Regional financing reforms and the Catalan agreement

The recent fiscal agreement reached with Catalonia seeks to increase the region's fiscal autonomy, bringing with it the potential to reshape Spain's autonomous financing framework. Nevertheless, while implementation faces challenges, it underscores the need for comprehensive debate on the future of Spain's interregional equity and fiscal stability.

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Abstract: The recent agreement reached between Catalonia's Partit dels Socialistes de Catalunya (PSC) and Esquerra Republicana de Catalunya (ERC) marks a potential shift in Spain's regional financing model, aiming to enhance Catalonia's fiscal autonomy while minimizing interregional redistributive flows. Key proposals include transferring the administration of all taxes collected in Catalonia from the central government to the regional tier and establishing a "Catalan contribution" to offset reduced central taxation power. Financial projections indicate that Catalonia's per capita financing would substantially rise. More broadly, however, the agreement could lead to structural changes in Spain's decentralization framework, reducing central government fiscal capacity and potentially influencing other regions to pursue similar autonomy arrangements. While the agreement faces implementation challenges, including the need to reform basic legislation and address the risks of increased tax competition and fiscal fragmentation, it ultimately underscores the need for comprehensive debate on the future of Spain's interregional equity and fiscal stability.

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Foreword

On 30 July 2024, two Catalan political parties, Partit dels Socialistes de Catalunya (PSC) and Esquerra Republicana de Catalunya (ERC) struck an agreement to inaugurate the socialist party's candidate as the president of the regional government of Catalonia (PSC & ERC, 2024). A core part of that agreement has to do with the region's funding.

The deal reached significantly reinforces the regional government's autonomy, to the point of minimising the state's room to tax in Catalonia. In addition, the preliminary analyses (De la Fuente, 2024b) point to a substantial reduction in today's interregional redistributive flows, with Catalonia benefitting from the new scenario. Nevertheless, the inauguration document leaves important matters undefined, impeding an accurate quantification of its impacts and obliging us to resort to simulation of a series of alternatives making different assumptions about several aspects of the agreements. Moreover, its implementation will require amendments to organic laws, involving a debate in the Congress of Deputies and absolute majorities at a time when votes are highly fragmented.

The goal of this paper is to analyse the agreement and its implications. To do so, we briefly review its core aspects, take a look at its potential financial consequences, identify other economic derivatives of the agreement and, finally, debate some of its broader implications for Spain's current subnational government system.

The contents of the agreement

As far as the regional financing regime is concerned, the core goals of the agreement between PSC and ERC are to achieve full financial autonomy for the Catalan regional government, prioritise bilateral relations between the regional and central governments, and obtain a substantial increase in funding for Catalonia by reducing its contribution to other regions of Spain. To deliver these three goals, the parties have agreed on the following two fundamental changes to the existing model:

a) Replacement of the state tax authority (AEAT) with the Catalan tax authority (ATC) for the management, collection, settlement, and inspection of all taxes borne in Catalonia, giving the regional government significantly greater regulatory power. The handover would be implemented on a staggered basis, starting with personal income tax in 2025.

b) To offset this withdrawal by the central government, the idea is to create a "Catalan contribution to the state's finances", made up of two components: (i) a contribution to the central government's expenditures; and (ii) a contribution to the interregional equalisation system (a

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"solidarity" contribution as it is termed in the agreement) which would be limited by the "no reordering principle". In other words, Catalonia's position on the regional ranking must be the same before and after the equalisation payments.

The combination of these two changes looks similar to the special regional tax regimes in place in the Basque region and Navarre, albeit with certain differences. Firstly, in the case of Catalonia, the agreement states that the region will continue to contribute to the regional equalisation system, albeit in an as yet undefined amount. Secondly, the ultimate scope of the tax regulation powers to be delegated to the Catalan regional government has yet to be specified. The lack of definition in both instances will have to be resolved via a later negotiation process and then written into law, adding uncertainty around their implementation.

The scale of the changes agreed means having to amend organic laws in the Congress of Deputies, which would, in turn, imply having to garner the support of at least 176 deputies, a threshold that might be hard to reach considering the diversity of public positions around regional financing.

Financial consequences of the agreement

The lack of definition described in the previous section makes it impossible to accurately estimate what impact effective implementation of the agreement might have. What we can do is quantify scenarios making assumptions for some of the inputs, most importantly the region's "solidarity" contribution to the rest of Spain. De la Fuente (2024a) has already run some scenarios for the economic impact on the Catalan and Spanish treasuries. He assumes that the size of the intraregional contribution will be set as a function of the Catalan regional government's deficit reduction target in 2023. By his calculations, the impact in the medium-term would range between 6.6 billion and 13.2 billion euros, which would imply increasing the regional government's like-for-like financing per capita by between 25% and 50%, starting from an index per capita (relative to the average) of 101 in 2022.

Fernández Leiceaga and Lago Peñas (2024) use a different approach to run their scenarios. Under the terms of the agreement, the Catalan treasury would be allocated all taxable income generated in its territory in 2022 and would be expected to contribute to the state government's expenditure in proportion to its gross domestic product (GDP). The Catalan tax authority would increase its net income by 5.28 billion euros and its adjusted financing index per inhabitant would increase to 120, the average being 100. If the contribution to the central government's expenditure were calculated in proportion to its population, the figures above would increase to 9.04 billion euros and an index of 135, respectively. In both instances, implementing a "solidarity" contribution would decrease the figures proportionately. For example, if the Catalan contribution to interregional equalisation under the new system were 50% of its contribution under the current system, the top-up for the Catalan treasury would be 2.64 billion euros if the contribution were calculation as a function of GDP and 4.52 billion euros if it were estimated based on the population of Catalonia.

In addition, the authors simulate what would happen if the Catalan arrangement were applied across the board to all of Spain's autonomous regions. Without any

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redistribution and assuming that the regional contributions to government spending are calculated based on GDP, the movements in adjusted financing per inhabitant would be disruptive. Financing in Madrid would increase to an index of 151 relative to the average, while funding in Extremadura, which is at the opposite end of the spectrum, would fall to 67. The index in the Balearics would be 134.

In short, no reform until now has had anything like the impact on the relative position of an autonomous region as that proposed under the Catalan agreement.

Additional economic effects

The economic ramifications of extending the new financing arrangements nationwide are not limited to the immediate financial effects estimated in the section above. Specifically, a nationwide application presents the following risks and problems (Fernández Leiceaga and Lago Peñas, 2024):

- The central government currently faces a structural deficit in funding its responsibilities, which are very important and require sufficient budgetary coverage, and in honouring its unavoidable payment commitments (García Díaz, 2024). As for the first set of responsibilities, we are talking about transfers to social security to finance pensions; fundamental public goods such as national defense, citizen protection, and justice; the overall infrastructure policy and necessary initiatives in industry and energy, culture, R&D and agriculture, to mention a few. As for the second universe of obligations, they include the interest due on the country's public debt, transfers to the local governments and contributions to the European Union. Increasing the regional governments' tax autonomy and funding cannot sidestep this reality.

- Reducing the central government's tax capacity in respect of a growing portion of Spanish territory would limit its ability to respond to asymmetric adverse shocks in line with those that have materialized over the last 15 years. The loss of central government autonomy would also move the country further from an integrated and homogeneous nationwide fiscal system, beyond the autonomy exercised by the subnational governments.

- A reduction in the central government's fiscal capacity without a corresponding transfer of financial liabilities would also harm the balance between the volume of debt borne by the central government and the tax base underpinning it. This would affect Spain's sovereign bond credit ratings.

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- There is no precedent among the main federal countries in the OECD for the transfer of 100% of personal income tax. Its transfer would curtail the ability to define, at the highest level, the progressiveness of the Spanish tax system and common distributive criteria, to implement measures for application in an equal fashion to the entire population and tackle asymmetric crisis at the regional level.

- Territorial fragmentation of tax management would complicate the collection processes and control of fraud. Highly advanced and efficient information-sharing and coordination mechanisms would be required, although this may not be realistic. The reality is that today we do not have these mechanisms for the taxes that are already being managed by the regional tax authorities and the experience concerning coordination between the Navarre and Basque treasuries and the AEAT is far from ideal.

- The transfer of corporate income tax along with regulatory powers to the regional governments would open the door to potentially harmful tax competition, increase compliance costs for taxpayers, and heighten the risk of tax fraud.

Implications for Spain's system of subnational government

Taking a historical perspective, the agreement between PSC and ERC would lead to changes in the regional financing system that are different in nature to those derived from the reforms undertaken to date. In the past, the reforms introduced paved the way for increasingly shaping the concept of the regional treasury as a federal treasury. With each round of reforms, progress was made in reinforcing the regional governments' tax autonomy and tax management space, alongside the recommendations emanating from the theory of fiscal federalism and the shared experiences of comparable federal countries. [1] Unquestionably, problems remain, and multiple adjustments are needed. The White Paper drafted in 2017 identified them and suggested solutions. The Catalan concert is another scenario. It is important to underline this fact.

Some analysts believe that the agreement sets limits for the proposed reforms and that it would be possible during the process of pinning it down to make it fit with the logic presiding over the current "common" regional financing regime (outside of Navarre and the Basque region). The difficulty with that in practice is that the votes of one of the parties (ERC) are fundamental not only for the stability of the government in Catalonia but also for the passage of the general state budget for 2025, as well as for many of the initiatives under debate in Congress. As a result, the room for straying from ERC's positions in defining the details of the agreement is limited. At any rate, the text agreed in July is the only tangible thing that can be debated and used to generate simulations and implications at present. And that agreement implies a shift towards a model more akin to a confederation in which the parts and not the whole become the protagonists. The exercise of tax powers would be effectively transferred to the regional government under the agreement, with the central government becoming subsidiary in fiscal matters. It turns the current situation on its head and makes the central treasury look more like the regional treasuries in the 1980s: a treasury financed via grants.

Thirdly, if the spirit of the agreement prevails, other regions would have strong incentives to ask for a similar arrangement. Both Madrid and the Balearics would stand to benefit financially from a similar agreement in their regions. Even in Galicia, a net beneficiary under the current interregional redistribution scheme, the nationalist political party, BNG, has already staked its claim. Mainstreaming the new arrangement would not only undermine interregional equalisation but would also reduce the central government's fiscal capacity. And that is what really sets this agreement apart. Even in the US, where there is no explicit interstate redistribution system like there is in Spain, Switzerland, Canada, Australia, and Germany, the federal government reserves broad tax powers over the union and has its own sources of funding to implement compensatory policies of various kinds. In the opposite scenario, in which the agreement does not prosper, it would become the benchmark for a broad social and electoral majority for years to come in Catalonia, complicating a return to a scenario of multilateral negotiations around regional financing, putting an issue the Catalan government has been dodging for a decade on the agenda.

The regional financing proposal at the heart of the agreement between PSC and ERC affects Spain's model of decentralisation. Its implementation on the terms drafted would imply a turning point for the regional financial system, for the current asymmetries, for the vertical distribution of power, and for relations between the central and regional governments. The decisions finally taken need to guarantee that the preferences of the majority of Spaniards remain aligned with Spain's subnational government model, making a prior broad and well-informed debate about its effects and implications a prerequisite.

Notes

[1] Refer to the papers by Lago Peñas (2021) and Cadaval *et al.* (2024).

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