IEB
Institut d'Economia de Barcelona

IEB's Report on Fiscal Federalism '12

IEB Càtedra de Federalisme Fiscal
Universitat de Barcelona
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IEA Institut d'Estudis Autonòmics

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Research Report

Editorial: Decentralisation and the Crisis / The Crisis and Recentralisation

As with the three previous editions (2009, 2010 and 2011), the economic crisis has shaped the content of the *IEB's Report on Fiscal Federalism'12*. Since the beginning of the economic downturn, the budgetary situation of the various government levels (and, in particular, of the sub-central level) has continued to deteriorate. In the early years, this was the result of the strong impact caused by the decrease in revenue, the adoption of fiscal stimulus policies and, ultimately, a lack of political will to implement the budgetary adjustment required. In Spain, the fiscal consolidation effort has been more evident recently (both at the central and sub-central levels of government) but its effectiveness has been limited.

Since the onset of the crisis, in Spain there has been an increasing tendency to attribute much of the responsibility for budgetary problems to sub-central governments. Firstly, it has been suggested that the current public financing problem is largely due to the low budgetary discipline exhibited by the Autonomous Regions during the expansion period. In the years leading up to the crisis, both Autonomous Regions and local governments increased expenditure to very high rates, thanks to the extra revenues generated by the housing boom. Secondly, several voices also attribute the difficulties facing the necessary budgetary adjustment policies to the Autonomous Regions' resistance to apply them. Finally, there is also a certain state of opinion that believes that what happened during the expansion period has proven that sub-central governments in Spain are not able to efficiently manage spending and are largely susceptible to the lure of economic interests. The many examples of the so called 'white elephants' (i.e., infrastructure with a very low social performance), the epidemic of corruption in regional and local politics, the role of sub-central politicians in the mismanagement of savings banks, and the headlines on astronomical salaries and the proliferation of sub-central positions and entities contribute to building this impression.

It is unclear, however, to what extent this state of opinion is based on actual facts (some of which are irrefutable), or is a response generated by the current difficult economic situation; or whether it is simply the result of a deliberate attempt to weaken the current Spanish decentralised system of government from those sectors that were already not in favour before the crisis. Moreover, even if it were proven that decentralisation has been partly responsible for the crisis and the difficulty of managing it, it is not entirely clear how we should react to such information. Different voices in Spain have questioned the current system of decentralisation, proposing a recentralisation of State powers which would affect both Autonomous Regions and local governments. This recentralisation process is already taking place, although there is, as yet, no detailed evaluation of its outreach.

This study seeks to provide evidence and promote the debate on two questions already mentioned: *What effect has decentralisation had on the rise of the economic and budgetary crisis and the reaction thereto?* And finally: *Has State recentralisation taken place as a reaction to the economic and budgetary crisis?* The *Forum* section of the *IEB's Report on Fiscal Federalism'12* contains two papers which address the first question, and a further two which address the second. In each case, one of the papers looks at the international scenario, whereas the other deals with the Spanish case. The remaining sections of the Report (*Around the world, Research Report*) may also contain short responses to these questions as part of other papers.

Decentralisation and the crisis

The first two papers review the role of sub-central governments in the growth and response to the crisis. The first paper is written by Jürgen von Hagen (University of Bonn) and Dirk Foremny (Universitat de Barcelona & IEB) and is titled *Fiscal Federalism in Times of Crisis: Sharing the Cost of Adjustment*. This paper analyses the behaviour of sub-central government finances in Europe during the expansionary period (1996-2007) and during the current crisis (2008-2010). The authors examine the behaviour of "unitary" and "federal" countries (i.e., those with an intermediate level of government) separately, distinguishing between those which have experienced a fiscal crisis and those which have not. The work concludes that the type and intensity of budgetary adjustment depends on these characteristics.

In "unitary" countries that have not experienced a fiscal crisis, sub-central budgetary adjustments occur in the form of increased intergovernmental transfers. In this case, the central government would be protecting sub-central government from the swings caused by the economic crises, in return, obviously, for a tighter control of their decisions. In unitary countries which have indeed experienced a fiscal crisis, the central government has failed to protect sub-central governments from the adverse effects of the crisis, responding with a sharp downward adjustment in expenditure in response to falling revenue. In federal countries that have not suffered a fiscal crisis, sub-central governments have been able to borrow in order to stabilise the provision of public services. In this case, greater financial autonomy is granted in exchange for supporting higher borrowing costs. In federal countries that have experienced a fiscal crisis (as is the case with Spain), access to credit by sub-central governments has been limited and, given the budgetary constraints of the central government, sub-central expenditure has been dramatically adjusted. The analysis of these countries' behaviour during the economic boom also reveals that part of the problem stems back to the strong growth rates of public expenditure, financed by highly pro-cyclical revenue.

The second paper in the *Forum* section is titled *Regional Public Finances during the Crisis: from Peace of Mind to Agitation* and is written by Andrés Leal Marcos (Public Economics Research Group) and Julio López Laborda (Universidad de Zaragoza & Public Economics Research Group). This paper studies the budgetary adjustments made by the Autonomous Regions more in depth. Their conclusion is that the Autonomous Regions reacted late in adjusting their expenditure policies in response to the economic crisis. All financial expenditure grew significantly between 2007 and 2008, as did public employment. The brunt of the adjustment (when it occurs) falls on capital expenditure. In any case, there is a general failure to meet the deficit objectives. The work also identifies the reasons that led to the growth of the problem during the expansion period. One of the most important reasons is the strongly expansive performance of regionally assigned taxes (the so-called *impuestos cedidos*, e.g., estate tax, tax on asset transactions). These increased at very high rates during the growth stage, but plummeted after 2007. Between 2007 and 2011 their performance was worse than that of transfers.

Both studies, therefore, provide some evidence suggesting that the decentralisation of the public sector's financial activity may indeed explain the severity of the crisis and the difficulty of budgetary consolidation. In any case, we do not believe that it is possible to deduce from this evidence that any type of decentralisation impedes macroeconomic and budgetary management. In the Spanish case, for example, we could state that some design characteristics of the financing system may have aggravated the problem. Firstly, it is well known that decentralising exclusively on the expenditure side, but not the revenue side, weakens fiscal discipline. Despite the progress made in fiscal co-responsibility over recent years, the truth is that the Autonomous Regions have not (as yet) considered that their budgetary restrictions were 'strong'. Secondly, for years, the Autonomous Regions were able to finance their increasing public expenditure with the revenue windfalls from the construction industry. Moreover, the financing assurances that were in place in the 1990's were also eliminated with the aim of ensuring that regional revenue from transfers and tax shares had a stronger response to the positive evolution of the cycle. Finally, budgetary accountability and control of the regional accounts have been far from perfect over the past years. As explained by Santiago Lago Peñas (Universidade de Vigo & IEB) in a short paper included in the *Around the world* section (titled *The New Budgetary Stability in Spain: A Centralising Approach*), the response of the central government to this problem has been to impose a centralised and hierarchical control of regional budgets and deficits. Although this is perhaps the only feasible solution in the short term, it is not clear whether it is a suitable long-term solution, given the harm it causes to the financial autonomy of the Autonomous Regions. A better suggestion would have been perhaps an overhaul of the system, by increasing the incentives for proper budget management. The central government would be advised to take note of this and try to design a system that is more flexible and respectful with autonomy for when the crisis comes to an end.

The crisis and recentralisation

The following two papers included in the *Forum* section attempt to answer the question as to whether the current economic and fiscal crisis has given rise to a trend of State recentralisation. The first of these papers is titled *Fiscal Decentralisation and Economic Crisis* and is written by Gustavo Canavire-Bacarreza (EAFIT University) and Jorge Martinez-Vazquez (Georgia State University). In this paper, the authors describe how sub-central governments around the world have adjusted their budgets in response to the economic and fiscal crisis. Based on this description, they will attempt to answer the question of whether recentralising measures have been adopted in response to the crisis. The results show a positive correlation between periods of crisis and government centralisation. In times of crisis, the fall in sub-central revenues can imply that these governments are less able to comply with the expenditure responsibilities that have been assigned to them. This can damage citizens' confidence and cause central governments to use the crisis as a means to justify decelerating or even reversing the decentralisation process, particularly in those countries where decentralisation does not have a long tradition and/or where it has been subject to controversy in the past. Furthermore, the authors also point out that during an economic crisis, citizens demand more action from the central government, as it is expected to have greater powers in regard to macroeconomic policies. Also, on many occasions there is no alternative to an intervention by the central government, as only this might be able to capture resources from the financial markets. The main conclusion that can be drawn from this paper is that crises contribute to the promotion of recentralisation, and as such, it is not a phenomenon exclusive to the Spanish case. In a short article in the *Around the world* section, Massimo Bordignon (Università Cattolica del Sacro Cuore) analyses the recent recentralisation process that Italy has undergone (*Economic Crisis and Recentralization of Government: the Italian Experience*). The Italian scenario described by the author is far more devastating than the Spanish one, judging from the outreach of recentralisation, as analysed in the following paragraph.

The following paper included in the *Forum* section is titled *The Recentralisation Process of the State of Autonomies*, and is written by Carles Viver Pi-Sunyer (Institut d'Estudis Autonòmics & Universitat Pompeu Fabra) and Gerard Martín (Institut d'Estudis Autonòmics & Universitat Pompeu Fabra). This paper provides significant evidence showing the existence in recent years of a very intense recentralisation process of government authority in Spain. Among many examples, they mention, firstly, the use of intergovernmental grants by the State as part of the economic stimulus policy. Secondly, the authors refer to all the measures related to deficit control, including the deficit commitments negotiated with the EU, the constitutional reform with regards to the deficit cap, or the decision on how to distribute the deficit among the different government levels; all of these unilateral decisions encroach on regional competences. Thirdly, numerous examples are given of measures affecting the administrative and institutional self-organisation capacity of the Autonomous Regions (e.g. those related to recruitment and remuneration of civil servants), measures affecting certain policies (e.g. health care, education, commercial regulation) or even measures adopted under the pretext of coordinating regional policies. This kind of unilateral interventions began already before the economic crisis and are the result of a lack of delimitation of competences and the decisions of the Spanish Constitutional Court, which have resulted in the disappearance, in practice, of limits on the extension of the central government's policy framework, to the detriment of the Autonomous Regions. According to these authors, the end result of the measures adopted is that the existing type of autonomy and the structural elements of the State of Autonomies have started to be affected. The recentralisation process might not only be causing a loss of political autonomy by the Autonomous Regions, but also, a reduction in their managing autonomy.

Although this paper proves the existence of recentralising trends, it does not analyse their causes. In the first place, recentralisation measures probably follow – in the case of measures of control of regional budgets – the adoption of a certain fiscal consolidation strategy. On the one hand, the central government seems to believe that the solution to the problem is based upon severe centralisation and a system of warnings and sanctions. As already mentioned, the paper by Santiago Lago Peñas reviews the design of this policy and leaves the evaluation of its effectiveness open. On the other hand, certain decisions in this area can be due to the governing party's own views as to how to implement a fiscal adjustment. Thus, the generous setting of deficit caps in the central government's favour can hide the fact that it is considered that fiscal adjustment can be a good instrument for reducing the size of the welfare state (i.e., education, health and social services, expenses which fall under the remit of the Autonomous Regions). In any case, in order to adequately evaluate the impact of these measures on the distribution of power between the different levels of government, we should be able to determine whether these are provisional measures (restricted to emergency situations), or if they will remain in place when the fiscal crisis eases up. Our point of view is that, while centralisation of the fiscal authority can be useful at exceptional times (due to the lack of an alternative multi-level budgetary management system, which was non-existent at the onset of the crisis and is difficult to improvise), the consolidation of this system is not desirable, as it might end up eliminating any trace of regional financial autonomy.

Secondly, in Spain, the economic and budgetary crisis could be used as an excuse for recentralisation, as a means of reversing a decentralisation process which, even before the crisis, was considered to have gone too far. There are various reasons as to how certain sectors of public opinion could have reached these conclusions. First, the perception of inefficiency and lack of coordination emerging from the operation of the current multi-level government system in Spain; Second, and surely vital, the incapability of the regional system to solve certain territorial disputes. With regards to the first issue, it remains to be seen how much of this perception of inefficiency is based on reality, and how much is the result of manipulated information seeking to justify already predetermined recentralising positions. Furthermore, as previously mentioned, it is not clear that the solution would be to dismantle the system; the right approach would be to determine the problem first and then find the best possible solution to each individual disruption. With regards to the second issue, it is not clear at all that the problem with Catalonia will be solved through State recentralisation. Furthermore, while it is true that the calls for centralisation have arisen in the rest of Spain, the majority of population still supports the State of Autonomies, and recent changes are mostly provisional, as shown by Sandra León in her paper in the *Around the world* section, titled *Crisis, Public Opinion and State of Autonomies*.

Local Administration: Governance and Reform

Local governments are not immune to many of the problems mentioned thus far in relation to the Autonomous Regions. The crisis has greatly affected their finances, given that a large share of their revenue depended on the real estate sector. Furthermore, transfers from higher levels have been cut, and local governments face severe difficulties in accessing credit.

But in addition to financial issues, other problems exist: first, the perception that there are too many levels of local administration; second, a lack of delimitation of competences, and specific overlapping with those of the Autonomous Regions; third, management efficiency is also questioned, due to the creation of unnecessarily large or oversized facilities in relation to municipal size; fourth, the numerous examples of urban planning corruption that can be found. The report dedicates two papers to this issue in the *Research Report* section. One of these is written by Pilar Sorribas-Navarro (Universitat de Barcelona & IEB), who looks at the effects of local urban planning corruption on the Spanish municipal elections of 2007. The paper is titled *Do Spanish Voters Really Tolerate Local Corruption?* Sorribas-Navarro maintains that voters do not tolerate corruption. The press has a major role to play in unveiling corruption, helping voters discern unfounded accusations from those based on fact, punishing the latter. Likewise, it can be noted that voters appear to have a short memory, given that recent corruption cases are punished more severely than those which occurred in the past. On the other hand, Anwar Shah (World Bank & SWUFE), with a paper titled *Decentralization and Corruption: Panacea or Pandorah's Box?*, provides an empirical analysis of local government based on a broad sample of countries, which concludes that conferring more power to the local government (political responsibility and accountability) has a major negative effect on the incidence of corruption.

Given the issues that the local administration has, it seems that action should be taken by the government. Although urgent measures were already adopted to pay suppliers, a local administration reform is currently being prepared, with the claimed objective of streamlining said administration, and thus, reducing public expenditure. In February 2013, the central government submitted a first draft proposal to address this reform. Núria Bosch and Albert Solé-Ollé (Universitat de Barcelona & IEB) study this proposal in their paper included in the *Around the world* section, titled *A Preliminary Evaluation of the Local Administration Reform in Spain*. The authors' conclusion is that the reform is not aimed at fulfilling all the criteria that any local reform should meet: economic efficiency, provision of public services at the lowest possible cost and political efficiency, which should encourage politicians to meet citizens' demands instead of their own personal interests. In turn, according to the authors, this reform can only be considered either as a proposal to meet the demands for a greater administrative centralisation, or as an attempt to reduce regional autonomy to allow for an easier control of public debt.

The central government's reform measures affect four areas: *delimitation of competences, organisational rationalisation, financial control* and *professional management*. With regards to powers, it is clear that a delimitation of competences is needed at the local level, mainly due to the current weight of the so-called non-core competences. The reform sets a list of core competences, thus clarifying the issue. Nonetheless, some doubts have arisen from the measures adopted such as, for example, the fact that some competences are transferred to the Autonomous Regions without any specification as to how these should be financed. To streamline the administrative organisation, the proposal establishes that, in the event that the cost of a core competence is higher than the pre-set standard, and the municipality in question has less than 20,000 inhabitants, said competence will be transferred to the Provincial Council. Nonetheless, this transfer will not necessarily reduce costs, given that, for the majority of services, the cost per inhabitant or user is high due to low population density, or the existence of many population centres. On the other hand, serious doubts exist as to whether a standard cost can be calculated when municipalities do not account for these costs, and it would be inappropriate to do so on the basis of per capita expenditure, given that the local sphere is very diverse in both resources and preferences. In addition, there are other reasons to believe that the transfer of these services to the Provincial Council makes no sense. The geographical dimension of Provincial Councils seems excessive. It might occur that, in some regions, most local services were provided by the Provincial Council, and this goes against the concept of political efficiency, as the managers of these administrations are not directly elected by citizens.

Financial control is meant to be improved by having local auditors report once again to the Ministry of Finance and Public Administration. This measure seeks to make auditors more independent from local politicians and creates more obligations for them. According to Bosch and Solé-Ollé, these measures are imprecise and, if as expected, remuneration and redundancy pay continue to depend on local politicians, nothing will change. At the same time, the reform establishes salary caps for elected positions, advisors and other positions of trust, which results in 82% of elected positions being non-remunerated. In consideration of the recent corruption scandals, we can agree that there are citizens who demand that the salaries of politicians be kept under control. As such, it is reasonable to establish some limits to these salaries. However, this is not certain to produce any kind of savings, given that those politicians whose salaries are below the limit could qualify for a raise, and that there are many who do not currently receive a salary and so, this could have an undesired effect on per diem allowances and other expenses. On the other hand, it should be noted that there are studies showing that an appropriate remuneration for politicians is a key condition for the recruitment of the most able candidates.

Finally, the work of Bosch and Solé-Ollé highlights the main characteristics that should be part of any local reform. Seven recommendations are given:

Reduction of the number of municipalities. In Spain, 84% of municipalities have less than 5,000 inhabitants. Municipalities should have a population of such a size that guarantees the provision of services at minimal cost. As such, there should be incentives for the merger of municipalities. The minimum population should be 5,000 inhabitants and, where possible, closer to 10,000, although historical, geographical, cultural and economic circumstances should also be considered.

Clarification of competences. There should be a delimitation of municipalities' core competences, as provided for by the current reform proposal. Likewise, the possibility of delegating other competences, with the ensuing financing arrangements, should also exist for municipalities of at least 10,000 inhabitants.

Financial Control. It is suggested that, among others, local auditors should be independent from local political power, both in terms of their activities and remuneration.

Accountability: the direct election of the mayor and local councillors by district is suggested, in order to achieve a good representation of the merged municipalities.

Professionalisation. All municipalities should have a local auditor and a secretary. With regards to the salaries of elected positions, these could be regulated by establishing a salary cap, but one which allows for local autonomy and which is generous.

Limitation of the role of the Provincial Councils. The proposal is for either limiting the competences of the Provincial Councils to matters of municipal policy coordination or to remove them completely.

Financing. The IBI (Municipal Property Tax) should be strengthened with a better Land Registry management, in which both Autonomous Regions and local governments should take part. The local shares of the main State tax should be increased and made available to all municipalities; at present, these are limited to municipalities with more than 75,000 inhabitants. A surcharge on personal income tax should also be considered. The reduction in the number of municipalities would reduce heterogeneity and would allow that the general grant from the central government acted as a genuine equalisation grant; moreover, it would reduce capital transfers, which are currently a major source of revenue for small municipalities, despite the fact this interferes with regional autonomy and is used as a discriminatory tool in favour of those municipalities of the same political allegiance as the granting administration.

We can draw a few general conclusions from all the papers that are included in the *IEB's Report on Fiscal Federalism'12*. Firstly, the economic crisis has uncovered the limitations of multi-level government systems, both in Spain and in other countries. Given the extraordinary nature of this crisis, this is probably the most demanding challenge that any decentralised system has faced or will face in the future. Secondly, the difficult fiscal situation makes this a good time to embark on an in-depth reform of sub-central governments' organisation. This reform should be based on the evidence pointing out those aspects of decentralisation that are causing the problems. Thirdly, the dysfunctions of the sub-central governments which have been brought to light in the wake of the current crisis should not overshadow the advantages of a decentralised system. In this sense, rushed and opportunistic recentralising measures based upon cyclical changes in public opinion and incorrect diagnoses of the current situation should be avoided by all means.

Núria Bosch and Albert Solé-Ollé
Editors

Institut d'Economia de Barcelona (IEB)
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Forum

Economic Crisis and Recentralization

Fiscal Federalism in Times of Crisis: Sharing the Cost of Adjustment

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1. Introduction

In all countries, government consists of several layers, local, regional, and central. While local governments are typically charged with the provision of a large range of public goods and services, from water and sewage to parks, schools, and hospitals, central governments are charged with macroeconomic stabilization, redistributive policies, country-wide public goods such as national defense, and regional governments stand somewhere in between, providing public goods and services with a larger than local geographical incidence, and making use of economies of scale in the provision of public goods and services[1].

The most important taxes, those on personal and corporate income and value added, are typically collected at the central or regional level to avoid detrimental tax competition at the local level. This leaves local governments with own taxes characterized by relatively small tax bases and revenues and taxes shared with higher-level governments. As a result, these different layers of government are interlinked by flows of financial funds and net flows are typically top-down, i.e., central and, where they exist, regional governments pay net transfers to local governments. The degree of "vertical imbalance", defined as the share of local government spending financed out of transfers from higher-level governments is an important characteristic of the organization of a country's public finances.

Individual countries are commonly classified as either unitary or federal. A typical unitary country has two layers of elected governments, local and central. Local governments have limited authority to manage their own affairs and depend strongly on transfers from the central government[2]. In contrast, a typical federal country has three layers of elected governments, local, regional (state), and central. Local and regional governments have considerable freedom to manage their own affairs and depend much less financially on the central government than local governments in unitary states[3]. Thus, existing designs of the public sector involve a trade-off between political autonomy and financial dependence at the local level: The larger the degree of political autonomy, the smaller the degree of financial dependence of local from central governments, i.e. the lower the degree of vertical imbalance.

Economists commonly perceive and justify this trade-off on efficiency grounds. In countries where differences between local economic circumstances and local preferences over public goods are large, local governments must be able to respond to local circumstances to deliver public goods and services efficiently. However, this ability must be combined with at least some responsibility for financing the public goods and services delivered out of taxes collected locally to avoid problems of moral hazard and free riding leading to excessive spending at the local level. Therefore, a high degree of local political autonomy must be combined with a low degree of vertical imbalance. In contrast, when differences between local economic circumstances and preferences are small, efficient provision of local public goods and services is possible with a lower degree of autonomy granted to local governments and a higher degree of vertical imbalance.

[1] This corresponds to the classical assignment of responsibilities by Musgrave (1959, 1971).

[2] Where regional governments exist, they are typically not elected and serve as administrative units.

[3] Obviously, this is only a coarse classification and intermediate cases exist. For example, the combination of two layers of government and a high degree of autonomy of local governments in Scandinavian countries is sometimes called "Scandinavian federalism", see Rattso (1998).

The recent economic and financial crisis, commonly dubbed the Great Recession, leads us to consider the trade-off between the autonomy of subnational governments and the degree of vertical imbalance from a different perspective. This crisis, which hit European economies in 2007 after a string of years of relatively strong growth, caused a sharp decline in public revenues and an increase in public spending due to automatic stabilizers and discretionary macroeconomic stabilization policies. Public sector balances worsened in all European countries as a result. The question we raise in this chapter is, how was the fiscal adjustment to the Great Recession distributed between central and subnational governments? In view of the trade-off between political power and financial dependence, the answer to this question is not obvious. On the one hand, central governments might use their greater financial strength to shield local governments against the impact of the crisis. This would involve an increase in the transfers from central to local governments and, therefore, an increase in the degree of vertical imbalance during the crisis. On the other hand, central governments might use their greater political power to force local governments to absorb a greater part of the required fiscal adjustment by cutting transfers and forcing local governments to cut spending by more than in the first scenario. Apriori, it seems plausible that federal systems would tend to be closer to the second alternative and unitary systems closer to the first. The difference between the two scenarios matters, since allocative efficiency calls for a high degree of stability in the provision of local public goods and services, and would seem greater in the first.

"On one hand, central governments might use their greater financial strength to shield local governments against the impact of the crisis. On the other, they might use their political power to force local governments to absorb a greater part of the required fiscal adjustment"

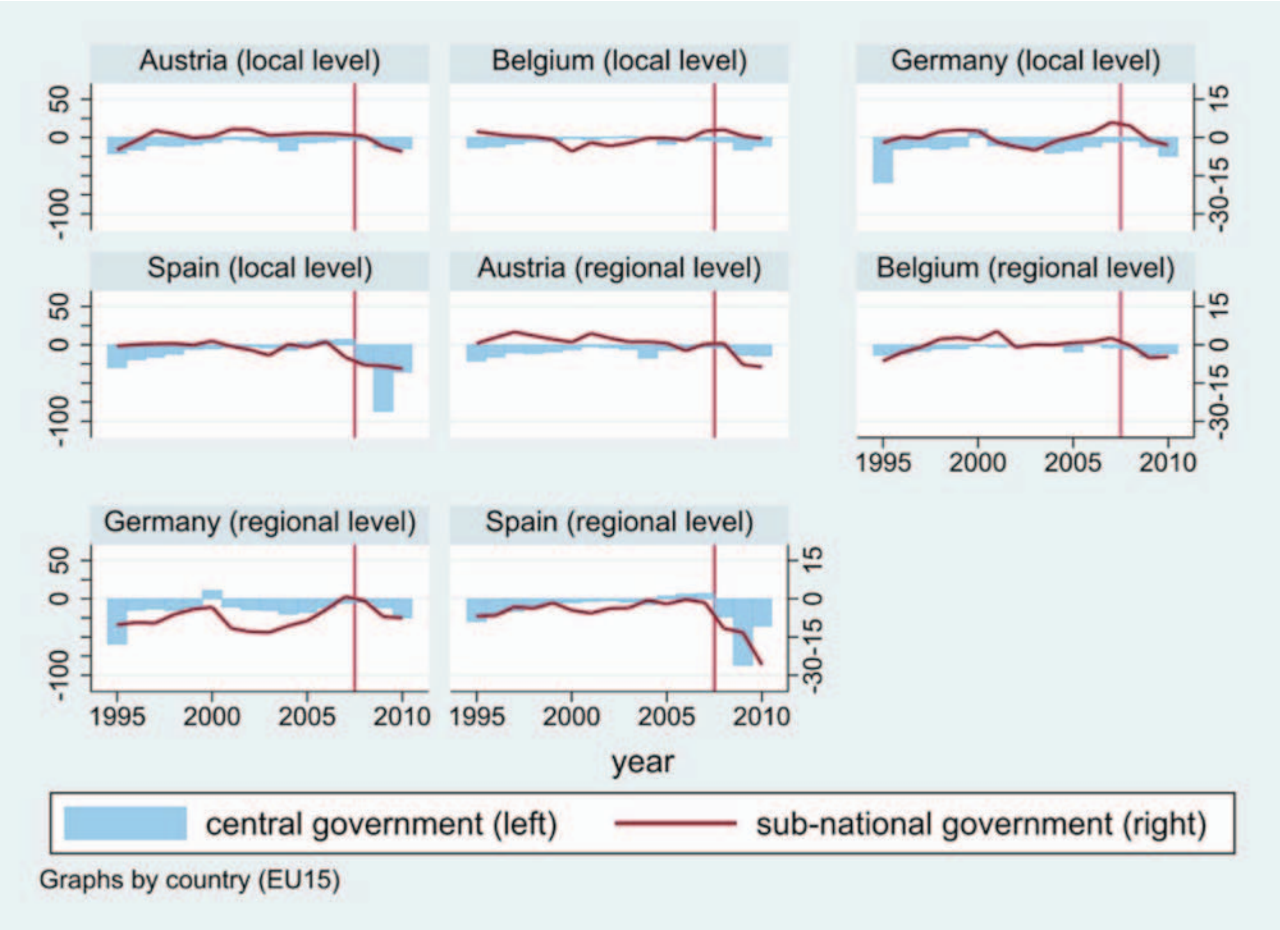
Empirical studies of the public finance ramifications of the Great Recession are scarce so far. Ter-Minassian and Fedelino (2010) discuss the impact of the Great Recession on sub-national government finance on qualitative grounds as data was not available. Most of their considerations are in line with our quantitative results presented below. Blöchliger et al. (2010) tackle the hurdle of missing data by using budget projections and results from questionnaires for a sample of OECD countries. Their paper focuses on the cyclical behavior of sub-national public-finances and national stimulus packages. Interestingly, their results indicate that part of some countries' stimulus packages consisted of grants and transfers to sub-national governments. The authors conclude that coordination of the reactions of central and sub-central governments to the Great Recession is essential to ensure that the financial stimulus efforts are as effective as possible. Jonas (2012) uses US data and documents a sharp decline in sub-national tax revenues due to the Great Recession. He discusses the procyclical policy reactions which occur due to borrowing limitations at the state and municipal level. The institutional set-up in European countries, however, differs substantially. Our analysis contributes to the literature by using most recent European sub-national fiscal data to study the differences between unitary and federal states.

The remainder of this chapter is organized as follows. Section 2 describes the impact of the Great Recession in terms of output gaps and government balances. Section 3 analyzes the response of the main budgetary aggregates of subnational governments during the Great Recession. Section 4 delves deeper into the material by distinguishing between the countries that fell into a public debt crisis after 2009 and those that did not. Section 5 concludes.

2. The Fiscal Impact of the Great Recession

Our sample consists of 15 EU member states for which consistent data is available, Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden, and the UK. Of these, Austria, Belgium, Germany, and Spain are federal countries, the others are unitary. For reasons of data availability, we distinguish between two levels of government in our empirical work: central government and subnational government, which includes local and regional government in the case of federal countries and local government in the case of unitary countries. Denmark, Sweden, and the UK do not belong to the euro zone, the others do. The sample covers the years from the beginning of the euro in 1995 to 2010, as more recent public finance data does not yet exist for all countries. Therefore, we cannot study the European public debt crisis in more detail.

Figure 1. Central and sub-national budget balances in federal countries



Notes: Budget balances as share of revenues. Data based on EUROSTAT and own calculations.

Figures 1 and 2 show the development of central government and subnational budget balances over the entire period. Figure 1 has the federations in the sample, while Figure 2 shows the data for the unitary states. The vertical red lines mark the beginning of the Great Recession. Clearly, central government balances turned negative with the onset of the recession everywhere. The evidence for subnational balances is more mixed. In the federations, subnational balances turn negative, too. In unitary states, however, no such general trend can be observed.

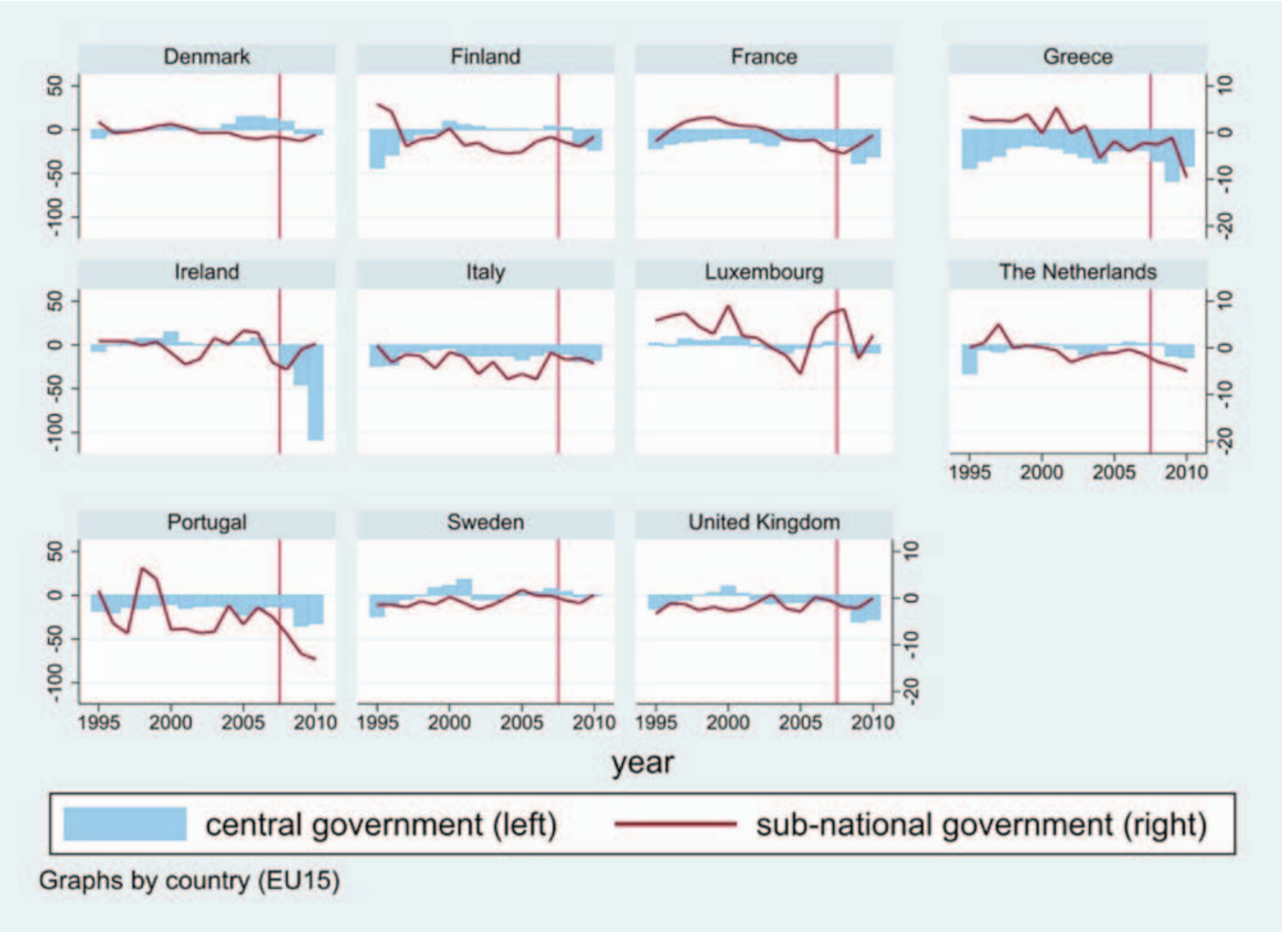
Figure 3 shows the development of the output gap over the sample period and for the sample countries. While the performance of individual countries was quite different in the period from 1995 to 2006, it is obvious from the large increase in the negative output gaps that the Great Recession hit all of them simultaneously in 2007. This provides a natural basis for the comparison we have in mind in this chapter.

Table 1 shows the shares of the main budget categories for subnational governments before the Great Recession. On the revenue side, revenues from tax bases where the sub-national jurisdiction has the power to change the tax rate autonomously (own taxes) have to be distinguished from taxes which are collected with a tax rate common to all jurisdictions and redistributed to regions or municipalities (shared taxes)[4].

Subnational governments in unitary states have a much larger share of own taxes and a much smaller share of shared taxes than subnational governments in federal states. Furthermore, subnational governments in unitary states finance themselves much more out of fees than subnational governments in federal states. Finally, subnational governments in unitary states receive relatively more transfers than subnational governments in federal states. These differences, except for transfers, are also statistically significant.

[4] The exact definition follows the OECD Fiscal Decentralization Database. We computed the share of own revenues according to this definition for all years covered in our dataset. For a more detailed discussion, see Foremny (2012).

Figure 2. Central and sub-national budget balances in unitary countries



Notes: Budget balances as share of revenues. Data based on EUROSTAT and own calculations.

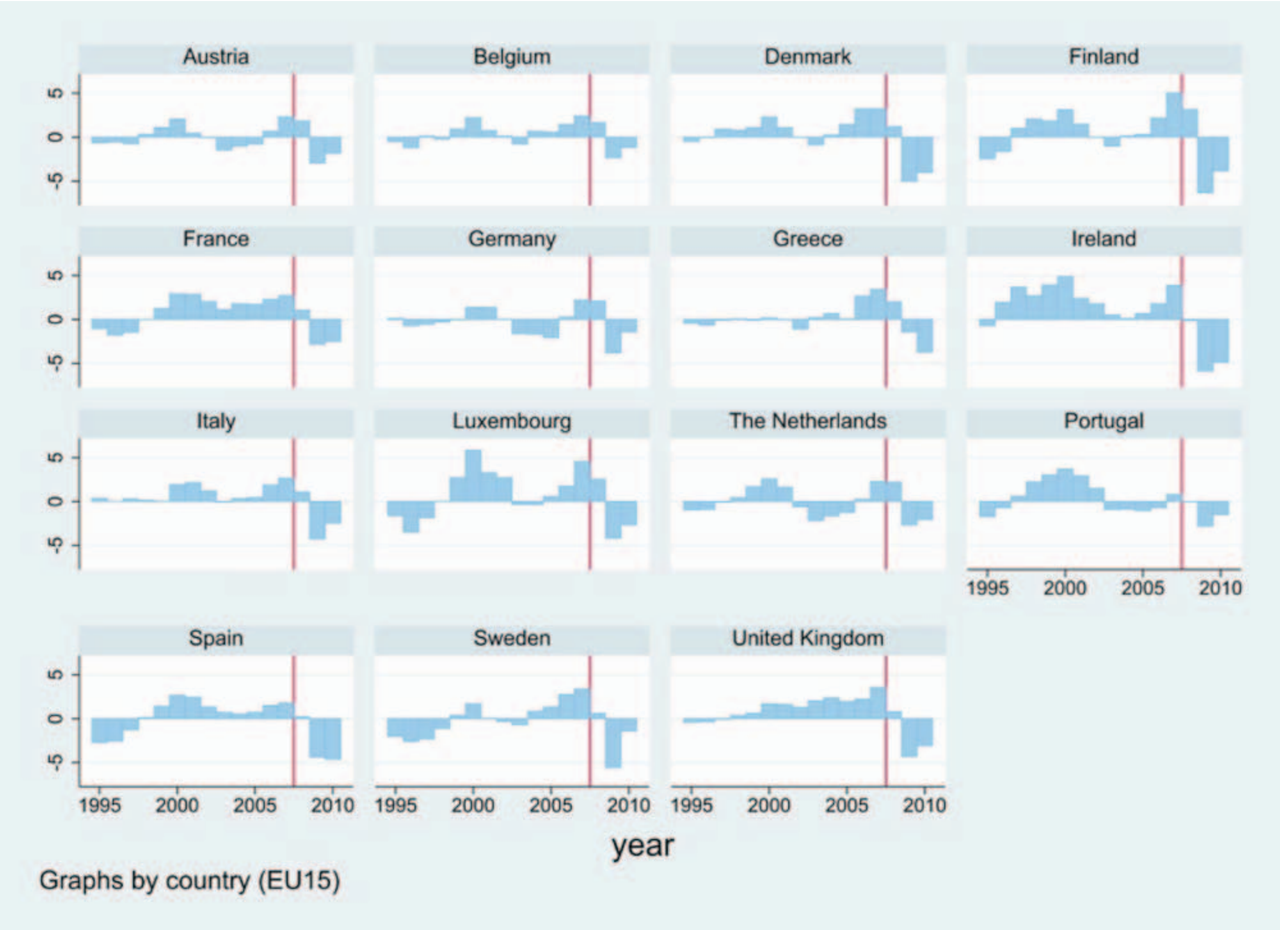
On the expenditure side, subnational governments in federal states have a larger share of spending on public services and education than subnational governments in unitary states. Conversely, the latter spend relatively more on housing and health. With regard to the other main spending categories, there are only minor differences in the shares between unitary and federal states.

Table 2 shows the response of central and subnational government balances to changes in the output gap in the years before and during the Great Recession. We regress the ratio of budget balances to total revenues at the respective level of government on the output gap. We use the ratio of budget balances to total revenues instead of the more commonly used ratio of budget balances to GDP, because consistent GDP data do not exist at the subnational level for all countries. Furthermore, this takes into account the different size of sub-national sectors relative to their capacity to raise revenues. All regressions are performed with and without country fixed effects.

Several observations are noteworthy. First, the response of central budget balances to the output gap is somewhat larger in federal states than in unitary states, but the difference is not statistically significant. Second, the response of central budget balances to the output gap increased significantly during the Great Recession in both federal and unitary states, with regression coefficients almost doubling for both groups. In terms of their budgetary responses to the Great Recession, central governments in federal and in unitary states are thus remarkably alike.

Things are different at the subnational level, however. Table 2 shows that, in the years before the Great Recession, subnational budget balances in federal states responded significantly and positively to changes in the output gap. Using the more reliable fixed-effects estimator, a one percent widening in a negative output gap would come with a worsening of aggregate subnational budget balances by 0.7 percent of aggregate revenues, which corresponds to about one fifth of the reaction of central government balances. Subnational

Figure 3. Output gap and impact of the crisis



Notes: Data based on EUROSTAT.

governments in European federal states thus behave anti-cyclically and pick up part of the macro economic adjustment to a widening recession. During the Great Recession, the reaction of subnational budgets to the output gap more than doubled, mimicking the stronger response of central government budgets to the recession.

The behavior of aggregate subnational government balances in unitary states is remarkably different. Table 2 shows that, before the Great Recession, subnational budget balances did not respond at all to changes in the output gap. The OLS estimate for the Great Recession has a significantly positive coefficient on the output gap, but the more reliable fixed-effects estimator has suggests no significant coefficient. This difference between unitary and federal countries during the Great Recession is also statistically significant. Thus, the data suggest that subnational government balances in our group of unitary countries are effectively shielded against cyclical movements of the macro economy.

"The data suggest that subnational government balances in our group of unitary countries are effectively shielded against cyclical movements of the macro economy"

This stark difference in the performance of subnational government finances between federal and unitary states is open to a number of different interpretations. One is that, in unitary states, central governments protect subnational governments against macro economic developments, and that central governments in federal states do not do that to the same extent. In a sense, the greater exposure of subnational governments to macro economic shocks in federal states could be interpreted as the price these governments have to bear for enjoying greater independence from

Table 1. Budget categories (1995-2007)

groups	(1) taxes	(1a) own taxes	(1b) shared taxes	(2) trans-fers	(3) fees	(4) other	(5) public services	(6) social protection	(7) defense	(8) public order and safety	(9) eco-nomic affairs	(10) envir-onment pro-tection	(11) housing and community amenities	(12) health	(13) re-creation culture and religion	(14) edu-cation
	revenue side (shares of total revenues)						expenditure side (shares of total expenditures)									
federations	40.6***	17.7***	22.9***	40.9***	8.8***	9.8***	20.4***	16.4***	0.0	4.5***	13.6***	4.1***	4.3***	10.5***	5.4***	20.8***
	(1.8)	(1.5)	(1.4)	(1.8)	(0.56)	(0.38)	(0.96)	(1.2)	(0.00)	(0.34)	(0.51)	(0.44)	(0.46)	(1.4)	(0.32)	(0.88)
unitary countries	32.4***	28.4***	4.0***	44.4***	14.4***	7.8***	15.7***	18.0***	0.01***	2.6***	13.2***	6.5***	6.7***	14.3***	6.3***	16.5***
	(1.6)	(1.3)	(1.2)	(1.6)	(0.48)	(0.34)	(0.82)	(1.0)	(0.00)	(0.29)	(0.43)	(0.37)	(0.39)	(1.2)	(0.28)	(0.75)
Observations	247	247	247	234	247	234	247	247	236	247	247	247	247	247	247	247
R-squared	0,79	0,71	0,53	0,84	0,82	0,84	0,77	0,68	0,29	0,51	0,87	0,62	0,62	0,44	0,76	0,81
F-test[1]	11,73	28,63	106,30	2,16	57,95	16,45	13,76	1,11	27,10	18,59	0,44	17,83	18,66	3,95	4,24	14,15
p-value	0,00	0,00	0,00	0,14	0,00	0,00	0,00	0,29	0,00	0,00	0,51	0,00	0,00	0,05	0,04	0,00

Notes: Standard errors in parentheses. 1) F-test for equal coefficients. No data for transfers available for Greece. *** p<0.01, ** p<0.05, * p<0.1

Table 2. Cyclical response of budget balances

variables	groups		(1a) CS	(1b) FE	(2a) CS	(2b) FE
			budget balance as share of revenues			
			sub-national		central	
output gap	federations	1996-2007	**0.41***	**0.70****	**3.9*****	**3.4*****
			(0.23)	**(0.29)**	**(0.69)**	**(0.77)**
		Great Recession (2008-2010)	**2.8*****	**1.8*****	**6.7****	**6.2****
			(0.48)	**(0.44)**	**(2.9)**	**(2.8)**
	unitary countries	1996-2007	0.004	0,05	**2.2*****	**2.3*****
			(0.19)	(0.13)	**(0.44)**	**(0.51)**
		Great Recession (2008-2010)	**0.46*****	0,31	**4.3*****	**4.5*****
			(0.18)	(0.20)	**(1.4)**	**(1.5)**
interest			-0.05***	0.04*	-2.8***	-3.3***
			(0.01)	(0.02)	(0.43)	(0.9)
constant			0.37	-2.2***	-1,5	-0.2
			(0.38)	(0.6)	(1.4)	(2.7)
		Observations	304	304	240	240
		R-squared	0,247	0,223	0,369	0,427
		Number of groups		19		15
		F-test (H01)[1]	9,7	3,8	0,93	1,4
		Prob > F (H01)	0,00	0,07	0,34	0,26
		F-test (H02)[2]	2,8	1,0	2,1	2,7
		Prob > F (H02)	0,09	0,33	0,15	0,13
		F-test (H03)[3]	10,2	9,7	0,60	0,29
		Prob > F (H03)	0,00	0,01	0,44	0,60

Notes: Robust standard errors in parentheses. 1) F-Test H_0^1 for equal coefficients of both periods in federations, 2) F-Test H_0^2 for equal coefficients of both periods in unitary countries, 3) F-Test H_0^3 for equal coefficients of unitary countries and federations during the crisis. *** p<0.01, ** p<0.05, * p<0.1

the central government. If subnational governments borrow to keep their expenditures for the provision of public goods and services stable in the face of adverse macro economic shocks, the cost of borrowing could be interpreted as the price they pay for enjoying a greater political freedom. In contrast, subnational governments in unitary states are insured against macro economic shocks, but they enjoy less independence from the central government in return.

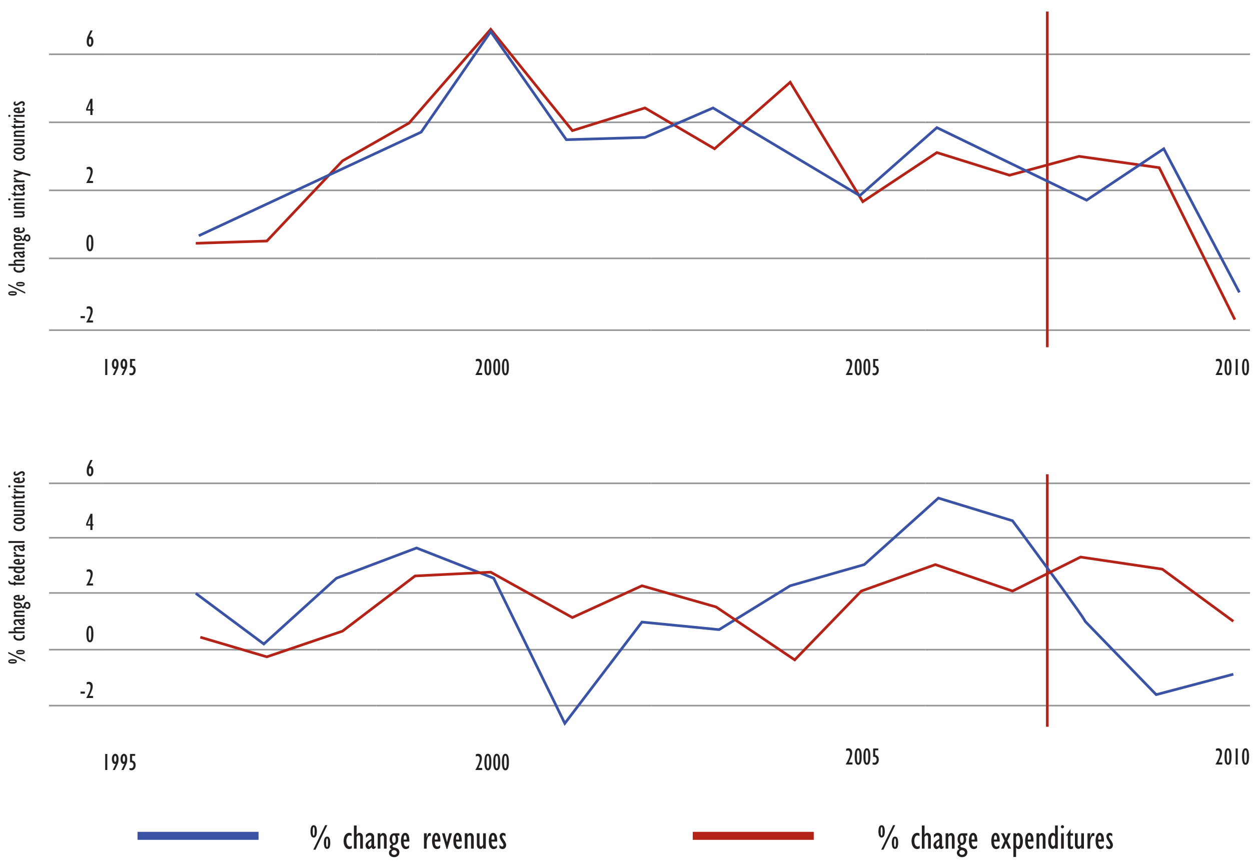
The other interpretation is that the different reactions of subnational budget balances to macro economic shocks reflect different degrees in the ability and legal authority of subnational governments to borrow in their own right. If subnational governments in unitary states are more restricted in this regard than subnational governments in federations, the result that subnational balances in unitary states do not react to macro economic shocks might indicate that subnational governments are forced to cut spending in line with falling revenues during a recession, and that they increase expenditures when revenues are strong in good times. This would imply that the provision of local public services is less stable over time in unitary states than in federal states. In the next sections, we will explore these different interpretations in more detail.

> **"The greater exposure of subnational governments to macroeconomic shocks in federal states could be interpreted as the price they have to bear fo enjoying greater independence from the central government"**

3. Subnational Fiscal Adjustment to the Great Recession

Figure 4 shows the average annual growth rates of real subnational government revenues and expenditures over the sample period.

Figure 4. Year-on-year percentage change of revenues and expenditures



Notes: Real values price adjusted with the GDP deflator. Average weighted by country GDP.

Table 3. Short-term changes in fiscal policy-revenues

	groups			(1) budget balance as share of revenues	(2) total	(3) tax	(3a) own tax	(3b) revenue side shared tax	(6) transfers	(7) fees
A) unitary vs. federal countries	federations		1996-2007	-1.2***	1.9***	5.4***	7.9**	5.2*	1.8*	0,03
				(0.38)	(0.49)	(1.9)	(3.8)	(3.2)	(1.0)	(1.1)
			Great Recession	-5.1***	-0,27	-0,82	-3.0	-1,4	1,5	2.0***
			(2008-2010)	(1.3)	(0.75)	(1.8)	(1.8)	(1.8)	(1.9)	(0.59)
	unitary countries		1996-2007	-0.45*	3.2***	4.2***	5.5***	3.3*	2.8***	3.5***
				(0.27)	(0.57)	(0.68)	(1.5)	(1.7)	(1.0)	(0.46)
			Great Recession	-2.5***	0,92	-0,21	-2,4	0,15	4.8***	1,12
			(2008-2010)	(0.68)	(1.0)	(1.2)	(3.1)	(4.7)	(1.8)	(0.77)
			Observations	304	285	285	285	285	270	285
			R-squared	0,18	0,16	0,10	0,05	0,02	0,07	0,10
B) crisis vs. non-crisis countries	federations	non-crisis countries	1996-2007	-0.90*	0,49	2.4**	1.6	4.0	1,3	-1,6
				(0.49)	(0.51)	(1.2)	(1.6)	(4.1)	(1.2)	(1.4)
			Great Recession	-2.6***	0,12	1,1	-1,7	1,2	0,03	1.6**
			(2008-2010)	(0.91)	(0.61)	(2.1)	(2.3)	(1.4)	(1.9)	(0.60)
		crisis countries	1996-2007	-2.0***	6.0***	14.2**	26.9*	9.2***	3.3**	4.9***
				(0.47)	(0.72)	(6.4)	(14.0)	(3.2)	(1.6)	(1.4)
			Great Recession	-12.8***	-1,4	-6.7**	-6.7***	-9.1**	5,9	3.3**
			(2008-2010)	(2.5)	(2.3)	(2.8)	(2.0)	(4.5)	(4.6)	(1.4)
	unitary countries	non-crisis countries	1996-2007	0,07	2.6***	3.0***	3.1***	3,3	2.8***	3.5***
				(0.30)	(0.44)	(0.60)	(0.56)	(2.6)	(0.91)	(0.48)
			Great Recession	-1.2**	2.4***	0,4	0,09	-5,1	6.4***	1.4**
			(2008-2010)	(0.60)	(0.48)	(1.0)	(1.1)	(3.5)	(2.2)	(0.60)
		crisis countries	1996-2007	-1.4***	4.3***	6.3***	9.8**	3.4**	2,7	3.4***
				(0.52)	(1.4)	(1.5)	(4.0)	(1.7)	(2.6)	(0.94)
			Great Recession	-4.9***	-1,7	-1,3	-6,8	9,3	1,3	0,64
			(2008-2010)	(1.3)	(2.5)	(2.7)	(8.1)	(11.1)	(3.1)	(1.9)
			Observations	304	285	285	285	285	270	285
			R-squared	0,31	0,23	0,17	0,12	0,04	0,08	0,14

Notes: From (2) onwards year on year percentage growth rates of budgetary categories in real values. No data for transfers available for Greece. Robust standard errors in parentheses. Budget balance data from 1995 onwards. *** $p<0.01$, ** $p<0.05$, * $p<0.1$

Averages are weighted with countries' GDPs, and real data are computed using the GDP deflator. The upper panel of Figure 4 shows the growth rates for unitary states. It indicates, first, that the growth rates of real revenues and real expenditures track each other very closely and cross frequently, indicating that any change in the deficit is quickly reverted. Second, the Figure shows that, in the two major recessions that occurred during the sample period, the recession of 2001 and the Great Recession, the growth rates of real spending and real revenues fell together.

The lower panel of Figure 4 illustrates that subnational governments in federal states on average behave quite differently. Expenditure and revenue growth track each other much less closely. In particular, real spending growth is much more stable in recessions than real revenue growth. Comparing the upper and the lower panel indicates that the differences in growth rates during recessions are much more pronounced in federal states and that real spending growth is much more stable in federal states. This is confirmed by the observation that the standard deviation of real expenditure growth rates over the entire sample is 2.02 percent for unitary countries, which compares to 1.20 percent for federal countries.

The top panel A) of Table 3 shows how subnational governments performed in the period before the Great Recession and how

Table 4. Short-term changes in fiscal policy - expenditures

	groups			(9) total	(10) public services	(11) social protection	(12) public order and safety	(13) economic affairs	(14) en-vironment protection	(15) housing and community amenities	(16) health	(17) recreation, culture and religion	(18) education
				expenditure side									
A) unitary vs. federal countries	federations		1996-2007	1.5***	1.2**	2.4***	3.4***	1.9**	1.0	0,89	4.5**	3.7***	1.6**
				(0.51)	(0.56)	(0.67)	(1.2)	(0.83)	(1.9)	(1.7)	(2.0)	(1.2)	(0.78)
			Great Recession	2.6***	2.7**	4.5***	1.7*	2.4*	0,58	1,5	3.1***	1,1	2.8***
			(2008-2010)	(0.49)	(1.3)	(0.92)	(0.92)	(1.3)	(1.3)	(2.8)	(1.1)	(0.78)	(0.75)
	unitary countries		1996-2007	3.4***	3.2***	8.5*	2.3***	4.2***	5.3***	3.7**	4.5**	3.5***	4.1***
				(0.60)	(0.88)	(4.8)	(0.79)	(1.1)	(0.7)	(1.5)	(2.2)	(0.85)	(0.54)
			Great Recession	1,4	1,2	2,9	3.4**	1,4	-1,2	0,7	6,5	2.0	0,02
			(2008-2010)	(0.97)	(1.9)	(2.3)	(1.3)	(1.5)	(1.6)	(3.5)	(9.1)	(1.4)	(1.7)
			Observations	285	285	285	285	285	285	285	285	285	285
			R-squared	0,17	0,08	0,03	0,08	0,08	0,08	0,02	0,03	0,10	0,16
B) crisis vs. non-crisis countries	federations	non-crisis countries	1996-2007	0,03	0.0	0,76	2,21	0,51	-0,59	0,12	3,5	2.7*	-0,24
				(0.53)	(0.65)	(0.63)	(1.5)	(1.0)	(2.4)	(2.2)	(2.3)	(1.5)	(0.49)
			Great Recession	2.5***	1,9	3.5***	1.9**	2.3**	1,1	-0,27	1,8	1.8**	3.4***
			(2008-2010)	(0.35)	(1.2)	(0.49)	(0.83)	(0.94)	(1.4)	(2.9)	(1.1)	(0.79)	(0.41)
		crisis countries	1996-2007	5.8***	4.9***	7.5***	7.0***	6.0***	5.9**	3,2	7.2*	6.6***	7.2***
				(0.70)	(0.77)	(1.5)	(2.0)	(1.7)	(2.3)	(2.4)	(4.3)	(1.0)	(2.5)
			Great Recession	2,8	5.0	7.5**	0,88	2,45	-1.0	6,9	7.2***	-0,83	0,79
			(2008-2010)	(1.7)	(3.5)	(3.1)	(2.7)	(4.3)	(2.8)	(6.4)	(2.4)	(1.8)	(2.6)
	unitary countries	non-crisis countries	1996-2007	2.7***	2.4**	1.8*	2.5**	3.1**	4.7***	2,9	5.2*	2.8***	3.7***
				(0.45)	(1.0)	(0.91)	(1.5)	(1.6)	(0.86)	(2.2)	(3.1)	(0.79)	(0.50)
			Great Recession	2.6***	2,1	4.7***	2.4***	3.9***	-0,97	3,8	9,9	1.7*	1,2
			(2008-2010)	(0.66)	(1.4)	(0.98)	(0.85)	(1.4)	(2.2)	(5.3)	(14.4)	(0.96)	(1.2)
		crisis countries	1996-2007	4.8***	4.7***	20,2	2.0*	6.1***	6.2***	5.0**	3,3	4.6**	4.9***
				(1.5)	(1.6)	(13.0)	(1.2)	(1.5)	(1.2)	(2.0)	(2.9)	(1.9)	(1.2)
			Great Recession	-0,63	0,18	-0,36	5,1	3.0	-1,6	-4.7**	0,46	2,4	2.0
			(2008-2010)	(2.3)	(4.8)	(5.9)	(3.3)	(2.9)	(2.0)	(2.0)	(0.68)	(3.5)	(4.3)
			Observations	285	285	285	285	285	285	285	285	285	285
			R-squared	0,25	0,11	0,05	0,10	0,12	0,10	0,03	0,03	0,11	0,22

Notes: Year on year percentage growth rates of budgetary categories in real values. Robust standard errors in parentheses. *** $p<0.01$, ** $p<0.05$, * $p<0.1$

they adjusted the revenue side of their budgets to the Great Recession. The first column shows the average budget balance as a ratio of total revenues for the period from 1995 to 2007 (pre-crisis) and during the Great Recession (2008-2010, crisis). Consider the pre-crisis period first. As suggested by Figure 4 already, average deficits at the subnational level were much larger in federal countries than in unitary countries. Total real revenues were growing on average in both groups, but more so in unitary states. While real revenues from both own taxes and shared taxes were growing at significantly positive rates in both groups, the main difference between the two was that the growth of transfers and fee incomes was highly significantly positive in unitary states but only weakly significant or not significant at all in federal states.

During the Great Recession, more differences emerged between the two groups. While the average deficit widened in both countries, it did much more so in federal states. The average deficit of federal countries during the Great Recession is statistically significantly different from that of unitary countries.

This is consistent with our observations from Table 1. While the growth rates of real revenues from all sources except transfers from above and fees turned negative (though not significantly so) for federal countries, the pattern is much more mixed in unitary countries, where revenues from shared taxes actually increased (though not significantly). In part, at least, this reflects deliberate policies on the part of central governments which increased the subnational governments' share in these revenues. In Finland, for example, the subnational governments' share of corporate tax income was raised by 10 percentage points to 32 percent for the fiscal years 2009 to 2011. This indicates that the distinction between transfers from the central government and revenues from shared taxes is somewhat murky in unitary countries; if the central government can change the distribution of shared taxes between the two levels of government, shared taxes are much like transfers from the central to local governments[5]. Subnational governments in federal countries saw a significant growth in revenue from fees during the Great Recession, which cannot be observed for subnational governments in unitary countries. The latter, however, saw a significant increase in transfers from the central government during the Great Recession which did not occur in federal states. This suggests that the degree of vertical imbalance increased in unitary states but not in federal states, and that subnational governments in the latter group took much stronger recourse to fees to finance their activities than subnational governments in unitary states. This pattern is also confirmed by the statistical tests. Deficits, total revenues and total tax revenues grew at significantly different rates before and during the Great Recession in both groups.

"Subnational governments in unitary countries saw a significant increase in transfers from the central government during the Great Recession which did not occur in federal states"

Table 4 provides similar data for the expenditure side of the budget. During the period before the Great Recession, subnational government real spending was growing at significantly positive rates in both groups, but the average growth rate in unitary states was about twice the rate in federal states. During the Great Recession, total subnational spending grew significantly and at a higher rate than before in federal countries. This growth can be mainly attributed to a strong increase in the growth rate of real spending on social protection. In unitary states, the growth rate of total real spending fell and became non-significant during the Great Recession. The largest declines in real spending growth occurred in the areas of environmental protection, housing and community amenities, and education. Comparing Tables 3 and 4, it seems that increasing real expenditures contributed significantly to the emergence of subnational budget deficits in federal states, while subnational budget deficits in unitary states were mainly due to declining revenues.

4. Subnational Fiscal Performance in the Debt Crisis Countries

The bottom part B) of Tables 3 and 4 provide similar data as before, but they distinguish between those countries that fell into public debt crises after 2009 and the rest. Among the federal states, we count Spain as a crisis country. Among the unitary states, the crisis countries are Greece, Ireland, Italy, and Portugal.

Table 3 again considers the budget balance ratios and real revenue growth rates. Clearly, subnational governments in crisis countries had much larger deficits relative to total revenues already before the Great Recession and these deficits widened both relative to total revenues and compared to non-crisis countries during the Great Recession. Note that subnational governments in unitary non-crisis countries had practically balanced budgets over the period from 1996 to 2007, while subnational governments in crisis countries had an average deficit of 1.4 percent of total revenues. Table 3 thus indicates that there was a lack of fiscal discipline at the subnational level in (what later turned out to be) the crisis countries already before the Great Recession, and that subnational government budgets in countries that fell into a debt crisis seem much more exposed to cyclical downturns than in subnational government budgets in non-crisis countries.

Turning to the growth rates of real revenues, Table 3 shows that subnational governments in crisis countries generally had much stronger revenue growth in the years before the Great Recession and experienced a much stronger decline in revenue growth during the Great Recession than subnational governments in non-crisis countries.

Finally, the Table shows that there are interesting differences between unitary non-crisis and crisis states. In the first group, transfers to subnational governments increased significantly already before the Great Recession, and central governments stepped up their transfers even more during the Great Recession. This group thus corresponds very well to the paradigm of central governments insuring subnational governments against losses of tax revenues in bad times. In contrast, transfers to subnational governments grew significantly neither before nor during the Great Recession in the crisis countries, resulting in much more procyclical revenues in these countries.

Turning to the expenditure side, Table 4 suggests that, in the group of federal states, subnational government real spending did not grow

[5] For a similar observation in Portugal, see Portuguese Council of Public Finances (2012).

significantly on average over the period before the Great Recession in the non-crisis countries, but subnational governments increased spending significantly and mostly on social protection during the Great Recession. In the crisis countries, in contrast, subnational government spending grew very rapidly and in all categories already before the Great Recession. When the recession hit, subnational governments had to increase spending on social protection and cut spending growth in all other categories.

Among the unitary states, we observe that subnational government real spending grew much faster in the crisis states than in the non-crisis states before the Great Recession. With the onset of the recession, subnational governments in non-crisis states managed to maintain a stable spending growth rate both for total spending and for most individual categories, only spending on social protection grew much more rapidly than before. The crisis states, in contrast, had to cut spending growth drastically, resulting in negative growth rates for total spending and several individual categories including social protection.

"In non-crisis states, transfers to subnational governments increased significantly before and during the Great Recession. The crisis states had to cut spending growth drastically, resulting in negative growth rates for total spending"

5. Conclusions

This chapter has studied the subnational fiscal adjustment to the Great Recession in a sample of European countries. We find that the Great Recession had important ramifications for public finances in the sample countries, and that there are important differences between unitary and federal countries.

Our results show that subnational governments in federal states reacted to the Great Recession by running larger budget deficits driven by increased spending particularly on social protection and weak revenue performance. In contrast the revenues of subnational governments in unitary states increased during the Great Recession due to larger transfers from central governments. Subnational government deficits increased much less in unitary states as real spending growth fell.

Several different patterns of adjustment to the Great Recession emerge. Unitary countries that did not fall into a debt crisis later conform most to the paradigm of a country where a financially and politically strong central government shields local governments against the effects of adverse macro economic shocks, allowing them to maintain a stable provision of local public goods and services. In federal countries that did not fall into a debt crisis later, subnational governments managed to borrow to stabilize their spending on the provision of public goods and services while increasing their spending on social protection. These countries conform most to the paradigm of a federalist model where the cost of borrowing during adverse macro economic times is the price subnational governments pay for their greater independence from the central government.

In unitary states that fell into a debt crisis, the central government failed to shield local governments against the adverse macro economic consequences of the Great Recession, forcing them to adjust real spending to falling real revenues. As a result, subnational governments performed more pro-cyclically than in the non-crisis group. It is likely that this had more adverse consequences for the efficiency of the provision of local public goods and services than in the former group of unitary countries. This result suggests that sound public finances at the central level are critical to assure that subnational governments can deliver their allocative functions efficiently in the face of adverse macro economic conditions. In fact, our results suggest that greater allocative efficiency in unitary states calls for tighter controls on expenditure growth during goods times and better protection against falling subnational revenues in bad times.

"Sound public finances at the central level are critical to assure that subnational governments can deliver their allocative functions efficiently in the face of adverse macro economic conditions"

Similarly, subnational governments in Spain, the crisis country among the federal countries in our sample, had to revert drastically the previously fast growth of real spending during the Great Recession, probably with adverse allocative consequences for the provision of local public goods and services. Our results suggest that subnational governments in Spain rely on revenues from taxes which are more cyclically elastic than subnational governments in other European federations, and that they let their real expenditures grow much faster in good times than subnational governments in the other federations. A more efficient model of federalism would call for a higher degree of fiscal discipline at the subnational level in good times to assure that subnational governments can sustain the anti-cyclical adjustment the federal model requires of them in bad times.

We find that the countries that fell into a debt crisis after the Great Recession are characterized by weaker fiscal discipline at the subnational level already in the decade or so before the Great

"Subnational governments in Spain had to revert drastically the previously fast growth of real spending during the Great Recession"

Recession. While we cannot make any assertions about causality between these two based on our data, this observation suggests that the sustainability of subnational public finances is an important prerequisite for a country to maintain sustainable public finances at the level of general government in the face of adverse macro economic developments. Paying attention to this prerequisite is important for both federal and unitary states and justifies the imposition of appropriate fiscal rules by the central government in both types of systems, even if the design of such rules is likely to differ between them.

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Regional Public Finances During the Crisis: From Peace of Mind to Agitation

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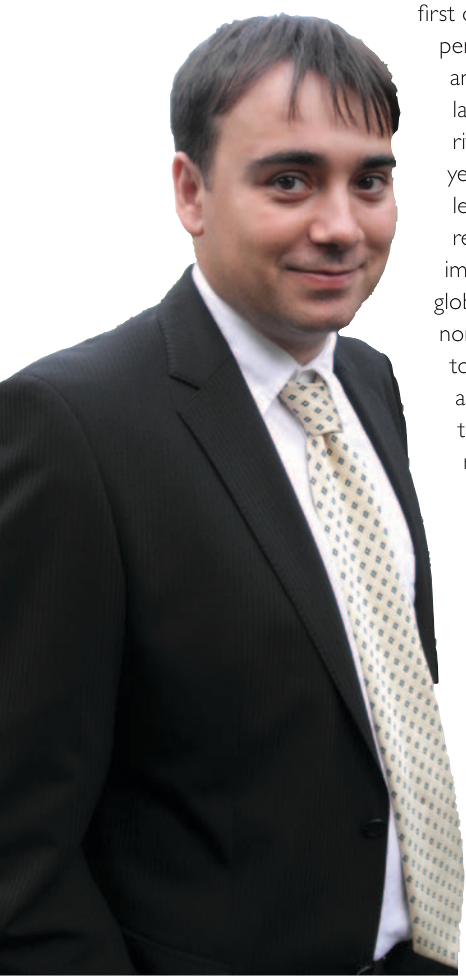
1. Introduction

The economic crisis has dealt a strong blow to all the public administrations in Spain. Public revenue has plummeted fast, forcing all levels of government –central, regional and local– to reconsider their fiscal policies.



This paper has two main objectives. The first one is to describe the aggregate performance of regional revenue and expenditure from 2007 –the last year of economic prosperity– to 2011, the last financial year for which we have the settled accounts of the autonomous regions. The second objective implies moving downward from global data to those of each autonomous region. The idea is, firstly, to present the existing differences among autonomous regions in terms of their expenditure and revenue performance during the sample period and, secondly, to identify the factors which can explain such disparities in performance[1].

These objectives are addressed, in order, in the following two sections. The paper concludes with a section summarising the main conclusions and a brief commentary on the evolution of the financial performance of the autonomous regions in the first semester of 2012.

2. Revenue and Spending at the Autonomous Region Level Between 2007 and 2011

Graphs 1 and 2 respectively show the aggregate performance of the revenue and spending of the autonomous regions as a whole, both under the common and foral (chartered) regimes, between 2007 and 2011. In terms of revenue, the following aspects are worth noting. Current revenue drops slightly in 2008 (by 0.11%) and, after an equally slight recovery in 2009, the year in which the autonomous financing model reform comes into force, it falls once again in 2010 and 2011, at a slower rate in 2011, year in which we can appreciate a certain growth of GDP. In 2011, current revenue reaches 87.05% of that registered in 2007.

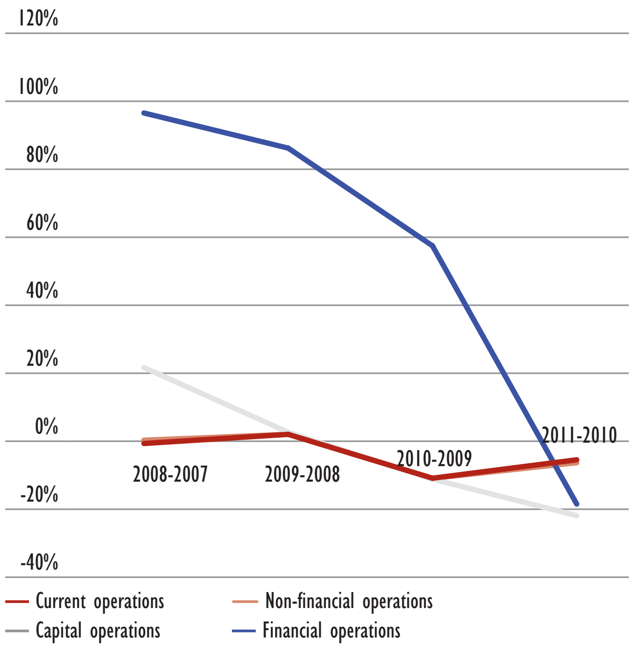
Capital revenues performance is similar: there is a substantial growth in 2008 and 2009, and a reduction in the last two years of the period. In 2011, capital revenues account for 88.21% of the revenue of 2007. Consequently, non-financial revenues in the autonomous regions as a whole experience a slight increase in 2008 (0.88%) and 2009 (2.67%), and a downturn in 2010 and 2011, accounting for 87.10% of the figure for 2007 in this last year.

On the other hand, as shown in Graph 1, the growth rates of financial revenues have been high but gradually decreasing between 2007 and 2010, and have fallen in 2011. Between 2007 and 2011, financial revenues have increased by 375.80%.

As shown in Graph 2, the autonomous regions have slowly reacted to the economic crisis in terms of their expenditure policies. All non-financial expenditures experience significant growth between 2007 and 2008: current expenditure by 10.48% and capital expenditure by 11.69%, thus producing an increase of 10.70% in non-financial operations. A drop of 11.41% in financial operations is recorded for that year.

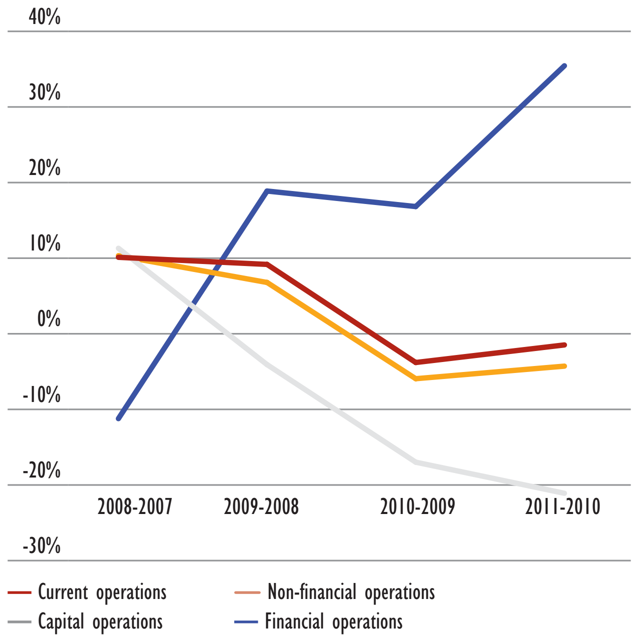
[1] For the performance of the public finances of the autonomous regions during the crisis, see also Cardoso et al. (2011), FUNCAS (2012) and Ruiz-Huerta et al. (2012).

Graph 1. Evolution of Autonomous Community revenues 2007-2011(year-on-year variation)



Source: Own elaboration based on information provided by the General Secretariat for Regional and Local Coordination (Ministry of Public Finances and Public Administration). Data for 2007-2010: Settlement of Budgets of Autonomous Regions and Cities; 2011 Data: Quarterly budgetary execution of Autonomous Regions (execution data, Report on budgetary execution of Autonomous Regions). Revenues relating to Local Financial Intermediation, EAGF Funds and other items of a similar nature have been removed.

Graph 2. Evolution of Autonomous Community expenditure 2007-2011(year-on-year variation)



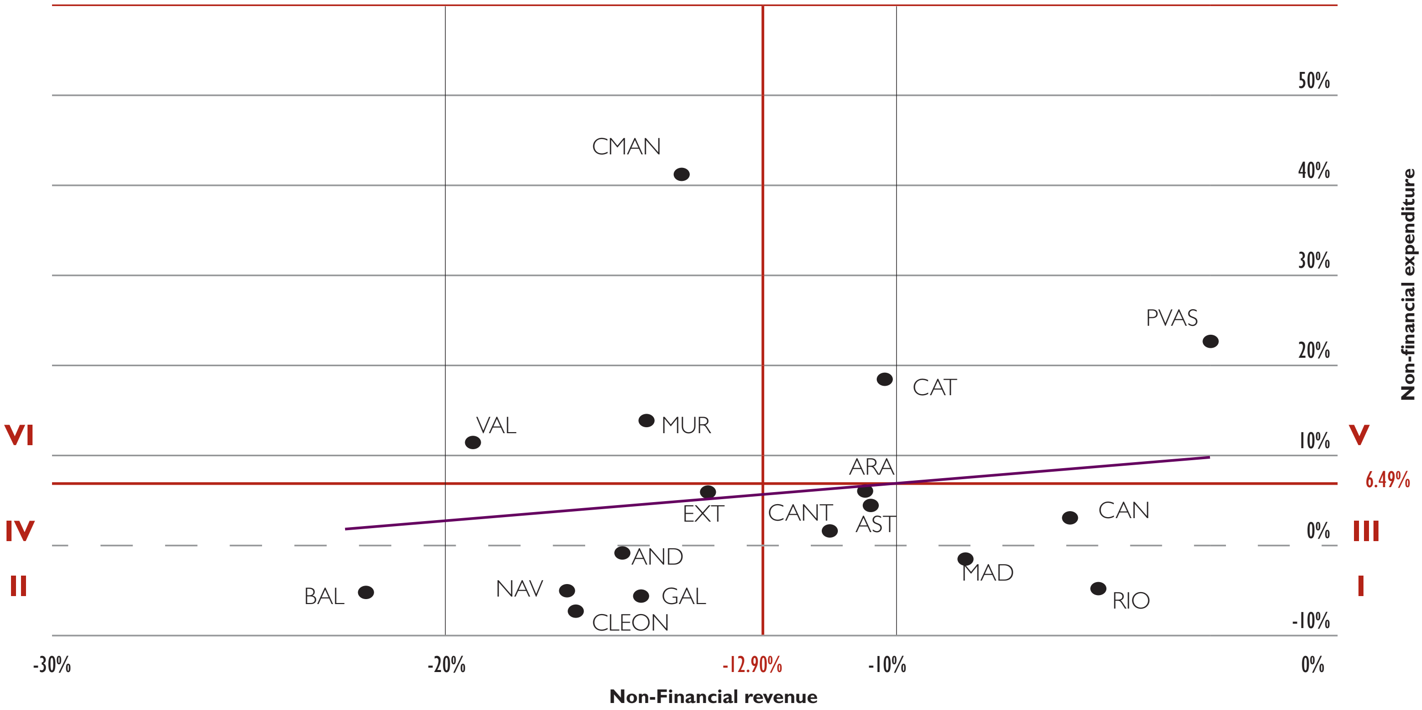
Source: Own elaboration based on information provided by the General Secretariat for Regional and Local Coordination (Ministry of Public Finances and Public Administration). Data for 2007-2010: Settlement of Budgets of Autonomous Regions and Cities; 2011 Data: Quarterly budgetary execution of Autonomous Regions (execution data, Report on budgetary execution of Autonomous Regions). Expenditures relating to Local Financial Intermediation, EAGF Funds and other items of a similar nature have been removed.

Consumption expenditure continues to grow in 2009, but at a lower rate than the previous year, with the exception of financial expenditure (debt interests) and current transfers. As a result, the rise in current expenditure is somewhat moderate, reaching 9.51%. However, capital expenditure suffers its first adjustment, with a reduction of 4.03% compared to 2008, leading to an increase in non-financial expenditure of 7.05%. Financial operations likewise increase considerably between 2008 and 2009.

2010 is the first year in which adjustments are made to all expenditure items, with the logical exception of financial expenditure and financial operations, which continue to grow throughout the year and the next. However, on the one hand, this effort becomes less intense already in 2011 and, on the other, the adjustment burden continues to be placed, to a greater extent, on capital expenditure. In fact, while current expenditure falls by 3.89% in 2010 and by 1.49% in 2011 (except for personnel costs, which increase in 2011), capital expenditure falls by 17.21% and 21.41% respectively. Non-financial expenditure falls by 6.06% in 2010 and by 4.35% in 2011.

"The autonomous regions have slowly reacted to the economic crisis in terms of their expenditure policies. All non-financial expenditures experience significant growth between 2007 and 2008"

Graph 3. Evolution of non-financial revenue and expenditure by Autonomous Community (variation 2007-2011)



Source: Own elaboration based on information provided by the General Secretariat for Regional and Local Coordination (Ministry of Public Finances and Public Administration). Data for 2007-2010: Settlement of Budgets of Autonomous Regions and Cities; 2011 Data: Quarterly budgetary execution of Autonomous Regions (execution data, Report on budgetary execution of Autonomous Regions). Revenues and expenditures relating to Local Financial Intermediation, EAGF Funds and other items of a similar nature have been removed.

When comparing the obligations recognised for 2007 and 2011, it is clear that only capital expenditure has fallen during this period, by 30.26%. All other items have risen, quite significantly in some cases. As for current expenditure, current acquisitions of goods and services have risen by 8.47%, current transfers by 9.92%, personnel costs by 17.20% and financial expenditure by 110.19%, thus causing current operations to grow by 14.56% and non-financial operations by 6.49% in the period between 2007 and 2011. During this period, the financial expenditure has increased by 68.52%.

The deficit levels are the logical reflection of the performance of non-financial revenues and expenditures of the autonomous regions. According to the Protocol on the Excessive Deficit Procedure, the aggregate regional deficit accounted for 0.2% of the GDP in 2007, 1.7% in 2008, 2.0% in 2009, 3.5% in 2010 and 4.7% in 2011. On its part, the overall debt held by the autonomous regions went from 5.8% of GDP in 2007 to 13.3% at the end of 2011: an increase in excess of 129%.

3. Different Performances of the Autonomous Regions

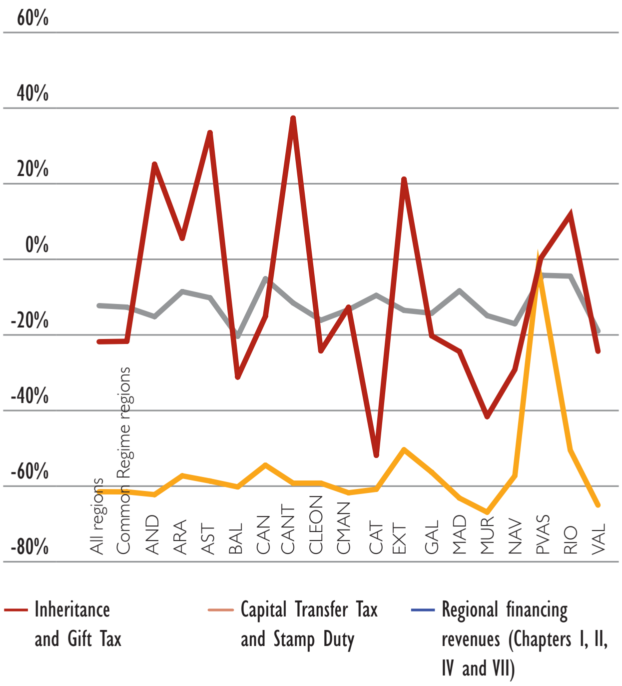
The aggregate analysis undertaken in the previous section conceals the considerable differences in the performance of revenue and expenditure for each of the seventeen autonomous regions. In this section we track the autonomous regions individually for the overall 2007-2011 period, that is to say, without considering the year-on-year changes which might have taken place in each region.

Graph 3, which classifies the autonomous regions according to the performance of their non-financial revenue and expenditure between 2007 and 2011, will prove very useful for this examination. As can be observed in the Graph, there is a certain correlation between the drop in non-financial revenue and the adjustment of non-financial expenditure.

"The overall debt held by the autonomous regions went from 5.8% of GDP in 2007 to 13.3% at the end of 2011: an increase in excess of 129%"

As we shall soon see, the differences in the performance of non-financial expenditure depend, to a large extent, on the policy decisions made by each autonomous region. However, several factors affect the performance of non-financial revenue. In the first place, and as logical, this is also affected by the tax policy measures adopted by the regions, in some cases, designed to increase, and in others, to reduce, the revenue from own and transferred (ceded)

Graph 4. Evolution of taxes by Autonomous Community (variation 2007-2011)



Source: Own elaboration based on information provided by the General Secretariat for Regional and Local Coordination (Ministry of Public Finances and Public Administration). Data for 2007-2010: Settlement of Budgets of Autonomous Regions and Cities; 2011 Data: Quarterly budgetary execution of Autonomous Regions (execution data, Report on budgetary execution of Autonomous Regions). Revenues relating to Local Financial Intermediation, EAGF Funds and other items of a similar nature have been removed.

Table 1. Regressions of the evolution of non-financial revenue of autonomous regions between 2007 and 2011

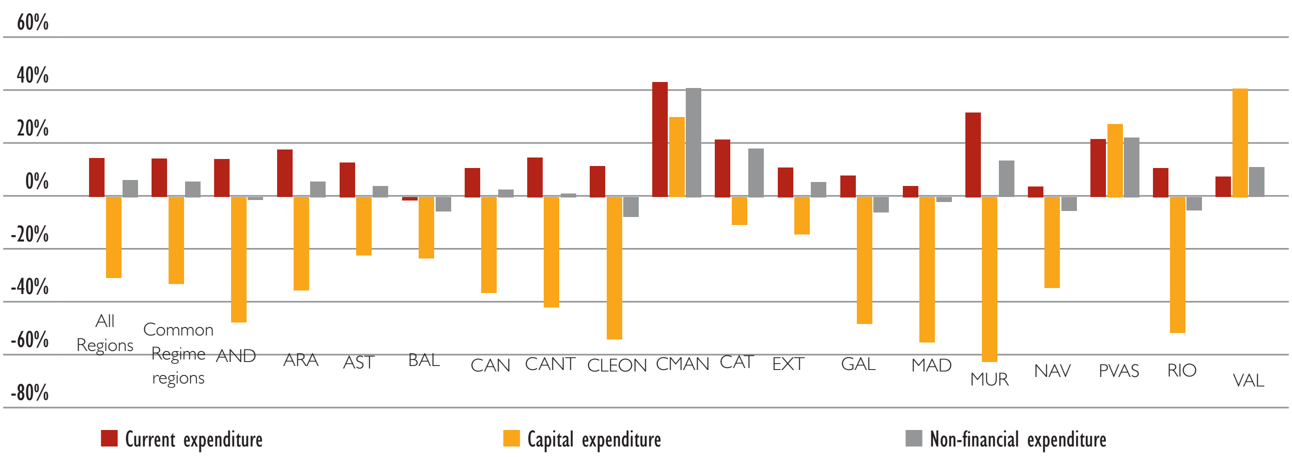
	(1)	(2)	(3)
GDPCHANGE	4.0605***	-	1.4099*
AUTONOMY 2007	-	-0.1696***	-0.1319***
Number of observations	17	17	17
Adjusted R^2	0.59	0.79	0.82
F	25.63	66.79	39.68
Prob > F	0.0001	0.0000	0.0000

* significant at 10%; *** significant at 1%.

taxes and fees. Graph 4 shows the performance of revenues from Inheritance and Gift Tax, Capital Transfer Tax and Stamp Duty, and the item which, for the sake of simplicity, we shall refer to as "Regional Financing Revenues" (Headings I, II, IV and VII of the revenue budget), and which is shown in aggregate form in order to neutralise the changes to the regional financing structure introduced in 2009.

Furthermore, the changes in non-financial revenue are due to other factors which have affected the autonomous regions in different ways, such as the evolution of regional GDP between 2007 and 2011 and the structure of regional revenue. In order to analyse these relationships we have carried out a number of straightforward regression exercises on the change in the non-financial revenues of the autonomous regions during that period with the following two explanatory variables: the change in regional GDP for that same period (GDPCHANGE) and the ratio of tax revenues to total revenues in each region in 2007, according to regional funding model (AUTONOMY2007). The

Graph 5. Evolution of non-financial expenditure by Autonomous Community (variation 2007-2011)



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results are shown in Table 1. With all due caution required by the low number of observations used, it can be argued that there is, as expected, a positive relationship between GDP growth and the growth of non-financial revenues of the regions. The other variable has a negative sign, which suggests that greater fiscal autonomy in 2007 (which has also led to a higher level of autonomy in the subsequent years within this period) has resulted into a greater downturn in non-financial revenue. Indeed, between 2007 and 2011, regional tax revenues –and, especially, "traditional" ceded taxes – have fared much worse than transfers.

Graph 3 suggests a classification of the autonomous regions into six different groups. The first two are made up of the regions which have reduced their non-financial expenditure between 2007 and 2011. In Group I we find Madrid and La Rioja, two regions which have experienced a drop in non-financial revenue lower than the average of 12.90%. Group II includes Andalusia, the Balearic Islands, Castile and León, Galicia and Navarre, with a drop in revenues above the regional average.

As shown in Graph 5, these two groups of autonomous regions exhibit a growth in current expenditure which is, in general, clearly below the average (and a drop, in the case of the Balearic Islands), and a reduction in capital expenditure much higher than the average (except for the Balearic Islands, where expenditure has fallen below the average).

The following two groups are made up of the regions whose non-financial expenditure has increased during the period considered in this work, but below the average of 6.49%. Group III comprises Aragon, Asturias, the Canary Islands and Cantabria, which have experienced a drop in non-financial revenue below the average, and group IV, Extremadura, with a drop in revenues above the average.

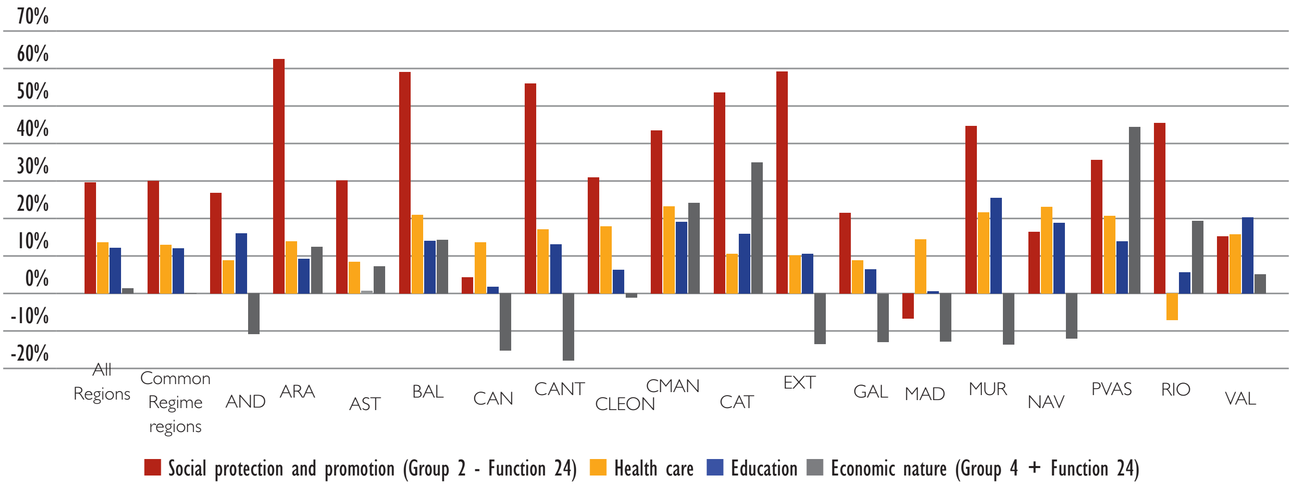
A closer look at Graph 5 shows that, with the exception of Aragon, current expenditure in these regions has experienced a below-average increase and, with the exception of Asturias and, especially, Extremadura, their capital expenditure has experienced a slightly above-average reduction.

"Between 2007 and 2011, regional tax revenues –and, especially, "traditional" ceded taxes – have fared much worse than transfers"

The two last groups are made up of the regions whose non-financial expenditure has experienced a growth above the average for the autonomous regions as a whole between 2007 and 2011. Based on the reduction in non-financial revenue below or above the average, we can differentiate, respectively between Group V, made up of the regions of Catalonia and the Basque Country, and Group VI, which includes Castile-La Mancha, Murcia and the Valencian Community.

Graph 5 shows that a common trait of these regions is an increase in current expenditure which is considerably higher than the regional average, with the exception of the Valencian Community. Capital

Graph 6. Evolution of functional expenditure by Autonomous Community (variation 2007-2010)



Source: Own elaboration based on information provided by the General Secretariat for Regional and Local Coordination (Ministry of Public Finances and Public Administration). Settlement of Budgets of Autonomous Regions and Cities. Expenditures relating to Local Financial Intermediation, EAGF Funds and other items of a similar nature have been removed.

Table 2. Net lending (+) or net borrowing (-) for the purposes of verification of compliance with budgetary stability target, 2003-2012*

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012 (1st semester no advances)	2012 (1st semester with advances)
Andalusia	0.0%	0.3%	0.0%	0.06%	0.05%	-0.75%	-1.37%	-3.13%	-3.22%	-1.27%	-1.27%
Aragon	0.0%	0.0%	0.0%	0.00%	0.00%	-0.75%	-1.74%	-2.99%	-2.88%	-0.68%	-0.68%
Asturias	0.0%	0.0%	0.0%	0.00%	0.00%	-0.60%	-1.32%	-2.68%	-3.64%	-0.53%	-0.53%
The Balearic Islands	0.0%	0.0%	0.0%	-0.03%	-0.05%	-3.28%	-3.26%	-4.00%	-4.00%	-0.40%	-0.40%
Canarias	0.0%	0.0%	0.0%	0.00%	0.01%	-0.70%	-1.06%	-2.29%	-1.80%	-1.24%	-1.24%
Cantabria	0.0%	0.0%	0.0%	-0.01%	0.00%	-1.08%	-3.22%	-2.87%	-4.00%	-1.01%	-1.01%
Castile and León	0.0%	0.0%	0.0%	0.01%	-0.01%	-0.71%	-1.41%	-2.26%	-2.59%	-0.87%	-0.87%
Castile – La Mancha	0.0%	0.0%	0.0%	-0.02%	-0.01%	-2.79%	-4.86%	-6.32%	-7.31%	-1.32%	-0.73%
Catalonia	-0.1%	-0.1%	-0.08%	-0.05%	-0.09%	-2.58%	-2.41%	-4.22%	-3.70%	-1.03%	-0.59%
Extremadura	0.0%	0.0%	0.0%	0.01%	0.01%	-1.18%	-1.67%	-2.39%	-4.59%	-1.89%	-1.89%
Galicia	0.0%	0.0%	-0.02%	0.01%	0.02%	-0.17%	-0.75%	-2.38%	-1.61%	-1.07%	-1.07%
Madrid	0.0%	0.0%	0.0%	0.01%	0.00%	-0.74%	-0.43%	-0.71%	-2.21%	-0.47%	-0.47%
Murcia	0.0%	0.0%	0.0%	0.02%	0.00%	-2.86%	-2.64%	-4.94%	-4.33%	-1.80%	-1.80%
Navarre	0.0%	0.0%	0.0%	0.04%	0.02%	-4.70%	-2.63%	-3.03%	-1.88%	-2.50%**	-2.50%**
The Basque Country	0.0%	0.0%	0.0%	0.07%	0.07%	-1.18%	-3.89%	-2.40%	-2.56%	-0.19%	-0.19%
La Rioja	0.0%	0.0%	0.0%	-0.01%	-0.01%	-1.08%	-0.68%	-3.05%	-1.97%	-0.55%	-0.55%
Valencian C.	-0.1%	-0.1%	0.0%	0.01%	-0.04%	-2.11%	-3.09%	-3.57%	-4.50%	-0.98%	-0.30%

*From 2003 to 2007, percentage of national GDP (one decimal); from 2006 to 2007, percentage of national GDP (two decimals); from 2008 to 2012, percentage of regional GDP (two decimals). Non-fulfilment of budgetary stability targets shaded in grey.

**The Foral Community of Navarre has modified in 2012 the criterion for recognition of accrued revenue refunds.

Source: Own elaboration using data from the Council for Fiscal and Financial Policy (years 2003 to 2010), Rebalancing economic and financial plans 2012–2014 (year 2011) and Ministry of Public Finances and Public Administration (year 2012).

expenditure has risen significantly in Castile-La Mancha, the Basque Country and, in particular the Valencian Community, whereas this has dropped well below the regional average in Catalonia, and well above in Murcia.

We can supplement the information provided by the previous Graphs with Graph 6, which shows the evolution in regional expenditure according to functional classification, albeit only for the period 2007-2010, the last year for which such data are available.

The functions of social protection and promotion exhibit an outstanding growth in most of the regions, particularly in Aragon. The most remarkable feature is the weak growth that this functional group has experienced in the Canary Islands, as well as its decrease in Madrid.

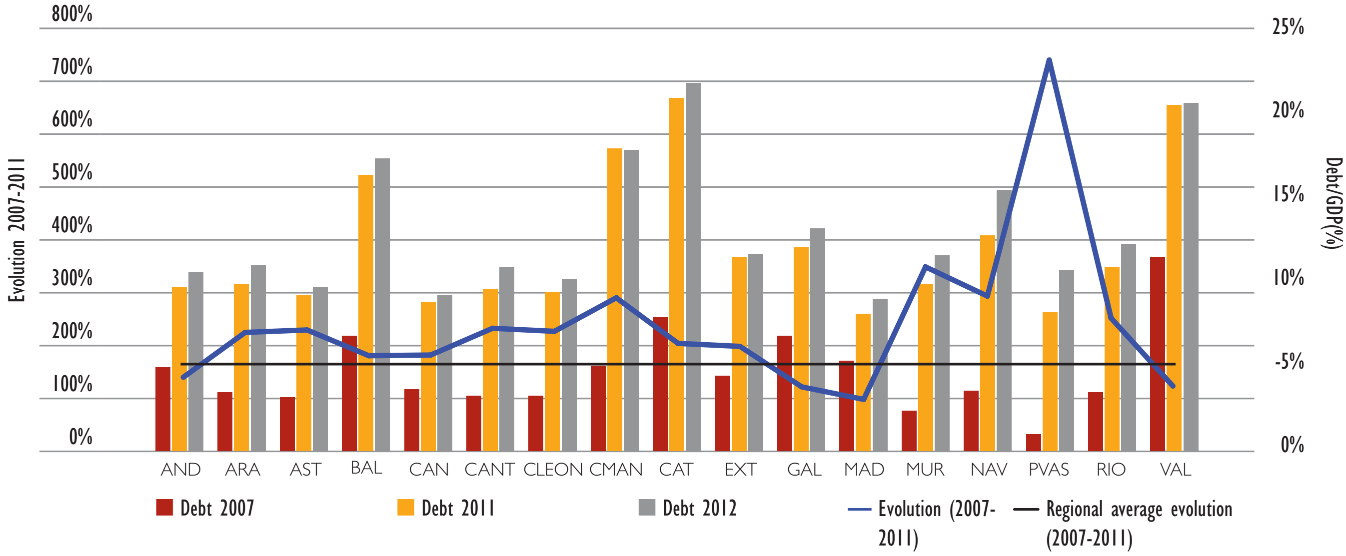
Health care increases well above the average in the Balearic Islands, Castile-La Mancha, Murcia, Navarre and the Basque Country. On the other end of the scale, health care expenditure in La Rioja has dropped between 2007 and 2010.

As far as education expenditure is concerned, the greatest increases have taken place in Castile-La Mancha, Murcia, Navarre and the Valencian Community. Expenditure on education hardly undergoes any growth in Asturias, the Canary Islands and Madrid.

Finally, expenditure of an economic nature (such as infrastructure) has fallen in most of the autonomous regions, especially in Cantabria. The most outstanding expenditure increases in this area have occurred in Catalonia and the Basque Country.

The uneven behaviour of the regional public finances during the crisis is naturally reflected in the deficit levels. Table 2 quantifies the public deficit for each autonomous region in relation to GDP between 2003 and 2011 (also adding the figures for the first half of 2012), for the purposes of compliance with budgetary stability targets, and highlights the non-fulfilment of targets. The table does not show the deficit from productive investments authorised by budgetary stability regulations. During the 2003-2007 economic growth period, targets were met across the board, although three regions by that time had already failed to meet them in a couple

Graph 7. Evolution of public debt by Autonomous Community (2007-2012)



Source: Own elaboration based on information published by the Bank of Spain.

of years: Catalonia, La Rioja and the Valencian Community. On the other hand, during the 2008-2011 recession period, non-fulfilment became widespread, reaching in 2011 to all regions. The Canary Islands, Castile and León, Galicia and Madrid failed to meet their targets in one single year, whereas seven regions did so throughout the four years of the period: the Balearic Islands, Cantabria, Castile-La Mancha, Catalonia, Murcia, Navarre and the Valencian Community. With the exception of Cantabria, these regions stand out in Graph 3 either for the increase in non-financial expenditure or for the drop in non-financial revenue.

"Between 2007 and 2011, the functions of social protection exhibit an outstanding growth in most of the regions. Health care and education expenditures in Castile-La Mancha, Murcia and Navarre are remarkable"

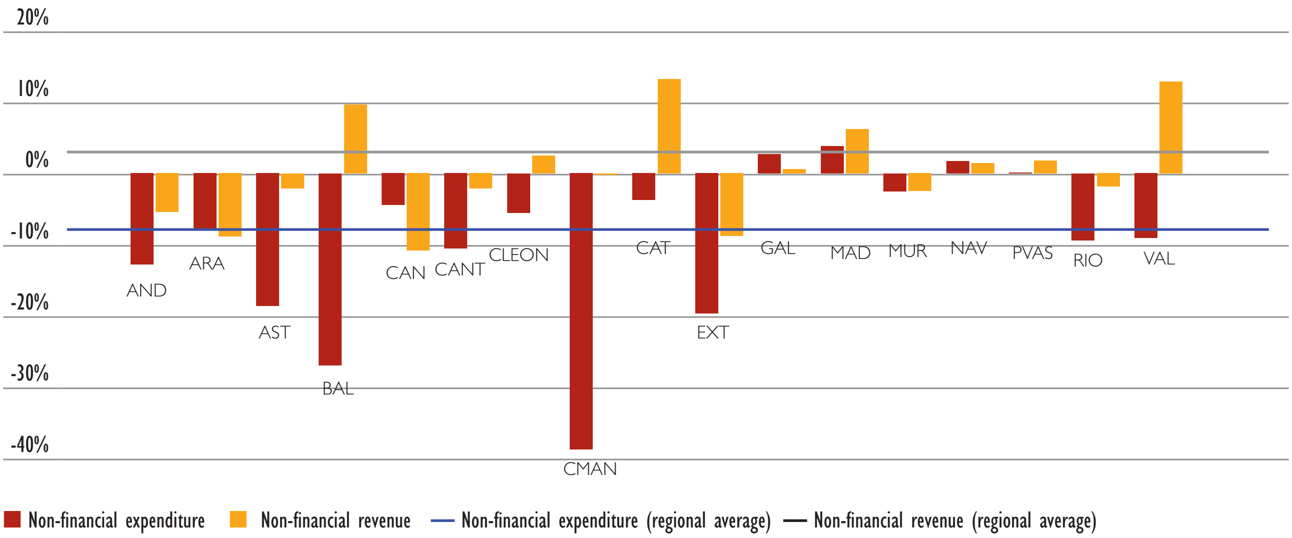
We shall conclude this analysis of the regional public finance performance by taking a look at the debt and the entities dependent on the autonomous regions. Graph 7 shows the evolution of the ratio of the outstanding debt stock to GDP between 2007 and 2011, added to the situation of each autonomous region at the end of the first semester of 2012. As we have already mentioned in the previous section, this ratio has increased for the autonomous regions as a whole by 129.31% during the period examined herein. The most significant increases take place in Murcia and the Basque Country. In 2011, there are four regions with debt/GDP ratio above 15%: Catalonia, the Valencian Community, Castile-La Mancha and the Balearic Islands. By contrast, the coefficient in Madrid and the Basque Country is barely above 8%.

"Between 2003-2007, deficit targets were met across the board. By 2011, non-fulfilment became widespread to all regions"

The debt of regional public corporations has experienced a 33.33% growth in the period for the whole of the autonomous regions. Some regions have experienced clearly significant increases, such as Castile and León (600%), Andalusia (400%) and Cantabria (200%). In other regions, the debt/GDP ratio has been substantially reduced, such as in La Rioja (100%), Castile-La Mancha (89.47%) and Navarre (71.43%). In any event, in order to interpret these growth rates accurately, the reduced debt/GDP ratio of publicly-owned companies must be taken into account: on average, it accounts for a 1.2% of GDP in 2011.

The number of entities dependent on the autonomous regions (corporations, foundations, consortia, autonomous bodies, etc.) hardly appears to have changed during the crisis in aggregate terms: there were 2,325 entities on 1 January 2008 and 2,326 on 1 January 2012. However, the years 2008

Graph 8. Evolution of non-financial revenue and expenditure by Autonomous Community (year-on-year variation - 2nd quarter 2012 vs 2nd quarter 2011)



Source: Own elaboration based on information provided by the General Secretariat for Regional and Local Coordination (Ministry of Public Finances and Public Administration). Quarterly budgetary execution of Autonomous Regions (execution data, Report on budgetary execution of Autonomous Regions). Revenues and expenditures relating to Local Financial Intermediation, EAGF Funds and other items of a similar nature have been removed.

and 2009 saw more entities created than eliminated. The adjustment does not begin until 2010, intensifying in 2011, when 35 entities are created and 135 are eliminated. A closer analysis of each autonomous region shows a rise in the number of dependent entities in most of the regions during this period. Of particular note are the figures for Cantabria (10 additional entities, accounting for an increase of 17.24%), Aragon (12 entities; 11.65%) and Extremadura (6 entities; 9.38%). The largest reductions take place in Castile-La Mancha (24 entities; 30.38% reduction), Navarre (18 entities; 18.95%) and Madrid (16 entities; 8.60%).

"The number of entities dependent on the autonomous regions hardly appears to have changed during the crisis: there were 2,325 entities on 1 January 2008 and 2,326 on 1 January 2012"

4. Conclusions. The Regional Public Finances in 2012

The previous pages contain a description of the performance of revenues and expenditures of the autonomous regions between 2007 and 2011, with special emphasis on the identification of the factors which might explain the differences found in the behaviour of the different autonomous regions during this period. We shall now summarise the main conclusions reached in the foregoing sections of this paper.

The non-financial revenue (and in particular, current revenue) of the autonomous regions already begins to show signs of weakness in 2008. Between 2007 and 2011, it falls by 12.90%. However, the reaction concerning expenditure adjustment does not begin until 2010, and is based on a massive cutback of capital expenditure, dropping by 30.26% between 2007 and 2011. During that same period, non-financial expenditure for the whole of the autonomous regions increases by 6.49%.

The crisis has not affected all regional public finances in the same way, nor have they all responded in a similar fashion. The behaviour of regional revenue has been subject to the evolution of regional GDP, as well as by the taxation measures adopted by the regions themselves and the different weight of tax revenues and transfers in the revenue structure of each region.

In regard to expenditure, the information presented here seems to suggest that the disparities between the regions are due to differences in the policies adopted. Whereas one group of regions has managed to contain the growth of current expenditure and substantially reduce capital expenditure, another group has maintained a high growth rate of current expenditure whilst reducing to a lesser extent and, in some cases, even increasing, capital expenditure.

"The non-financial revenue already begins to show signs of weakness in 2008, but the reaction concerning expenditure adjustment does not begin until 2010. Between 2007 and 2011, capital expenditure dropped by 30.2%"

In the end, the different behaviours in regard to revenue and expenditure has also translated, as expected, into differences between regions in terms of the fulfilment of budgetary stability targets in relation to public deficit.

At the time of drafting this paper (October 2012), the budgetary, the budgetary data of autonomous regions for the first six months of 2012 have been published. By way of conclusion, we shall briefly examine the more significant figures, without attempting to extrapolate results for the rest of the year.This last exercise would be extremely complicated for several reasons. On the one hand, some regions have received advances of the liquidation for 2010 and of the payments on account for 2012. On the other hand, the effects of the revenue and expenditure adjustments adopted both by the central government and the autonomous regions in their rebalancing economic and financial plans to ensure fulfilment of the budgetary stability targets are yet to be seen on the regional finances[2].

Graph 8 summarises the change in regional non-financial revenue and expenditure between the first semester of 2011 and the first semester of 2012. Non-financial expenditure has fallen by 7.65%, whereas, as a result of the measures mentioned in the previous paraGraph, non-financial revenue has increased by 2.32%. The weight of the adjustment continues to fall mainly on capital expenditure, which drops by 38.99% compared to a reduction of 4.13% in current expenditure.

In most of the autonomous regions, both revenues and expenditure have been reduced: Andalusia, Aragon, Asturias, the Canary Islands, Cantabria, Castile-La Mancha, Extremadura, Murcia and La Rioja. The reduction in expenditure has been very considerable in Castile-La Mancha, Extremadura and Asturias. In Aragon and the Canary Islands, the reduction in expenditure has been lower than that in revenues.

In Galicia, Madrid, Navarre and the Basque Country, non-financial revenue and expenditure have both been increased. In Galicia and Navarre, the increase in expenditure has been greater than that in revenue.

[2] For a more detailed description of the budgetary execution of the autonomous regions for the first semester of 2012, see Ministry of Public Finances and Public Administration (2012). In Conde-Ruiz et al. (2012) compliance by the autonomous regions with their budgetary stability targets for 2012 is discussed.

Lastly, four regions have experienced a year-on-year increase in their revenue and a reduction in their expenditure: the Balearic Islands, Castile and León, Catalonia and the Valencian Community, of which the reduction in non-financial expenditure in the Balearic Islands is especially worth mentioning.

The last two columns in Table 2 show the budgetary deficit of the autonomous regions in the second semester of 2012. The breach of the 1.5% target set for the whole year can be observed for some regions. Finally, Graph 7 shows the ratio of regional debt to GDP for that same semester. On the one hand, Navarre becomes one of the autonomous regions with a ratio above 15%. On the other end of the scale, only Madrid, the Canary Islands and Asturias remain under 10%.

"The different behaviours in regard to revenue and expenditure has also translated into differences between regions in terms of the fulfilment of targets in relation to public deficit"

Moreover, some developments have taken place in 2012 which considerably affect the performance of the public finances of the autonomous regions. In the first place, the Parliament approved the Organic Law 2/2012, of 27 April on budgetary stability and financial sustainability, which develops the recently amended article 135 of the Spanish Constitution[3].

Secondly, Royal Decree-law 7/2012, of 9 March, created the Supplier Payment Fund to assist in carrying out the transactions required to pay the overdue bills of the autonomous regions which have opted for this funding mechanism. And, in the third place, Royal Decree-law 21/2012, of 13 July, on measures for the public administrations liquidity and in the financial sphere, created the Regional Liquidity Fund, to meet the settlement of the debt for those autonomous regions that request it and to provide the necessary resources to fund the debt allowed by budgetary stability regulation.

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Fiscal Decentralization and Economic Crisis

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1. Introduction

Over the past several decades decentralization has been a trend that has taken over the world, with several distinct features across countries. Through decentralization, policy makers have stressed efficiency gains, reduction in operational costs, and improved public sector performance in service delivery mainly through a deeper understanding of preferences at the subnational level. Yet, fiscal decentralization as a government strategy design varies across countries and its performance for a variety of reasons has been uneven across countries.

In fact, economic stability plays a key role on the assessment of the success or failure any fiscal decentralization process. Countries presenting high levels of inflation, high volatility on their gross domestic product, increasing unemployment, and unmanageable debt may have second thoughts about the potential connection of those harmful effects with their ongoing decentralization process. In particular, countries facing shocks, such as the current economic crisis, may be more prompt to undertake re-centralization policies, by comparison to those countries that have been experiencing higher macroeconomic stability. This is so because of the interpretation that fiscal stabilization policies need to be coordinated with other macroeconomic policies such as monetary and exchange rate policies by the central government and that fiscal decentralization can weaken the ability of central governments to pursue these goals (Ter-Minassian (2009)). Current events involving the worldwide financial crisis that began in 2007 and 2008 have affected significantly the economies of both developed and developing countries, with the negative impacts being much more pronounced on the first ones to a large extent due to the financial nature of the crisis. Contrary to previous economic crises, the "great recession" of the past four years is taking place in a much more economically integrated and financially complex world where global patterns of trade flows and foreign direct investment have allowed reduced aggregate demand and financial wealth in OECD countries to lead to lower exports and investment inflows in practically every economy in the world. The results have been generalized decreases in economic activity and higher unemployment.

Abstracting from political economy considerations, the channels through which subnational governments are affected by an economic shock are diverse, yet it is possible to think that the current crisis affects sub-national finances both directly through their own budgets and indirectly through its impact on central governments budgets. Among the direct effects, the economic shock affects the bases of own taxes induced by the recession and other factors (e.g. the fall in asset and commodity prices), by the negative impacts on tax compliance and enforcement, and by putting upward pressures on cyclically sensitive sub-national expenditure programs. Though less straightforward, the crisis has also led to increases in interest payments, the loss of market access, and losses in financial investments. Among the indirect effects of the economic shock there are losses for subnational from shared revenues, resulting from automatic stabilizers, discretionary tax cuts, or weakened tax enforcement at the central government level. Central government budget cuts can also translate into reductions in the overall funding for transfers, be automatic, such as in the case of the pool of funds available for equalization grants, or discretionary, such as in the case of conditional grant for recurrent and capital infrastructure programs. On the other hand, the crisis can also lead to increases in earmarked transfers from central government to finance (wholly or partially) discretionary increases in spending programs (especially investments) implemented as part of macroeconomic stimulus programs.

"Countries facing shocks, such as the current economic crisis, may be more prompt to undertake re-centralization policies"

In the aftermath of the current crisis it is clear that public finances in most advanced economies have weakened quickly and significantly, especially by comparison to less developed ones (Jonas, 2012). Budget deficits have mushroomed as most taxes have yielded lower collections, while expenditures have been more difficult to cut because of the additional social spending needed to alleviate the effects of the crisis on ordinary citizens and in some cases they have increased due to the large economic stimulus packages that many central governments have implemented to soften the impact of the recession.

As in previous crises, the ability to weather the adverse economic conditions has been different for central governments and subnational governments. While the former can incur large deficits financed by debt, the latter (outside of a small number of federal or quasi-federal countries) are often very constrained by law and financial market realities in terms of the extent to which they can run budget deficits and borrow. Without sufficient ability to borrow, subnational governments facing some combination of lower own-source revenues, cuts in transfers from higher levels of government, and reductions in the value of their assets find themselves in a very difficult fiscal position. The situation is likely to be most serious for local governments (cities, municipalities, villages, etc.) because of their often heavy dependence on transfers as well as their more limited fiscal autonomy and ability to manage external shocks.

There is therefore ample reason to be concerned that the crisis may have a negative impact on decentralization and subnational governance at least in those countries that have been most affected by the crisis. If budgets are reduced due to revenue shortfalls, subnational governments will be less able to meet their important responsibilities and will face an erosion of citizen trust. Beyond that, central governments, especially but not exclusively in less developed countries lacking a long decentralization tradition, may also use the crisis to justify the questioning or slowing down the decentralization process or even instituting open re-centralization measures.

At the same time, some countries appear to have recognized the need to keep resources flowing to subnational governments (especially at local level) during the crisis because of the important roles they play in service delivery and the promotion of economic development. This has been particularly the case in a number of OECD countries, including Australia and several countries in Europe and North America. Some developing or middle income countries have also been trying to provide additional resources to subnational governments as part of their counter-cyclical policies.

This article examines the ongoing interplay between the economic crisis and fiscal decentralization trends from a broad perspective. Section two of this note reviews some theoretical issues on the relationship between fiscal decentralization and economic crisis. Section three presents some empirical evidence on how this relationship has shaped up over time. Section four summarizes the responses to the crisis across a large sample of countries. Finally, section five presents some discussion and concludes.

"Subnational governments facing some combination of lower ownsource revenues, cuts in transfers and reductions in the value of their assets find themselves in a very difficult fiscal position"

2. What Can Be Anticipated From Theory on Fiscal Decentralization and Economic Crisis?

There is significant consensus in the literature that sub-national governments are far more in tune with their local jurisdiction's needs than the central government and therefore they are more able to efficiently provide public goods and services for their constituents. However in times of economic crisis, and given the characteristics of sub-national finances, this goal of enhanced efficiency can be threatened due to several factors involving both the expenditure and revenue sides of their budgets. As De Mello (2000) points out, economic crisis can affect the proper redistribution of resources across subnational governments reducing the welfare enhancing mechanism that fiscal decentralization has.

A recent literature discusses the channels through which economic crisis may affect subnational finances (Martinez-Vazquez and Smoke, 2009; Ter-Minassian, 2009; and Ter-Minassian and Jimenez, 2011). This literature presents a taxonomy of the channels of transmission from economic crisis to subnational finances. In general, it could be thought that the most significant direct impact of economic crisis are on the level and composition of sub-national government finances on both the revenue and expenditure sides of the budget. Yet there are some other indirect effects that should also be taken into account.

On the revenue side, the immediate direct effects include the decline of tax bases (for a variety of causes, such as the reduction in the number of firms, lower levels of income and sales, or the reduction in property values), declines in tax compliance, and loses of financial assets related to bankrupt financial institutions (mostly in Western Europe). The recent economic downturn in countries that have experienced housing bubbles (for example, the U.S., Ireland and Spain) have led to significant decreases in revenues from property taxes and property transfer taxes for regional and local governments(Reinhart and Roggoff, 2011). Also, as Reinhart and Reinhart (2010) show, financial crises, such as what we are experiencing today, have significant direct effect on income and sales taxes via several channels, with firm destruction and unemployment being the most prominent ones.

On the expenditure side, there can be upward pressure on cyclically sensitive sub-national expenditure programs especially those related to social welfare, inability to adjust in fundamental social services such as education and public health, increases in interest payments from higher debt accumulation and interest rates, pressures to bailout regional enterprises and associated financial institutions, and the deviation of expenditures towards emergency programs (Martinez-Vazquez and Smoke, 2009 and Ter-Minassian, 2009). In general, when facing economic crisis capital expenditures may be expected to be cut more drastically than current expenditures because they are more easily interrupted or postponed. Of course, the size of the cuts may differ based on the size of the crisis, for example during the current crisis, subnational governments in many countries have also been forced to reduce current expenditures not only for maintenance and operation but also for some categories that have been relatively unaffected in past crises, such as social services and general public employment. As Brumby and Verhoeven, (2011) report, reductions in capital spending at the subnational level have been substantial in a varied list of countries, including Bulgaria, Mexico, Nicaragua, Philippines, Russia, Senegal, Ukraine and the U.S. In addition, significant cuts in current spending have taken place in other countries such as Ireland, Italy, Spain and Sweden in Europe or Mexico, Nicaragua and Peru in Latin America. Cuts in current expenditures in sensitive areas such as education and health have been particularly damaging for general government goals such as poverty reduction and human capital development.

"With the crisis, subnational finances have seen a reduction in their tax bases and an increase in pressure on social welfare programs"

Other indirect channels through which the economic crisis has affected subnational government budgets are related with losses of shared revenues in national taxes, discretionary tax cuts by central governments, and decreases in general unconditional grants and earmarked transfers from central governments. As Martinez and Smoke (2009) show, revenue declines from shared taxes are among the most important effects of the current crisis, in a variety of countries such as, Bulgaria, Estonia, Iceland, and Spain. Significant losses for subnational governments in revenue sharing from natural resources are reported for Bolivia and Peru. The CEMR survey[1] reports significant reduction in central government transfers to subnational governments in Europe, quite drastic in the Baltic countries. Deep cuts in transfers have been implemented in Latin America (for example, Mexico and Nicaragua and among African and Asian countries. These significant reductions in fiscal transfers from central governments frequently replicate similar central government policies during past crises (e.g., the Asian crisis in the later 1990s).

"The crisis has also affected the Autonomous Communities with the loss of income from national taxes, tax reductions and the fall in subsidies and transfers"

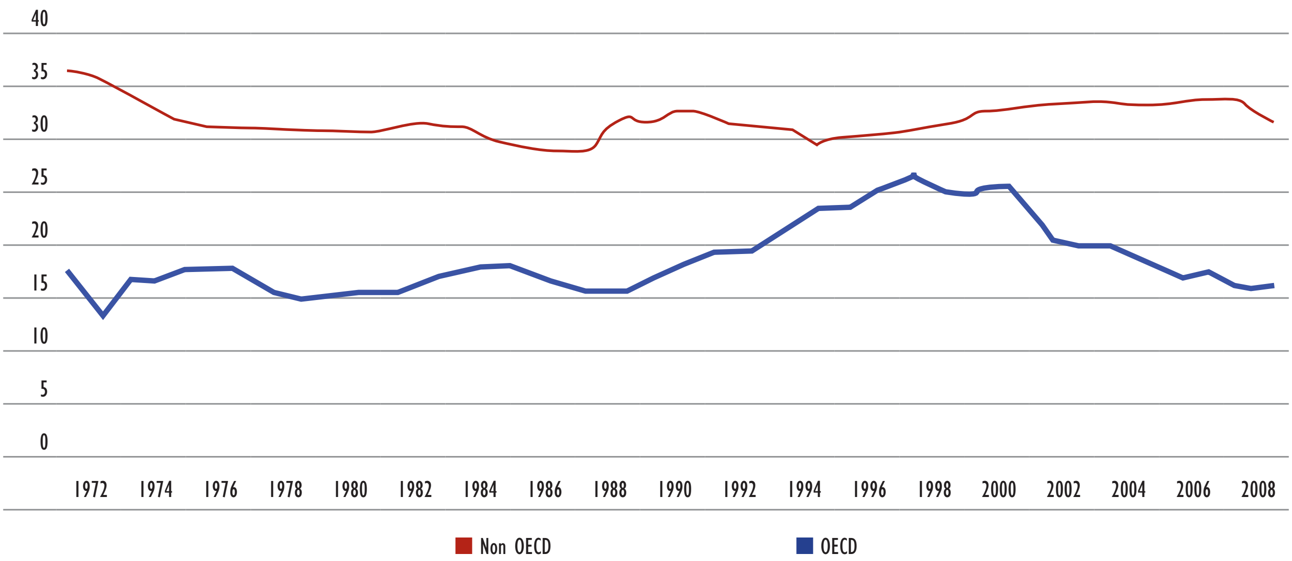
The damage to the subnational finances is likely to vary depending on a number of factors, such as the severity of the downturn in different regions, the structure of the subnational debt, the structure of own and shared revenues of subnational governments, the extent of subnational responsibility for more cyclically-sensitive expenditures, and the nature and extent of central government support (Ter-Minassian, 2009). Stronger degrees of transfer dependence tend to make the recovery more difficult; under budgetary pressure, central governments have a long history of slowing down, reducing, or simply eliminating budget allocations to subnational governments (Martinez-Vazquez and Smoke, 2009).

3. On the Empirical Relationship Between Fiscal Decentralization and Economic Crisis

Across the world there has been a trend over the past several decades with more countries undergoing decentralization reforms. However, and within the well-known limitations on the quality of data available on the measurement of decentralization, there have not been any sharp increases in the level of decentralization on the expenditure and revenue sides of the budget. The overall shares of subnational expenditures and revenues in total expenditures and revenues have remained fairly steady over the past almost forty years (see figure 1 and figure 2). In the case of OECD countries, the subnational share of expenditures show a relatively stable trend around 30 percent (figure 1) and the share of subnational revenues around 20 percent (figure 2). There are nevertheless identifiable

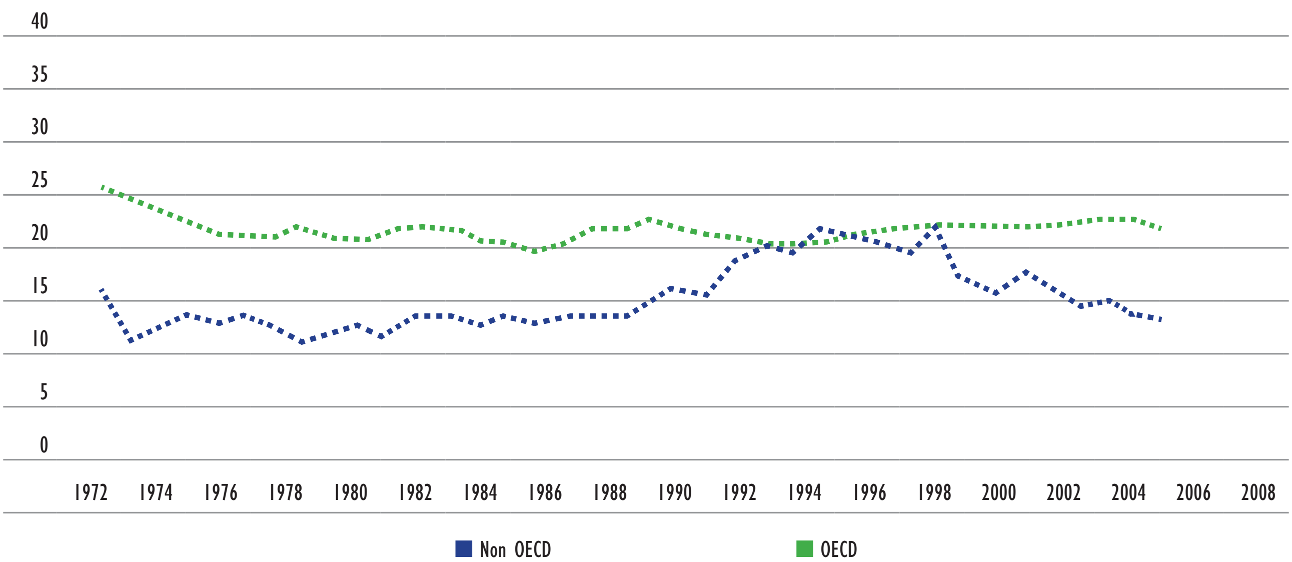
[1] « Impact de la crise sur les collectivités locales et régionales en Europe ». Parlimentary Assembly (2012).

Figure 1. Sub-national expenditures as % of total expenditures (1972-2009)



Source: Own estimations based on GFS and OECD dataset.

Figure 2. Sub-national revenues as % of total revenues (1972-2009)



Source: Own estimations based on GFS and OECD dataset.

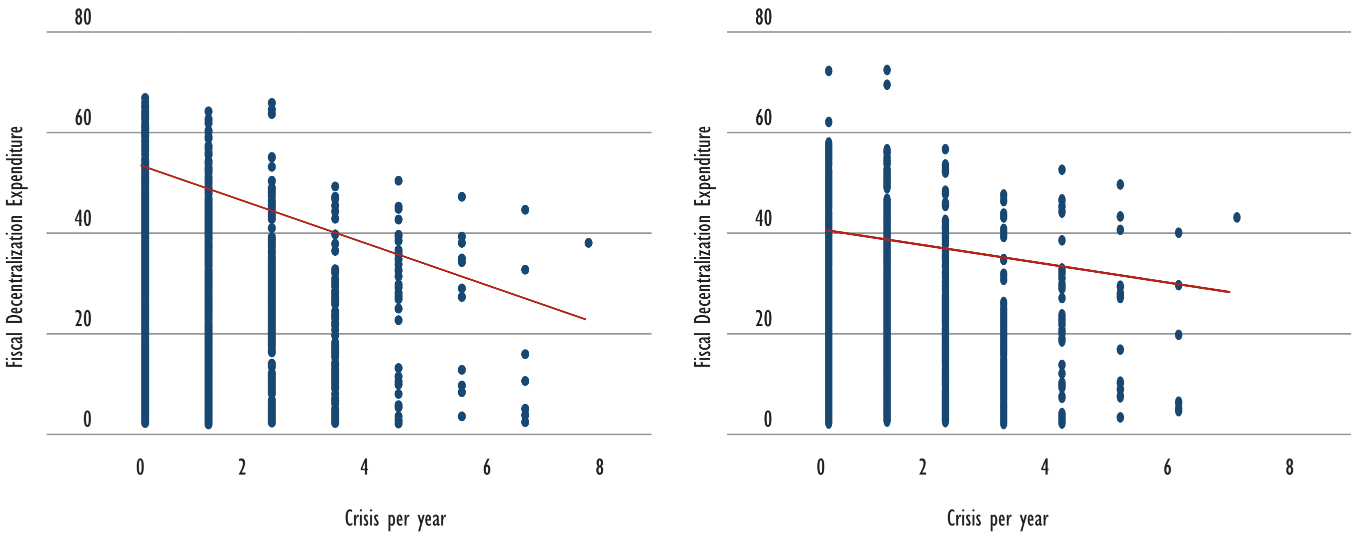
bumps on those trends, as for example the dips in the mid-nineties (associated with the .com crisis) and more recently since 2007 (associated with the current crisis). For non-OECD countries the expenditure decentralization measure show considerably higher volatility, especially during the 1990s, but overall along the last nearly four decades subnational expenditures have settled around 15 percent of the total. In the case of the revenue shares there is also considerably more volatility for non-OECD countries, especially during the 1990s settling on a long terms trend just above 10 percent.

Our main interest in this section is to identify what type of correlation exists between economic crises and the level of fiscal decentralization. For this purpose, and following Reinhart and

Table 1. Economic Crisis episodes (1972-2010)							
Countries	**Currency Crises**	**Stock Market Crises**	**Banking Crises**	**Dom. Sov.Debt Crises**	**Ext. Sov. Debt Crises**	**Inflation Crises**	**Total**
Non-OECD	26.90%	18.60%	19.00%	6.70%	28.80%	23.0%	1938
OECD	25.80%	44.50%	23.50%	0.30%	5.90%	13.7%	818
Total	21.2%	21.4%	16.3%	3.7%	17.1%	20.2%	100%

Source: Own estimations based on Reinhart and Rogoff (2010).

Figure 3. Relationship between fiscal decentralization and crisis episodes



Source: Own estimations.

Rogoff (2010), crises can be broadly classified under six definitions (see table 1). Currency crises (defined as annual depreciation versus the US dollar of 15 percent or more), inflation crises (defined as an annual inflation rate of 20 percent or higher), banking crises (defined as closure, merging or take over by public sector of one or more institutions, due to bank runs or not), debt crises (domestic and external, defined as the failure to pay principal or interest on debt), and stock market crisis (unanticipated drop in stock prices).

As Obstfeld and Rogoff (2009) show, there is a straight correlation between economic crisis, the characteristics of the crisis, government structure, and the level of economic development. Overall, developed countries (OECD) show a lower number of crisis episodes.Also less developed countries (non-OECD) are more prompt to face debt crises inflation pressure crises. As table 1 shows around 23 percent of the crises suffered by low and middle income countries are related to inflation being higher than 20 percent, while only 14 percent of the crisis episodes in OECD countries have to do with this phenomenon. Likewise debt crises are mostly a less developed country feature, with this type of crisis comprising around 33 percent of the total episodes in non-OECD countries, by comparison to 6.2 percent for OECD countries. Most of the crisis episodes in developed countries are clustered around stock market crises, currency crises, and banking crises, which account for almost 80 percent of the crisis situations in these countries.

Figure 3 shows the relationship between fiscal decentralization measures and the number of accumulative crisis per year; the y axis shows the level of fiscal decentralization in a country in a particular

Table 2. Pearson Correlation of fiscal decentralization measures and crisis

Crisis type	Expenditure Measure		Revenue Measure	
	OECD	Non-OECD	OECD	Non-OECD
Currency Crises	0.1277*	-0.1951*	0.0722	-0.1423*
Stock Market Crises	-0.1836*	-0.0726	-0.1575*	-0.0911
Banking Crises	-0.0831	-0.0484*	-0.0544	-0.0186
Inflation Crises	-0.0735	-0.2225*	-0.0077	-0.1854*
Dom. Sov.Debt Crises	-0.0594	-0.0326	-0.0696	-0.0329
Ext. Sov. Debt Crises	0.0238	-0.1910*	-0.0043	-0.1181*

Source: Own estimations.
Note: Star represent 1% of significance.

year while the x axis shows the number of crisis episodes in that year. For example, countries such as Angola, Argentina, Russia or Zimbabwe suffered more than five crises episodes in a year and show lower levels of fiscal decentralization in those particular years[2].

The expected negative relationship between fiscal decentralization and economic crisis is evident through figure 3. In fact, it should be noted that expenditure decentralization measure shows a steeper negative relationship compared to the revenue one. While we cannot claim a causal effect from the above graphs, there is clearly a negative correlation between economic crisis and decentralization. However, there is some prevalent heterogeneity on the relationship.

In general, crisis episodes affect fiscal decentralization in a more significant manner in the case of less developed countries (non-OECD), and therefore the correlation with fiscal centralization measures tend to be stronger and more significant. The relationship between crisis and fiscal decentralization is also stronger when examining the expenditure side of fiscal decentralization. This supports the theory discussions asserting the higher responsiveness of expenditures to macroeconomic shocks.

As can be seen from table 2, the negative relationship between fiscal decentralization and economic crisis is prevalent, however the effect differ in size and significance across different types of crises. For instance, stock market crises have a higher and more statistically significant relationship with fiscal decentralization measures, affecting more OECD countries, especially on the expenditure side. This may be the category in Reinhart and Rogoff (2010) that gets closer to describing the most recent economic crisis which has led, as discussed in the next section, to a generalized reduction in sub-national government expenditures and to the shrinking of the public sector. On the revenue side, stock market crises also have a negative effect on revenue decentralization causing a reduction of the fiscal decentralization levels, especially in the case of OECD countries. This sort of story also relates closely to the effects that have prevailed in the current economic crisis. Other types of crises such as banking crises have also higher impacts on the decentralization levels in developed countries. For low and middle income countries, the relationship between stock market crisis and fiscal decentralization is not highly significant; however, the direction of the effects remains towards higher centralization of both revenues and expenditures.

"Across the world there has been a trend over the past several decades with more countries undergoing decentralization reforms, but there have not been any sharp increases in the level of decentralization on the expenditure and revenue"

The types of crisis that have stronger effects on low and middle income countries are mostly related to macroeconomic instability episodes; in particular, inflation crises and external debt crises are those showing a stronger and more negative relationship with fiscal decentralization in low and middle income countries. Again the relationships are bigger in size and more statistically significant when looking at the expenditure decentralization measure.

[2] Between 1998 and 1999 Russia suffered an inflation crisis, a currency crisis, a stock market crisis, debt crises (both external and internal), as well as a banking crisis.

4. The Response to the Current Crisis

As we have seen above, data availability does not allow us to investigate changes in decentralization level beyond 2008-09. However, there are a series of narratives on the experiences of different countries which support the view that the response of decentralization policies to the current crisis fall well in place with those of past crisis.

"Developed countries show a lower number of crisis episodes. Also less developed countries are more prompt to face debt and inflation pressure crises"

But, first, in order to cope with the current crisis several strategies have been implemented across different countries aiming to reduce the negative impact of the crisis and which have affected subnational governments. More specifically, some countries have used subnational fiscal space to respond in a counter cyclical manner to the crisis. For example in countries such as Denmark and Korea this has involved accommodating the operation of the automatic fiscal stabilizers, while other countries have engaged in more active fiscal stimulus measures, through reductions in taxes and/or discretionary spending increases. However, in many more countries the existing binding budget constraints have pushed central governments toward more pro-cyclical responses. These responses for the most part have concentrated in measures aiming to boost revenues and to cut spending programs, in many cases directly affecting the education and health sectors. On the revenue side, many of the measures included increases in subnational tax rates, reductions in exemptions, and increases in non-tax revenues involving user fees and charges (Ter-Minassian and Fedelino 2010). While we don't aim to describe in detail all the programs in the paragraphs below we offer a glance of some of these main changes.

4.1 Expenditure Side Reforms

Substantial parts of the reforms taken in response to the crisis affect directly the core functions of fiscal decentralization and are closely related with expenditures and revenues at the subnational level. Many countries in Europe have taken advantage of the crisis to reform and simplify their vertical structure of government. For example, Greece restructured subnational governments abolishing several entities as part of its spending reduction strategies. The policy package reduced the number of prefectures and created 13 new regions, and in addition it reduced the number of local entities by a half. A large number of the redundant public employees (a rough estimate of 10,000 in 2 years' time) from the restructured local government entities were transferred to other authorities and cities. In addition, the government reduced wages for the local political staff by 10 percent accompanied by a reduction of the minimum wage by 22 percent. The cuts in subnational budgets also affected sectorial expenditures, mainly in education and health programs. Other measures affecting public sector employees included a hiring freeze, the elimination of temporary contracts, and the reduction in public-sector salaries by 15 percent[3].

Other countries have also sought to implement rationalization programs in the vertical structure of government. In Luxembourg a municipal merger process is on-going and to be completed by 2017; the government is planning to reduce the number of municipalities from 116 to 71 with a high focus on smaller municipalities which are thought to be less efficient. In this same line, the United Kingdom government abolished the Regional Development Agencies and other government offices involved in regional strategies for economic development and housing. Many of those functions have been picked up by the local councils and business-led partnerships and with the central government picking up the rest. In Ireland 20 local authorities have been merged in order to trim the number of civil servants and streamline expenditure. Similar measures have been taken in Latvia and Lithuania reducing the number of subnational governments in order to cope with the crisis. For example, in the case of Latvia, the 26 districts (former regional level) were abolished in July 2009. In Sweden, proposals to merge the current 21 counties into 6-9 larger regions by 2015 were never passed. In Norway, the merger of local governments will be promoted by the central government, especially in remote areas, as a result of the increased competencies in the health and social services sectors and increased revenue reforms implemented in 2010.

"Some countries have used subnational fiscal space to respond in a counter cyclical manner to the crisis"

Not as pronounced as in the case of Greece, other countries have implemented cuts. Ireland cut social welfare and expenditure in education and health, along with a reduction of public servants wages by at least 5 percent[4]. Finland has reduced municipal government spending by €631 million mostly affecting productive investment. In Bulgaria, the government cut funds for budget transfers to

[3] For more information see Leven and Santi (2012)EU austerity and reform: A country by country table(Updated May 3).
[4] Based on BBC News (2012).

municipalities by 2015 as outlined in its 2010 budget. In Romania, the new the law on local public finances has been amended limiting the number of public servants relative to the number of inhabitants and public salaries have been cut by 25 percent.

"Many countries in Europe have taken advantage of the crisis to reform and simplify their vertical structure of government"

4.2 Revenue Side Reforms

In many decentralized countries shared revenues account for the lion share of total revenues of regional governments. Something similar, although less pronounced holds for local governments. For this reason, a passive counter-cyclical policy by the central government, accommodating the endogenous decline in its revenues, would shift a significant part of the revenue losses to subnational governments, unless offset by increased transfers. On the other hand, revenue side measures have been taken at subnational level to offset revenue declines. These have included rates increases for a variety of taxes, such as in excises on tobacco, alcohol, luxury goods and services, and in business and property taxes) in countries such as Australia, France, Spain, Sweden, the United Kingdom and the U.S. In some cases subnational governments have used their taxing powers that had not been used for many years before the crisis. For example, the Catalan regional government in Spain increased its regional personal income tax rates in recent times. A big part of the responses to the crisis had to deal with increases in VAT (see Blöchliger et al. 2010). Countries such as Italy, Portugal and Spain have in the last two years increased their VAT general tax rates in several percentage points. But other taxes such as those on gasoline and gambling have also been increased. The crisis has also been a cause for changes in tax structure. For example, the Italian government of Mariano Monti reintroduced the property tax, which had been abolished just a few years before by the government of Silvio Berlusconi. Latvia also has introduced new property taxes[5].

However, in countries such as Canada, Japan and Switzerland, subnational tax cuts have been implemented with counter cyclical character. At an earlier stage of the crisis some EU members also adopted counter cyclical tax cuts (OECD, 2010).

5. Some Conclusions

Crisis episodes tend to lead to re-centralization measures and lower levels of fiscal decentralization. The causes for recentralization are multiple, from political opportunism daring to implement policies that would be much less accepted in normal circumstances to using fiscal policy as a stabilizer by central governments. Since Musgrave's (1959) allocation of macroeconomic stabilization policies to the central governments there has been considerable discussion in the public finance literature of what role (if any at all) subnational governments should play in counter cyclical policies. This is a discussion that goes beyond this note, but suffices to say that whether or not they are supposed to, many subnational governments engage on counter cyclical measures. This has been the case with some of the policy responses during the past crisis by subnational governments.

In our brief analysis we have been able to clearly identify relationships between economic crisis and fiscal decentralization, both from the expenditure and revenue side. The channels through which a crisis affects subnational governments have been grouped in the existing literature as direct and indirect effects on subnational budgets. Direct effects are the ones related mostly with changes in tax bases, tax compliance and enforcement, upward pressure on cyclically sensitive sub-national expenditure programs, increases in interest payments, loss of market access, and losses on financial investments. Among the indirect effects of a crisis, there are losses in shared revenues resulting from automatic stabilizers, discretionary tax cuts, or weakened tax enforcement at the central government level, and changes in unconditional grants and earmarked transfers from the central government. Overall, the majority of the types of crises analyzed have a significant impact on fiscal decentralization levels with clear differences between developed and developing countries. Inflation crises and debt crises show a strong correlation with re-centralization centralization in low and middle-income countries, while stock market crises, such as the one of the past years, have a higher correlation with re-centralization in more developed countries.

"There have been increases for a variety of taxes (tobacco, alcohol, luxury goods and services, and in business and property taxes) in Australia, France, Spain, Sweden, the United Kingdom and the U.S."

A brief review of the responses to economic crises at the subnational level have shown the shrinking of the public sector with a large part of the response focused on the reduction of public spending in areas of relative significance in subnational budgets such as programs in health and education. On the revenue side, the responses are mostly related to discretionary measures to offset losses in revenue sharing revenues and the shrinking of own tax bases.

[5] For more information see Leven and Santi (2012)EU austerity and reform: A country by country table(Updated May 3).

"Crisis episodes tend to lead to re-centralization measures. The causes are multiple, from political opportunism to using fiscal policy as a stabilizer by central governments"

Overall, the effect of crises on fiscal decentralization shows the need for coordinating subnational fiscal responses with central government fiscal policy. A reasonable strategy that some governments have used lies in the fact that central governments can redistribute budgetary resources across their subnational governments to counteract asymmetries in exogenous shocks affecting lower-level governments. But an approach that places the whole burden of economic stabilization on central governments budgets undermines incentives for subnational governments to build both fiscal space and institutional capacity to respond to exogenous shocks.

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The Recentralisation Process of the State of Autonomies[1]

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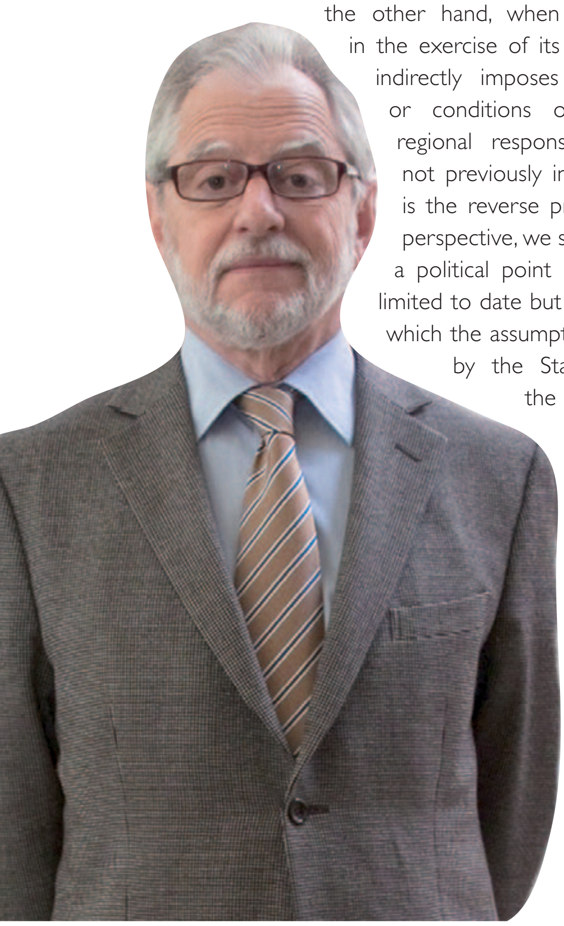
1. Introduction

In this work we shall apply a strict definition of recentralisation. We consider that this phenomenon takes place in two different situations: on the one hand, when the State – the central Government bodies and institutions – takes over responsibilities previously undertaken by the Autonomous Regions – and, on the other hand, when the State legislator, in the exercise of its functions, directly or indirectly imposes controls, limitations or conditions on the exercise of regional responsibilities which were not previously in place. Although this is the reverse process from a formal perspective, we shall also analyse, from a political point of view, the cases – limited to date but highly significant – in which the assumption of responsibilities by the State is the result of the refusal by certain Autonomous Regions to continue to undertake some of the responsibilities they had hitherto assumed.



There are certainly other factors of very different natures, basically political and economic, which also contribute, often quite significantly, to the transfer of political power from the Autonomous Regions to the State. Throughout this paper, we shall refer to these issues although, as we have already mentioned, this is not the object of the research summarised here.

The current recentralisation process began a while ago. It has been developing for years, particularly as the material scope and degree of regulation of the exercise of basic and cross-cutting responsibilities of the State – Sections 149.1.1 and 149.1.13 of the Spanish Constitution – have increased, with the ensuing limitation of the scope of autonomous regional powers.

It is, furthermore, an on-going and, to date, irreversible process: the State has steadily begun to take over new material spheres and, once in place, it has consolidated its position in such a way that the return or "devolution" of power to the Autonomous Regions is a practically unprecedented phenomenon.

However, this protracted and persistent process has quickened its pace and become deeper with the outbreak and subsequent aggravation of the economic crisis. In fact, we shall focus primarily on the measures taken by the State to tackle the situation as of 2008 and, specifically, as of 2010, when the stimulus measures became, suddenly and radically, austerity measures.

Nevertheless, we must begin by pointing out that, all the recentralising measures of the period analysed are neither a direct result of the economic crisis, nor are they only aimed at tackling it. Many of these measures do not have this association, or, at least, not exclusively, but rather, are driven by other deeper reasons and objectives; for instance, in what concerns us here, the belief, shared by many social, political, economic and media sectors, that the decentralisation process has gone too far and that the State needs to regain responsibilities and exercise its power to coordinate the

"The protracted and persistent recentralisation process has quickened its pace and become deeper with the outbreak and subsequent aggravation of the economic crisis"

[1] A broader and more detailed version of this study is available on the websites of the Chair of Fiscal Federalism and the Institute of Autonomous Studies, including some contents which, due to the lack of space available, have been eliminated from this publication.

[2] The authors wish to express their gratitude for the assistance provided in the completion of this work by Helena Mora, Head of Autonomous Studies and Initiatives at the Institute of Autonomous Studies.

activities of the Autonomous Regions. Logically, not everybody agreed or agrees with this analysis. There are also large sectors, mainly in the Autonomous Regions of Catalonia and the Basque Country, which hold a radically different view, and which consider that political decentralisation in Spain is more apparent than real and must be dramatically reinforced, even to the extent of arguing that the model must be changed so that Autonomous Regions can enjoy a political power denied to them to date.

In any event, at the time of writing (December 2012), the recentralisation process is in full swing and all evidence points towards confirming that this trend shall experience a remarkable increase in the near future.

In this paper we shall not go into the debate on the constitutionality or otherwise of the recentralisation measures adopted by the State. In our legal system there is a lack of well-defined and minimally certain criteria to delimit the scope of state and autonomous responsibilities; from a legal perspective, the state legislator enjoys almost total freedom to establish the scope of its own powers and, therefore, the powers of the Autonomous Regions. The Spanish Constitutional Court, with its Ruling on the Statute of Autonomy of Catalonia in 2006, has given final recognition to this phenomenon and, in doing so, has transformed the doctrinal debate on power limits into a largely fruitless discussion. For this reason, we shall restrict our discussion to stating, in the most relevant cases, the constitutionality issues which might hypothetically arise from the measures adopted, and to recall what the Spanish Constitutional Court and the Catalonian Council for Statutory Guarantees have ruled on to date.

On the other hand, we will analyse the impact of the recentralisation measures adopted on the power distribution system, on the level and quality of the autonomy of the Autonomous Regions, and on the set-up of the model of territorial organisation of the so-called State of Autonomies. We shall try to establish whether these recentralisation measures have altered the pre-existing power distribution system, whether they have transformed the kind of autonomy allocated to the Autonomous Regions and whether they have had an impact on the structural elements upon which the State of Autonomies has been based thus far. And we shall do so by accepting from the beginning the difficulty of determining when changes – which can be defined as drastic or structural – take place in the power distribution system, in the kind of autonomy of the regions and, in short, in the territorial organisation of power.

From this perspective, and in advance of this discussion and the main conclusions of this paper, the starting point must be stating the fact that, for most areas of competence, from the onset of the State of Autonomies, the interpretation and application of the Constitution and the Statutes of Autonomy in place have transformed political autonomy – which, formally speaking, the Autonomous Regions could have enjoyed – into a merely administrative or managerial autonomy. The capacity of the Autonomous Regions to set their own policies in actual social, political or economic areas has gradually been reduced until, for most matters, it has almost disappeared. In fact, in most cases, the Autonomous Regions do not even have the capacity to adapt external policies – EU or State – to their own specific circumstances. Moreover, as we shall prove, even administrative autonomy is being significantly reduced in many areas, beset by the State's recovery of executive powers through measures of coordination and even administrative supervision, amongst others.

Having placed the issue in context, until a few months ago, it was possible to defend the thesis that the provisions approved by the State in the last five years had led to a clear progression in the 'administrativisation process' of regional autonomy, but had not involved a radical change in the power distribution system, in the kind of autonomy of the regions or in the structural elements of the State of Autonomies. And this was the case, not because recentralisation was not very relevant in practice, but because, on the one hand, the aforementioned flexibility and lack of determination of the power distribution system, added to the State legislator's freedom of configuration had allowed the State to carry out all the recentralisation activities it had deemed appropriate without altering the power distribution system or affecting the kind of autonomy in place, which, in fact, was already essentially a merely administrative autonomy long before 2008. (This is argued in Viver, Carles; to be published shortly). However, the measures adopted in recent months, especially in the field of regional funding, as well as some of the measures contained in drafts and proposals of laws currently being processed, allow us to state, albeit within the abovementioned relativity, that a radical change is currently under way which is affecting the kind of autonomy in place and even structural elements of the State of Autonomies.

The first conclusion is reached from the observation that the financial autonomy of the Autonomous Regions is being almost completely hollowed out, particularly in cases like Catalonia, which have had to resort to accessing the Public Administration Liquidity Fund. This is a radical change, a consequence of the accumulation of measures which, if conside-

"The measures adopted in recent months allow us to state that a radical change is currently under way which is affecting the kind of autonomy in place and even structural elements of the State of Autonomies"

red individually, would not lead to this effect but that, together, lead to the almost complete ablation of important components of regional autonomy, such as the political, and even mere administrative aspects of financial autonomy. The second conclusion would be reached if the drafts under way were approved; these seek to replace the jurisdictional controls over the exercise of regional responsibilities with political or opportunity controls, or else, with the possibility that the State could bring disciplinary administrative proceedings against senior positions in the Autonomous Regions.

2. Stimulus Measures for the Economy (2008-2009)

From the perspective of recentralisation, among the many different stimulus measures adopted by the State at the onset of the crisis (See Viver, Carles; 2011; pages 163 to 165), subsidies have undoubtedly proven to be the most problematic. The State's subsidising activity, which at that time reached a significant financial level, in many cases had a considerable recentralising impact insofar as it became the State's opportunity to make and execute rules in areas of regional competence. One such example is the many subsidies granted directly to the city councils by the State, with no intervention from the Autonomous Regions. Some of these subsidies were earmarked for the execution of public works (such as, for instance, Royal Decree-Law 9/2008 of 28 November, leading to the creation of the State Fund for Local Investment and the Special State Fund to Encourage Economy and Employment); others even funded current expenditure in areas such as education or social services, areas in which, the Autonomous Regions have broad responsibility (Royal Decree-Law 13/2009, of 26 October, leading to the creation of the State Fund for Employment and Local Sustainability). These subsidies were designed on the basis of the dual nature – State and regional – of the competences on local administration although, in practice, the result was a significant strengthening of the State's role in regard to local entities, to the detriment of the role of the Autonomous Regions.

The regulatory and executive powers assumed by the State over such subsidies got very close to the limits tolerated then and now by the doctrine of the Constitutional Court, often clearly exceeding them. However, for obvious political reasons, in light of the economic crisis, these were not challenged by the Autonomous Regions. There was only one exception: the Government of the Generalitat of Catalonia appealed against the aforementioned Royal Decree-Law 13/2009, of 26 October. The proceedings were settled by Spanish Constitutional Court Judgment No. 150/2012 of 5 July, which declared the unconstitutionality of several precepts of said Royal Decree-Law due to the encroachment of the powers of the Generalitat of Catalonia.

"The State's subsidising activity, in many cases had a considerable recentralising impact. It became the State's opportunity to make and execute rules in areas of regional competence"

In any event, from a political rather than legal perspective, but not less importantly, we must highlight the fact that, the magnitude of the stimulus measures taken by the State and massive publicity thereof, contributed – along with other factors such as the internationalisation of the crisis and the ensuing protagonism of the States – towards reinforcing the pre-eminence and leadership of the State Government in relation to the Autonomous Regions. This also served to strengthen the perception by citizens that the State was the only body with actual power to face extremely important and complex situations. This fact – which is certainly common in most politically decentralised states in times of economic crisis – was subsequently compounded by an unfounded smear campaign against the Autonomous Regions, which was even reflected in the preambles of some state laws – such as Royal Decree-Law 16/2012, of 20 April, on urgent measures to guarantee the sustainability of the National Health System and improve the quality and safety of its provisions. This campaign likewise 'blamed' the Autonomous Regions for the outbreak of the crisis and the difficulties facing the State to tackle it, a good example being the Stability Programme of the Kingdom of Spain 2012-2015, submitted by the Spanish Government to the European Commission, in which the Autonomous Regions were proclaimed to be the source of over two thirds of the budget deviation, and at the same time accusing them of a lack of accountability.

These phenomena carry a strong recentralisation component and have helped to lower the image of the Autonomous Regions and political decentralisation in the eyes of the citizens of some of these regions.

3. Measures Limiting the Financial Autonomy of the Autonomous Regions

Financial autonomy and, more broadly, the economic policies of the Autonomous Regions, are undoubtedly the areas most affected by recentralisation measures. It is true that, particularly since 2001 and, in a more muted manner, since 2006, the State already enjoyed significant powers which allowed it to limit the financial autonomy of the Autonomous Regions and since such times, and with the increasing approval of the Constitutional Court, has been exercising these powers in a more or less flexible way depending on the case. However, since the beginning of the second decade of this century, this recentralisation process has accelerated, strengthened and even acquired new dimensions, invoking to this end demands from the European Union in a manner that is not always fair if we consider that, in contrast with the Autonomous Regions, the State does not only take part in the adoption of such demands, but actually promotes them.

On the other hand, we should also examine the extent to which the recommendations made by the EU to the regions of the States are induced by the States themselves – and, incidentally, not all such recommendations are issued by way of formal legal acts from the EU bodies and institutions, but are often issued in the form of notes, declarations and other informal acts.

The start of this new period can be attributed to the commitment – which is extraordinarily relevant from the point of view of the restrictions applied to the financial autonomy of the Autonomous Regions – undertaken in May 2010 by the State before the EU authorities, to reduce the overall deficit of the State, the Autonomous Regions and local entities by 8.5% in only three years (i.e. from 11.5% at the end of 2009 to 3% by 2013). This commitment was unilaterally adopted by the State, without previously consulting the Autonomous Regions as required by the legislation in force, although it was subsequently ratified by the Regions at the Fiscal and Financial Policy Council (hereinafter, FFPC). The distribution of the deficit reduction over the three levels of government was approved by the Spanish Parliament, at the proposal of the State Government, following a non-binding report by the FFPC and consultation with all Autonomous Regions.

This distribution meant a much higher containment effort for the Autonomous Regions than for the State, particularly taking into account the volume and nature of public expenditure managed by each Administration and the fact that, as we shall examine shortly, this disproportion has increased as of 2012.

The second important recentralisation measure was the amendment of Section 135 of the Spanish Constitution, of 27 September of 2011, which establishes the principle of budgetary stability, prohibits the incurring of structural deficits which exceed the limits established by the European Union and determines the priority of payment of public debt interest and capital. The reform was the result of a suggestion made by the EU which, however, allowed for other materialisations.

For the purposes of this paper, we must begin by highlighting that the initial drive of the reform was reserved exclusively to the two main state-wide parties, excluding from this first phase all other parties with parliamentary representation and, it goes without saying, with no institutional intervention whatsoever by the Autonomous Regions, even though the reform directly affected their financial autonomy. This fact once again presents a scenario of extraordinary recentralisation, insofar as it suggests that a constitutional pact which affects such fundamental matters as budgetary stability and debt and structural deficit limits for all public administrations, can be decided upon exclusively by Central Government institutions, which are essentially represented by the main parties at State level; the perception of a certain exclusion of the Autonomous Regions has since then hung over the constitutional pact. Furthermore, the remission to a future organic law to implement the principles set forth in Section 135 of the Spanish Constitution, created the framework for the State, via the Spanish Parliament, to unilaterally outline the application of the principle of budgetary stability for the Autonomous Regions, which implies an impact on their financial autonomy.

"The start of this new period was in 2010, when the State adopted the commitment to reduce the overall deficit before the EU authorities. Another important recentralisation measure was the amendment of the Spanish Constitution in 2011"

The abovementioned is Organic Law 2/2012, of 27 April, on Budgetary Stability and Financial Sustainability which, for the purposes of this paper, begins by establishing three rules considerably limiting the financial autonomy of all Public Administrations, therefore including the Autonomous Regions:

- In the first place, it strictly establishes that no Public Administration may incur a structural deficit as of the year 2020, and sets a limit of public debt of 60% of GDP, distributed unequally among the three levels of government (the State reserves 44% for itself, and allocates 13% and 3% to the Autonomous Regions and local entities, respectively).

- In the second place, it establishes what it refers to as "the expenditure rule", which sets forth that Public Administration expenditure may not exceed the reference growth rate of the medium-term Gross Domestic Product of the Spanish economy. Moreover, this rule shall still be applied even if the public administration in question obtains higher earnings than expected, as this "surplus" shall be used in full to reduce the level of public debt.

- Finally, in the third place, it contains the principle of absolute priority of payment of interest and capital of public debt held by Public Administrations over any other expenditure.

As is well known, these last two rules have a direct impact on the most characteristic area of the financial autonomy of the Autonomous Regions, that of expenditure versus income (Spanish

Constitutional Court Judgment No. 228/2003, of 18 December, Point of Law 7).

On the other hand, Organic Law 2/2012 grants the State a number of new and reinforced powers that can also affect the financial autonomy of the Autonomous Regions. For instance, it allows the State to freely and unilaterally set budgetary stability and public debt targets for all the Autonomous Regions both as a whole and individually; pursuant to Organic Law 3/2006, amending Organic Law 2001, of 13 December, complementing the General Law on Budgetary Stability. The only requirement for this is the prior issue of a non-binding report by the Fiscal and Financial Policy Council, thus abolishing the need for any previous consultation with all Autonomous Regions for the setting of their targets as a whole, and any previous bilateral negotiation with each of them to set their individual targets. The participation of the Autonomous Regions in the process of determination of their own budgetary stability targets, both as a whole and individually, is therefore dramatically reduced.

The State has already applied this regulation of Law 2/2012, reserving for itself full capacity for flexibility over the deficit cap granted by the EU to Spain for the year 2012, and setting the target for the Autonomous Regions at 1.5%. The stability objectives for the period 2013-2015 confirm this tendency towards demanding a greater reduction effort from the Autonomous Regions, as reflected in the table below:

Table 1. Budgetary Stability Target for the Period 2013-2015(*)
Funding Capacity (+) Necessity (-) ESA-95 (as a percentage of GDP)

	2013	2014	2015
Central Administration	-3,8	-2,7	-2,1
Autonomous Regions	-0,7	-0,1	0,2
Local Entities	0,0	0,0	0,0
Social Security	0,0	-2,8	0,0
Total for all Public Administrations	-4,5	-2,8	-1,9

Official Gazette of the Spanish Parliament – Senate. No. 87, 20 July 2012.

When comparing the percentage change in deficit targets, we can observe that the Autonomous Regions experience a greater toughening of their targets in comparison with the State, despite the fact that they bear the expenditure of most public policies of a compulsory nature and of rigid demand – i.e. education, health and social services. Thus, the State's deficit target for 2013, compared to the previous year, is reduced by 5% of the initial target (from 4% to 3.8%), whereas the deficit target for the Autonomous Regions is reduced by 53.33% (from 1.5% to 0.7%). The comparison between 2013 and 2014 also shows this trend (the State reduces its deficit target by 28.94%, whereas the reduction for the Autonomous Regions is of 85.71%).

Continuing with the analysis of Organic Law 2/2012, it is important to highlight the exclusive reservation to the Spanish Parliament – specifically the Congress of Deputies, by absolute majority – of the decision on the exceptional circumstances which allow for the previously set structural debt ceiling to be exceeded. In this regard, the Law, which merely follows what is set forth in the new Section 135.4 of the Spanish Constitution, differs from what is established by German legislation, although the initial promoters of the reform argue that this had at first been their model.

In order to ensure compliance with targets of budgetary stability, public debt and the expenditure rule, Organic Law 2/2012 establishes a series of obligations which must be met by the Autonomous Regions and assigns the State a number of powers related to budget preparation, approval and implementation, and to other actions which affect the income and expenditure of the Autonomous Regions and allow it to carry out a true financial guardianship over said Regions. And so, for example, the Spanish Ministry of Finance is expected to issue several reports throughout the year on the degree of compliance of targets by the Autonomous Regions, upon which the State has the power to apply preventive, corrective and coercive measures.

"The Autonomous Regions have experienced a greater toughening of their deficit targets in comparison with the State, despite the fact that they bear the expenditure of public policies on education, health or social services"

These preventive measures consist of the formulation of reasoned warnings by the State Government, obliging the Autonomous Regions to adopt the measures required in order to prevent non-compliance with the aforementioned targets.

There are three types of corrective measures. In the first place, the State must authorise all debt operations of each Autonomous Region, not only in the event of failure to meet budgetary stability targets, as was the case before Organic Law 2/2012 came into force, but also when exceeding public debt limits. This authorising power of the State has been strengthened by Royal Decree-Law 21/2012, of 13 July, on Liquidity measures for the Public Administration and the financial sphere, which has granted new control powers – authorisation, supervision and direct management – to the State in regard to all borrowing operations of those Autonomous Regions adhering to the funding mechanism regulated by the Royal Decree-Law.

Secondly, in the event of non-compliance with budgetary stability, public debt or targets set by the expenditure rule, the granting of subsidies or the reaching of agreements between the State Administration and the Autonomous Regions in breach shall require the issuing of a favourable report by the Spanish Ministry of Finance and Public Administrations. This implies, in practice, that the State may suspend the granting of subsidies and the reaching of agreements with the affected Autonomous Regions, as it has already done.

Finally, Autonomous Regions in breach must submit a financial and economic plan for approval by the Fiscal and Financial Policy Council, the implementation of which will be controlled by the Ministry of Finance and Public Administrations, through the submission of quarterly reports which might even end up serving as the grounds for the State Administration to demand the adoption of new measures, should a deviation in the execution of the plan be detected.

If the plan is not submitted, not approved or not met, coercive measures are then applied. These include, among others, the obligation to make a deposit in the Bank of Spain equal to 0.2% of the GDP of the Autonomous Region in question, or that autonomous regulatory powers on assigned taxes are taken over by the State. Should the breach persist, the deposit shall not accrue any interest and may result in a coercive fine; these measures also include the creation of an expert committee to propose measures of mandatory compliance by the region in default, and even considers the possibility of the State adopting measures of mandatory compliance by the Autonomous Region pursuant to Section 155 of the Spanish Constitution.

"In order to ensure compliance with targets of stability, Organic Law 2/2012 establishes a series of obligations which must be met by the Autonomous Regions and assigns the State the power to impose preventive, corrective and coercive measures upon them"

Such measures could be completed with the drastic provision contained in the draft of the law on Transparency, Access to Public Information and Good Governance, which considers, in Section 27.2, Paragraphs b) and d), in relation to Section 28.4 b), the possibility of the Ministry of Finance and Public Administrations dismissing and disqualifying senior officials and other positions of the Autonomous Administrations who fail to meet the obligations arising from Organic Law 2/2012 – to whom the provisions of the law shall apply, in accordance with Section 22.2 thereof.

It is clear that, depending on how Section 155 of the Spanish Constitution and, if approved, the regulation set forth in the law on transparency are applied, the recentralisation process might undergo a significant qualitative change; this is because it could be argued in this case that the structural elements of the territorial organisation model would be affected by the introduction of a new type of control over the Autonomous Regions which deviates substantially from the controls provided for in the current model.

To complete this scenario, we must add that, for the State to be able to exercise these powers of supervision and control over the Autonomous Regions, Organic Law 2/2012 and the provisions that implement it – essentially, Order HAP/2105/2012, of 1 October, of the Ministry of Finance and Public Administrations – impose strict measures on the Autonomous Regions in what is termed to be "transparency requirements", and obliges them to supply to the State an exhaustive and continuous volume of information.

"Coercive measures include the obligation to make a deposit in the Bank of Spain equal to 0.2% of the GDP of the Autonomous Region, or that autonomous regulatory powers on assigned taxes are taken over by the State"

Finally, a reference must be made to the extraordinary state control measures over the accounts of the Autonomous Regions contained in the aforementioned Royal Decree-Law 21/2012, regulating the liquidity mechanism from which the eligible Autonomous Regions can benefit. This provision subjects the Autonomous Regions to the principles of financial prudence established by Ruling of the General Secretariat of the Treasury and Financial Policy, and also regulates other measures to be met, such as the preparation and submission of equally strict adjustment and cash flow plans. At the same time, the State assumes many executive powers (authorisation of securities operations and credit operations abroad; management, in the name and on behalf of the Autonomous Region in question, of the repayment of public debt at maturity, etc.). Consequently, the financial management autonomy of the Autonomous Regions becomes extraordinarily conditioned by State intervention, on the grounds that it has been the State who has provided liquidity to the Autonomous Regions.

In light of what has been discussed so far, it is not surprising that, in a press conference after the Meeting of the Spanish Council of Ministers of 26 October 2012 – as reported by the daily newspaper *El País* the following day – the Vice President of the

Spanish Government stated that "the Autonomous Regions have already been intervened almost in full, particularly those that have resorted to the Rescue Fund. It is not a case of visiting the regional government departments to see what each one has; in fact, they are already assessing their adjustment plans with the Ministry of Finance on a daily basis."

In order to appreciate the practical relevance of such measures, we must bear in mind that it all seems to suggest that quite a few Autonomous Regions will face difficulties in meeting the deficit and debt targets set by the State, both in 2012 and, particularly, 2013, when these targets will be tougher. Moreover, we must emphasise that 9 Autonomous Regions have currently already resorted to the Liquidity Fund available to Public Administrations.

"In 2012, the Vice President of the Spanish Government stated that "the Autonomous Regions have already been intervened almost in full, particularly those that have resorted to the Rescue Fund"

The share of responsibility of the Autonomous Regions in the difficult financial situation they are facing cannot be underestimated. Nevertheless, it is important to remember the existing structural flaws in the regional funding system – which is particularly obvious in some cases – or the adverse effects that certain actions and omissions of the State have over this financial situation. Although these cannot be classed as recentralisation measures in the strict sense of the term as used here, they can indeed indirectly lead to this recentralising effect insofar as they may become the final trigger for the application of the abovementioned preventive, corrective and coercive measures to the Autonomous Regions. This would be the case, among many others, of the cutbacks in state transfers which, together with the Autonomous Regions, co-funded certain activities such as those arising from the so-called Dependent Care Law – see the fortieth additional provision of the State General Budget Law for 2012 – or the dramatic drop in state investments in infrastructure or, in the case of Catalonia, the State's refusal to advance the payment of the Competitiveness Fund – provided for under Law 22/2009 of 18 December, regulating the financing system of Common Regime Autonomous Regions – on the grounds of a lack of legal provisions. In some cases, this involves transfers and investments that were already committed or that arose from certain statutory provisions and that the State has not met, such as the 3rd additional provision of the Statute of Autonomy of Catalonia – to which the Spanish Constitutional Court denied any binding legal effects (Judgment No. 31/2010, of 28 June, Point of Law 138).

Similar effects to those examined above are caused by a series of measures recently adopted by the State that restrict the capacity of the Autonomous Regions to raise their own income by exercising their own tax collection powers. These are, in the first place, measures of a "jurisdictional" nature, designed to contest taxes created by the Autonomous Regions; in this regard, it is worth mentioning that, the Cabinet, in the meetings of 14 and 21 December 2012, requested from the President of the Government an objection before the Constitutional Court to two taxes approved by the Parliament of Catalonia on the provision of services by the Department of Justice and the issue of medical prescriptions, and the appeal of the tax of said Parliament on deposits made in credit institutions. Other measures are of a "regulatory" nature; for instance, the obligation to charge the citizens of a given Autonomous Region the excess cost of electricity supply arising from the entry into force of a regional tax (Section 38 of Royal Decree-Law 20/2012, of 13 July, on measures to guarantee budgetary stability and encourage competitiveness).

Along these lines of limiting financial autonomy in raising income, it is worth noting the Draft Law on taxation measures currently under way in the Spanish Parliament, by which, a new state tax shall apply to deposits made in banking institutions at a rate of 0%, with the aim of preventing Autonomous Regions from establishing any other kind of tax on such deposits.

As we have already mentioned on several occasions, neither the reduction in transfers from the State to the Autonomous Regions nor the limits set on tax revenues raised by them can be deemed as direct recentralisation measures; however, these measures further aggravate the difficult financial situation facing the Autonomous Regions and indirectly lead to the application of actual recentralisation measures that must be taken into account, as their direct impact on the financial situation of the Autonomous Regions may lead to the complete elimination of the financial autonomy of their governments (see Judgment No. 742/IX of the Parliament of Catalonia, on the general political direction of the Government, Official Gazette of the Parliament of Catalonia No. 390, of 2 October 2012).

To conclude our analysis, and also among the recentralisation measures that affect the financial and economic sphere, we must also refer to the reform of the savings banks, which has led to a significant loss of political and economic power by the Autonomous Regions, with which they maintained an important mutually-influential relationship – although possibly not as important as that between the German Länder and their respective *Länderbanks*, which nonetheless have been excluded from any restructuring process; this has been primarily motivated by the presence of regional and local administration representatives in the management and control boards of the savings banks headquartered in the respective Autonomous Region and the special 'sensitivity' displayed by these financial institutions towards the funding of the productive economy and social demands relevant to their Region. We may have to wait some time to obtain an in-depth understanding of the effects of this reform, which has significantly affected 50% of the Spanish financial system. For the time being, and within the scope of this paper, we shall only point out that the reform had two main effects on the relationship between savings banks and the Autonomous Regions in which they were headquartered.

In the first place, Autonomous Regions have lost power in relation to savings banks as a result of the disappearance of many of these financial institutions – of the 45 in existence in 2010, there are only 12 as of the end of 2012, and the process is not yet over – and the "delocalisation" of merged savings banks or banks from the Autonomous Region where the savings banks taking part in the merger were originally based.

Secondly, the regulations passed in the last three years have also contributed to the weakening position of the Autonomous Regions, at least in three regards: First, the double possibility – put into practice in most cases – that savings banks have to either carry out their activity as credit institutions through a banking institution to which their entire financial business must be transferred (Section 5 of Royal Decree-Law 11/2010, of 9 July, on governing bodies and other aspects of the legal regime regulating Savings Banks), or transfer all assets attached to their financial activity to another credit institution in exchange for shares in the latter, thus becoming a special type of foundation and losing their status as a credit institution (Section 6 of Royal Decree-Law 11/2010, amended by Royal Decree-Law 6/2012, of 9 March, on urgent protection measures of mortgage debtors without resources); this situation can lead to a loss of the aforementioned "regional sensitivity", insofar as the banking or credit institutions in question shall be required to serve the interests of their shareholders.

"Among the recentralisation measures that affect the financial and economic sphere, the reform of the savings banks has led to a significant loss of political and economic power by the Autonomous Regions"

Secondly, such regulations limit the presence of members elected by the Autonomous Regions and local entities in the savings banks' governing bodies; specifically, they limit public administration representation from 50% to 40% of total voting rights, and establish that the potential participation of the Autonomous Regions in governing bodies must be made through members who are appointed exclusively by the relevant regional Parliament, and who are persons of recognised standing and professionalism (Section 3.2 of Royal Decree-Law 11/2010).

And, thirdly, these regulations have conditioned the exercise of autonomous regional powers to authorise the mergers of savings banks, given that, although mergers will continue to be subject to the authorisation procedure set forth in regional regulations, an additional stipulation establishes that denial of authorisation may only take place by reasoned judgement when the resulting entity could be seen to be in breach of any of the requirements provided by said regulations (Paragraph 24 of Royal Decree-Law 11/2010). In any event, the reduction in the number of savings banks has limited the potential scope of this authorising power.

4. Measures Affecting the Capacity of the Autonomous Regions for Administrative and Institutional Self-Organisation

In regard to the autonomy of the Autonomous Regions to establish, regulate and manage their own administration and self-governing bodies, the analysis of the State's involvement can be divided into two large sections.

On the one hand, there are basic provisions, many of them developed in great detail, which regulate those measures directly affecting public administrations, including regional ones, and which aim to monitor and reduce public expenditure and improve administration efficiency. Among these measures are those which refer to the ban or limitation on recruitment of new personnel, salary reduction and the regulation of aspects related to the working hours of civil servants.

Specifically, within the scope of personnel recruitment, two measures are worth mentioning: on the one hand, the ban on recruiting new staff, with the exception, among others, of the education and health care sectors, in which a reduced personnel replacement rate is allowed, although limited to 10% (Section 23.1, Paragraphs 1 & 2, of Law 2/2012, of 29 June, on State General Budget for 2012); and, on the other hand, the ban on recruitment of temporary staff and on the appointment of temporary statutory personnel or interim civil servants, except in exceptional cases, and only to cover urgent needs in priority areas or matters affecting essential public services (section 23.2, Paragraphs 1 & 2, of the State General Budget Law for 2012).

In terms of remuneration, there are four relevant measures: one, the reduction of civil servant salaries for the month of December 2012 (Section 2 of Royal Decree-Law 20/2012, of 13 July, on measures to guarantee budgetary stability and encourage competitiveness); two, the ban on pension plan contributions (Section 22.3 of the State General Budget Law for 2012); three, the regulation of incompatible remuneration received by certain former senior positions (Section 1 of Royal Decree-Law 20/2012); and, four, the modification of wage supplements paid to civil servants in situations of temporary disability (Section 9 of Royal Decree-Law 20/2012).

Finally, some of these measures affect the working hours of civil servants; namely, their standard working hours are regulated (see seventy-first additional provision of the State General Budget Law for 2012), the authorised leave policy is modified (Section 8.1 of Royal Decree-Law 20/2012) and, lastly, the length of the holiday period is standardised (Section 8.2 of Royal Decree-Law 20/2012). Other measures affecting teaching staff shall be mentioned when we analyse the recentralisation process which has taken place in several material areas. In any event, it is appropriate to remark that the Council for Statutory Guarantees has presented several objections on the grounds of the unconstitutionality of said measures (Resolutions 9 & 11/2012).

"Basic provisions regulate those measures directly affecting public administrations, including regional ones: they refer to the ban or limitation on recruitment of new personnel, to the salary reduction, or to the working hours of civil servants"

In regard to measures aimed at improving the efficiency of all Public Administrations, including those of the Autonomous Regions, we could mention, on the one hand, those contained in Law 2/2011, of 4 March, on sustainable economy; although of a mainly principled content, this law manages to set forth general principles and guidelines which must govern, for instance, the drafting process of regional rules and, particularly, the measures contained in the aforementioned draft law on transparency, access to public information and good governance; this draft law, which recognises broad rights of access by citizens to information relative to public institutions, also establishes in great detail a number of obligations for all public administrations which include, amongst others, the requirement for a proactive attitude towards providing information on their organisation, operations, remuneration etc., as well as setting rules and principles of good governance which they must abide by. Another example of a measure which seeks to bring about administrative efficiency is Royal Decree-Law 16/2012, of 20 April, on urgent measures to guarantee the sustainability of the National Health System and improve the quality and safety of its provisions which, on the basis of seeking efficiency and administrative transparency in health care management, classifies the services provided by the National Health System.

To these measures we could add the proposals – some already applied –to remove some regional organisations. This objective has been assumed and reiterated by the State Government, and has been proclaimed, amongst others, in the aforementioned National Reform and Stability programmes for 2012-2015 – which accuse the Autonomous Regions of duplicating State bodies – and has been broadly and significantly embraced by some of them. To date, the State has not implemented any measures which have obliged the Autonomous Regions to remove bodies or to reduce their 'scope' (for instance, their number of members); in fact, if adopted, this option could lead to serious constitutionality issues and, in some cases, would require reforms to be made in the Statutes of Autonomy.

However, as is well known, some Autonomous Regions that have accepted the position of the State Government have begun to remove bodies which carry out institutional duties of some relevance. For instance, by passing Law 12/2011, of 3 November, on the removal of the Autonomous Ombudsman, the Autonomous Region of Castile-La Mancha eliminated this institution; this removal implies the waiver on the part of this Autonomous Region to exercise, through said institution, the guardianship over the rights and freedoms of its citizens, and the acceptance that it should be the State, through the Spanish Ombudsman, who fulfils this duty. Along the same lines, the Autonomous Region of Madrid supressed the Children's Commissioner, assuming that its citizens could appeal to the Spanish Ombudsman.

Such measures carry significant recentralising effects, reduce the power of the Autonomous Regions and, in fact, imply their acceptance of the degradation of their political autonomy.

In other material spheres, some Regions have considered the possibility of returning certain responsibilities to the State, such as the administration of justice. To date, this has not progressed any further in that it would require, as mentioned earlier, a reform of the Statutes of Autonomy. In any event, the mere consideration of this possibility reveals the depth being achieved by this recentralising process and the repercussion it may eventually have on the State's territorial organisation model.

Other decisions of some Autonomous Regions on the suppression of regional entities and bodies have not resulted in a recentralisation of duties in favour of the State, as these have been assigned to other regional administration bodies. This is the case, for instance, of the elimination of the Competition Tribunal of the Autonomous Region of Madrid, the duties of which have been taken on by the regional department handling domestic trade (Law 6/2011, of 28 December, on Fiscal and Administrative Measures of the Autonomous Region of Madrid), and of the Public Employment Service of Castile-la Mancha, the duties of which have been assumed by the regional department dealing with employment (Decree 313/2011, of 29 December, on the elimination of the autonomous body of Public Employment Service of Castile-la Mancha).

Another highly remarkable case is that of those Autonomous Regions which, according to suggestions made by the State Government at the end of 2011, have decided to close down their Offices and Delegations in Brussels and join the REPER (Permanent Representation of Spain to the European Union). To be specific, Asturias and Castile-la Mancha have completely closed down their respective offices. La Rioja and Castile and León have transferred their personnel to the REPER, who will report to the authorities of this State body. Aragón, on its part, has already announced the closure of its representative office in Brussels, and the Balearic Islands have also suggested they may do the same. Such decisions are relevant insofar as they reveal some Autonomous Regions' idea of the kind of autonomy to which they aspire, in light of the increasingly strong effect of European Law on regional policies and the fact that, as the experts in the matter point out, despite some progress, the participation of the Autonomous Regions in the European institutions is currently one of the weakest in comparison with the rest of the regions with full legislative capacity (See González Pascual, Maribel; forthcoming).

"Some regions have considered the possibility of returning certain responsibilities to the State. This reveals the depth being achieved by this recentralising process and the repercussion it may eventually have on the State's territorial organisation model"

Likewise, we must mention that, as of the end of December 2012, over 60 foreign-based trade offices from the Autonomous Regions of the Canary Islands, Valencia, Galicia, Castile and León, Castile-La Mancha, Aragón, Murcia and Cantabria, have already joined the State network.

Lastly, it is significant that some Autonomous Regions have also adopted measures which directly and negatively affect the institution which bestows political power to their autonomy: the Autonomous Parliament. Such measures have involved the reduction in the number of regional parliament members and, in some cases, may eventually affect their remuneration system. Thus, the Autonomous Region of Cantabria has already approved the reduction in the number of members of its Autonomous Parliament from 39 to 35 (9th additional provision of Law 2/2012, of 30 May, on Administrative, Economic and Financial Measures for the implementation of the Public Services Sustainability Plan), and the political authorities of other Autonomous Regions have announced they may act along the same lines. For instance, Castile-La Mancha also plans to reduce the number of members of its Autonomous Parliament (from 53 to 25) and to eliminate their remuneration, replacing it with compensation for attendance to plenary meetings and sessions.

5. Recentralising Measures Affecting Other Material Areas

In addition to the areas examined, these recentralising measures have affected, to a greater or lesser extent, nearly all areas of responsibility. In this section we shall discuss a few examples of this. In the first place, we will refer to four areas ruled by Autonomous Region public policies – either independently or in cooperation with the State – and their management, as well as the obligation to assume the expenditure thereby generated. Such areas are: health care, education, universities and social services.

In the area of health care, Royal Decree-Law 16/2012, of 20 April, on urgent measures to guarantee the sustainability of the National Health System and improve the quality and safety of its provisions is particularly noteworthy, amongst others. In its preamble, the Royal Decree-Law sets its objectives to be the reduction in expenditure and "the homogenisation of services and provisions" to which patients of the different Autonomous Regions have access. In doing so, it restricts the free and universal access to the public health system; promotes the homogenisation of health care services provided by the Autonomous Regions; firmly encourages the homogenisation of the regional regulations regarding health care professionals, including aspects related to their training and the centres where it is provided; assigns control duties over the access to public health services to the State Government, as well as instrumental functions on the control of data related to the public health system and executive duties in regard to the official recognition of health care training centres. These duties were hitherto not assumed by the State, and limit the legislative and executive powers of the Autonomous Regions in this field.

In matters of education and universities, Royal Decree-Law 14/2012, of 20 April, on urgent measures of rationalisation of public expenditure in education, also includes some recentralising provisions. Specifically, in the area of non-university education, two measures stand out: the setting of the number of teaching hours to be covered by the teaching staff at public and private education centres subsidised with public funds, and the introduction of limits on the system for replacing teaching staff – the appointment of temporary and replacement personnel is set as of ten days of leave of absence.

As far as universities are concerned, the work scheme of the teaching staff of public universities is regulated: the "rationalisation" of the university roadmap and the range of degrees on offer is established; detailed thresholds of public fees for university access are set – which in the previous regulation were only subject to the limits set by the General Conference on University Policy; and, lastly, regulatory power is returned to the State Government in regard to requirements for the creation of faculties, senior technical colleges and polytechnic institutes, departments and other centres and structures which organise education activities at Universities.

In the area of social services, the regulation introduced by the State is a continuation of its centralisation approach to regulatory policy in matters of exclusive autonomous authority. In this regard, Royal Decree-Law 20/2012, of 13 July, on measures to guarantee budgetary stability and encourage competitiveness, introduces various provisions which condition and limit the action of the Autonomous Regions, such as the creation of a new and detailed implementation schedule for benefits in matters of Dependent Care and determination of the maximum amounts of financial aid that can be granted as support to families, personal care and allowances for disability-related services; the regulation of the incompatibility system in regard to economic benefits and services; the decision that the Territorial Council for Social Services and the System for Personal Autonomy and Dependent Care should agree on common criteria of composition and action for the individual dependent care assessment bodies of the Autonomous Regions; and, lastly, the unilateral determination of the contribution to be made by the General Administration of the State to fund the minimum protection levels.

We have so far analysed four different areas in which the State has taken measures that can be deemed as recentralising, mostly related to cuts in public expenditure. Other state provisions also contain recentralizing measures with an economic component, but linked in these cases to the need to stimulate economic activity.

This is the case, for instance, of the liberalisation measures adopted in relation to business opening hours by Royal Decree-Law 20/2012, of 13 July, on measures to guarantee budgetary stability and encourage competitiveness, which modifies State Law 1/2004, of 21 December, on business opening hours. This Law imposes even more restrictions on the already limited autonomous powers in this matter. Indeed, this provision includes a detailed specification of the type of commercial establishments that enjoy full freedom of opening hours leaving no power of decision whatsoever to the Autonomous Regions to regulate this aspect; moreover, it clearly broadens the type of establishments that fall under this category, so the percentage of establishments over which the Autonomous Regions have authority becomes increasingly smaller. As a matter of fact, the State has established an overall minimum number of opening hours and a minimum number of Sundays and public holidays on which they can be open for business, as well as the criteria to be met by the Autonomous Regions when establishing the actual number of such Sundays and public holidays; furthermore, it has eliminated the capacity for Autonomous Regions to set the number of business hours for establishments allowed to be open on such days. The consequence of this Law is the drastic reduction of autonomous regulatory capacities and the scope of regional authority over business hours. In fact, the Council for Statutory Guarantees has presented objections on the grounds of unconstitutionality against most of the aforementioned measures regulated by Royal Decree-Law 20/2012 (Resolution 11/2012).

"In matters of health, education, universities and social services, the State has taken recentralising measures. It has also done the same in business opening hours; itinerant trade or permits prior to opening of commercial premises"

Business opening hours are not the only aspect related to domestic trade which has been subject to regulation by the State, however; other aspects have also been subject to state provisions designed to limit the scope of autonomous regulatory powers. Such is the case of sales promotions (Royal Decree-Law 20/2012, of 13 July); itinerant trade (Royal Decree 199/2010, of 26 February, regulating itinerant and non-sedentary selling – which infringed the exclusive powers of the Generalitat of Catalonia in matters of trade, as declared by the Spanish Constitutional Court on Judgment No. 143/2012, of 2 July); and the removal of necessary municipal licences and permits prior to the opening of commercial premises with a surface area of up to 300 square metres (Royal Decree-Law 19/2012, of 25 May, on urgent measures for the liberalisation of trade and certain services).

Secondly, we must also mention Law 2/2011, of 4 March, on sustainable economy, which was passed to tackle the economic crisis. Although, the content is mainly of a principled nature, as we have already pointed out, it also carries considerable recentralising potential. This provision, which aims to achieve ambitious targets such as "accelerating the renovation of the production model" or "boosting the development of a more competitive and innovative economy capable of renewing the traditional production sectors and embracing new activities which require quality, stable employment", establishes a number of rules and, above all, principles, aiming to guide the action of all public powers, autonomous bodies included. Such rules and principles affect a large number of areas, some of which are exclusively under autonomous authority – such as urban planning, rehabilitation of urban areas and housing – or under shared power – such as the energy system and environmental protection.

Specific recentralisation measures can also be found in areas which, although the executive powers pertain to the Autonomous Regions, the State approves provisions which allow it to reserve certain executive powers for itself. Examples of this can be found in matters of labour, where the State assigns itself the power to validate training contents determined by businesses – although these refer to cases in which there are no vocational training qualifications or professional diplomas available related to the work to be carried out by the employee – and to authorise centres offering such training programmes (Royal Decree-Law 3/2012, of 10 February, on urgent labour reform measures); health care, where the State Administration has assigned itself the accreditation of centres or units offering training for health science professionals (Royal Decree-Law 16/2012, of 20 April, urgent measures to guarantee the sustainability of the National Health System and improve the quality and safety of its provisions); and the environment, assigning to the State the power to grant geological carbon dioxide storage concessions (Law 40/2010, of 29 December, on geological carbon dioxide storage). The undertaking by the State of all these powers has been considered by the Council for Statutory Guarantees as an infringement of the powers of the Generalitat of Catalonia in the relevant areas (Resolutions 2/2011, 5/2012 and 6/2012).

6. Recentralisation Measures in Process or Announced

To conclude this brief review, we must recall that the recentralisation process described so far is currently in full swing and all evidence points towards its growth in the future. In fact, there is evidence of a number of regulatory initiatives – some in progress in the Congress of Deputies and others announced by various ministries – which involve important recentralising elements. We shall mention four examples affecting the following areas: public administration organisation, local organisation, education and economic activity regulation.

In the area of organisation of public administration, we recall that the draft law on transparency, access to public information and good governance, considers the possibility of the State Administration dismissing senior and other positions of an Autonomous administration. Such dismissals would occur on the grounds of failure to meet the obligations set forth in the Law of Budgetary Stability, as well as setting many obligations for the public administrations in regard to the provision of information on their organisation and operations, as well as setting rules of good governance which must be met.

In matters of local organisation, the Government seeks to drive an organisational restructuring (preliminary draft law of rationalisation and sustainability of Local Administrations) which, if passed, will result, amongst others, in the consolidation of the scope of action of provincial councils, to the detriment of other possible options such as the strengthening of Autonomous administrations.

In the area of education, the Ministry of Education, Culture and Sports has presented an organic preliminary draft law designed to improve educational quality; if the current wording is kept, this will mean a radical change in the scope of regulatory powers hitherto enjoyed by the Autonomous Regions in educational matters, which will be drastically reduced in favour of state regulatory policies. To name but a few, we will highlight only two aspects: firstly, the State educational administration assumes the setting of 100% of core subject teaching hours and contents – except for pre-school education and vocational training; and secondly, the preliminary draft law significantly reduces the regulatory powers of those Autonomous Regions that have their own language other than Spanish in deciding on the language regime of instruction, in regard to aspects such as the regulation of the main language of instruction, the consideration of co-official languages as specialty, non-core subjects and, finally, the possibility to pass the final examination leading to Secondary Education (ESO) and Higher Secondary Education (***Bachillerato***) Diplomas without being examined in the subject of the Autonomous Region's co-official language which is different from Spanish.

"The recentralisation process is currently in full swing with the draft laws on transparency, rationalisation of Local Administrations, and the one designed to improve educational quality"

In regard to economic activity regulation, the Ministry of Finance and Public Administrations has announced the upcoming passing of a draft law on "market unity" which, in response to demands from economic "sectors", may definitively restrict the regulatory and even executive powers of the Autonomous Regions in economic matters, thus resulting in practically the entire area being governed by the very broad powers already conferred by Section 149.1.13 of the Spanish Constitution.

7. Coordination Measures

The recentralising measures analysed so far go hand in hand with a very notable recent increase in coordination measures. These measures are the result of strong public opinion in Spain that the lack of coordination between the State and the Autonomous Regions is one of the few problems yet to be resolved in the State of Autonomies. The Spanish Constitutional Court has also contributed, from a different perspective, to the increase of these coordination measures by abandoning the previous restrictive doctrine which limited their application to the areas of responsibility, the coordination of which was attributed to the State, according to the Constitution (for instance, in matters of health care or general planning of economic activity), and replacing it with a new doctrine by which the State may exercise a coordinating power in all material areas in which it has regulatory power, arguing that, in such cases, the State cannot disregard the regional implementation of state legislation (See Spanish Constitutional Court Judgment No. 111/2012, of 24 May).

This is not the forum for an in-depth analysis of the constitutional scope of coordination powers and their differences with similar forms of cooperation. So, for our purposes, the only aspect we will highlight is that, such measures, which, more or less intensively, exist in all politically decentralised States, always carry a recentralising effect, insofar as they introduce limits on the freedom of action of the Autonomous Regions while expanding the State's scope of action. For this reason, we shall complete our analysis of recentralisation with a brief reference to the increasing number of coordination measures which, in a subtle and indirect manner, also bear important recentralising effects.

Among such coordination measures, understood in their broadest sense, there are some which contain planning instruments (i.e. strategies, plans and programmes) such as those reflected in organisational structures (i.e. reference networks, centres of reference and information systems).

In relation to the approval of strategies, plans and programmes, we must point out that the State has found a channel through which to establish, often in great detail, its own policies in material areas upon which the Autonomous Regions have exclusive or shared powers. Through these instruments, the State sets targets, regulates the means to achieve them, provides for funding and even decides which executive actions shall be carried out by public administrations (state, autonomous and local).

In most cases, these Plans essentially allocate coordinating powers to the State, leaving a certain scope of action to the Autonomous Regions. However, this profusion of state planning instruments ends up becoming a path which the Autonomous Regions are forced to follow – having experienced a reduction in their power to establish their own policies in that material area – and becomes a regulatory framework which protects and legitimises subsequent executive intervention by the State (i.e. public aid programmes, promotional activities, control actions, etc.).

Examples of such plans can be found in many different areas, such as tourism (National and Integral Tourism Plan 2012-2015, passed by agreement of the Council of Ministers of 22 June 2012), rural areas (First programme for sustainable development in rural areas 2010-2014, passed by Royal Decree 752/2010, of 4 June), and biodiversity (Strategic Plan for Natural Heritage and Biodiversity 2011-2017, passed by Royal Decree 1274/2011, of 16 September).

Another instrument used by the State is made up of a number of organisational structures (reference networks, centres of reference and information systems) which carry out executive functions in material areas of exclusive or shared responsibility of the Autonomous Regions.

"The coordination mesures, which exist in all politically decentralised States, carry a recentralising effect. They introduce limits on the freedom of action of the Autonomous Regions while expanding the State's scope of action"

The so-called *reference networks* usually exhibit two common features: firstly, they include centres, bodies or institutions which may belong to either the State or the Autonomous Regions; secondly, the State plays a major part, as it usually performs coordination duties over the network, which is equivalent to stating that it controls the executive actions which Autonomous Regions may carry out through their own centres of reference within the network.

Let us examine two examples. The first is that of the Early Warning and Information System for Invasive Alien Species (Royal Decree 1628/2011, of 14 November, regulating the Spanish Directory and listing of invasive alien species), made up of the focal points designated by the Autonomous Regions and the State. The same Royal Decree sets up a coordination office under the General State Administration. As a second example, we will mention the Network of Protected Marine Areas, which includes the marine areas which have been declared protected by the State or the Autonomous Regions (Law 41/2010, of 29 December, on protection of the marine environment). The management of the Protected Marine Areas included in the Network must be subject to two instruments: a Master Plan – which is the basic coordination instrument – and common criteria to be established by the Council of Ministers, aiming at a coordinated management of these Areas.

The second organisational instruments are centres of reference. These are bodies which the State believes carry an element of excellence which justifies them becoming a *role model* for the relevant material areas. Such bodies, which may either belong exclusively to the State or include centres of reference pertaining to the Autonomous Regions, perform executive duties precisely in those areas in which the Autonomous Regions have executive power. The very process of appointing such centres forces them to adjust to the requirements set by the State, both in terms of organisation and performance of their duties. The effects are therefore similar to those of coordination measures.

Examples of this can be found in areas such as food safety (the State designates national reference laboratories which may belong to the Autonomous Regions, as set forth by

Law 17/2011, of 5 July, on food safety and nutrition), and environmental health (the Spanish Ministry of Health approves centres as national centres of reference for the identification, assessment and management of population health risks arising from environmental risks, in accordance with Law 33/2011, of 4 October, on Public Health).

The third of these organisational instruments are the so-called *information systems*. These are coordination bodies which aim to integrate, at a state level, the information arising from the exercise of autonomous responsibilities. They act in the area of labour (Public Employment Services Information System, regulated by Royal Decree-Law 3/2011 of 18 February, on urgent measures for the improvement of employability and reform of active employment policies), in health care (Food Safety Information System, regulated by Law 17/2011, of 5 July, on food safety and nutrition), and urban planning (the Information System on Vacant Buildings or in Need of Renovation and Obsolete Urban Areas, and the Land and Urban Development Information System, regulated by Law 2/2011, of 4 March, on sustainable economy).

There is yet a last kind of "coordination" measure used by the State, as a result of recent EU requirements which, in some cases, as well as requiring the States to appoint a single representative, go as far as demanding single coordinating authorities within each State; single processes for the granting of European aid (Commission Regulation (EC) No. 501/2008 of 5 June 2008, laying down detailed rules for the application of Commission Regulation (EC) No. 3/2008 on information provision and promotion measures for agricultural products on the internal market and in third countries); state-level planning instruments in areas of autonomous responsibility (Commission Regulation (EC) No. 1698/2005, of 20 September 2005, on support for rural development by the European Agricultural Fund for Rural Development (EAFRD)); and even single authorities to carry out executive duties in material areas of autonomous responsibility. An example of this type of measure is the designation of the National Accreditation Body as the only national body authorised to certify that products benefiting from the policy of free movement of goods meet the requirements of a high level of protection of the public interest, in areas such as general health and safety, health and safety at work, consumer protection and environmental protection (Royal Decree 1715/2010, of 17 December, by which the National Accreditation Body – ENAC – is appointed as the national accreditation body pursuant to Commission Regulation (EC) No. 765/2008 of the European Parliament and the Council, of 9 July 2008, setting out the requirements for accreditation and market surveillance relating to the marketing of products).

In summary, the recentralisation process is not only reaching the peak of the process of loss of political autonomy by the Autonomous Regions, but is also having an important effect on the last remaining stronghold of regional autonomy: management autonomy.

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2

Around the world

Economic Crisis and Recentralization of Government: The Italian Experience

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1. Introduction

The simplest way to describe the situation of local public finance in Italy, in the mid of the worst recession and financial crisis the country has experienced since the end of the Second World War, is by using the expression "war economy". In the attempt of restoring public finances and re-gaining markets confidence, the late Berlusconi government and particularly the new "technical" government by Mario Monti, formed in November 2011, launched a massive fiscal adjustment program, meant to reduce public deficit and debt and improve the efficiency of the public sector. Necessarily, this program had to affect local governments too, as in Italy regions and lower levels of government control large part of public expenditure. But in so doing the government took a number of actions versus local governments that could only have been possible in a perceived situation of extreme risk for the country, analogous to that of an international conflict. Indeed, the policies implemented or proposed by the national government are so invasive of local governments' autonomy to stretch to the limit the precepts of the Italian constitution (reformed in 2001). It is at the moment unclear how this conflict will resolve. It is quite possibly that the constitution will eventually be amended, reverting the decentralization trend that had characterized the '90's developments. The loss of popular consensus towards the Italian political class, including their regional and local components, induced by the economic crisis and by an apparently never ending chain of political scandals and alleged appropriations of public money by elected local officials, makes it more likely that some amount of re-centralization will eventually take place.

Yet, somewhat paradoxically, not all the proposed interventions should be judged negatively, even in the narrow perspective of intergovernmental relationships. The (sad) truth is that fiscal federalism, how it evolved in Italy during the 2000's, as a result of the 2001 constitutional reform and a confused national policy of implementation of the reform, had largely betrayed the promises of a more efficient and more responsive system of local governments. A framework law, passed in 2009 with the aim of interpreting "holistically" the 2001 constitution, had resulted (through its implementing decrees) in an incredibly complex and contradictory system of local government financing and regulations, so complex to make it very unlikely that it could ever work. The policies implemented by the Monti government, that de-facto neutralized the framework law, at least reintroduced some rationality in the financing structure of local government as well as attempting some long-needed re-organization of local structures. Once the financial emergence will have subdued, there is then at least the hope to rebuild local finance on more rational basis.

2. The Financial Squeeze

The next two tables set up the scene, clarifying the role of the different levels of government in Italian public finance[1].

As can be seen by the last column of Table 1, in 2008, that is, just before the beginning of the crisis, the "periphery" (made up by 15 ordinary regions, 6 special regions, 103 provinces and about 8800 municipalities) spent 202 billion euros (207, if one also includes 4,5 billion for interests payments on local debts). In contrast, general government expenditure, including social security, was about 727 billion. But notice from the first column of Table 1, that net of social security and interests on national debt, public expenditure reduced to "only" 431 billion; this residual expenditure was shared almost equally between central (53%) and local governments (47%). Italy is therefore a quite decentralized country, at least as expenditure in public and merit goods is concerned.

[1] Tables 1 and 2 are taken from Giarda (2011), who carefully computed the fiscal flows across governments for the fiscal year 2008. There is no comparable analysis with more recent data; however, the general picture has remained unchanged.

Table 1. The structure of the Italian Public Sector

	General	Center	Periphery
Total revenues	697.6	449.5	98.1
Pension contributions (c)	150.0		
Tax revenues (a)	**547.6**	**449.5**	**98.1**
Total expenditure	-726.8	*(82.1)*	*-17.90%*
Pension expenditures. (d)	-216.4		
Interest expenditures.	-79.7	*-53.3*	*-46.70*
Own expenditure (b)	**-430.7**	**-229.0**	**-201.7**
Balance I: a + b (e)	116.9	**220.5**	-103.6
Balance pensions: c + d (f)	-66.4	-66.4	0
Interests (g)	-79.7	-75.2	-4.5
Balance II: e + f + g (h)	-29.2	-78.9	-108.1
Transfers to periphery (i)	0.0	-114.2	**114.2**
Final balance: h + i	-29.2	**-35.3**	6.1

Source: Giarda, 2011 (data from ISTAT 2008), billion euros.

Table 2. A break down of local government expenditure and revenues

	Regions (incl. Health)	Provinces	Municipalities	Others	TOTAL periphery
Own revenues	66.2	5	28.6	0.2	98.1
Own expenditures	-131.2	-10.2	-52.1	-8.2	-201.7
Interests	-1.7	-0.3	-2	-0.5	-4.5
Total expenditure	-132.9	-10.5	-54.1	-8.7	-206.2
Balance	-66.7	-5.5	-25.5	-8.5	-108.1
Own revenues/exp.	0.50	0.48	0.53	0.02	0.48

Source: Giarda, 2011 (data from ISTAT 2008), billion euros.

Table 2 breaks down revenues and expenditures of the different levels of local government: regions (including special regions), provinces and municipalities. Clearly, in 2008, regions alone spent more than twice as much as the other two levels of governments put together: 131 billion versus 62. However, the largest component of regional expenditure, for about 110 billion of Euros in 2008, was represented by Health Care, which in Italy is a shared competence of both regional and central governments (Bordignon and Turati, 2009). Finally, as again shown in Table 2, local expenditure was financed by local taxes (including tax shares on national taxes) and tariffs for about 48% of the total; the rest came from central government grants, for a total sum of 114 billion of euros in 2008 (table 1)[2].

With these figures in mind, Table 3 summarizes the cumulated effect of all fiscal interventions decided by the central government on local governments' finance since 2010 (when the crises began) and with effects up to 2015[3]. As shown, most effort is concentrated in the years up to 2014, when Italy should reach an overall balanced budget, as agreed with European partners.

As can be seen, the total sum of all approved interventions on local finance in the five years from 2011 to 2015 is an amazing 74 billion

[2] Most of these grants are untied, although as a matter of fact regions perceive the largest component, transfers for health expenditure (about 60 billion, see Table 2), as tied money.

[3] In the fiscal year 2011 only, there were four different fiscal maneuvers, three decided by the late Berlusconi government between May and October and one by the new Monti government in December 2011; for simplicity we report here only the cumulated effect. These repeated interventions reflected the increasing desperation of Italian governments in face of collapsing stock markets, increasing interest rates on Italian bonds and capital flights. The obvious inability of the Berlusconi government to handle the situation led to a political crisis and the birth of the Monti government.

Table 3. Cumulated effects of central government interventions - in billion euros						
	2011	**2012**	**2013**	**2014**	**2015**	**Total**
Special regions	500	1,600	3,200	6,500	3,000	**14,800**
Ordinary regions	4,000	4,500	5,300	7,700	6,100	**27,600**
Provinces	300	500	900	1,300	2,500	**5,500**
Municip. > 5.000	1,500	4,200	5,000	10,500	4,500	**25,700**
TOTAL	6,300	10,800	14,400	26,000	21,875	**79,375**

Source: Our computation on Bank of Italy data.

of Euros, out of a total expenditure that as shown in 2008 was just above 200 billion. In aggregate terms, the adjustment imposed on the local government sector was higher than that requested by the other components of the public sector[4]. The government justified this asymmetric treatment with the fact in the decade 2000-10 local expenditure had increased more than centrally managed expenditure (see again Giarda, 2011)[5].

The numbers reported in Table 2 need to be taken with care. First, they represent a reduction not with respect to expenditure in 2008 but respect to what local expenditure would have been in each year without the intervention, a larger figure. Second, there is possibly some duplication in the numbers that we could not eliminate. Finally, only about a third of the maneuvers are actually "cuts" in intergovernmental transfers or in other local resources; 2/3 comes from a strengthening of the National Stability Pact on Local Governments[6] (NSP). The NSP works as follows. First, it computes a total "mixed" expenditure (including recurrent expenditure and the yearly disbursement for capital investment) for each local government in some standard reference year (usually three years in advance). Second, it imposes each local government to improve its total balance (including yearly capital expenditure) with respect the previous year of some percentage points of this targeted expenditure. Up to 2010, local governments in overall budget equilibrium (and that had respected the NSP in the past) were not requested to increase savings. But with the financial emergence, NSP constraints were extended across the board, implying that even local governments in surplus had now to run even larger surplus.

Note that the NSP refers to overall budget balance, not to expenditure. This implies that some of the interventions in Table 3 did not and will not translate in expenditure cuts, but in increases in local taxes. Indeed, although comprehensive data for 2012 are yet not available, there are several indicators that suggest that regional and local taxes (and tariffs) will shoot up in the present year. Data on expenditure for 2012 are also not available; but for example, already in 2011 municipal (nominal) total expenditure fell by 3 points, and the reduction will certainly be much more massive in 2012-13. As is always the case with fiscal adjustment, it is in particular capital expenditure that suffers the strongest reduction, as projects are abandoned or postponed to the future. The Bank of Italy already computed that in the 2010- 2011 period, capital expenditure fell by more than 30%.

The effect on local public investments is aggravated by another feature of the NSP. Since 2008 NSP has been extended to local budgets as computed both in cash and in accrual terms; this means that some local governments, although rich in resources on accrual bases, are unable to spend them as they have already met their cash ceiling[7]. *Dulcis in fundo*, the central government also imposed in March, 2012 that all savings of local governments had to be held not in the private banking sector, but in the current account that each government has in the national Treasury (remunerated at a zero interest rate); as an effect, all local governments' savings immediately translate in an automatic improvement of the general government cash account.

As already anticipated, the above describes a "war economy" situation for local finance. Local governments are not just "squeezed" by the central government as a result of cuts in grants.

[4] The main intervention of the Monti government on the expenditure side was concentrated on the public pension system, with a sharp increase in the minimal retirement age and a reduction in the generosity of the system. The reform will have strong effects on the future dynamics of public expenditure, but limited immediate effects.

[5] Although the most dynamic part of local expenditure was represented by health care, which is a shared responsibility of regions and central government.

[6] The Pact is supported by tough administrative sanctions (mostly freezing on local hiring and reduction in future transfers) that have been reinforced along the time. Up to 2011, less than 5% of municipalities did not fulfill the Pact; the situation for 2012 is still unknown, although it is likely that a larger share will not be able to respect the Pact. For Health expenditure (that has its own Pact), the situation is different. Currently, 8 regions in the center-south of the country are under special surveillance by the Ministry of Economy as they did not respect the Health Pact in the past. In practice, these regions have lost their autonomy on health management and have to follow a plan defined and enforced by the central level in order to reduce expenditure.

[7] In practice, local governments are forbidden to pay their suppliers even if they have the money to do so. Official data are not available; in 2012, Ifel, the research center of Italian Municipalities Association (Anci) computed the stock of cumulated unpaid obligations of Italian municipalities in about 20 billion euros, although this figure is probably overestimated.

They are actually forced to raise money, through accumulated surpluses and forced saving, to finance the general government budget, a clear violation of local governments' budgetary autonomy. None of these interventions would have been possible without the extreme perception of risk induced by the financial emergence; and none of them will last once the emergence is resolved.

There are a few other aspects, put in evidence by Table 3, that are worth mentioning. First, it is evident that the lowest levels of government are more severely treated than regions. Municipals' total expenditure in 2008 for instance was about 55 billion, while regions' total expenditure was more than twice as large (see Table 2). And yet, as can be seen by Table 3, the "sacrifice" imposed on municipalities is about of the same magnitude than the one imposed on ordinary regions.

There are two reasons for this. First, the main source of expenditure of regions is Health care, partly a responsibility of the central government too. Second, since the 2001 reform, regions are more "constitutionally" protected than lower levels of government. For instance, while the functions of regions are dictated by the constitution, it is a responsibility of central government to determine functions, financing and forms of government for municipalities and provinces.

Finally, special regions were also treated particularly badly. In terms of total population the 5 special regions (the two isles and three small regions in the north of Italy) together amount at about 9 million, whereas the Italian population is about 58 million[8]. This implies that in per capita terms the fiscal adjustment imposed on special regions is more than three times the one required by ordinary region. This reflects an attempt by government to redress an historical inequity. Because of their particular financing system (based on tax shares rather than transfers), special regions have so far enjoyed a particularly generous system of funding. As an effect of government policy, this advantage will be roughly eliminated.

3. Institutional Changes

The policies implemented by the Monti government however go beyond the financial side, and might have longer term institutional effects for the relationship between center and local governments.

First, on the funding side, the Monti government re-introduced municipal taxation on resident housing wealth that the Berlusconi government had abolished in 2008[9]. This redresses a fundamental problem left over by the 2009 framework law that explicitly forbade taxation on resident property, thus leaving municipalities without a sound source of autonomous funding. Second, as a consequence of the increased financial effort imposed on local governments, the central government was forced to anticipate the introduction of some autonomous sources of financing for the different levels of government (mostly, tax surcharges on national taxes) already dictated by the framework law but over a much longer time span[10]. Somewhat paradoxically, local governments are now more autonomous on their financing side that they were just two years ago –although admittedly this extra autonomy has been introduced so far in order to make local governments better able to collect resources to the benefit of general government.

Third, transfers to local governments have been dramatically reduced, a bad thing in itself but with some positive consequences for intergovernmental financial relationships. In particular, the cut in grants will force to re-consider the baroque construction envisaged by the framework law for the allocation of intergovernmental grants. This law in fact interpreted the 2001 constitution (wrongly, in my view) as dictating a complete abolition of all intergovernmental transfers (except equalizing grants), substituting them with tax shares to regional and national taxes[11]. The result has been an overly complex and probably unworkable system of tax shares, reducing any space for useful discretionary intervention. Finally, the framework law also extended the notion of constitutionally guaranteed functions to most municipal functions, again on the grounds of a very doubtful interpretation of the constitution, thus forcing the introduction of a new system of extremely complicated rules for allocating equalization transfers[12]. With the sharp reduction in the transfer fund, these rules make no sense as the resources that they had to redistribute are no longer there. Hence, they will also have to be revised, hopefully in a more rational manner.

On the institutional side, the Monti government also attempted to rationalize the structure of local governments. This is where the proposed policies clash most clearly with the present constitution. The Italian system of local government is excessively complex, with too many local governments and too many levels of government with imprecisely defined and overlapping functions. This reduces accountability, overly complicated the life of citizens and firms, and increases the cost of providing services, a waste of resources that the country cannot longer afford. Proposals to reduce the number

8 It should be noted that each special region is a "special case" in its own, meaning that the system of funding differs across these regions. Roughly, Sicilia, Trentino Alto Adige and Val D'Aosta cash almost all national taxes revenues raised in their territory; Friuli-Venezia Giulia a smaller part, while Sardinia has a financing system similar to that of an ordinary region. These funding differences also reflect differences in expenditure responsibilities across special regions, although the match is hardly one to one.

9 The new property tax is called IMU, while the abolished property tax was called ICI. The two taxes are not identical; there are several differences in regulations and tax base definitions. Space constraints forbid us to discuss them here.

10 Again, space constraints do not allow us to discuss them here.

11 This refers not only to the transfers paid by the central government to local governments, but also to all grants made for any reason by regions to provinces and municipalities. These also had to be substituted by tax shares on regional taxes.

12 Not yet implemented.

of governments (merging the smaller units) and eliminate one level of government (provinces[13]) are continuously and routinely advanced in the political debate, but they have never been applied. On the contrary, the number of provinces has increased in the last decade, as introducing a new territorial unit is a way to create new elected (and generously paid) positions for the political class and increases the resources flowing to a particular territory. The problem is that as a result of the 2001 amendment the constitution now explicitly enumerates the level of governments, and in the case of regions also fixes their number and functions, so that what can be done at unchanged constitution is limited (Ambrosanio et al., 2010).

The experience of the Monti government in this context is informative. In the 2011 December law, the government had proposed to emasculate provinces, transforming them from directly elected bodies in indirect elected ones (with provincial councils made up by representatives of municipality executives) and letting municipalities and regions absorb functions and resources of the present provinces. A more direct strategy of just eliminating them was considered unworkable, as provinces are explicitly mentioned in the constitution. However, this initial attempt has been blocked by a threat to appeal to the constitutional court by the present provincial governments. Hence, the government is now attempting a more limited strategy, halving the number of existing provinces and streamlining their functions. But it will have to be seen if even this more limited attempt survives constitutional scrutiny.

Other reasonable policy prescriptions face the same problems. For instance, because of the constitution, it is not clear whether the central government has the power to reduce the number of municipalities, despite their obvious inefficient scale[14]. Thus, there have been instead several, and mostly unsuccessful, attempts to try to force the smaller units to provide jointly the services, in order to reduce fix costs. Now the Monti government is attempting an indirect strategy, extending the NSP to municipalities below the 5000 inhabitants and linking the NSP to joint provision of public services. For regions, there would be clearly a need to harmonize pay and numbers of regional councilors, that in some regions have gone beyond any reasons, as well as to streamline regional competences, eliminating overlapping with central ones. But again, what can be done without changing the constitution is limited.

The popular discredit surroundings regional governments (and provinces) as a result of a number of recent scandals, and the inability of central government to act because of constitutional constraints, makes it now more likely that a constitutional amendment will be attempted. In order to survive, the political class will be forced to act; and indeed as national elections get closer (they are due in March-April 2013), all main political parties are already proposing to review the constitution to lift these constraints. A rationalization of the existing local governments, as well as a streamlining of their functions, could only be welcome; the risk of course is that the intervention will go too far, eliminating even the few good things that the recent decentralization period in Italy had accomplished.

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[13] Provinces are also not particularly liked by citizens, as shown by the turnout at the provincial elections, which is usually about half of what registered for regional and municipal elections.

[14] 75% of Italian municipalities have less than 5,000 inhabitants.

Crisis, Public Opinion and State of Autonomies

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1. Introduction

As was the case in other countries in which decentralising reforms took place in the wake of a dictatorship, decentralisation in Spain has stemmed from the consolidation of democracy and the transformation of State structures. On the one hand, the creation of a state composed of Autonomous Regions meant the institutionalisation of territorial governments as a way of responding to self-governance demands and acknowledging the distinctive situations of Catalonia and the Basque Country. On the other hand, decentralisation involved the modernisation of State structures and an increase in their efficiency and control by bringing public administration closer to the citizens.

This State of Autonomies has traditionally garnered much support among the citizenship. The favourable perceptions of its implications have had more to do with bringing public matters closer to the people than with its achievements in catering to separatism or improving coexistence among different nationalities and regions. Despite the fact that this territorial model has undergone many changes since its inception, such changes have been made in tune with the preferences of the population, insofar as the most frequent answer to the question regarding preferred territorial models has been "A State made up of Autonomous Regions as we have at present."

The aggravation of the economic crisis has led to a dramatic change in this scenario. Public opinion of the current territorial model has deteriorated and undergone territorial polarisation: whereas the number of citizens in favour of recentralisation of responsibilities has grown in most regions, in the Basque Country since 2005, and more recently in Catalonia, there has been an increase in the number of citizens preferring a State in which Autonomous Regions can become independent states.

The increase in preferences for a greater recentralisation of the State seem to be mainly linked to the economic circumstances, as such opinions are particularly widespread among citizens most affected by the economic situation (unemployed, pensioners, housewives). On the other hand, the increase in support for independence in Catalonia is mainly due to a feeling of national identity among the population and its rise reflects the reinforcement of a trend towards a more autonomous stance which has taken root in recent years in Catalan public opinion.

2. Public Opinion and Territorial Model: General Characteristics

A differentiating factor in the decentralisation process of Spain compared to other countries is its asymmetric nature, both in terms of the differences in access to autonomy (fast-track vs. slow-track Regions) and in financing schemes (common regime vs. "foral" regime) on the one hand, and in the uneven relationship between the broad decentralisation of expenditure and the limited co-responsibility for revenues in Common Regime-funded regions on the other.

However, Spanish public opinion has not widely supported the existence of asymmetries in the level of responsibility across Autonomous Regions, or in regard to the unequal provision of services across regions. A study on the balance sheets of autonomous institutions for the period 1980-2000[1] shows that the citizens of the regions which gained autonomy with fewer spending responsibilities (known as slow-track) unanimously demanded the completion of the transfer process and that all Autonomous Regions should have the same number of responsibilities.

The view that there is a unequal provision of services across Autonomous Regions is shared by the majority of public opinion[2].

[1] Study code: CIS 2386, year2000.

[2] "Service Quality" surveys from the Centre for Sociological Research: CIS 2813 (year 2009) question 33; CIS 2762 (year 2008) question 4; CIS 2706 (year 2007) question 5; CIS 2655 (year 2006) question 7.

Table 1. Assesment of the evolution of the Regional State (1998-2010)[1]

I shall now read you a number of views on the evolution of the State of Autonomies and I would like you to tell me to what extent you agree with each of them. Autonomous Regions… [1 Complete agreement, 2 Quite in agreement, 3 Neither agreement nor disagreement , 4 Quite in disagreement, 5 Complete disagreement]	1998	2002	2005	2010
Have helped to bring the management of public affairs closer to the citizens	2.4	2.4	2.4	2.7
Have contributed towards the development of separatist tendencies	2.8	2.9	2.8	3.1
Have led to an increase in public spending without any improvement in public services	2.6	2.8	2.7	
Have improved the co-existence of different regions and nationalities	2.9	2.8	2.7	

[1]Fuente: Barómetros Autonómicos del CIS.

Although heterogeneity is one of the benefits which theorists attribute to decentralisation, as it allows for better adaptation of public policy provision to the preferences of each region and greater innovation in service provision, it is unfavourably perceived by most citizens in Spain, who believe that there should be no differences in the services and benefits offered by the different autonomous governments[3].

The gradual consolidation of the regional structure, even in regions with little or no self-governance tradition, is evident in the majority support of the citizens of such territories to a greater decentralisation of expenditure, that is, that a share of the revenues collected by the State be transferred to the autonomous and local governments[4]. By and large, the levels of government that are closest to the population are the highest rated. Citizens claim to feel better informed and more concerned by the activities carried out by their local council than by the actions of the regional or central government[5]; by contrast, central administration institutions are the worst rated[6].

Citizens prefer decentralisation of responsibilities to the Autonomous Regions in the areas of health care, education and social services; whereas they are more inclined towards pensions, immigration or unemployment benefits being managed by the central administration. In regard to transport, public opinion supports greater shared management among the three administration tiers, whereas local government is the preferred level of government for managing services such as libraries, parks and gardens and municipal waste management[7].

Citizen support for decentralisation of expenditure is mostly related to bringing the public administration closer to the people. This is reflected in the assessment of the effects of the territorial model. Among the various effects which can be attributed to the State of Autonomies, the one which has the greatest public support (including the Basque Country and Catalonia) is that it has helped to bring the handling of public issues closer to the population, over and above other effects, such as the improvement of the coexistence among different nationalities and regions, the rise in separatist tendencies or increased public spending (See Table 1)[8].

In regard to the decentralisation of revenue, opinions are not as favourable as those related to the decentralisation of expenditure, and appear to show greater disparity across different regions. Moreover, these opinions mainly focus on the support for shared responsibility between the two administrations (central and regional), rather than on the wish for this responsibility to be held exclusively by the Autonomous Regions[9].

[3] Except for Navarra and the Basque Country, where the percentage of citizens in favour of equality in service provision is of 43% and 48%, respectively (Autonomous Region Barometer of the Centre for Sociological Research (CIS 2829), question 18).

[4] The average percentage of answers agreeing with part of the revenue collected by central government being decentralised towards the Autonomous Regions for the period 2000-2009 is of 73%. In regard to local government, the percentage is 76%. See Public Opinion and Fiscal Policy (CIS series).

[5] See Autonomous Region Barometers of the CIS for 1998 (CIS 2286), 2002 (CIS 2455) and 2005 (CIS 2610). In the Autonomous Regional Barometer of 2010 (CIS 2829) there is a significant increase in the percentage of citizens who feel affected by the decisions made by the local, regional and central administrations, with no significant differences across levels of government.

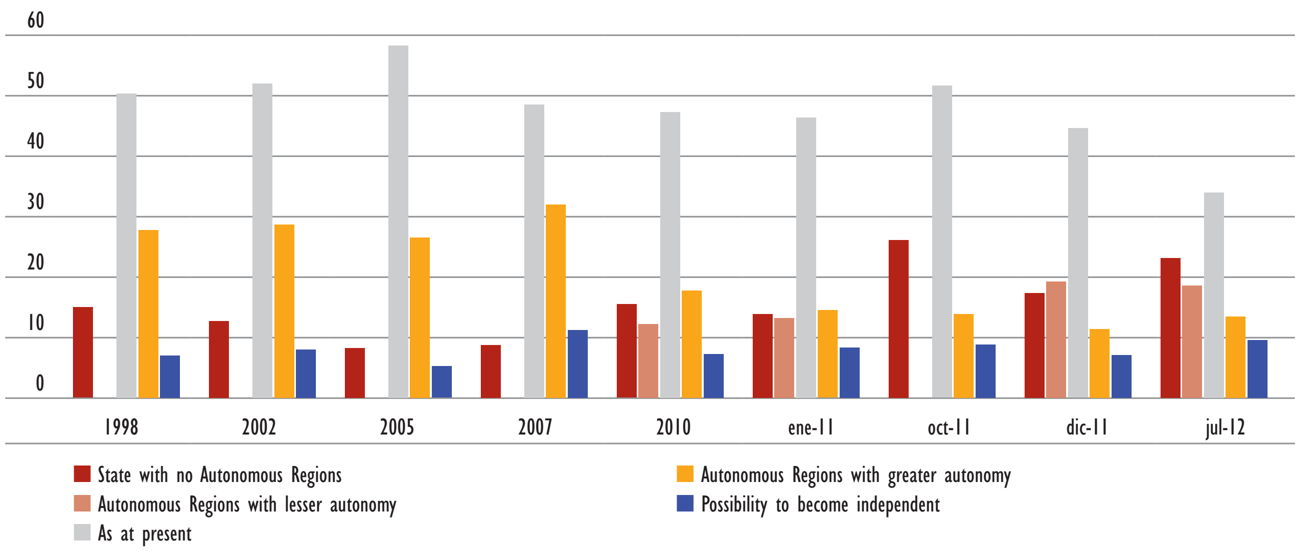
[6] See the comparison of the assessment of regional institutions with the evaluation of central and local government institutions in the CIS Autonomous Region Barometers for the years 1998 (CIS 2286), 2002 (CIS 2455) 2005 (CIS 2610) and 2010 (CIS 2829). Moreover, in the Autonomous Region Barometer of 2010 (CIS 2829) citizens are asked about the more corrupt administration level. 36% believes corruption to be "very widespread" at central government level; 24% at regional level; and 24% at the local level (question 35).

[7] See papers "Opiniones y Actitudes Fiscales" (Fiscal Opinions and Attitudes) 2005, 2006, 2007 and 2010 (by the Spanish Institute of Fiscal Studies) and the survey on "Allocation of Responsibilities" of the CIS (Code 2734).

[8] In the 2010 Autonomous Region Barometer (CIS 2829), citizens are asked which aspect of the State of Autonomies they believe is the most worthy of mention. The most common answers refer to the possibility to manage citizens' matters in a more approachable manner and, to a lesser extent, to the capacity to elect representatives who make decisions on the issues of their region and the defence of the unique identity and characteristics of a region. The percentages in Catalonia and the Basque Country are as follows: in Catalonia, 20% highlights the ability to elect representatives, 56% the existence of an administration which is closer to the people, and 25%, the defence of regional identity. In the Basque Country, these percentages are 30%, 46% and 27%, respectively.

[9] "Opiniones y Actitudes Fiscales" (Fiscal Opinions and Attitudes) 2005, 2006, 2007 and 2010 (Institute of Fiscal Studies).

Graph 1. Evolution of territorial model preferences in Spain (1998-2012)[1, 2]



[1] Not all polls are comparable, only those which contain the same response categories.

[2] Source: CIS Autonomous Region Barometers 1998, 2002, 2005, 2010; CIS Poll on Allocation of Responsibilities 2007 (only for the Basque Country, Catalonia, Andalusia, Galicia and Castilla-León); January 2011 Barometer, Pre-Election Poll October 2011, Post-Election Poll December 2011 and CIS Barometer July 2012.

Furthermore, when asked about which level of government best manages tax revenue, the percentage of citizens who mention the central government is usually higher than those who favour the regional administration, except for Catalonia, the Basque Country and Navarra, where citizens think otherwise[10]. The prevalence of the central administration is likewise reflected in the control of public spending, insofar as even in Autonomous Regions which clearly favour self-government, most citizens agree with the intervention of central government in order to prevent regional and local governments from incurring excessive debt[11].

Finally, one of the characteristics of decentralisation in Spain which distinguishes it from other countries is that the process of transfer of responsibilities has been very intense and has been accomplished in a relatively short period of time. Consequently, there is still much confusion in regard to the responsibilities undertaken by regional governments, despite these having managed the main expenditure items for many years now (health care, education and social services)[12]. On the other hand, citizens' perception of the responsibilities pertaining to central government and local councils are closer to the mark. Central government is correctly allocated responsibilities over pensions and unemployment benefits, and local councils are perceived as the bodies responsible for the maintenance of parks and gardens and urban waste management.

[10] See series of "Opinión Pública y Política Fiscal" (Public Opinion and Fiscal Policy) 2000-2011, except for the year 2010.

[11] See series of "Opinión Pública y Política Fiscal" (Public Opinion and Fiscal Policy) 2000-2009. The average number of answers in favour of central government intervention to prevent regional debt is of 88%. This percentage is 63% in the Basque Country and 81% in Catalonia.

[12] The last responsibility to be transferred to the "slow track" Autonomous Regions was health care, in December 2001.

The consolidation of the Autonomies model has not helped to improve citizens' ability to properly identify the responsibilities held by the Autonomous Regions. Moreover, the extent of public awareness of the distribution of responsibilities differs from region to region. In the regions where responsibilities over education and health care were transferred at a later date (slow-track regions), the percentage of citizens who continue to believe that the central administration is responsible for these areas is high. By contrast, the Basque Country has a relatively high percentage of citizens who believe the responsibility for pensions and immigration control −central administration responsibilities− is held by the Basque government[13]. Such differences highlight the disparity across regions in regard to the degree of visibility of the central government versus that of the regional government.

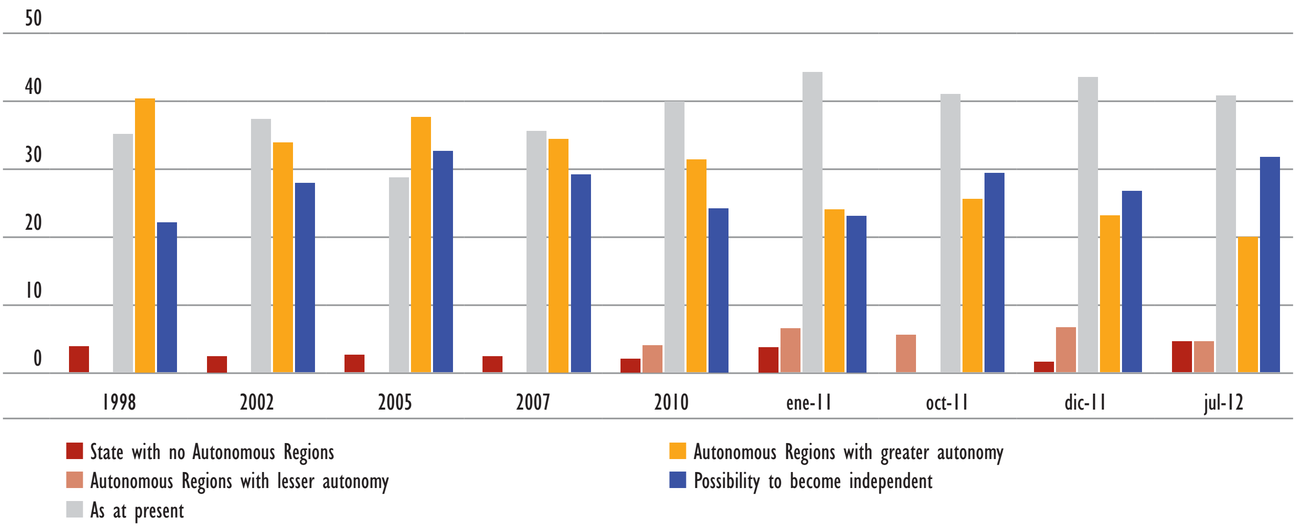
3. Changes in Public Opinion on the State of Autonomies during the Crisis

In recent years, the perception of the State of Autonomies and public preferences on an ideal territorial organisation have undergone a significant transformation. On the one hand, the overall rating of the effectiveness of the territorial model has deteriorated. If between 1998 and 2005 over 70% of the opinions on the creation and development of the Autonomous Regions were positive, this percentage has dropped to 56% in the year 2010[14]. In general, the negative effects of the State of Autonomies have become widespread among public opinion, whilst the positive effects have declined (see the evolution of such opinions in Table 1).

[13] See León (2010, 2012).

[14] See CIS Autonomous Region Barometers (1998, 2002, 2005 and 2010).

Graph 2. Evolution of territorial model preferences in the Basque Country (1998-2012)[1,2]



[1] Not all polls are comparable, only those which contain the same response categories.

[2] Source: CIS Autonomous Region Barometers 1998, 2002, 2005, 2010; CIS Poll on Allocation of Responsibilities 2007 (only for the Basque Country, Catalonia, Andalusia, Galicia and Castilla-León); January 2011 Barometer, Pre-Election Poll October 2011, Post-Election Poll December 2011 and CIS Barometer July 2012.

On the other hand, preferences in regard to State organisation have experienced a territorial polarisation. Between 1998 and 2005, the evolution of public opinion on the territorial model in most Autonomous Regions was marked by the continuity or increase in those defending the existing model (a Regional State "like the current one") compared to the views of greater centralisation (to reduce the responsibilities of the regions) or decentralisation (a State in which the Autonomous Regions have more responsibilities or a State which offers the possibility of such regions becoming independent States) (see Graph 1).

However, data as of 2010 shows an increase in preferences for the recentralisation of the territorial model[15]. This trend comes hand in hand with a change in the stances of the regional political leaders, who for the first time include demands for returning responsibilities to the central government.

The evolution of public opinion in the Basque Country and Catalonia has clearly been different to that of the rest of Autonomous Regions.

[15] The increase in preferences for a recentralisation of the territorial model is evident in the assessment of the different design features of the model, such as the extent of fiscal co-responsibility. Between 2005 and 2007, 40% of those who replied to the question as to which administration should be solely responsible for taxation indicated a preference for central government, compared to the 26% who favoured the regional administration or the 34% who supported a shared responsibility. Although the data are not strictly comparable (in that the 2010 survey included the local government level), in 2010, the percentage of citizens who preferred the central administration to be solely responsible for taxation rose to 47%, those preferring the regional government kept at 26%, and those opting for shared responsibility fell to 19%. See "Opiniones y Actitudes Fiscales" (Fiscal Opinions and Attitudes) 2005, 2006, 2007 and 2010.

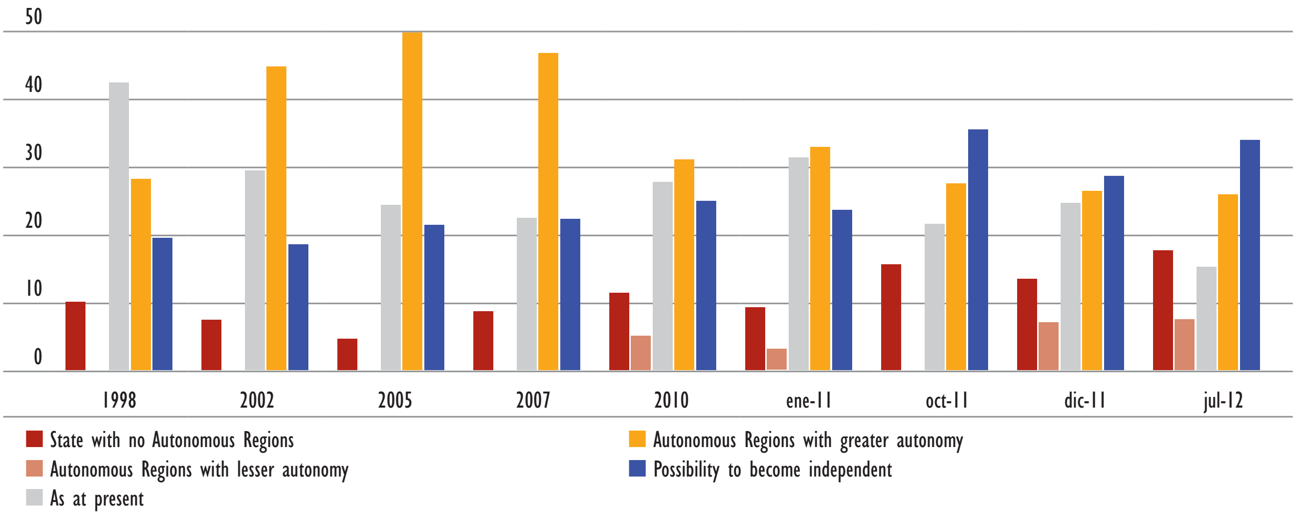
In these regions, the percentage of those in favour of maintaining the current territorial model has been gradually falling in favour of more decentralising or separatist viewpoints. However, the timing has been different in each of these territories. The Basque Country showed an upturn in opinions in favour of independence between 1998 and 2007, whereas preferences for decentralisation or independence decreased between 2007 and 2012, a year which has witnessed an increase in the support of independence (See Graph 2).

The more radical changes in Catalonia have taken place more recently. Between 1998 and 2007, the percentage of citizens in favour of keeping the territorial model unchanged dropped, whereas the share of those preferring greater decentralisation was on the rise. Since 2007 and until 2012, the trend towards greater decentralisation of State control has grown, with an increase in the percentage of citizens preferring a State in which Autonomous Regions may become independent. In contrast to the Basque Country, Catalan society has exhibited greater internal polarisation, in that the period 2005-2012 has also witnessed an increase in more centralising views (see Graph 3).

In summary, in recent years, the number of citizens in favour of modifying the State of Autonomies has increased. However, the change in territorial model preferences goes in two opposite directions: on the one hand, a recentralising trend seeking to reduce or remove regional responsibilities and, on the other, a trend concentrated in the territories of Catalonia and the Basque Country, which advocates for independence.

The polarisation of preferences regarding the State of Autonomies does not go together with a significant change in national identities.

Graph 3. Evolution of territorial model preferences in Catalonia (1998-2012)[1, 2]



[1] Not all polls are comparable, only those which contain the same response categories.

[2] Source: CIS Autonomous Region Barometers 1998, 2002, 2005, 2010; CIS Poll on Allocation of Responsibilities 2007 (only for the Basque Country, Catalonia, Andalusia, Galicia and Castilla-León); January 2011 Barometer, Pre-Election Poll October 2011, Post-Election Poll December 2011 and CIS Barometer July 2012.

Between 1998 and 2011, the percentage of citizens who feel "only Spanish" or "more Spanish than belonging to the Autonomous Region" has increased by 3%[16]. In the Basque Country, identities have remained virtually unchanged since 1998, with a leaning towards moderation in the more autonomous stances ("I feel more Basque than Spanish) and "I only feel Basque"), whereas in Catalonia, the percentage of citizens who feel "Only Catalan" rose by 6% between 1998 and 2011[17].

A more detailed analysis of the public opinion data shows that citizens' national identity has a different effect over the more extreme preferences in regard to the territorial model (full recentralisation or independence). On the one hand, the likelihood of a citizen supporting full recentralisation of the State of Autonomies ("A single central government with no Autonomous Regions) is greater among those who feel "Only Spanish" or "More Spanish than belonging to the Autonomous Community") and also increases among those who rate the economic situation negatively and those most affected by the economic crisis (unemployed, pensioners and housewives)[18,19].

On the other hand, the likelihood of a citizen from Catalonia supporting a State in which the Autonomous Regions have the chance to become independent is not affected by their employment situation or perception of the economic situation, but principally by their feeling of national identity[20]. In fact, the more educated individuals (and, therefore, those who would be potentially less affected by the crisis) are more likely to favour independence than those less educated.

All in all, the analysis suggests that recentralising preferences may be of a more temporary nature and, therefore, more dependent on the evolution of the economic crisis, than support for independence. The former are found more frequently among the citizens most affected by the economic crisis and those for whom the financial situation has the worst outlook. The nature of the latter cuts across the socioeconomic situation of individuals, in that it is not conditioned either by their job situation or their views on the economic situation. On the other hand, they are indeed affected to a greater extent by feelings of national identity which, as has been previously mentioned, often prove to be more stable over time.

[16] Percentages calculated without the Basque Country and Catalonia, based on the CIS Autonomous Region Barometers.

[17] According to data of the *Centre d'Estudis d'Opinió* (the Catalan Centre of Opinion Studies), the percentage of those who feel "Only Catalan" has increased from 17.3% in 2010 (the first wave of the study) to 22.7% in 2012 (second wave).

[18] Results obtained from a logistic regression where the dependent variable is 1 if the respondent prefers a "State with no Autonomous Regions" and 0 if other options are preferred. The independent variables are: ideology of the respondent, voting choice in the last general election, employment situation, rating of the economic situation and national identity. The sample belongs to the joint data from the 2010 Autonomous Region Barometer and the 2011 Post-Election Poll.

[19] These results are also obtained by analysing only a sample of individuals in Catalonia.

[20] Results obtained from a logistic regression where the dependent variable is coded as 1 if the respondent prefers "A State in which Autonomous Regions may become independent" and as 0 if any of the other options are preferred. The independent variables are: ideology of the respondent, voting choice in the last general election, employment situation, perception of the economic situation and national identity. The sample belongs to the joint data from the Autonomous Region Barometer of 2010 and the Post-Election Poll of 2011 for Catalonia.

4. Conclusions

Public opinion assessment of the State of Autonomies has been very positive overall, and mainly associated with the perception that decentralisation of responsibility leads to a closer relationship between the public administration and the citizens. Opinions favouring the decentralisation of expenditure have been greater in number and more homogeneous among the regions than opinions in support of decentralisation of tax. Since the decentralisation process has been acute and has taken place over a relatively short period of time, citizens are still somewhat confused about the allocation of responsibilities among levels of government, particularly in regard to the responsibilities of the Autonomous Regions.

The economic crisis has transformed the perception of the State of Autonomies and public opinion preferences as to the ideal form of territorial organisation. Since 2010, the general assessment of the efficiency of the territorial model has deteriorated, and preferences in regard to the form of State organisation have become polarised. This has led to an increase in the number of citizens who want a territorial model different to the one currently in place, but the alternatives they support move in two opposite directions: a recentralising trend which seeks to reduce or remove regional responsibilities on the one hand, and a trend which concentrates in the territories of Catalonia and the Basque Country and supports independence on the other.

An analysis of the factors behind the more extreme preferences in terms of territorial models (those seeking a single central government with no Autonomous Regions on the one hand, and those which support a territorial model enabling regions to become independent, on the other), shows that the more recentralising preferences have become widespread among the citizens most affected by the economic crisis (unemployed, pensioners and housewives). However, the views in support of independence among Catalan public opinion are more influenced by feelings of identity. This suggests that the preferences for greater recentralisation of the State of Autonomies are more temporary and will depend on the evolution of the economic crisis, whereas the strengthening of positions in favour of autonomy in Catalonia is due to more structural changes in public opinion.

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The New Budgetary Stability in Spain: A Centralising Approach

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I. Budgetary Stability in Spain: The History [1]

It cannot be said that budgetary stability is not present in the minds of our legislators. In a little over ten years, spanning from the end of 2001 to mid-2012, Spain has passed three organic laws (2001, 2006, 2012), a number of ordinary laws and decrees, and an unprecedented constitutional reform in the summer of 2011, following a rapid political accord between the two main political parties. A record which is hard to match.

The history is well known[2]. Let us focus on the realm of the Autonomous Communities. The eighties were marked by the caps on indebtedness set by the LOFCA [Organic Law on Autonomous Community Funding], which proved in practice to be a very lax restriction due to the non-existent indebtedness levels at the beginning and the very sharp growth in non-financial income in the Autonomous Communities as a result of the continuous and gradual flow of responsibility transfers. By the first half of the nineties we witnessed the first Budgetary Consolidation Scenarios ("Escenarios de Consolidación Presupuestaria" or ECP), which were designed to meet the so-called "Maastricht criteria". The success of these ECPs as deficit control tools was somewhat limited, with insufficient regulatory framework.

Things changed dramatically in 2001. The ordinary and organic laws on budgetary stability passed in December go well beyond what is required by Brussels and firmly consolidate the "zero deficit" principle, also for the Autonomous Communities. Criticism was then made on the withdrawal of compensation powers of fiscal policy, an even more serious loss within a context of upward transfer of responsibilities in matters of monetary policy. The response was that public administrations must pursue a structural surplus of at least 1% in order to conform to the stabilisation policy and attenuated optimal taxation. This surplus would also help to offset and face, among others, the implicit liabilities stemming from an ageing population (González-Páramo, 2001).

In 2006, stability policies were amended by Law 15/2006 and Organic Law 3/2006. In summary, commitment to stability was made compatible with a maximum total deficit of 1.5% when the actual GDP growth is under 2% and at least 0.5% of this deficit is used to fund increases in productive investment. Of this maximum limit, the Autonomous Communities would keep the lion's share (1%). Once again, a regulatory framework which met euro-related EU requirements perfectly.

However, the economic crisis wrecked this framework as of 2008. Income plummeted, discretionary expenses increased, automatic stabilisers came into effect and extraordinary deficit levels were reached. Levels which were, in fact, excessive for an output gap the magnitude of Spain's. The real estate bubble had likewise artificially inflated public income at all government levels, causing tax revenues to drop well beyond the levels expected considering the GDP contraction figures and the assumed revenue elasticities[3]. The concern for this imbalance, magnified by the well-known response from the international financial markets, led to an unprecedented agreement between PP and PSOE which enabled the proverbial difficulty of amending the 1978 Constitution to be overcome with breakneck speed.

[1] The text was completed on 31 August 2012.

[2] For a long term outlook, from the eighties to 2008, see Monasterio and Fernández Llera (2008). In Caamaño and Lago Peñas (2008) we offer a detailed analysis of the reforms of 2001 and 2006.

[3] For instance, the sale and purchase of property by private individuals does not generate GDP but does generate revenues via the Property Transfer and Stamp Duty Tax of around 8% of the declared value, depending on the transaction and Autonomous Community.

Finally, Organic Law 2/2012, which was passed in April, introduced important changes for the stability of the Public Administration as a whole and for the Autonomous Communities in particular. The four main cornerstones of the Law are the introduction of a public spending ceiling which will prevent an increase in spending above the pace of GDP nominal growth; the establishment of a cap on public debt expressed as a percentage of GDP (60%) to be distributed among different government levels (13% for the Autonomous Communities); the replacement of the concept of total deficit by that of structural deficit[4] and a zero-level target (by 2020); and greater attention paid to the control and supervision of sub-national tax administrations, including severe sanctions and penalties[5]. Undoubtedly, this Law places us at the forefront of the EU in matters of fiscal regulations.

The second section examines the aspects which cast doubts and shadows on the fiscal consolidation strategy wherein which the new regulations play a central role. On the other hand, in the third section I will discuss the aspects which might support their effectiveness in regard to stabilisation. The fourth section contains the conclusions reached.

2. Reasons Why the New Legislative Framework Cannot Become the Panacea for Fiscal Consolidation

The experience of Spain shows that setting strict caps on debt or indebtedness is not enough to achieve the intended outcome. The disastrous episode of the final 2011 deficit deviation in excess of two points is still raw. International experience also mentions interesting results for Spain. The work by Foremny (2011) on EU-15 countries and the 1995-2008 period shows that fiscal regulations are particularly efficient in highly centralised countries. In decentralised countries like Spain, however, the degree of autonomy and fiscal co-responsibility of the sub-national governments becomes more important. Eyraud and Lusinyan (2011) confirm that, during the 1969-2007 period, in 27 OECD countries, a wide gap between decentralised revenues and expenditure caused the public deficit to be generally higher. Fiscal discipline increases with tax decentralisation.

[4] In principle and theoretically, this is a positive replacement. The problem lies in the difficulty of the accurate and early estimation of the economy's cyclical position (the output gap) and the sensitivity of the budget to the cycle. Possible estimates for these elasticities in Spain vary substantially depending on the method and period analysed. For example, González-Páramo (1998) calculates it at 0.4; Corrales et al (2002) at 0.8; and Andrés and Domènech (2012) at 0.65. The recently passed law establishes that all such calculations shall be made according to European Commission methodology, which can be consulted at: http://ec.europa.eu/economy_finance/economic_governance/sgp/data_methods/index_en.htm.

[5] The agreement reached between PP and PSOE in 2011 considered the possibility of a maximum structural deficit of 0.4%. The insistence of PP to set it at 0.0%, with exceptions made for situations which would allow for upward deviations (section 11.3 of the Law), led to the break-up of the agreement.

In the third place, the European Commission (2009) itself considers that fiscal rules are more effective when the agent controlling the definition and compliance thereof is an independent authority (a council of tax experts, a court of auditors or even the Parliament) rather than a country's Ministry of Finance, as has been set forth in the new Spanish regulations. And the same happens with the issuing of disciplinary measures and punishments.

In the fourth place, the new quantitative targets established are not more demanding than those set by the previous legislation, particularly that which was passed in 2001:

- First of all, because a zero structural deficit is less demanding than a zero deficit[6]; and a debt target of below 60% is automatically achieved in the long term if the structural deficit approaches zero, as a result of the effect of growth in GDP. This is what happened in Spain over the last decade, with a public debt which was clearly under 40% of GDP, despite the low number of surpluses recorded. Having said that, it is true that setting a maximum value for the structural deficit will constrain the government's capacity for action during periods of expansion, so ill-considered tax reductions such as the ones seen in Spain over the last decade would be halted. On the other hand, imposing the growth in nominal GDP as the spending ceiling, as has been the case, would not seem to be a very relevant setback in times of expansion. Between 2000 and 2007, the expenditure/GDP ratio in Spain went from 39.1% to 39.2%, with all other years ranging between 38% and 39%: public spending increased by almost the same as the GDP.

- Secondly, because a broad transitional period (up to 2020) is considered for the achievement of the zero structural deficit and a public debt level of 60% of GDP. In the meantime, the annual target for reduction of structural deficit is set at 0.8% of GDP. This is not a particularly hard target to meet given the starting point of the structural deficit. This must be reduced at a much faster pace if, for instance, the aim is to achieve an overall deficit below 3% by 2014, in light of the cyclical deficit outlook.

3. Reasons why the New Regulatory Framework Could Prove to be Efficient for Fiscal Consolidation

In the first place, the central government's role in the setting, control and execution of deficit, spending and debt levels of the Autonomous Communities has been substantially strengthened. The political autonomy of the Autonomous Communities in budgetary matters has been reduced. As for the bilateral dialogue

[6] In fact, the 1.5% overall limit established in the regulations approved in 2006 would have been more demanding than the zero structural deficit in 2011 and 2012. The cyclical deficit for both financial years easily exceeds 1.5.

between the central administration and each of the Autonomous Communities prior to presenting the individual targets for deficit and debt levels set forth in Article 5 amended by Organic Law 3/2006, the new Article 16 introduced a unilateral approach. In July 2012, we witnessed the application of this reform and the ensuing conflict: the absence of Catalonia at the meeting of the Fiscal and Financial Council held on July 31st and the early and irate departure of Andalusia. Supervision of execution becomes more comprehensive, particularly when there are regional adjustment plans under way, as is the case nowadays in most of the Autonomous Communities. Finally, the possibility of sending control missions to the regional treasury departments becomes regulated.

Secondly, the new regulations require greater transparency in regard to budgetary preparation and execution, to the point that the Autonomous Communities must publicly disclose the forecasts on which the budget estimates are made, as well as the methodology, assumptions and parameters on which they have been based. More information must be sent to the central administration, often in real time. This is clearly positive and can help to increase internal pressure in the Autonomous Communities in favour of greater budgetary realism.

Thirdly, penalties for failure to achieve targets become clearer (blocking debt transactions, conventions and subsidies, deposits which can be converted into fines), become partially automated and, as a last resort, the possibility to suspend self-government provided by Article 155 of the Constitution is established –albeit an unexplored option thus far.

If the foregoing is the scenario portrayed by the text of Organic Law 2/2012, the subsequent Royal Decree 21/2012 which regulates the so-called Autonomous Liquidity Fund ("Fondo de Liquidez Autonómica" or FLA) further strengthens the hierarchisation of the autonomous community treasury in various ways: it calls for the formulation or reformulation of adjustment plans, it brings forward the need to apply spending cuts and tax increases under the auspices of the central administration, information disclosure obligations in matters of budgetary management are broadened and the arrival of control missions fully empowered to review the management in the Autonomous Communities at an earlier stage than in the case of Autonomous Communities under an adjustment plan which do not resort to the FLA is provided for.

4. Conclusions

In facing the challenge of budgetary stability, two routes were possible. The first involved moving towards a federal approach in inter-governmental relations: more fiscal autonomy and responsibility for the Autonomous Communities, greater loyalty and commitment to agreements, and more dialogue, negotiation and agreement in regard to targets. The second involved the centralisation of the design, execution, supervision and control of this stability; the unilateral setting of targets with no leeway for negotiation; the introduction of coercive measures by way of penalties, exclusion from funding lines and access to credit, and even the suspension of self-government.

The Spanish Central Government has chosen the second route, albeit with two exceptions. The first is that it will not use independent bodies to take part in the design and control of stability. The second is that it seems not to be concerned about losing the support of the main opposition party along the way and which clearly reflects its party line: meetings with the heads of the Autonomous Communities the day before the meeting of the Fiscal and Financial Council displays little regard for the protocol and logic of a federal country.

But why has the Spanish Central Government chosen this route? One hypothesis is that the preference (ideology) of the voters and Leaders of PP is to avoid making further inroads towards decentralisation, but rather to move towards centralisation, and so, the Government is reflecting such a preference. Opinion polls have repeatedly shown that the correlation between PP votes and the desired extent of decentralisation is negative. A second hypothesis suggests that the Central Government does not trust the Autonomous Communities. There are different reasons for this lack of trust. Many Autonomous Communities have proven to be disloyal to the Central Government in the past, having failed to meet what was agreed on and then concealing the breach. The clearest case is the deviation of the Autonomous Community of Madrid in 2011, which came to light months after year-end closing and after having boasted about its leading position in fiscal responsibility throughout the common regime territories.

There are reasons to believe that the new Government and the new legislation will prove to be efficient in the fiscal consolidation process. The Ministry of Finance is keeping a firm stance within the Fiscal and Financial Policy Council and its public statements; to date, it has been strictly applying what has been approved; it has taken advantage of the regulatory development of the FLA to enforce an even tighter control over the Departments of Finance of the Autonomous Communities. A few weeks ago, BBVA Research Services (BBVA Research 2012) highlighted "the positive sign displayed in admonishing eight Autonomous Communities on their financial performance, as it shows that the mechanisms set forth in the Law on Budgetary Stability have been implemented".

Undoubtedly, whatever happens in the remainder of 2012 will play a critical role in the credibility of the new legislation. Within the next few months we shall learn whether the degree of effectiveness in control reached offsets what has been lost (or what has not been gained) in other important matters of a decentralised country.

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A Preliminary Evaluation of the Local Administration Reform in Spain

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1. Introduction

The current economic crisis is causing financial problems for a great number of Spanish municipalities. There are various reasons for this: the disappearance of virtually all revenues raised from building-related activities during the expansion period, the sudden drop of tax revenues shared with the Central government, discretionary cuts in specific transfers from the upper levels of government, and the nearly impossible access to credit. This problem is, however, less severe than the one affecting other levels of government, for various reasons: local debt is a very small part of the total; the local level of government is the only one to have reduced its level of indebtedness so far[1], and the most dramatic consequences of the current situation (e.g. defaults in payment of suppliers) were successfully redressed in 2012[2]. We can therefore say that, either due to their own initiative or to the budget adjustment plans imposed by the Central government, most Spanish municipalities are already on the right path to fiscal consolidation.

Despite this, there is the opinion that too many levels of local government exist, as well as a certain overlapping of responsibilities between these and the Autonomous Regions. Furthermore, the outbreak of corruption scandals related to local urban development and the many instances of unnecessary or oversized public construction projects has led to the opinion – accurate or otherwise – that local government efficiency has ample room for improvement. For these reasons, and in addition to the abovementioned "emergency measures", the Spanish Government is preparing a reform affecting local administrations, aiming at the rationalisation of administrative structure and, therefore, the reduction of local public expenditure. After several months of rumours about these measures, the Central government approved a first draft in February 2013. In this paper, we shall describe the measures contained in said proposal[3]. But first, we will briefly review the criteria that a reform like this should follow, before we go on to analyse the measures proposed in relation to these criteria.

The conclusions that we will reach are that most of these proposals do not follow the criteria introduced here and that the implementation thereof can only be understood either as a response to the demands for more administrative centralisation among the voters of *Partido Popular*[4], or as an attempt to reduce local autonomy with the purpose of reinforcing the control over public deficit. In this regard – as Santiago Lago states in his contribution to this report in relation to the Autonomous Regions – the future will tell whether or not the adopted measures helped to achieve fiscal consolidation[5]. In any case, it seems clear that these reforms will play a minor role in improving the functioning of local governments. In the last section of this paper we shall list the aspects that any reform seriously intending to meet this objective should provide for.

[1] The debt of the Local Administrations barely accounted for 4.5% of the total in 2012, compared to the 18.7% and 76.8% of the Autonomous Regions and the Central Government, respectively. Moreover, the local level is the only one to have reduced its debt in 2012 (by 3.5% in 2012, in contrast with the increase of 10% and 16% of the Autonomous Regions and the Central Government, respectively).

[2] In 2012, nearly 2,700 local councils adhered to the Supplier Payment Plan, which allowed them to access loans earmarked for the payment of suppliers, on the condition of submitting an Budget Adjustment Plan.

[3] The description of the measures herein contained is based on the "Draft Proposal of Law on the Rationalisation and Sustainability of Local Administration", as of 18.02.2013. There is a possibility that, at the time of publication, the content of this draft has already been modified.

[4] Carles Viver's contribution to the Forum Section of this report describes the recentralisation measures adopted by the Central Government during the current economic crisis, which affect the Autonomous Regions particularly.

[5] It is important to note that other countries have reformed the organisation of their local government with the only goal of solving municipal financial problems. A good example of this is the reform adopted by Israel in the 1990's. A recent work of Reigewertz (2012) seems to show that the reform obtained a deficit reduction in those municipalities that were in worse financial situation – which were obliged to take part in municipal mergers.

2. Reform Criteria

Any reform should start by clearly stating what it seeks to achieve. From our point of view, the reform of local government should follow two criteria: Economic efficiency – i.e. service provision at the lowest possible cost – and Political efficiency – i.e. local politicians should have suitable incentives for aiming at meeting public demands instead of their own personal interests.

Economic efficiency. This consists of local governments having an optimal population size or, in other words, which can guarantee that services under their authority are provided at the lowest possible cost. The size of Spanish municipalities is too small: 91% of these have less than 10,000 inhabitants, 84% have less than 5,000, 60% have less than 1,000 and 47% have less than 100. The level of municipal size fragmentation is even significantly higher in some Autonomous Regions, such as Castile and León and Castile-La Mancha.

A study by the Council of Europe considers that the minimum size for a municipality to be considered financially viable is around 8,000 inhabitants, and that the desirable size for municipalities to be able to undertake all areas of responsibility that should be under the control of local government is 10,000 inhabitants. In the case of Spain, a very important limitation of municipal size is that it makes it impossible to have a professional administration (i.e. with at least a Manager –the so-called *Secretario*–, a Financial Controller –or *Interventor*– and a Technical staff office). Several studies suggest that scale economies in the provision of certain services – such as waste management – can also be achieved through several forms of municipal cooperation and/or through the privatisation of services (see Bel, 2011), but this is not the case with administration costs, which is probably the area in which larger diseconomies of scale exist.

However, this problem does not always show as an increased level of expenditure, but rather, in administrative understaffing. This situation leads to an unprofessional local administration and jeopardises key areas such as personnel recruitment and financial control. We could consider that 5,000 inhabitants is the minimum threshold that could guarantee municipal feasibility from an administrative point of view. Service provision at the lowest possible cost would require a larger municipal size.

Political efficiency. This consists of providing suitable incentives for local governments to respond promptly and appropriately to citizens' demands. Local political institutions should also facilitate accountability in the activities of elected representatives. This implies motivating citizens to take part in public life and putting the necessary pressure on politicians so that they seek public interest and/or that they put enough effort into performing their duties. These concerns support the "principle of subsidiarity": if there is no evidence of any significant cost considerations, it is preferable to leave services to be managed at the local level, as proximity to the problem allows for the relevant information on voters' needs to be obtained and, more importantly, that information gives local politicians the necessary stimulus to meet these demands.

Several studies show that municipal size is key to these issues. For instance, a recent study on the effects of the municipal merger process recently undertaken in Denmark shows that mergers into larger municipalities reduce the impression that voters have of being able to contact politicians to influence their decisions (see Dreyer Lassen and Serritzlew, 2010).

It has also been proven that political efficiency is just as important, if not more so, than economic efficiency on its own. The reason is that, whether the taxpayers' money is put to good use or not, depends on political efficiency: it is no use having an optimal production structure in terms of costs if the improper functioning of political institutions implies that public funds are not used for the improvement of public services but, instead, for giving rise to inefficiency and even corruption. Several studies show that, when decentralisation allows for citizens to be closer to the decision-making process, corruption is effectively reduced (see Ivanyna and Shah, 2011).

Nonetheless, it is also true that other studies point out that corruption could be reduced in larger municipalities, as they are more professional and have a more efficient financial control (see Fundación Alternativas, 2009). This would be an argument to propose a more balanced municipal size: large enough to have a professional administration but small enough to still be able to meet citizens' demands. In any case, in order to avoid an excessive gap between voters and representatives in larger municipalities, the election procedure of local politicians should be changed. For example, a good combination could be to have a directly elected mayor together with district representatives, as districts are associations composed of several merged municipalities.

Some authors have suggested solving the supposed contradiction between Economic efficiency and Political efficiency through inter-municipal cooperation. Although there is some evidence that it is possible to achieve economies of scale in this way (Bel, 2011), the generation of duplicated administration procedures creates additional costs that have proven to reduce accountability[6]. In any case, since 1970's, many countries have applied reforms that have drastically reduced the number of municipalities (Portugal and Greece most recently; Denmark in 2007; Germany, Belgium and

[6] See Moisio (2011) for evidence on Finland regarding this matter. Finland is the only Scandinavian country that does not have a history of using municipal mergers as a mechanism to obtain an optimal scale for service provision. In Finland, municipalities are very small, and most services are provided by inter-municipal bodies that have received criticism both for duplicated administrative costs and for the significant distance between voters and decision-makers. The Finnish government is currently reconsidering this model, by introducing financial incentive schemes to promote voluntary municipal mergers.

Holland in recent decades; Britain and the Scandinavian countries, first in the 1970's and again more recently). In Europe, only France, Spain and Italy seem to have problems reducing the number of municipalities.

3. Description of the Reform

The measures included in the reform of the government can be divided into four large groups: *Delimitation of competences, Organisational rationalisation, More effective financial control and Professional management.*

Delimitation of Competences

This intends to increase the precision in the definition of local competences. To do so, a list of core competences was created. Those competences not included in this list are referred to as "non-core competences". Responsibilities over education, health and social services are specifically assigned to the Autonomous Regions. Regulation seeks to guarantee appropriate funding to cover core competences, while eliminating or greatly restricting expenditure on non-core competences.

In the event of any agreements to delegate competences from upper levels of government – usually, the Autonomous Regions – to lower levels of government, such agreements must provide for the full resources earmarked for financing the services involved. Moreover, mechanisms are created to avoid payment defaults by these upper levels of government, such as: debt consolidation between different administrations, renouncing delegation if there is no funding available for it, or even the possibility of the Central government withholding part of the transfers to be made to the administration in default.

Organisational Rationalisation

The reform limits the provision of services to those municipalities that can accomplish it efficiently. This objective will be put into practice by calculating the standard cost for each service and comparing this figure to the actual cost. In the case of core competences, in the event that the actual cost is higher than the standard cost and the municipality responsible for it has less than 20,000 inhabitants, the competence in question shall then be transferred to the pertaining Provincial Council. On the other hand, the provision of services related to non-core competences can only take place if core competences are guaranteed, as duly proven to the relevant Ministry, on the condition that no duplication with regional competences occurs, and financial sustainability in regard to the newly assumed competences can be guaranteed. In any case, these services shall also be transferred to the Provincial Council, should the actual cost of providing those services exceed the standard cost.

This project also includes measures seeking to avoid the proliferation of local organisations. For instance, any Associations of Municipalities (the so-called *Mancomunidades*) that fail to be accountable for their activities within a maximum period of three months shall disappear, and any non-core competences that this kind of organisations may have shall be transferred to the Provincial Council.

More Effective Financial Control

The reform includes a reinforcement of local financial controllers, who shall go back to reporting to the Ministry of Finance and Public Administrations. This measure aims to guarantee a stronger independence of these financial controllers from local politicians in order to strengthen their role in financial control. The reform provides for other obligations to be undertaken by these financial controllers, who must periodically report to the Ministry of Finance and the Court of Auditors and inform of any irregularities detected. The proposal also clarifies which situations can cause the Ministry of Finance and Public Administrations to intensify the control over local accounts, and even allows for direct intervention by the Ministry.

Professional Management

The measure establishes that 82% of elected local politicians shall not be entitled to receive a salary. The measure sets the share of elected positions that can be remunerated, as well as other advisors and positions of trust, according to population-size group[7].

4. Discussion on the Measures

Delimitation of Competences

There are various reasons that explain why municipalities are actually spending on "non-core" competences. In some cases, the proximity of the local government to citizens, together with neglect by upper levels of government, leads to local intervention. In other cases, regional regulations create cost obligations that are not duly offset by the Autonomous Region in question. In other cases, noncompliance by an Autonomous Region of its financial

[7] Instead of this measure, previous drafts included the elimination of 30% of elected representatives as an alternative. This proposal encountered great opposition from the local sphere and minority parties, which, given the requirement for a minimum percentage of votes to obtain their first representative, saw their participation endangered, especially in the case of those municipalities with a population under 10,000 inhabitants. In the end, this measure was eliminated from the text.

obligations is the reason. The latter is being used as a strategy to reduce regional debt, as a result of the current crisis. In some cases, this strategy was used by the municipalities themselves in the years of economic expansion, as they sought to increase their scope of action in order to justify requesting more funds in the future. Therefore, it seems obvious that a clear delimitation of competences was necessary, and the fact that action has finally been taken should be celebrated.

The measures adopted, however, leave room for some doubts. They allow for the responsibilities to be transferred to the Autonomous Regions without the consideration of any financial contribution to be made by municipalities for the exercise of these responsibilities. Moreover, in some cases, an Autonomous Region can ultimately determine that these services should be managed at a local level and can, consequently, delegate them back to the municipalities. In such cases, the provision of these services usually combines regional regulation with local and regional co-funding. This is, for instance, how municipal nurseries and music schools are managed. While it would seem unfair for the Autonomous Regions to free themselves from their previous commitments regarding the funding of these services – which is happening as a result of the current crisis – by increasing the share to be borne by local taxpayers and families, it is difficult to assume that, from now on, they shall be able to meet the requirement to fully fund these services from their own budgets. Therefore, in practice, there will most likely be no changes in this regard. Something else that remains to be seen is the effectiveness of the measure that provides for the possibility of local councils to demand that the Central government responds for the defaults in payment to municipalities by the corresponding Autonomous Region.

Organisational Rationalisation

Expenditure per capita is significantly reduced when the population increases. This doesn't imply, however, that economies of scale are present in local service provision. Most diseconomies of scale have more to do with extra costs caused by low density than with population size. That is to say, that cost per capita – users or citizens – are high because of a low population density, and because many population centres exist. This affects most core services involving the expansion of network infrastructure – such as sewage, water supply, street paving, etc. – or the displacement by the units designated to supply the service or the citizens themselves– e.g. waste collection, social services, etc. The transfer of these services to Provincial Councils does not necessarily imply a cost reduction, unless the quality of such service provisions drops – e.g. service is interrupted in less populated areas (see Bel, 2011, for evidence). Another reason for having a higher expenditure per capita is related to fixed administration costs and the mere existence of the local council. The remuneration of a Manager, a Financial controller, and other qualified servants is a fixed cost that can lead to dramatic differences in costs per capita. Such differences, however, cannot always be observed, as many municipalities do not have these services simply because they cannot face the costs involved. The reform is not very clear in regard to the possibility of transferring all of these services to the Provincial Councils.

In any case, even if some economies of scale were to exist, Provincial Councils do not appear to be the best option to manage these services. For a start, their geographical scope is excessive. Even in the unlikely event that all municipalities with a population lower than 20,000 inhabitants were shown to have higher than standard costs – taking for granted that the minimum possible cost is achieved with 20,000 habitants – we would still have some provinces with only two de facto municipalities: the provincial capital and the rest of the province, under Provincial Council management. While it is obvious that the more than 8,000 municipalities existing in Spain offer a picture of excessive municipal fragmentation, the solution proposed by the Central government seems clearly exaggerated. Secondly, in a large part of the Spanish geography, local service provision would be left in the hands of some organisations led by people who have not been directly elected by citizens, which would compromise the aforementioned principle of <u>Political Efficiency</u>. The method for the election of provincial representatives – based on the aggregate results of local elections at district level – is absolutely unconceivable by citizens and leaves the power to appoint provincial positions in the hands of the main political parties. Starting from the basis that the need to reform local administration concerns the governance and quality of democracy issues that have been experienced in recent years, it seems that proposals for change should seek to improve democratic functioning, instead of eliminating any sign of democracy existing at the local level.

In regard to the reduction in the number of Associations of Municipalities, it should be noted that, in the case of Spain, these may indeed have caused some administrative duplication and, furthermore, management in the hands of these associations has made accountability more difficult. However, it is also true that, in some cases, there is evidence that management by these associations – e.g. water, waste etc. – has contributed to achieve a certain minimum scale for service provision (see Bel, 2011).

Our opinion on this is that, even in this case, larger municipalities could help to achieve sufficient democratic quality through a suitably-designed political representation system, without needing to leave any services in the hands of dysfunctional and barely democratic institutions – such as the Provincial Councils.

In relation to other aspects, the reform proposed by the Central Government should be compared to the reform on local government currently being prepared by the Autonomous Region of Catalonia[8]. In this case, municipalities with a population under 1,000 inhabitants are also expected to delegate responsibilities to the Counties (the so-called comarcas)[9], which could also undertake responsibilities currently being managed by other inter-municipal bodies, such as Associations of Municipalities. Moreover, the Counties will basically become technical offices for managing services. The reform would eliminate the current indirect election procedure of the president and the members of the county council – which is very similar to that of provincial councils – and would replace these political institutions by a Council of Mayors, in which all municipalities would be represented. Some remarks can be made on this proposal. Firstly, the size of the Counties – both from the point of view of population size and surface area – seems more reasonable than that of the Provincial Councils. Secondly, the decision-making process also seems more appropriate. Thirdly, the measure raises some doubts: amongst others, the 1,000-inhabitant threshold is very low, the residual function of these small municipalities is not very clear, and the influence of larger municipalities within an institution that will provide them fewer services compared to smaller municipalities is perhaps disproportionate. Our position in this regard is that merging municipalities under a certain size by transferring all their functions to the Counties would be more reasonable. Municipalities not taking part in mergers would retain management of all their responsibilities. Finally, the reform does not provide for the elimination of Provincial Councils; this means that, in Catalonia, at least two levels of government above the local level would still exist, resulting in duplicated administrative costs[10].

In any case, the measures proposed by the Central Government can be criticised on the grounds of unfeasibility. In the first place, determination of standard costs of municipal services is a very complex task and the Ministry does not have the necessary resources for this, which makes it impossible to know such costs, especially in smaller municipalities. For some services, the standard cost is not clear and, for others, costs are regulated at the regional level, thus leading to territorial differences. Moreover, the local sphere is very diverse, in terms of needs (e.g. waste collection in rural or tourist towns requires a different design than in urban towns), resources (e.g. in some municipalities tax bases allow for more resources, thus permitting higher quality services to be provided), or preferences (e.g. the citizens of certain municipalities could agree to assuming higher tax rates). This means that standards cannot be established in terms of expenditure per capita, hence the difficulty of this task. Our opinion here is that, either this proposal will come to nothing, or standards will be reinterpreted in terms of either expenditure or deficit and will therefore be used to remove competences from those local councils that do not adjust their budgets.

In the second place, even if it was possible for standards to be applied, the reform does not establish what would happen with the funding of the services. Would part of the municipal funds be transferred to the Provincial Councils? Let's imagine so. In that case, would the transferred funds come from Central government tax shares or own taxes? Could we have municipalities without any expenditure responsibilities that would, however, still receive transfers and make fiscal decisions? Would it not be more reasonable to eliminate these municipalities? Or is this perhaps the as yet unexplained purpose behind the reform? In our view, if this is so, the reform should have faced the problem directly, proposing the elimination (by way of merger) of municipalities, thus creating larger scale municipalities instead of transferring responsibilities to the Provincial Councils.

More Effective Financial Control

Financial control in Spanish municipalities is channelled in two different ways. On the one hand, financial controllers perform a prior audit in terms of legal compliance, whereas the Court of Auditors does so afterwards[11]. The reform does not include any measures in relation to the Court of Auditors, the auditing function of which is clearly insufficient, due to the lack of technical means to supervise the more than 8,000 Spanish municipalities and the lack of actual independence from political parties. If independent and rigorous external audits were performed, taking measures in regard to internal audits would perhaps become less urgent.

Financial controllers hold a state-wide qualification obtained after passing highly complex, objective tests. They are in theory well informed and are committed to their role as independent auditors of municipal accounts. However, their status has weakened over time. Currently, their appointment, remuneration and even disciplinary regime – in some Autonomous Regions – are in the hands of local politicians. In some cases, the situation is even worse, as this position has been filled with interim civil servants who may not even be duly qualified, and who may not even have received the necessary

[8] This refers to the future Law on Local Government of Catalonia. In this case, no drafts of this document are available at the time of writing, even though the aforementioned measures have already been announced by the Regional Government. There are also doubts concerning the preeminence of the new Central Government regulations in regard to the proposals made by the Autonomous Region. The current proposal of the Central Government does not seem to respect the exclusive competences in matters of local organisation granted to the Catalan Government by virtue of the Statute of Autonomy of Catalonia. Therefore, the resolution of this issue adds even more uncertainty to the result of the ongoing reform process in Catalonia.

[9] There are 41 *comarcas* in Catalonia and they are an upper level local government between the municipality and the provincial council (there are four provincial councils in the region). This upper layer of local government in nonexistent in most the remaining Autonomous Regions.

[10] In the urban area of Barcelona, the *Comarca* (County) and the *Diputación* (Provincial Council) coexist with the Metropolitan Area of Barcelona. The reform provides for the elimination of the Comarca in this case. In the rest of the territory, the Provincial Councils would become *Vegueries* – a territorial delimitation provided for in the Statute of Autonomy of Catalonia. It still remains to be seen whether these new inter-municipal governments shall inherit the competences and administrative structures of the Provincial Councils or if the reform will bring a streamlining of functions.

[11] External auditing is also performed for each Autonomous Region by the external control bodies dependent on each Regional Parliament.

training to perform these duties. Some local councils even avoid inviting tenders for this position, as their politicians prefer to deal with officers directly appointed by them. Other councils – the smaller ones – cannot cover these positions, as there are currently no public examinations and the shortage of certified financial controllers results in high remuneration levels that these municipalities cannot afford. In some small local councils there is a Manager-Financial Controller *(Secretario-Interventor)*, so the person in charge for management is also responsible for supervising such management, which is somewhat schizophrenic. This leads to a situation in which, these councils, either do not have a financial controller at all, or the independence of the position is subject to political power.

The situation is so critical that any action taken in this regard should be celebrated. However, the Government's proposal is too vague. It is not clear how the status of financial controllers will change. If, as it seems, their recruitment, remuneration and dismissal continues to depend on local politicians, nothing will change. And unless more public examinations are opened, the problem will not be solved either. In any case, it is unlikely that the Ministry will pay financial controllers directly. If it did, it would become obvious that there are not enough financial controllers for the existing number of municipalities and/or that the number of municipalities needs to be reduced. In fact, one of the main benefits of municipal mergers is to be able to guarantee that all municipalities can have their own independent financial controller.

Professional Management

The economic crisis and the number of scandals related to corruption and/or municipal management that have come to light in the recent years have made citizens more sensitive to the remuneration of elected politicians. Moreover, the level of qualifications of politicians at the local level is much lower than at other levels of government, which strengthens even more the opinion that their salary does not correspond with their level of education. Therefore, it seems reasonable to set limits on remuneration. In any case, there are some points to be made.

In the first place, it is not clear how this measure will produce any savings. The setting of these maximum limits will reduce the salaries of those mayors and elected politicians that currently surpass them, but it can also justify a salary increase for those below this limit. The effect of the reduction in the number of paid local representatives shall be very limited as, currently, very few receive remuneration; however, this could have unwanted effects on subsistence allowances and other expenses. Moreover, even if these measures were to have a real impact, the savings generated at the local level would not necessarily translate into lower spending, as the reduction would probably be offset by an increase in other items of expenditure.

In the second place, and contrary to what is generally thought, establishing an appropriate remuneration for politicians is vital in order to attract the most able candidates. In a recent study of Italy, Nannicini and Gagliarducci (2013) show that offering higher salaries at the local level attracts candidates with higher qualifications who, after taking office, improve service provision efficiency by reducing expenditure. It is interesting to note the finding of the authors that the highest remuneration does not result in politicians displaying a better behaviour (i.e. bad politicians continue to be so despite receiving higher salaries). The positive effect is only due to an improvement in the recruitment process, and is therefore dynamic. In another study of Mexico, Finan and Ferraz (2013) obtain a similar result and furthermore show that the higher level of education of politicians is not at the expense of a lower interest in public service. Here, the conclusion is similar than before: municipal mergers are required in order to have better paid politicians and, therefore, to raise the quality of human capital.

5. An Alternative Reform

The reform proposed by the Government contains some valuable elements (e.g. delimitation of competences, reinforcement of financial controllers, etc.) but is very unspecific. Furthermore, it focusses on certain side aspects (e.g. salaries of politicians) and avoids facing more important issues directly (e.g. municipal size, local voting system, etc.). For this reason, we shall summarise the different aspects that any balanced reform of local governments should cover as to comply with the principles of Economic Efficiency and Political Efficiency.

Below are our 7 recommendations:

1. <u>Reduction in the number of municipalities</u>, by merging municipalities with the aim of achieving a minimum of 5,000 inhabitants and, where possible, closer to 10,000. Definition of municipal borders taking into account, to the extent possible, historical, geographical, cultural and economic circumstances. Shared municipal merger process: the Central government would offer financial benefits to promote rapid, voluntary mergers and, after a certain period of time, mergers would be compulsory. The Autonomous Regions would manage the process of delimiting the newly created municipalities.

2. <u>Clarification of competences.</u> Definition of the core competences of the local councils, similar to what is set forth in the current reform. Explicit delegation of competences, with the corresponding financing agreement, if the minimum target of 10,000 inhabitants is achieved. Competence delegation protection clauses similar to those of the current reform.

3. Financial control. Improvement of the financial and staff resources of the Court of Auditors and free election of its members, not subject to political parties. Independence of the financial controller in charge of supervising local politics from both the operations and remuneration perspectives. Financial transparency mechanisms and citizen participation in budget preparation and control.

4. Accountability. Direct election of mayors. Election of local councillors by district, aiming at achieving an appropriate representation of each district. In some cases, the number of merged municipalities could be large and, therefore, it is not clear whether having a local representative for each of the municipalities taking part in the merger could be guaranteed.

5. Professionalisation. All municipalities would have a Financial Controller (*Interventor*) and a *Manager* (Secretary). The Secretary should be responsible for guaranteeing the recruitment of municipal staff and ensure the objectiveness of processes. The strengthening of processes and controls in staff recruitment should also be a goal. That said, limits could be set for the maximum remuneration allowed for all positions, although giving room for municipal autonomy and being generous in regard to the amounts.

6. Limitation of the role of the Provincial Councils. Reduction of the responsibilities of the Provincial Councils to the minimum necessary for the coordination of municipal policies. Change in the system for electing provincial representatives. Creation of a council of mayors in which all municipalities would be represented. Alternatively, elimination of the Provincial Councils.

7. Financing. A larger municipal size would allow for the reform of the municipal financing system, allowing municipalities to enjoy more autonomy in regard to revenues. The IBI (Property Tax) is the main local tax and should therefore be reinforced with a better management of the process of property value reassessment, in which, the Autonomous Regions and the municipalities should also take part. Besides, the use of tax sharing for the main taxes (i.e., income tax, excises, VAT) could also be extended to all the municipalities (this possibility is currently limited to municipalities over 75,000 inhabitants), as well as the possibility of applying a surcharge on the income tax. A reduction in the number of municipalities would also reduce the heterogeneity of circumstances, thus making feasible a reform of the grant system that aims at improving its equalization properties. Finally, as far as capital expenditure is concerned, larger municipalities could fund these investments with a lower reliance on capital transfers from higher layers of government. These transfers are currently necessary, given the reduced administration and self-financing capacity of smaller municipalities. However, these transfers interfere with local autonomy, thus distorting municipal preferences in relation to the projects to the developed; this has been, to an extent, the reason behind many of the inefficient projects that have been carried out in Spain over recent years. Moreover, as some recent studies show, these grants are used by political parties as an instrument to discriminate in favour of those municipalities the mayor of which belongs to the party in control of the level of government granting the transfer (see Solé-Ollé and Sorribas-Navarro, 2008)[12].

Local governments arising from a reform of this kind would be more efficient, due to their larger scale and the higher professionalization of their administrative structure. Moreover, this type of reform would improve accountability, thanks to the direct election of the mayor. The citizens' capacity to access their local politicians would be preserved by electing district representatives, although, as is obvious, the distance between voters and elected politicians would increase a little. In any case, the current situation does not seem any better for smaller municipalities, considering the proposal to remove their competences in favour of the Provincial Councils. In our opinion, even though the local sphere has reservations against municipal mergers, it should react by proposing a reform inspired by the suggestions made herein so as to avoid reforms such as the one proposed by the Central government from coming into force, as they are a real threat to local autonomy.

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3

Research Report

Decentralization and Corruption: Panacea or Pandorah's Box?

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1. Introduction

During the past two decades a silent revolution has swept the globe and a large number of industrial and developing countries have pursued decentralization reforms that attempt to move public decision making closer to people. The reform agenda has been pursued through varying combinations of political, administrative and fiscal decentralization initiatives that aim to shift some traditional central government functions to intermediate or lower orders of government. These reforms have proven to be controversial. This is because decentralization is perceived as a solution to some problems such as a dysfunctional public sector with lack of voice and exit as well as a source of new problems such as capture by local elite, aggravation of macroeconomic management due to a lack of fiscal discipline, race to the bottom and potentially greater barriers to common economic and social union through beggar-thy-neighbor policies. The impact of decentralization on corruption (defined as the abuse of public office for private gain or exercise of official powers against public interest) is an area of growing interest inviting much controversy and debate. A growing body of conceptual and empirical literature on this question has failed to settle this debate. Our research on this subject, summarized in the following paragraphs, has attempted to enrich this debate both conceptually as well as empirically as discussed below.

2. Drivers of Corruption and Decentralized Governance: Conceptual Underpinnings?

Previous conceptual literature can be broadly classified into two broad categories – the crime and punishment models and the principal-agent models. The crime and punishment models (Becker , 1968) argue that self-interested public officials often with monopoly powers seek out or accept bribes as long as the expected gains from corruption exceed the expected costs (detection and punishment) associated with corrupt acts. A common thread in principal agent models is that the government is led by a benevolent dictator, the principal who aims to motivate government officials (agents) to act with integrity in the use of public resources. Under both these models, centralized corruption bureaucracies act like a joint monopoly, whereas decentralized corruption bureaucracies behave as independent monopolies. Independent monopolies have the potential to drive up the cumulative bribe burden unless there is a strong inter-jurisdictional competition and jurisdictions are self-financed. According to both these models, corruption can be mitigated by reducing discretion, reducing the scope of gains from each transaction, increasing the probability for detection, and increasing the penalty for corruption activities (Klitgaard, 1988, Rose-Ackerman, 1975) and in a decentralized, setting enhancing competition (Ahlin, 2001, Arikan, 2004). Thus one has to have a rules-driven government with strong internal controls with little discretion available to public officials – a policy framework widely practiced in developing countries. Experience in highly corrupt countries, however contradicts the effectiveness of such an approach because rule enforcers themselves add an extra layer of corruption, and a lack of discretion is also thwarted by collusive behaviors of corruptors. In fact, lack of discretion is often cited as a defense by corrupt officials who partake in corruption as part of a vertically well-knit network enjoying immunity from prosecution. To overcome this, our research has advanced the conceptual underpinning in two directions. First, explicit consideration of political and bureaucratic culture especially conditioned by colonial past where political and bureaucratic elite imbue a culture of command and control and abuse of power rather than service to the people and have no accountability for results in service delivery performance (Shah, 2005). Thus fundamental discordance among the public sector mandate, its authorizing environment and the operational culture and capacity contributes to government acting as a runaway train and government officials' indulging in rent-seeking behaviors with little opportunity for citizens to constrain government. Decentralization offers the opportunity to constrain such rent seeking culture by having contractual results based management of service provision by facilitating competitive service delivery through an outsourcing, purchaser-provider split. Second and more importantly, we have incorporated the transactions cost approach borrowed from the neo-institutional economics (NIE) to provide a fresh perspective on the causes and cures of corruption (Shah, 2006). We have argued that opportunistic behavior of public officials is the result of citizens (as principals) not being empowered or facing high transaction costs to hold public officials (agents) accountable for their corrupt acts. The citizens (principals) have bounded rationality – they act rationally based upon the incomplete information they have. In order to have a more informed perspective on public sector operations, they face high transaction costs in acquiring and processing the information. On the other hand, agents (public officials) are better informed. This asymmetry of information allows agents to indulge in opportunistic behavior which goes unchecked due to high transactions costs faced by the principals and a lack of or inadequacy of countervailing institutions to enforce accountable governance. Thus corrupt countries have inadequate mechanisms for contract enforcement, weak judicial systems and inadequate provision for public safety. This raises the transactions costs in the economy further raising the cost of private capital as well as the cost of public service provision. The problem is further compounded by path dependency (i.e. a major break with the past is difficult to achieve as any major reforms are likely to be blocked by influential interest groups), cultural and historical factors and mental models where those who are victimized by corruption feel that attempts to deal with corruption will lead to further victimization, with little hope of corrupt actors being brought to justice. These considerations lead principals to the conclusion that any attempt on their part to constrain corrupt behaviors will invite strong retaliation from powerful interests. Therefore, citizen empowerment (e.g. through decentralization, devolution, citizens' charter, bill of rights, elections and other forms of civic engagement) assumes critical importance in combating corruption because it may have a significant impact on the incentives faced by public officials to be responsive to public interest and on the transactions costs incurred by citizens to hold government to account.

3. Decentralized Governance and Corruption: Empirical Links?

In practice, just as in theory, the impact of decentralization on corruptions remains an unsettled question. Our research has contributed to this debate in several ways. First, in our earlier research (Gurgur and Shah, 2002) rather than estimating eclectic equations, we specified an empirical framework that had a comprehensive focus on all potential drivers of corruption including the role of the state in the economy, institutions of accountability in governance, political, social and bureaucratic culture and incentives and the structure of government. Empirical application of this framework, however, imposed major limitations especially by the available measures of decentralization and corruption. Indeed the entire empirical literature is beset by these limitations. Our more recent work (Ivanyna and Shah, 2011 and 2012) have taken important steps in improving the measures of decentralization and corruption used in empirical research. For decentralization existing literature without exception uses various measures related to sub-national governance and finances as measures of decentralization. Such measures are inappropriate for comparative cross-country analysis as provinces and states in federal countries and large unitary countries are typically larger than nation-states in many unitary countries. Therefore shifting responsibilities to an intermediate tier may not represent strengthened local decision making – a hallmark of decentralization. Our research overcomes this problem by developing a unique dataset on comparative local governance (below intermediate tiers) and capturing its fiscal, administrative and political dimensions for a worldwide sample of 158 countries. We further utilize improved measures of corruption not previously used in empirical work on decentralization and corruption. For households, we utilize data on the frequency and the amount of corruption for more than 55,000 households worldwide from the Global Corruption Barometer (GCB). We also utilize data from the World Bank Enterprise Survey (WBES), which covers ninety–nine countries and provides micro-level data on the actual incidence of corruption – on both the frequency and the amount of bribery- for more than 80,000 firms representing divergent businesses worldwide. These two measures of corruption are superior to the Transparency International's Corruption Perception Index (CPI) used by the literature as the CPI captures mostly Western observers' perception of corruption in developing countries and these perceptions may be guided by political and ideological biases. By pursuing rigorous econometric analysis, our research demonstrates that decentralization, when properly measured to mean moving government closer to people by empowering local governments, is shown to have a significant negative effect on the incidence of corruption regardless of the choice of the estimation procedures or the measures of corruption used. In this context, voice (political accountability) is empirically shown to be more important in combating corruption than exit options made available through competition among jurisdictions.

4. Conclusions

The impact of decentralization on corruption is shaped by the specific design of decentralization policies and their interactions with location specific contextual considerations and social, political, historical and cultural factors. Our recent research has attempted to advance our understanding of both the conceptual underpinnings as well as empirical foundations of nexus between decentralization and corruption. Much further work lies ahead in a never ending quest to discover the true kernel of this nexus.

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Decentralization and Regional Inequality

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1. Introduction

In past decades, decentralization of the public sector has become increasingly popular. The main arguments for choosing a federal constitution are advantages of economic integration, and the opportunity of efficiency enhancing effects of a decentralized provision of public goods (Oates, 1972). However, nothing comes without cost. In particular potential negative redistribution effects are a concern. As Martinez-Vazquez and McNab (2003) put it: "unfettered fiscal decentralization is likely to lead to a concentration of resources in a few geographical locations and thus increase fiscal disparities across sub-national governments" (Martinez-Vazquez and McNab, 2003, p. 1605). The concentration of funds might lead to increased regional income inequalities. This report surveys the results of Lessmann (2012), a recent empirical study on the relationship between decentralization and regional inequality, which has been presented at the workshop on fiscal federalism taking place at the IEB in 2011.

2. Theoretical Background

Why should there be a link between decentralization and regional inequalities within countries? Following Prud'homme (1995) decentralization weakens the budgetary power of the central government thereby reducing the scope to redistribute resources from the richer to the poorer regions. At the same time, decentralization often involves fiscal competition, which may be at the cost of poor regions. In extreme cases, decentralization can be "*the mother of segregation*"(Prud'homme, 1995, p. 203]. Both arguments point at a negative effect of decentralization on regional inequality.

However, there are also arguments for equity promoting consequences – most of them grounded on the efficiency enhancing effects of decentralization. Following Oates (1972, 1993), decentralized authorities are better able to meet the demand of the local population compared to a central government. This might stimulate regional growth and result in convergence. Moreover, in a decentralized country sub-national jurisdictions often have the opportunity to actively pursue economic development policies that better fit to the strengths and weaknesses of their regions than central government policies (Martinez-Vazquez and McNab, 2003; Qian and Weingast, 1997). Therefore, decentralization might also reduce regional inequality in contrast to the arguments above.

In light of the ambiguous effects in the theoretical literature, it seems to be reasonable saying that the final consequences of decentralization on regional inequality remains an empirical question. Before we start to look at recent findings, I want to stress that the beneficiary effects of decentralization are unlikely to occur in developing countries. We know from a number of studies that decentralization causes coordination problems in those countries, leads to excessive regulation, higher administrative costs, and a poor quality of local bureaucrats (Tanzi, 1996). Decentralization might also increase corruption and cronyism in developing countries undermining potential efficiency gains (Lessmann and Markwardt, 2010). Thus, while the transmission channels that link decentralization to lower regional inequality may be valid for highly developed countries, this may not be the case in developing economies (Rodriguez-Posé and Ezcurra, 2010). The development level should therefore be taken into account when studying the impact of decentralization on regional inequality, since it might be a moderator of the different possible effects.

3. A New Empirical Approach Using Data of Developed and Developing Countries

There are a number of studies that analyze the impact of decentralization on regional inequality, but only few studies consider data of developed and developing countries, which should be important in light of the theoretical discussion above. The most recent study in this field, Lessmann (2012), has some advantages over the previous ones, since it has (1) a significantly larger data set, (2) it takes possible endogeneity of decentralization measures into account, (3) it considers different measures of political *and* fiscal decentralization, and (4) it studies the effect of decentralization on regional inequality conditional to the level of economic development.

The larger data set on regional inequalities was compiled from a number of resources: OECD Regional Statistics, EUROSTAT, Cambridge Econometrics, and a number of statistical offices and central bank statistics of developing countries. It consists of 54 countries and has a panel structure covering the period 1980-2009. Regional inequalities are measured by the population weighted coefficient of variation of regional GDP per capita.

Using the cross-country variation in the data, the analysis shows that countries with a higher degree of decentralization have lower regional inequalities. The major innovation is that the regressions use an instrumental variable approach. Decentralization is instrumented with different variables, which are unlikely to be affected by the level of regional inequality such as the share of the population within a country that speaks a major European language. Based on Hall and Jones (1999) I argue that countries with a historic link to core Europe are more likely to implement decentralized government structures than others. At least in case of measures of fiscal decentralization these instruments work quite well.

The different decentralization measures used in the study reflect the degree of political as well as the degree of fiscal decentralization. The degree of political decentralization is particularly important for some of the theoretical arguments, which argue based on the "autonomy" of sub-national governments. The indicators are taken from Treisman (2002). The results are quite similar for the different decentralization measures.

Whether decentralization has beneficial or adverse effects on regional inequality should depend on the level of economic development. To consider this hypothesis in the empirical analysis, the effect of decentralization on regional inequality is conditioned on the level of economic development. It turns out that decentralization is associated with lower regional inequalities in countries richer than 2,900 US$ GDP per capita, while decentralization might have negative redistributive effects in countries poorer than this threshold.

4. Discussion

The findings of Lessmann (2012) have implications for the design of federal structures. Several observers suspect increasing regional inequalities in decentralizing countries and demand the implementation of inter-regional transfer schemes. This study shows that this effect should not necessarily be a concern in high developed countries, since decentralization decreases regional inequalities there. However, the decentralization initiatives taking place in developing countries – promoted by international development agencies such as the World Bank – may indeed have negative redistributive consequences justifying the implementation of additional redistribution instruments. As an instrument which aims at a reduction of regional inequalities, inter-regional transfer schemes may be considered. However, the evidence on the effectiveness of such programs points at adverse effects of inter-regional transfers. Kessler et al. (2011) find that inter-regional transfers increase regional inequalities if people are mobile. Transfers increase the income of people in poor regions (with is desired), but at the same time, transfers inhibit convergence promoting internal migration from the poor to the rich regions. But what can countries do to reduce regional inequality apart from the implementation of formal fiscal equalization schemes? A hint is given by a recent study on regional development and human capital (Gennaioli et al., 2011). Based on an impressively large data set on regional economic performance, the authors find that the regional human capital endowment is the major driving force of regional development within national states. Thus, countries with high regional inequality might consider investing in human capital in poor regions in order to promote a more equal factor distribution.

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The Political Resource Curse

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1. Introduction

Suppose new oil is discovered in a country, or more funds are transferred to a local government from the central state. Are these windfalls of resources unambiguously beneficial to society?

This is a key question in the study of a variety of issues in macroeconomics and development economics, such as intergovernmental relations, transfers to lagging regions like the EU's Structural Funds, and international aid to developing countries.

Until a few years ago, the only reason for a negative answer to this question would have been provided by the "Dutch disease literature". A natural resource windfall can lead to a decline in income via a market mechanism, notably an appreciation of the real exchange rate that makes existing industries less competitive. In the last few years, a growing literature has argued that a windfall of natural resources can have further adverse effects through the political process and the interaction among interest groups, leading for instance to increased rent-seeking (see Tornell and Lane, 1999, Velasco 1999) or even to civil war (see Ross 2006, Besley and Persson 2008).

More recently, Caselli and Michaels (forthcoming) argue that oil discoveries in Brazilian municipalities have a positive impact on public good spending, but little or no effect on the quality of public good provision. They also provide indirect evidence that this might be due to rent-seeking and corruption. Litschig (2008), instead, shows the positive side of windfall government revenues. Exploiting the sharp variation of federal transfers to municipalities at the population thresholds established by the Brazilian constitution, he finds that an increase in funds increases spending on public education and improves literacy rates.

2. The Resource-Political Institutions Link

In a recent article that Fernanda Brollo from the University of Alicante, Roberto Perotti from Bocconi University, Guido Tabellini from Bocconi University and I wrote (see Brollo et al., forthcoming), we focus on the existence of what we call a "political resource curse", that is, the possibility that windfall government revenues worsen the functioning of institutions by reducing the degree of political accountability and deteriorating the quality of elected officials. We tackle this issue with both theory and data.

The theory studies the electoral competition between an incumbent and a set of challengers, all with different political abilities and different opportunity costs of entering politics. The incumbent faces a trade-off between using public resources for personal gains (corruption) and maximizing the probability of reelection. Our model highlights three specific channels of operation of windfall government revenues through such a political process. First, an increase in resources available to a government leads to an increase in corruption of the incumbent (a *moral hazard* effect). This happens because, with a larger budget size, the incumbent has more room to grab political rents without disappointing rational but imperfectly informed voters. Second, a larger budget induces a decline in the average ability of the pool of individuals entering politics (a *selection* effect). This is a byproduct of the first result (that rents increase with budget size) and of the assumption that political rents tend to be more valuable for low-ability candidates (who have fewer outside alternatives). Third, there is an *interaction* between these two effects that further increases the adverse consequences of a windfall of revenues on political corruption: an incumbent facing less able opponents can marginally grab more rents without hurting his or her reelection prospects.

We thus take these predictions to the data using a random sample of Brazilian municipalities. The obvious problem in testing the effects of government revenues is, as always, how to identify exogenous changes, that is, changes that are not completely driven by unobservable factors determining both the level of public resources and corruption or the quality of politicians at the local level. Indeed, one can think of a number of reasons why local government revenues might be correlated with both corruption and political selection. For instance, corrupt politicians might have a comparative advantage in obtaining higher transfers from other levels of government; or poorer areas might select low-quality politicians and, at the same time, receive higher transfers for redistribution purposes.

To address this empirical problem, we combine three different datasets. The first contains information on a program of federal transfers to municipal governments, determined in a discontinuous fashion by population size; the second consists of data on a program of random audits on local governments, with detailed reports on corruption charges; the third provides biographical and electoral information on the incumbent mayors and their opponents in municipal elections. We exploit a key feature of the federal transfers program that all municipalities in the same state and in a given population bracket should receive the same amount of transfers. As a result, the comparison of municipalities just below and just above each population threshold provides a clean source of exogenous variation in the amount of money received by Brazilian municipalities. This "regression discontinuity" setup allows us to study the impact of a change in revenues on both the corruption of the incumbent mayor (as measured by the random audit program in the spirit of previous work by Ferraz and Finan 2008) and the composition of the pool of opponents (as captured by their years of schooling and private sector occupation).

The empirical findings accord well with the implications of the theory. An (exogenous) increase in federal transfers to the municipality by 10%:

- raises the incidence of a broad measure of corruption by 12 percentage points (about 17% with respect to the average incidence);
- increases a more restrictive measure of corruption, including only severe violation episodes, by 10.1 percentage points (about 24%);
- worsens the quality of the political candidates challenging the incumbent, decreasing the fraction of opponents with at least a college degree by 3 percentage points (about 7%).

As a result, the incumbent who receives higher transfers experiences a raise in his probability of reelection by 4.1 percentage points (about 7%). We therefore detect evidence of a political resource curse in terms of increased corruption and worsened quality of politicians.

3. Conclusions

These findings have important policy implications. Lagging regions or countries often receive additional funds from higher levels of government or from international organizations, to make up for their underdevelopment. But since a common cause of economic backwardness is precisely the poor functioning of government institutions, the risk that these additional resources could be counterproductive cannot be neglected. Our results, however, are not inconsistent with higher transfers to municipalities increasing the quantity and quality of public services provided to the local population. For example, as discussed above, Litschig (2008) finds that an exogenous increase in funds to Brazilian local governments raises educational outcomes. Nevertheless, our evidence suggests that these specific benefits are accompanied by a general deterioration in the functioning of local government institutions.

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Do Spanish Voters Really Tolerate Local Corruption?

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1. Introduction

Recent studies show that democracies are less corrupt than other political systems (Treisman, 2000; Lederman et al, 2005). The main mechanisms ensuring that democracy works are its election systems that give voters the ability to hold politicians accountable, ousting them from office if there is evidence of corruption and rewarding honest behaviour with re-election. Yet, while most empirical studies addressing this question do report a negative impact of corruption on a candidate's vote, the magnitude of this effect is only moderate[1]. A notable exception in this regard is the study by Ferraz and Finan (2008), which concludes that corrupt Brazilian mayors might lose up to 30% of their vote share and see their re-election chances reduced by as much as 17%.

In Spain, there has been a recent upsurge in local corruption scandals involving land use regulations, a responsibility primarily in the hands of local governments. The scandals emerged during the massive boom in real estate and attracted considerable media attention. During the period July 1999 to May 2007 (two terms of office), 5,144 news stories concerning corruption, affecting 565 municipalities, were published in the Spanish press. Parallel to this, several articles in the same newspapers report (albeit on the basis of anecdotal evidence) that a large proportion of supposedly corrupt mayors have been re-elected. These news items suggest that Spanish voters tolerate corruption. The following newspaper headlines are typical of this reaction: "The polls forgive those involved", *El País,* 29 May 2007, and "Immune to corruption", *El Mundo* 23 May 2011. However, the empirical evidence on this question remains inconclusive.

Rivero and Fernández-Vázquez (2011), using data from two Spanish regions (*Andalucía* and the *Comunitat Valenciana*), do not find any difference in the electoral support received during the 2007 local election by majors against whom accusations of corruption had been made and those that had not been subject to similar accusations. The authors estimate the impact of corruption in relation to land use regulations (limited to cases involving the judiciary) on the mayor's vote share. However, as they themselves recognize, their model does not consider, among other characteristics, the mayor's popularity, which can be expected to be positively correlated with corruption. Furthermore, they restrict their study to just *Andalucia* and the *Comunitat Valenciana,* two regions with their own marked characteristics, including a high unemployment rate, which may have a determining effect on their estimates.

Barberá and Fernández-Vázquez (2012), drawing on data for all Spanish municipalities with more than 1,000 inhabitants, report that voters punished corrupt mayors at the 2011 local elections. They estimate the effect of a corruption scandal on the change in vote share between 2007 and 2011 and find that corrupt mayors lost 6.9% of their vote, while non-corrupt mayors lost 3.6%. However, when they distinguish between the corruption scandals according to whether the society obtains a benefit or whether only the mayor benefits personally, they find that scandals benefitting society generate additional votes (4.8%) while those that only benefit the major generate a loss of 8.1% of the vote share. Unexpectedly, they also report that scandals breaking just before the elections generate additional votes for the mayor. It should be noted that the authors adopt a broader definition of corruption scandal, and do not restrict themselves solely to cases involving land use regulations.

2. Corruption Scandals, Voter Information and Accountability

In a recent article that Elena Costas-Pérez, Albert Solé-Ollé and I wrote (see Costas-Pérez *et al,* 2012), we empirically studied the

[1] These studies fail to account for the omission of popularity shocks, which could bias their estimates.

effect of local corruption scandals involving land use regulations at the 2007 Spanish local elections. Unlike Rivero and Fernández-Vázquez (2011), we find that voters do punish corrupt mayors. However, we use a different methodology and our sample of municipalities covers the whole of Spain.

In our analysis we estimate the impact on the incumbents' vote share in those municipalities in which a corruption scandal was reported for the first time during the 2003-2007 term of office, comparing these results with vote shares in municipalities that had never reported instances of corruption. Thus, we exclude municipalities that had experienced prior cases of corruption, as this might have a different impact on the vote and might also depend on whether the incumbent was ousted or not. If more popular incumbents tend to be more corrupt (see, for example, Svaleryd and Vlachos, 2009), the failure to account for popularity would bias the estimated effect downwards. Thus, we have to control for regional popularity differentials between parties and for popularity differences that might be specific to a municipality. Such differences can be controlled using a "difference-in-differences" set up.

Our initial sample includes all municipalities with more than 5,000 inhabitants in 15 Spanish regions[2]. The corruption data were obtained from a local corruption survey, commissioned in 2007, and undertaken by the Spanish think tank *Fundación Alternativas*. The survey, which includes all news items published in the press about corruption, found a total of 241 cases during the 2003-07 term of office. In a second survey, cases involving the judiciary were noted and classified according to the particular stage reached in the judicial intervention. The information included in these surveys provides us with a good measure of how much voters know about a particular corruption scandal and when they would have received this information.

Our baseline results indicate that voters punish corrupt mayors. After a corruption scandal breaks, an incumbent stands to lose 3.8% of their vote share. We also find that:

– Electoral punishment is sensitive to *press coverage*. An incumbent involved in a scandal reported in more than ten published articles (25% of all the scandals) suffers an additional vote loss of 6.1%, and loses 8.8% of their vote share.

– Electoral punishment is also sensitive to the *intervention of the judiciary*. Scandals in which formal charges have been brought and for which press coverage is wide (i.e. more than ten published articles) cause incumbents to lose 14.5% of their vote share. However, scandals that have been dismissed by the courts and which have been reported widely in the press lead to a vote gain of 1.9%.

– The impact of the published articles depends on the *timing of their publication*. The effect of wide press coverage is six times greater in the second half of the term of office than in the first half. Scandals reported in ten newspaper articles and published in the second half of the term generate an additional vote loss of 6.2%, with incumbents losing 9.9% of their vote share (vs 3.7% when they are published in the first half of the term).

3. Conclusions

These findings show that voters do not tolerate corruption. They also show that information provided by the press about the degree of involvement of the judiciary is relevant. Such information helps voters distinguish between well-founded and unfounded accusations of corruption with voters only punishing well-founded accusations. However, voters would seem to be myopic, attaching greater importance to more recent than more distant reports of corruption.

These findings have political implications. Most instances of local corruption involve bribes received in exchange for amendments to the land use plans, the latter being essentially a municipal responsibility. This suggests that the characteristics of land use regulation in Spain, a highly interventionist and rigid system (Riera, 2000), have been influential in this surge in corruption. Thus, there would appear to a case for introducing some changes to the system. One possibility would be to make the regulations more flexible so as to avoid the rent differentials that are currently generated when the amount of developable land does not match demand. Similarly, there would also appear to be a need to increase transparency in land regulation decisions. A further option would be to ensure that regional governments fulfil their land use regulation responsibilities and monitor municipal land plans more closely. However, in practice, they typically just give the green light to the land plans presented by local governments.

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Rev

view

Nicholas Charron, Victor Lapuente and Lewis Dijkstra

Regional Government Matters: A Study of Regional Variation in Quality of Government within de EU

European Commission, 2012

This work is a report elaborated by the European Commission's Directorate General for Regional Policy. The report presents the "Quality of Government" (hereinafter, QoG) data for the 27 EU member countries, and 172 European regions. It is based on a 2009 survey of 34,000 Europeans on the perception of corruption and the quality of public services (education, health and police), both at national and regional government levels.

The first part of the report offers a detailed data description, robustness tests and results by country and region. In the second part of the report, the data are used to compare different hypotheses about the QoG.

The survey examines corruption in three different ways. The first consists in asking the respondent whether they had bribed anyone in order to use health services during the previous year. The second asks whether the respondent thinks that other citizens are paying some kind of bribe in order to use public services. The third question asks whether the respondent believes that corruption in general exists in the provision of public services.

The results show great differences across countries, and also within countries, for different regions. The first group comprises the Northern European countries, which show the highest levels of QoG. The second group contains the majority of Southern Mediterranean countries, along with Estonia and Latvia, with moderate QoG levels. Finally, there is another group containing most of the newest EU member countries, with low or low-moderate QoG levels.

There are great differences within each country. This occurs in federal or semi-federal countries, such as Italy, Belgium or Spain, and also, notably, in the most centralised countries, such as Portugal, Romania or Bulgaria. In turn, other countries, such as Denmark, Poland, Austria or Slovakia display very little differences between the regions.

The report also compares various hypotheses that could help to explain the differences in QoG levels across countries and within them. Strong empirical evidence was found of a positive relationship between the QoG indicator and the "Human Development Index" – a composite index based on a series of factors, such as life expectancy in good health, household income, and the ratio between high and low education levels among the population aged 25-64.

The relationship between the QoG indicator and the size of the countries or regions is not so strong. Nonetheless, some empirical evidence suggests that the more populated regions have a lower QoG level, which could imply that the QoG level in large cities is lower. Another result of the report is the lack of relationship between political decentralisation and the QoG indicator.

The most relevant result of this work is that the QoG level varies noticeably across EU countries and regions. Also, the lowest QoG levels are found in those areas with the worst human development index scores. Therefore, a policy conclusion would be that, aside from the existing transfer policies in the EU, efforts should be made to substantially improve the economic outlook and life ofresidents of those areas with lower QoG levels.

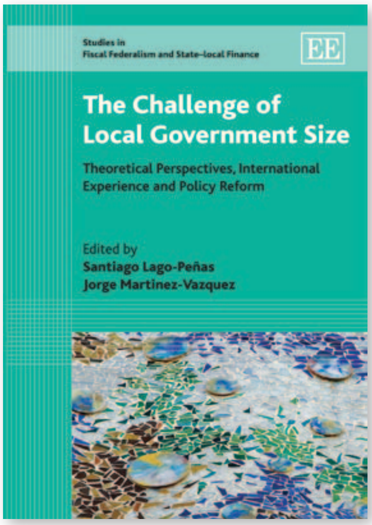
In short, this report opens the door to future research aiming at explaining the existing differences in quality of governance between countries and regions. It should be determined whether these differences can be explained by cultural, economic or institutional variables. In sum, the data presented in the report can be useful to students of many different areas, such as political economy, federalism and decentralisation, regional and EU policy, etc.

Santiago Lago-Peñas and Jorge Martinez-Vazquez (Eds.)

The Challenge of Local Government Size. Theoretical Perspectives, International Experience and Policy Reform

Edward Elgar, 2013

Many countries around the world have vertical government structures that are perceived as inefficient because of their high level of jurisdictional fragmentation. A common response has been the implementation of jurisdictional consolidation programs, both forced and voluntary. The main declared objective of these programs has been achieving economies of scale, thereby reducing production costs of local and regional public services. The aim of this book is to review the fundamentals of this strategy and its observed consequences. What are the drivers of local government fragmentation? Should we be really worried about economies of scale? Are there population thresholds to have in mind when choosing the optimal size of jurisdictions or devolution of powers? Does amalgamation of municipalities involve costs in terms of political representation and accountability? Is corruption related to jurisdictions size? What are the final results of both forced and unforced amalgamation? Are privatization and inter-municipal cooperation good alternatives to consolidations? This book sheds light on all these questions.



The book starts with the chapter by Jorge Martinez-Vazquez and Juan Luis Gomez-Reino, who address the identification of the main drivers of jurisdictional size. In the following chapter, Nicholas Charron, José Fernández-Albertos, and Victor Lapuente explore how differences in the size of the polity affects citizens perceptions of political representation and the quality of services provided by their governments.

In chapter 4, Michael A. Nelson works with a large cross-country data set of developing and developed countries to conclude that less fragmented municipal government structures are associated with more honest (less corrupt) behavior by government officials. In the same vein, the contribution by Fabio Padovano, Nadia Fiorino, and Emma Galli in chapter 5 analyzes the effect of fragmentation in interaction with fiscal decentralization on corruption.

The following two contributions are focused on the issue of economies of scale in both capital intensive and labour intensive local public services. Economic theory suggests that the size of units of local government has an important impact on the efficiency with which public services are provided. Conventional arguments about local government size assert that big is better, because larger units are able to capitalize on scale economies, though those economies may eventually turn negative as governments become plagued by bureaucratic congestion. Germá Bel focuses on capital intensive local services. By contrast, Rhys Andrews in chapter 7 examines the potential sources of economies of scale in the production of labor intensive public services.

In order to avoid the cost of smallness in municipal size, a number of options arise. Consolidation or amalgamation can sometimes be the most efficient alternative, but other institutional options, enabling intermediate solutions, may also be considered. In particular, inter-municipal consortia and privatization usually are alternatives easier to implement from a political standpoint. On the question of amalgamation, Bernard Dafflon extracts a number of lessons from the Swiss experience in chapter 8. Local governments often set up inter-municipal consortia to provide public services jointly, rather than individually. To shed further light on this issue, chapter 9, by Luiz De Mello and Santiago Lago-Peñas tests for the presence of scale and spillover effects in local government provision and estimates the determinants of the probability of local government participation in inter-municipal consortia. Chapter 10, by Brian Dollery, Michael Kortt, and Bligh Grant, focused on the same question. Local council collaboration through resource sharing and joint service provision represents the main alternative form of structural change which still retains local government activity within the public sphere. A third way, privatization and hybrid systems of local service delivery, is explored by Mildred E Warner in the last chapter of the volume.

Economists, public administrators and political scientists will find much of interest in this innovative volume, as will professors, students and international institutions interested on local government structure.

Girogio Brosio and Juan P. Jiménez

Decentralization and Reform in Latin America. Improving Intergovernmental Relations

Edward Elgar, 2013

This book makes an important contribution to the existing literature on decentralisation and fiscal federalism. It is a splendid collection of studies analysing the fiscal decentralisation economic policy in Latin America, where decentralisation has often occured as a result of major political reformation. Latin America has always been at the forefront of what is referred to as decentralisation in developing countries.

This volume contains contributions from distinguished experts on the subject: J.R. Afonso, E. Ahmad, V. Almeida, G. Arballo, G. Brosio, K. Castro, O. Cetrángolo, S. Dain, L. de Mello, A.C. Faveret, R. Gargarella, A. Goldschmit, J.C. Gómez Sabaini, V. Grembi, J.P. Jiménez, A. Manoel, J. Martinez-Vasquez, F. Rezende, C. Sepulveda, T. Ter-Minassian and J. Veloso.

The book is a collection of the best fiscal decentralisation experiences in Latin America during recent decades. Moreover, it presents a series of emerging problems, some of which are are produced by the specific characteristics of these countries, and proposes different solutions to these problems. In other words, one of the aims of this work is to evaluate the current functioning of the decentralised institutions and to outline the necessary reforms. On the one hand, the reader will learn how the characteristic problems of fiscal decentralisation, common to all decentralisation processes regardless of the country, are addressed: their constitutional bases, the issues concerning the allocation of responsibilities and service provision at sub-central levels (primarily, social services and infrastructure), the allocation of taxes to sub-central governments (especially those levied on natural resources), the design of intergovernmental transfers to correct inequalities between territories, and the macroeconomic implications of decentralisation.

On the other hand, the reader will also learn about other issues specific to Latin America from the perspective of fiscal decentralisation, which gives particular added value to this work. Thus, decentralisation is addressed in the context of a wide variety of fiscal institutions and in an environment that exhibits a high degree of inequality in the distribution of income from natural resources and important territorial and personal income level disparities. The problem of interterritorial equality is evident mainly in the distribution of natural resources —a very important issue in this geographical area, in the provision of social services, in investment expenses and in macroeconomic stabilisation. For this, this volume advises that improvements should be made to the fiscal equalisation transfer systems to correct both vertical and horizontal fiscal inequalities, with the aim of achieving a better, more efficient and equitable funding of subcentral services and greater social cohesion.

In conclusion, this book should be compulsory reading, not only for those interested in Latin America, but also for academics, researchers and politicians responsible for issues relating to fiscal decentralisation.

Aut

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