The assignment of revenue to Spain's Autonomous Regions

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Spain's regional financing model has improved significantly since its conception in the late 1970's. Outstanding work remains to ensure the now decentralized regime maintains high and equitable standards across the regions, but provision of public services is guaranteed.

Spain's basic model of regional financing has evolved considerably since its creation in the late 1970's. A key feature of the model is its high-degree of decentralization, placing Spain among the most decentralized countries at the European, as well as the global level. For the majority of regions under the common regime (excluding Navarre and the Basque Country, which are under a different system), based on approximation of expenditure needs, the model combines a system of assigned taxes, transfers, and other regional revenue to ensure the provision of essential, and to a certain guaranteed level, non-essential, public services to citizens.

Introduction

Spain is made up of seventeen autonomous regions (referred to here as regions) together with the autonomous cities of Ceuta and Melilla. Despite their short history, the regions have indisputably become major players in the country's economy. They are responsible for providing some of the welfare state's most important services, including education, health and social services. And they have competencies in other fundamental areas for regional economic development such as farming, industry, commerce, tourism, infrastructure, and R&D. The regions manage 35% of total public non-financial expenditure and are responsible for 34% of general government gross fixed capital formation. They account for over 50% of total public sector employment, and their revenues amount to 20% of total government non-financial revenues.

On the expenditure side, the regions are all similar, as they all basically exercise the same powers. However, on the revenue side a distinction needs to be drawn between those regions under the common regime and those under the charter regime (Navarre and the Basque Country), as the revenue allocation process is very different in each case.

This article aims to describe as simply as possible the way revenue is allocated to Spain's regions.

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The following sections deal primarily with the common regime, but reference is also made to the charter regime[2].

Revenue allocation to the regions under the common regime: General overview

Revenue allocation to the regions under the common regime is governed by the Organic Law on the Financing of the Autonomous Regions (LOFCA in its Spanish initials), drawn up centrally to implement the Spanish Constitution. This law contains the basic principles of the regional financing model, the proper application of which is agreed at the level of the Autonomous Regions' Fiscal and Financial Policy Board (CPFF), a joint body coordinating financial activities at central and regional levels. Every so often (generally every five years) the CPFF evaluates how the regions' public finances have progressed and makes the relevant adjustments.

To fully understand how revenues are allocated today it is worth briefly looking back at how the problem was solved when the system of Autonomous Regions was established. As provision of services was a power devolved to each region (beginning in the late seventies), their actual cost was calculated based on how much it had cost the State to provide the service in question in the region prior to decentralisation. This was then used by the Central government to determine the grant paid to the region to enable it to finance the services over which it now had authority.

This approach had two obvious shortcomings: first, it meant that each region could only continue providing these services at the same level as the State had done, not at the same level as other regions; and second, being based on transfers, it did not allow regional fiscal autonomy and accountability to develop.

Consequently, all the reforms made to the model, including the most recent, in 2009, have sought to rectify these shortcomings. The following sections will describe the system of revenue allocation currently in force, and will allow us to see if progress has been made since the beginning of the regional system. The analysis will address the three basic pillars of the regions' revenue structure: expenditure needs, assigned taxes, and transfers.

Expenditure needs

The first element of the regional financing model is the calculation of each region's expenditure needs. This relates to the level of expenditure a region needs to provide the same level of services in a particular area of its competency as other regions.

The procedure by which expenditure needs are calculated is complex. In simple terms, the main feature is that regional services are divided into two categories: essential public services, comprising education, health, and essential social services, which account for around 70% of the regions' spending, and non-essential public services, comprising the remainder.

The regions' expenditure needs for the provision of essential public services are calculated annually using a series of indicators reflecting cost and demand factors affecting the delivery of these services. The weighted indicators used to construct an indicator referred to as the *adjusted population* are: the region's population (with a weighting of 30%); the population covered by the health-care system, divided into age groups (38%); the population aged over 65 (8.5%); the population aged between 0 and 16 years (20.5%);

[2] For a more detailed description and analysis, see Joumard and Giorno (2005), López-Laborda and Monasterio (2007), López-Laborda *et al.,* (2007) and Zabalza and López-Laborda (2011).

the surface area covered (1.8%); population dispersal (00.6%); and insularity (0.6%).

The procedure applied in the case of non-essential public services is less precise and it does not quantify regions' expenditure needs. Here the model basically limits itself to ensuring that no region receives less revenues to finance these services than it had received historically.

Consequently, whereas the financing model pursues a clear objective of equalisation of the essential public services provided by the regions, in the case of other regional services, the goal is simply to ensure that revenues are sufficient.

Assigned taxes

In the same way that the State has been devolving certain services to the regions over the years, it has also gradually transferred taxes. These taxes are known as "assigned taxes" and are taxes that are set and regulated at the central government level, with some or all of their revenue being transferred to the regions. Moreover, in some cases the regions can administer the tax, set the tax rate, and grant allowances or tax credits applicable in their territory.

Today, almost all the taxes in the Spanish fiscal system are assigned to the regions in this way to some extent or other. The only major taxes that are not are corporate income tax, non-resident tax, and social security contributions.

Thus, 100% of the revenues from tax on net wealth, inheritance and gift tax, tax on asset transfers and documented legal acts (stamp duty), gambling tax, special tax on certain means of transport (vehicle registration tax), special tax on retail sales of certain fuels, and the electricity tax, is transferred. 50% of VAT and personal income tax is transferred, along with 58% of excise duties (on tobacco products, hydrocarbons and alcoholic beverages). In the case of personal income tax, the tax schedule has been divided into two equal tranches, one for the central government and the other for the region. Each region can maintain the standard regional tax schedule or set its own (as certain regions have done), although they cannot modify the rates applicable to earned income from savings: interest, dividends and capital gains. Regions can also establish their own tax credits. However, they have no powers to regulate VAT, or excise duties.

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Transfers

Transfers constitute the final component of the financing model. They provide revenues to the regions that are unable to meet all their expenditure from the assigned taxes. In order to explain how the two most important unconditional transfers work, we need to go back to the distinction between essential and non-essential services.

To finance essential public services, transfers are made from the Essential Public Services Guarantee Fund. This is calculated annually as the difference between each regions' expenditure needs for these services and 75% of standard revenue collection from the assigned taxes. The standard revenue collection (or fiscal capacity) is the revenue the region could obtain (not that

which it actually obtains) by applying the standard tax rate to its taxes. This transfer –which may be positive or negative– is therefore a genuine equalisation transfer. It guarantees, year to year, that if a region's tax effort from its assigned taxes is the same as that of the other regions, it can also provide the same level of education, health and social services.

In the case of non-essential public services, there is also a transfer through the Overall Sufficiency Fund. This is calculated as the difference between each region's guaranteed expenditure level and 25% of the standard revenue collection from the assigned taxes. This transfer –which may also be either positive or negative– aims to ensure sufficiency rather than equalisation. As we have already seen, the regions' expenditure needs for these services are not calculated, and the transfer is not quantified each year: its value in the first year varies at the same rate as do central government taxes.

If a region decides to demand a greater or lesser tax effort from its assigned taxes in its territory than has been established as standard, the consequences in terms of revenues of this decision, whether positive or negative, accrue to the region, as the transfers it receives are in no way affected.

There is another general transfer, which is quantitatively much less important than the others, called the Competitiveness Fund. This has two goals: it aims to avoid significant differences in total financing per adjusted inhabitant between regions, and at the same time it tries to avoid that the wealthier regions end up much worse off under the model than if they simply relied on their own fiscal capacity.

Revenue allocation under the charter regime

Navarre and the Basque Country have a special financing status under the charter regime. This is basically governed by the Economic Agreement between the State and Navarre Act *(Convenio)* and the Economic Agreement with the Autonomous Region of the Basque Country Act *(Concierto)*. These regimes are therefore also referred to in Spain as "agreement regimes". They differ substantially from the common regime on all of the three basic aspects identified in the preceding sections.

In the charter regime, there is no calculation of expenditure needs to guide revenue allocation as in the case of the common regime. The two regions concerned are financed exclusively from the taxes accruing in their territory, which are referred to as "agreed taxes." These two regions have very broad powers regarding these taxes, indeed far wider than is the case of the regions under the common regime. First, in the charter regime regions, all the taxes in the Spanish fiscal system are "agreed taxes," with the significant exception of social security contributions. Moreover, these regions are entitled to 100% of the revenues from these taxes, can administer them, and with certain exceptions (such as VAT and excise duties), they can also regulate them.

Given the considerable fiscal capacity of these regions and their high income level, the regions in the charter regime can clearly cover their expenditures from their tax revenues without requiring supplementary transfers. Indeed, these regions make annual transfer payments to the central government –the *cupo* in the Basque Country and the *aportación* in Navarre– with which they contribute to the cost of centrally provided public goods and services, although not to the equalisation of services with the other regions.

Other regional revenues

So far we have described what could be called the basic model of regional funding, i.e. the

revenues placed at the disposal of the regions to finance the competencies they have assumed. However, in addition to these basic resources, the regions in both the common and charter regimes have access to other revenues with which to implement their public policies. First of all, they can enact their own taxes, and this is something they have been doing, particularly in the environmental area. Secondly, they can receive transfers from the State or the European Union, with a view to promoting regional development and reducing the income and wealth differences between territories. Finally, they can run a deficit and borrow, within the framework of budgetary stability legislation. Spain has recently modified its Constitution to enshrine the principle of budgetary stability. To implement the Constitution, the Organic Law on Budgetary Stability and Financial Sustainability was passed in April 2012. In an orthodox way, this law imposes various limits on the financial activities of the Spanish public sector as a whole –on the structural deficit, public debt and public expenditure– sets a calendar to achieve them, and establishes an institutional framework and a set of preventive, corrective and enforcement measures, intended to act largely automatically, to ensure compliance.

Concluding remarks

Over a relatively short period, Spain has undergone a far-reaching process of decentralisation of public expenditure. The decentralisation of public revenue has been slower, although in the last fifteen years it has been given considerable momentum. This process has placed Spain among the world's most decentralised countries and at the top of the list of the European Union's most decentralised member states.

What stands out from the foregoing sections is the huge progress that has been made from the rudimentary model of financing applied in the late

The model gives the regions an ever-expanding sphere of tax competencies and ensures that if regions' tax effort from their assigned taxes is the same, they will be able to provide their citizens with the same level of health, education, and essential social services, and the rest of the services they have assumed, up to a certain guaranteed level.

seventies to the model in effect today, the basic components of which are not unlike those in other federal countries, such as Australia, Canada, Germany or Switzerland. The model gives the regions an ever expanding sphere of tax competencies and ensures that if regions' tax effort from their assigned taxes is the same, they will be able to provide their citizens with the same level of health, education, and essential social services, and that they will also be able to provide the rest of the services they have assumed, up to a certain guaranteed level.

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Recent key developments in the area of Spanish financial regulation

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Bank of Spain Circular amending accounting circular (Circular 6/2012, published in the State Official Gazette (BOE) on October 2nd, 2012)

Bank of Spain Circular 6/2012, September 28th, 2012, was published in the BOE on October 2nd, 2012 and amends Circular 4/2004, December 2nd, 2004, on reporting standards for public and confidential financial information and standard financial statements. The Circular came into effect on October 3rd.

Its aim is to adapt the Accounting circular to the provisions of Royal Decree-law 18/2012, May 11th, 2012, on the write-down and sale of real-estate assets held by the financial sector, in relation to the increased coverage requirements established in the RD-l for lending relating to land and buildings or property developments corresponding to the business in Spain of credit institutions, and which were classified as normal risk on December 31st, 2011.

Circular 6/2012 also covers the inclusion (in line with the rules on the information that credit institutions are to disclose in their individual and consolidated annual accounts) of certain information regarding refinancing operations, refinanced and restructured operations, and the concentration of risks in both sectors and geographical areas. It also completes the transparency requirements associated with exposures to the construction and property development sector, with information regarding assets awarded or received in payment of debts that are transferred to asset management companies.

Annex IX introduces modifications concerning risk policies institutions are required to put in place, adding to the policy of debt renegotiation, the policies of refinancing, restructuring and operation renewal. It incorporates the criteria applicable to refinancing and restructuring of operations (policies, decisions, contribution of new guarantees and the internal information system), and introduces modifications regarding the classification of clients by insolvency risk and its hedging. To this end the following definitions will apply:

- **Refinancing operation:** Operation used in situations of financial stress by the borrower to cancel operations held by the borrower or other group companies, or whereby these operations are brought fully up to date with payment to facilitate debt payment by holders of cancelled or refinanced operations who are unable to meet their conditions.

- **Refinanced operation:** Operation that is brought wholly or partly up to date on payment by means of a refinancing operation by the institution or another entity in its economic group.

- **Restructured operation:** An operation in which there is a debt write-down or assets are received to reduce the debt, or the financial conditions are modified.

- **Roll-over operation:** Operation to replace another granted previously by the same institution, without the borrower necessarily being in financial difficulties.

- **Strengthening credit institutions' solvency.** As of January 1st, 2013, credit institutions and consolidated groups of credit institutions taking reimbursable funds from the public must have core capital of at least 9% of their total risk-weighted exposures.

- **Renegotiated operation:** Operation in which the financial conditions are modified, without the borrower necessarily being in financial difficulties.

A new section has been added to Annex IV reproducing section 1 of article 1 and the annex of Royal Decree-law 18/2012 in relation to additional coverage for credit risk. Various statements are also modified, and the changes necessary to support the new information needed for supervisory purposes and that which credit institutions are required to disclose in their annual accounts are made to the Special accounting record of mortgage operations in Annex X. These changes are to be incorporated no later than December 31st, 2012.

Royal Decree amending certain Royal Decrees concerning the powers of the European Supervisory Authorities (Royal Decree 1336/2012, published in the BOE on October 5th, 2012)

On October 5th, the Royal Decree amending certain Royal Decrees concerning the powers of the European Supervisory Authorities was published. This Royal Decree completes the process of transposing European regulations to national legislation that began with Royal Decree-law 10/2012.

Royal Decree 1336/2012 completes the implementation of Directive 2010/78/EU, November 24th, 2010, in order to incorporate the obligation of collaboration, communication and notification by the competent authorities, the Bank of Spain and the CNMV, with the relevant European supervisory authorities. This details the adaptation of the national supervision arrangements envisaged in Royal Decree-law 10/2012 to the obligations under European Union Law established by the European supervisory framework.

As a result the following legislation has been amended:

- **Royal Decree 84/1993 implementing the Credit Unions Act referring** to the need to notify the inscription and discontinuation of Credit Unions in the Special Register and informing the EBA of this fact.

- **Royal Decree 1245/1995 on the creation of banks,** cross-border business, and other issues concerning the legal framework governing credit institutions, amended in the same terms as the previous Royal Decree.

- **Royal Decree 1310/2005 partially implementing the Securities Market Act,** concerning the listing of securities on official secondary markets, public offers of sale or subscription and the brochure required for these purposes. The modifications concern the notification of approval and registration of the brochure, and the cross-border effectiveness of brochures approved in Spain or in other EU member states.

- **Royal Decree 1332/2005, implementing the Financial Conglomerates Supervision Act,** which adds an internal control mechanism to help prepare and develop the bail-out and resolution mechanisms and plans, if necessary.

- **Royal Decree 1362/2007 implementing the Securities Market Act** in relation to the transparency requirements concerning information on issuers whose securities are listed on an official secondary market or another EU regulated market. It adds that the CNMV is obliged to notify the ESMA of the granting of exemptions to the obligations to provide regular information on issuers whose registered office is in a non-EU country.

- **Royal Decree 216/2008 on financial institutions' equity capital.** The modifications primarily concern the procedure for the declaration of branches as significant, the obligations to inform the Bank of Spain, and the rules of operation of colleges of supervisors of credit institutions. It also modifies some of the CNMV's competencies in relation to coordination with other supervisory authorities.

- **Royal Decree 217/2008 on the legal framework applicable to investment services companies** and other institutions providing investment services, partially modifying the Regulations of the Collective Investment Institutions Act. The modification consists of the CNMV notifying the ESMA of any authorisations of investment services companies in Spain, and any difficulty a Spanish investment services company may have in establishing itself in a non-EU Member State or in conducting its business there.

Law on the write-down and sale of property assets held by the financial sector (Law 8/2012, published in the BOE on October 31st)

This repeals Royal Decree-law 18/2012, May 11th, 2012, on the write-down and sale of property assets held by the financial sector (mentioned in SEFO nº. 1, May 2012) and incorporates the same requirements as established in the aforementioned Royal Decree-law.

Law amending the fiscal and budgetary legislation and adapting financial legislation to intensify measures to prevent and combat fraud (Law 7/2012, published in the BOE on October 30th, 2012)

This Law contains a series of measures aimed at preventing and combating tax fraud. The law includes novel measures designed to have a direct impact on niches of fraud detected as being the source of significant loss of public revenue, combined with other measures aiming to fine-tune the rules ensuring tax credit in order to update them and clarify their correct interpretation to improve legal certainty in the tax system and avoid unnecessary litigation.

It is worth highlighting the measures incorporated in the regulations with a clear vocation in the fight against fraud, which include the possibility of taking precautionary measures linked to alleged cases of offences against the public treasury, and the investigation of the associated assets, limitations on payments in cash, and the putting into place of new obligations to report assets and rights abroad.

The Securities Market Act has also been modified to avoid the potential for tax fraud in transfers of ownership of securities where the intermediation of a company is used as a means of transferring ownership of real-estate.