
17 Tax bases that are already subject to central government taxation cannot be taxed again, tax export effects are not allowed, and regional taxes cannot undermine the existence of a common market.
18 These new ceded taxes are the indirect taxes indicated in Table 2 in the last three rows, plus an increase in percentage in the case of Personal Income Tax. Though comparable National Accounts figures are not provided yet for these two countries, Pérez-García (2002) has made a simulating and hypothetical estimation in the Spanish case by which a relevant increase in own tax revenue is predicted, however grants still remain very significant as a financial source for most regions and nationalities.
19 The Senate has less in common with the German Bundesrat even if the 1978 Constitution says that it "should" be organised as a territorial chamber. See Span *et al.* (1998, p. 107).

[20] These two Laws require that ex-post annual deficits be compensated with superavits during the next three budgetary exercises. After being regional governments' plans for so doing discussed at the *Fiscal and Financial Policy Council,* an approval by the Ministry of Finance is required. Article 9 of the 5/2001 Law settles that the Ministry of Finance will also be responsible for the approval of new debt by regional governments, being his decision conditioned to how regional governments contribute to the budgetary stability purpose of the country, as the EMU compromises require.

[21] If we pay attention to the consolidated total income managed by these fifteen Regional Governments provisionally provided for 2002, the figure has increased again to reach 83,745,413,000 current 2002 euros.

[22] Factors such as those depicted in the previous introductory section, and even some others that are not either the focus of the present article. On the many ways formal and informal institutional frameworks usually impact upon growth see the much cited contributions by North (1990), (2005) and Rodrik (2000), (2004) and (2006).

[23] See Gamkhar and Oates (1996), Deller and Maher (2005), Turnbull (1998) or Strumpf (1998).

[24] The particularities of the Basque Country and Navarre foral financial system cannot be addressed in a short paper like this one. See Toboso (2005a).

[25] Referring to the well-known expression "coffee for all" (café para todos), Giordano and Roller (2004) emphasizes that all regional governments subject to the general financial system have finally achieved a similar level of policy responsibilities than the one enjoyed by the most demanding one.

[26] See also Mas *et al*. (1996), (2001) and (2003).

[27] According to final budgetary consolidated figures provided by the Ministry of Finance, capital transfers to firms by regional governments, including Basque Country and Navarre, amounted in 2002 to 9,300 millions of Euros, whereas their direct public investing amounted to 8,500 millions.

[28] See, for example, Oates (1999, p. 1126), Oates (1997), (1998), and also Frey (2001, p. 167). In Spain, Suarez-Pandiello (1998, p. 250) shares these worries. A similar assessment is made on the Argentina case by Saieg and Tomassi (1999), Sanguinetti and Tomassi (2000) and (2004) for those situations in which central government accommodates ex-post to the fiscal deficits of subcentral ones, which causes full insurance for problems of vertical fiscal imbalances but originates the so-called "tragedy of the fiscal commons, with excessive sub national spending…". Oates (2005) refers, however, to a "second generation theory of federalism" in which some NIE insights on the issue could be incorporated.

[29] See the institutional analysis on the topic contained in the classic text by Ostron (1990).

[30] See Köthenbürger (2002).

[31] We do not pay attention either to those cases in which tax competition by independent sub-national governments leads to fiscal distortions such as tax exporting, NIMBY taxation, beggar-thy-neighbor tax competition or race to the bottom tax competition. On this see Inman and Rubinfeld (1996), Sato (2000), Besley and Rosen (1998), Blackorby and Brett (2000), Oates and Schwab (1988), Oates (1999), or Kirschgässner and Pommerehne (1996).

[32] On this issue see Jimenez and Barrilao (2001) and Esteller (2003).

[33] According to IMF comparable figures, total consolidated public expenditure amounted to a 38.13 percent of GDP in 2000 whereas in Germany they amounted to a 48.17 percent.

[34] See Toboso and Ochando (2002) for a detailed analysis.

[35] See The Economist (1996) and The Time (2004). In The Economist report, it can be read that "*Spanish regions are playing a game of leapfrog, forever seeking more powers than their rivals*", and that "*economically Catalonia is Spain's most successful region... (It) has always been more outward-looking than other Spanish regions. And Barcelona could claim to be Europe's most successful city. A new airport, a new seafront, new roads, thriving businesses, Spain's biggest saving bank, and the 1992 Olympic games"* (pp. 15-16).

[36] Of course, occasional corruption political scandals has also come up.

[37] Many references could be provided on this issues. See, for example, Horn (1995), chapter 5. Bañon and Tamayo (1998) investigate how is being re-organised the remaining Central Administration since tasks and public workers are being transferred to the regional level. Caballero (2005) points out to role played by the "market preserving federalism" arguments emphasized by Weingast (1993) and (1995).

[38] Subirats (1998, p. 177) has calculated that, on average, each regional government was formed by arround 250 new politicians, including both the elected ones in the executive or legislative tiers and the public administration high officials who are freely appointed by each executive.

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