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The Role of Fiscal Coordination and Partisanship in the Spanish Fiscal Federalist System: Lessons for European Union reforms

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Abstract

An issue that the European Union continues to face is how to coordinate the economic and fiscal policies of its member states. Recent reforms that created the European Semester require additional information concerning member states' fiscal plans for the Commission and Council to review more rigorously. Spain has developed similar provisions for its regions. In this paper, we consider the possible lessons arising from the emerging federation in Spain for the European framework. We analyse the performance of Spain's fiscal federalist framework with a special emphasis on its coordination and political relationship with the autonomous regions. We explore the functioning of these schemes through analysis of its relationship with regional budgetary balance performance. We find that coordination agreements are negatively correlated with balances. This suggests that such agreements are indicators of fiscal problems and also that they did not contribute to lower deficits. Moreover, we find that politics, rather than fiscal rules and frameworks, led to differing fiscal performance. Over the entire period, having a different party in control at the regional level was associated with lower budget balances. Finally, we conclude with lessons from Spain's experience for the European Union.

Keywords

Spain, European Union, fiscal policy, coordination, shared goals

1. Introduction

The Economic and Monetary Union (EMU) created a framework meant to facilitate the coordination of economic and fiscal policies among all European Union members. The financial crises of 2008 and the 'euro crisis' that followed challenged the functioning of this system, to which the European Union responded by introducing a series of reforms, such as the 'Six Pack' and 'Two Pack'. An important element of these reforms is the increased monitoring of what member states do. The European Semester increases the information that member states have to report, while also formalising the Commission's and Council's comments on these plans. Similarly, the 'Two Pack' requires the European Commission to write a report on the budget plans of (eurozone) member states' governments before national parliaments vote on them. What are the benefits of continued discussions between the 'centre' and the member states?

We focus on 'fiscal federalism' in Spain as a relevant analogous case. Both academics (Marti and Perez, 2016; Lago-Peñas, Fernández-Leiceaga, and Vaquero-García, 2017) and international organisations (IMF, 2015) regard Spain as an example of a fiscal federal structure that facilitated a degree of fiscal consolidation in its regions after its own crisis.

Initially, the Spanish case was labelled a 'calamity' that challenged the survival of the European Union itself. Yet its recovery has attracted international attention (*The Economist*, 2018). Spain's recent economic progress, moreover, has not been a straightforward process. It involved, in line with the European Stability and Growth Pact (SGP) changes, three modifications to its fiscal framework (in 2001, 2005, and 2012). These changes aimed to regulate the autonomous communities' tax-raising capacities and ensure fiscal stability. The reformulation of the Spanish fiscal framework culminated with the inclusion of the principle of budgetary stability in the Spanish constitution (Art. 135), which limits the ability of regional governments to incur structural deficits.

Under this institutional framework, as the IMF (2015) notes, the Spanish government is supposed to align fiscal policy objectives at every governmental level (central government, autonomous communities, and local entities) and across ministries. The Spanish case involves 17 regions and two cities (Ceuta and Melilla), which have considerable autonomy in functions regarding tax collection, the ability to borrow, and overall budgetary management. This case is interesting beyond the European Union because it illustrates how the Spanish fiscal federalist framework, in particular its coordination features, may contribute to reaching common fiscal policy objectives across the regions (Lago-Peñas et al., 2017; Bryson, Jensen, and Van Hoose, 1993; Grazzini and Ypersele, 2003; Weingast, 2014).

This paper analyses the institutional roots of Spanish fiscal federalism with a special emphasis on its coordination framework and political relationship with the regions. On the former, we examine the role of coordination mechanisms, and we trace the development of their institutional design: (i) the Council of Finance and Tax Policy (Consejo de Política Fiscal y Financiera–CPFF) as a political entity that centralises regional fiscal demands with central government policies, and (ii) the bilateral agreements signed between central government ministries and regions in relation to sectorial and multilevel policies. The effects of this institutional entrenchment are analysed in the context of the reforms introduced by the Spanish government since its participation in Stage III of the Economic and Monetary Union, which led to the adoption of the euro as its currency in 2002. On the latter, we consider more straightforward political arguments concerning partisanship and party polarisation in parliament, which, as Weingast (2014) and Jessop (2014) stress, play a crucial role in either increasing or restricting fiscal deficits. In fact, we find that when a regional government is controlled by a different party from that at the national level, the region has more negative budget balances over the entire period. This suggests that political alignments rather than detailed fiscal 'pacts' are most relevant.

This paper proceeds as follows: Section 2 outlines the literature concerning fiscal federalism and explores the current division between 'first' and 'second' generation fiscal federalism. The former is more interested in welfare provision at the local level, while the latter focuses on the institutional and political dynamics created by a federal division of power. We consider that this paper amounts to this second generation of fiscal federalism studies. In addition, we explain our definition of 'fiscal policy coordination' and 'partisanship'.

The Spanish case was labelled a 'calamity' that challenged the survival of the European Union itself. Yet its recovery has attracted international attention.

Section 3 reviews the coordination framework at the European level and recounts the most important reforms introduced to the European economic policy coordination framework. Section 4 provides details about the Spanish federal political and fiscal coordination frameworks. Section 5 presents results from a panel regression analysis. Among the most important findings are that coordination agreements are negatively associated with budgetary balances. This suggests that regional governments ignore them, and that they serve rather as an indicator of future fiscal trouble. Also, we find that political alignment of the regions with the national government is a relevant predictor of improving fiscal balances. Section 6 concludes with a discussion of lessons from the Spanish case for the structure of fiscal governance at the European level.

2. Fiscal Federalism, Partisanship, and Coordination

The underpinnings of unitary and federalist fiscal systems have long been studied and their benefits and limitations extensively highlighted. Two perspectives have been predominant in explaining the logics and functioning of fiscal federalist systems. The first, known as 'first-generation fiscal federalism', is rooted in public choice theory and claims that local politicians seek to maximise the social welfare (either by benevolence or electoral pressures) of their given constituency (Oates, 2005: 350). In this scheme, local officials would take advantage of vertical transfers to generate public value through the provision of decentralised public services. This model regards as a minimum the possibility of party politics, ideological differences, and the overall political game having a key influence on the allocation of goods and services (Rodden, 2004).

The second approach, known as 'second-generation fiscal federalism', studies officials' political goals, their relationships with the institutional and fiscal incentives, and the effects of partisanship in the political context (Weingast, 2014: 14). This perspective considers institutional incentives and how they might promote behaviour that damages the federal system itself. Different from the 'first generation' studies, this approach addresses the real political game, fiscal regulation voids, and the manipulation of the electoral constituency by politicians to evaluate how these elements might shape fiscal performance in a federalist governmental structure (Congleton, 2015).

In the light of the financial crises, the 'second generation' approach became predominant to evaluate the institutional design of countries with a federative system of government. Past cases, such as Brazil and Mexico in the 1990s—which faced enormous fiscal imbalances due to regions' irresponsible fiscal behaviour—have largely provided evidence for the adoption of a more politically oriented research agenda to evaluate the dynamics of federal institutional design over fiscal policy outputs (Afonso and de Mello, 2017). The 2010 EU sovereign debt crisis also reveals that member states' partisanship and internal politics (e.g. Greece, Italy, Ireland, Portugal, and Spain) do play a role in either resisting or easing the acceptance of austerity measures imposed by the European Central Bank (ECB), IMF, and European Commission (see Hall, 2012: 365). This situation is even more relevant in our case, given Spain's strong internal political divisions during the crisis, such as the separatists claim in Cataluña and the emergence of a new party (PODEMOS).

Cases such as Brazil and Mexico in the 1990s have provided evidence for the adoption of a more politically oriented research agenda.

In sum, these cases illustrate that a lack of a common fiscal framework, oversight, permissive debt ceilings, and polarised party politics put at risk the existence of the federation itself, triggering fissiparous (the separation of the federation into multiple independent states) forces where regions either push for independence or the central government pushes for recentralising functions creating an 'administrative federation' (Cole and Kehoe, 1996; Porto, Pineda, and Eguino, 2018).

Given the nature of the Spanish case, its recovery since 2017, prized coordination mechanisms, and active regional politics (IMF, 2015), we place this research in the 'second generation' federalism approach. Thus, in line with Oates (2005), we argue that a careful institutional design, the establishment of optimal procedures for the reduction of informational multilevel miscommunications, and the promotion of coordination mechanisms to align 'inter-jurisdictional interdependencies' can help federalist countries navigate political and economic turbulence (Oates, 2005: 357). Yet we also consider, following Weingast (2014: 14–15), that adequate internal political manoeuvre or 'governance' remains crucial to avoid 'centripetal' (centralisation of all powers in a unitary state) and 'fissiparous' forces.

Thus, for this paper, coordination refers to central government efforts to align competing fiscal policies between regions, with the final objective of constructing shared policy goals (Peters, 2018). Moreover, authors such as Canzoneri and Henderson (1988) point out that policy coordination contributes to welfare creation, as well as improves a country's international profile. In the same line, Molnar (2012) shows, through an examination of fiscal rules in OECD countries, that coordination tends to curb fiscal deficits (in national and subnational governments) by reinforcing a common institutional framework. This is echoed by Fainboin et al. (2014) who argue that fiscal coordination can lead to the establishment of responsible fiscal practices obtained through the implementation of fiscal rules and robust financial management that has a "shared and realistic macroeconomic outlook" (133–140).

In relation to partisanship, we define it as the degree of parliamentary polarisation between central government and the regions (in our case, Spain's autonomous regions). Following McConnell et al. (2018), we argue that partisanship might work as a deterrent to cooperation, having also an important impact in the economic and fiscal arena. In an empirical study, Roesel (2017), for instance, shows that party alignment between German local governments and central government supervisors leads to higher budgetary deficits. In our case, previous research on Spanish regional politics also shows that 'party convergence' between regions and central government proves important to budgetary compliance (see Delgado-Téllez et al., 2016 and Simon-Cosano et al., 2013).

In conclusion, coordination and partisanship are crucial elements underlying the challenges faced by a federal state in addressing potential centripetal or fissiparous forces (Weingast, 2014). Coordination can help ensure policy convergence and the exercise of unitary criteria for the fiscal policy cycle (Candel and Biesbroek, 2016), while partisanship announces the effects of legitimate political divides and polarisation on a government's expenditure. Both concepts are—at least theoretically—relevant variables to explain fiscal compliance. Based on this revision, we explain the evolution of the coordination reforms implemented by the European Commission as a previous step to address how they have impacted Spain's fiscal coordination structure, its relationship with the regions, and the politics underlying it.

3. European Economic Policy Coordination Framework

The set of coordination instruments incorporated to obtain fiscal compliance and align the economic policy of member states has evolved since the creation of monetary union. Currently, the European fiscal coordination framework relies on the multilateral surveillance mechanism set in the Maastricht Treaty, the Stability and Growth Pact (SGP)—including its reforms—the Medium-Term (Budgetary) Objectives (MTO), the European Semester, the common budgetary timeline, and the enhanced regulation recently installed by the 'Two Pack' reforms (European Commission, 2018a; Zeitlin and Vanherke, 2018). Each of these instruments has important implications for European economic policy governance and they respond to the economic challenges and political environment that has faced the EU since its creation.

The SGP, for instance, was created with the aim of minimising fiscal externalities to other member states in 1997. It consists of two important regulatory arms: (i) a preventive mechanism, which oversees a state member's budgetary situation, and (ii) a corrective mechanism, which includes an excessive deficit procedure. The economic governance framework was the object of major changes first in 2005 through a reform of the SGP, then in 2011 through the 'Six Pack', and again in 2013 through the 'Two Pack' reforms[1] (Schuknecht, Moutot, Rother, and Stark, 2011).

The MTO, in turn, is a three-year calculated budget balance in cyclically adjusted structural terms. This instrument aims to provide a common reference framework for the member countries for the sustainability of their public finances. Initially a common MTO was set for the euro area in aggregate, but since the 2005 reform it is attuned to the economic situation and context of individual member states (de la Porte and Heins, 2016).

The European Semester, in turn, was introduced in 2011, along with the 'Six Pack' reforms[2] (see Table A-1 in the Appendix), as an instrument for creating a cycle of economic coordination among the 27 member states at the time. The 'Semester' implied the incorporation of a common process for the evaluation of budgetary plans and potential macroeconomic imbalances (European Commission, 2018b). This new coordination instrument involves a higher degree of macroeconomic and budgetary surveillance based on the 2008 crisis experience where some countries (e.g. Greece) misreported the state of their public finances (Delors, Fernandes, and Mermet, 2011).

Recently, the 'Two Pack' reforms, introduced in 2013[3], created a common budgetary cycle to complement and ensure synergies with the European Semester, ultimately improving economic policy coordination. This new instrument includes the yearly publication of a national 'medium-term budgetary framework' and a 'draft budget'. The former should include information concerning stability programmes and reforms to be pursued throughout the new year, whereas the latter should contain the main country's subsectors yearly expenditures. The draft budget plans have to be submitted by mid-October and are then assessed by the European Commission (for eurozone member states). Final budget plans should be available by the 31 December of the preceding year. This instrument also requires that member states create an independent fiscal body at the national level to monitor the methodologies used for the surveillance of governmental expenditures and the evaluation of potential excessive deficit procedures.

The European Council recently approved complementary surveillance (or 'enhanced surveillance') for member states experiencing economic difficulties and receiving financial assistance provisions.[4] Under this new mechanism, the Commission can require stress tests and detailed economic data,

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1 A more systematic review of the changes to the SGP can be found in Table A-1 (see Appendix).

2 These reforms modified the preventive and corrective arms of the Stability and Growth Pact (SGP) and incorporated a directive concerning the budgetary framework for European member states and five regulations concerning the strengthening of the surveillance, and enforcement of the excessive deficit procedures. For a more in-depth review of the changes introduced see Table A-1 in the Appendix.

3 Refer to Regulation EU 473/2013: On common provisions for the monitoring and assessing of budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area. Available at: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32013R0473&from=EN (accessed 11 November 2018).

4 See Regulation EU 472/2013: On the strengthening of economic and budgetary surveillance of Member States in the euro area experiencing or threatened with serious difficulties with respect to their financial stability. Available at: https://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:140:0001:0010:EN:PDF (accessed 11 November 2018).

suggest precautionary programmes, and apply continuous surveillance until nearly 75 percent of the assistance provided is repaid.

The key insight from these reforms is an effort to increase the exchange of information between a given member state and the European institutions, and in particular between the member state and the European Commission. The expectation is that all of this coordination will lead to more compliance with the European Union's fiscal rules. This means in practice that member states should have more positive budget balances than in the period before the crisis, when the coordination was less developed.

Spain's relative ability to coordinate a common fiscal policy goal in the light of—sometimes—conflicting regional governments' politics constitutes an important example for the EU's coordination and political bargaining mechanisms in its efforts to strengthen a common economic policy. The Spanish institutional structure that permits this level of coordination and political consensus, however, is not recent; it dates to the decentralisation process of the Spanish state since the recovery of democracy in 1978 and expands to the introduction, in 2012, of Article 135[5] of the Spanish Constitution on financial stability.

Historical regionalisms and competing national identities have made the Spanish political system especially reliant on political agreements.

The following section analyses the evolution of Spain's fiscal federalist framework that helped to improve coordination and build shared goals between central government and the autonomous communities, a process which, as the IMF (2015) and Lago-Peñas et al. (2017) report, the European Union still struggles to achieve.

4. The Spanish Political and Fiscal Federalist System

4.1 Overview

Spain is composed of 17 autonomous regions and two autonomous cities (Ceuta and Melilla). Historical regionalisms and competing national identities have had important repercussions in the governmental arena and make the Spanish political system especially complex and reliant on coordination and political agreements. Since the adoption of the 1978 constitution, the Spanish government has actively promoted a decentralisation process that some consider the most rapid and successful in Europe (Vérgez, 2011). The Constitution never defined the type of Spanish government (neither federalist nor unitary state); instead it left room for an 'optional autonomy system' known as the *principio dispositivo*.[6]

5 Article 135 of the Constitution establishes that: (i) central government and autonomous communities are impeded to incur structural deficit, (ii) that they also have to be authorised by law to borrow, (iii) that only in the case of natural disasters, recession, or extraordinary situations the limits to debt might be breached, (iv) that autonomous communities will adopt these constitutional dispositions and incorporate them in their regulations.

6 Established in Article 2 of the Constitution of Spain.

The *principio dispositivo*, however, does not imply complete autonomy of the regions, but a negotiated set of arrangements listed in Articles 148 and 149 of the Constitution. The Spanish Constitution grants the autonomous communities jurisdiction over certain matters such as: (i) the organisation of self-governmental functions, (ii) electoral issues concerning their administration, (iii) territorial organisation and housing mandates, among others. However, the Constitution also reserves general government functions for the central state, in particular those mentioned in Article 149, section 13, concerning the coordination and planning of the country's economic activity (Ruiz-Almendral, 2007). This constitutes a type of autonomy overseen by central government. Vérgez (2011) described it as a 'dual system of power', or 'controlled' autonomy.[7] It is important to mention that, within the prerogatives of the Spanish central state, there is the right for central government to intervene in the region under three special circumstances, as stated in Articles 150(3), 153, and 155 of the Constitution respectively.[8]

In 2009 the government expanded the regions' tax-raising capacities to more than 50 percent in the case of value-added tax, and up to 100 percent in the case of the electricity tax.

In fiscal terms, the Spanish regions are divided in two blocks:[9] the *foral* and the *common* systems.[10]

País Vasco and Navarra conform to the *foral* system. They are accorded a higher degree of fiscal autonomy in terms of tax-raising and policy instrumentation. This system is also known as 'asymmetrical federalism' (Ruiz-Almendral, 2013b: 13) since these regions have the right to establish and regulate almost every governmental tax except value-added tax (IVA) and import fees. It is crucial to mention that the *foral* regions transfer part of their collected taxes to central government, which are also subject to re-negotiation every five years. This mechanism is known as *cupo* ('coupon').

In turn, the *common* system covers the other 15 regions, and their financial regimes have been set through organic regulations established in 1996, 2001, 2006, and more recently 2012. Each of these changes responded to the major reforms promoted at the European level in the preventive and corrective arms of the SGP. It is important to highlight that these regulations set up the regional fiscal funding system and specify their responsibilities in terms of income tax raising and other administrative fees.

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7 These constitutional rights were not invoked provided that potential conflicts were resolved at the political level. However, the recent conflict with Cataluña in 2017 prompted the application of Article 155; this dissolved the government of Carles Puigdemont (*El Mundo*, 2018). More generally, the Constitution under Article 148 regulates the set of attributes that a region has.

8 Central government can dictate necessary arrangements to harmonise normative dispositions in the regions (even in the case of particular regulations belonging to them). Such control, Article 153 mentions, can be exercised through various forms: through the *Tribunal Constitutional*, the *Tribunal de Cuentas, the Consejo de Estado,* and *administrative-contentious* regulations of both autonomous regions and central government. In case the region does not meet the obligation assigned or challenges the general interests of state, the Senate, through absolute majority, can force the communities to meet their obligations.

9 *8/1980, Ley de Financiación de las Comunidades Autónomas (LOFCA).*

10 As established in Article 152 of the Spanish Constitution.

4.2 The evolution of the regional financing system[11]

The Spanish regional financing system was (initially) composed of three main instruments: a shared taxes collection system[12] known as 'extractive power', credit operations, and a *Territorial Compensation Fund*[13] which works as an equalisation mechanism.

This initial funding scheme evolved throughout the years. In 2001,[14] central government expanded the regions' extractive powers[15] (inheritance tax, IVA shares, hydrocarbons, etc.), incorporated a new *sufficiency fund*, which covers the differences between the global financial needs of the regions and their available resources,[16] and set a common deficit ceiling for all regions of above 3 percent of the GDP.

These new reforms, as Vérgez (2011) highlights, created a moral hazard problem. While regional taxing powers substantially grew between 2001 and 2006, actual tax collections and budgetary compliance did not. In the period before the economic crisis, the central government set permissive fiscal deficits (between equilibria and –.1 percent of GDP) without limiting regions' debt issue operations. Consequently, as the IMF (2015) reports, this institutional framework, despite its benefits in terms of coordination processes, promoted vertical imbalance problems. Ruiz-Almendral (2013a: 200) echoes this affirmation: *"The central state had greater power to collect income that actually it needed for the exercise of their authority, while other subnational governments are in the opposite direction."* This situation constituted one of the major arguments for the introduction of further changes to the regional financing system.

In consequence, in 2006,[17] the government introduced new reforms. They incorporated the logic of individually suited MTOs employed in the EU for each Spanish autonomous region. Under this new rule, the regional extractive power also grew. In 2009,[18] the government expanded the regions' tax-raising capacities to more than 50 percent in the case of the IVA, and up to 100 percent in the case of the electricity tax. Moreover, a third new fund was created: the *guarantee fund for fundamental*

11 For a more detailed review of the changes to the Spanish regional financing system, see Table A-2 in the Appendix.

12 Patrimonial income, special contributions, and central government transfers, conceded tributes from central government, credit operations, and fines and sanctions. See *8/1980, Ley de Financiación de las Comunidades Autónomas (LOFCA).*

13 *The Territorial Compensation Fund* consisted of vertical transfers provided to each region prorated by number of their inhabitants. Through this system—based in the solidarity principle—the central government aimed to cover potential imbalances between regions in their provision of basic social services.

14 *21/2001, Ley de regulación de medidas fiscales y administrativas del nuevo sistema de financiación de las comunidades autónomas de régimen común y Ciudades con Estatuto de Autonomía.*

15 This enlarged the shared tax-raising scheme to patrimony tax and inheritance tax, increased the share of value added tax to 35 percent, rent tax to 33 percent, and 100 percent of the tax on energy production (electricity), minor hydrocarbons trade and gambling taxes.

16 *Ley 18/2001, Ley General de Estabilidad Presupuestaria*, that aimed at "ensuring fiscal equilibria in the public sector and local entities and so to establish effective mechanisms that ensure the cooperation between the central government and the autonomous communities".

17 *Ley orgánica 3/2006, de 26 de mayo, de reforma de la Ley Orgánica 5/2001, de 13 de diciembre complementaria de la Ley General de Estabilidad Presupuestaria.*

18 *Ley 22/2009 por la que se regula el sistema de financiación de CCAA de regimen común y ciudadades con estatus de autonomía y se modifican determinadas normas tributarias.* Available at: http://www.boe.es/buscar/pdf/2009/BOE-A-2009-20375-consolidado.pdf (accessed 11 November 2018).

public services,[19] which seeks to equate regional imbalances in the provision of funding for the Spanish welfare state.

The reforms implemented in 2006 and 2009, however, had little time to settle due to the financial crisis. Between 2009 and 2011, the Spanish GDP deficit averaged 10 percent, making it the country with the largest deficit in absolute terms (Royo, 2014: 23). In response to this problem, the Spanish government introduced, by the majoritarian agreement of Parliament (Cortes Generales), a new Article in the Constitution (Art.135) which stipulates a principle of budgetary stability for all agents of the Spanish administration, prohibits them from incurring a structural deficit beyond the margins established by the EU working regulations, and limits the regions to issue bonds and acquire credit commitments.

Complementary to this constitutional mandate, the Spanish government has tightened control over the regions' debt issue process. In 2012,[20] the central government promoted a reform seeking to empower central coordination institutions, such as the Ministerio de Hacienda, to take action in effectively curbing debt, established a zero fiscal deficit objective,[21] and other provisions more in line with the current European Union procedures.[22]

4.3 Coordination of the regions

Multilevel coordination is one of the key aspects of the Spanish fiscal federalist framework. The Spanish government employs two main channels formally to coordinate with the regions: The Consejo de Política Fiscal y Financiera (CPFF) (Council of Finance and Tax Policy) and bilateral agreements and cooperation programmes. This section explains its development and presents a dataset on the use of agreements between the centre and specific ministries.

The CPFF architecture was set out in 1980[23] with the objective of strengthening the relations between the regions and the central Spanish government in matters concerning public budgeting, resource allocation, debt issue, and public investments. This norm also set out the governance structure of the CPFF, composed of the public administration and finance ministers in each region. The CPFF president is the finance minister of the central government and its vice president one of the democratically elected councillors from the autonomous regions.[24] This entity plays a central role in ensuring multilevel coordination and shared governmental objectives at the political level (Vérgez, 2011).

19 Article 9 of the *Ley 22/2009*, op. cit.
20 *Ley 2/2012, Ley de estabilidad presupuestaria y sostenibilidad financiera.* Available at: https://www.boe.es/boe/dias/2012/04/30/pdfs/BOE-A-2012-5730.pdf (accessed 11 November 2018).
21 With the only exception of –0.4 percent in case it serves to fund structural reforms.
22 Such as a debt ceiling for the overall government of up to 60 percent of the GDP, which for the regions only consisted of 13 percent of their GDP.
23 *Ley de Financiación de Comunidades Autónomas (LOFCA)*, op. cit.
24 Other public officers who also participate in the council are: the state and budget secretary, the secretary of territorial cooperation and, upon the invitation of the president of the CPFF, other governmental public officers.

The CPFF is in charge of: (i) the coordination of central government budgetary policy, (ii) determining the distribution of resources coming from compensation funds, (iii) the political coordination of credits and public investments policies, and (iv) all other types of financial activity that require coordination between the central government and the regions. In practice, the agreements reached through the CPFF are the subject of further monitoring through mixed commissions (comisiones mixtas), which oversee the fiscal articulation of central and regional budgets, evaluate regional tax-raising capacities, participate in the design of the general tax policy for each region, and provide them with technical assistance. In addition, these commissions are responsible for the analysis and evaluation of fiscal normative proposals filed by the autonomous communities.

While regional taxing powers substantially grew between 2001 and 2006, actual tax collections and budgetary compliance did not

Crucially, and related to the Commission's monitoring of individual member states in the European Union, Spain also relies on thematic bilateral agreements as a mechanism to align regional fiscal policies to the central government ones.[25] They are the "most frequent cooperation instrument […] employed by the central government to implement concrete measures and policies involving autonomous communities" (Ministerio de Política Territorial y Función Pública, 2018).[26] They involve conditional funding transfers and financial commitments from both governmental levels. This instrument works as a mechanism to incentivise autonomous communities to align their budgetary policy with centrally defined thresholds in exchange for social policies.

Central government also resorts to other coordination instruments. In 2004, it created the 'Presidents' Conference' where leaders of each region and the president of Spain seek to agree shared goals and policies. To ensure the implementation of the agreements, central government also promoted sectorial conferences on policy issues (culture, labour, education, security, health, among others), with equal representation of central and regional governments.[27]

Notably, the Spanish coordination system governs the relationships between central and regional governments in the context of their financing system. There are recent claims that Spain's coordination mechanisms and its management of political conflict were pivotal in the country's recent economic recovery and also contributed to its fiscal consolidation (IMF, 2015: 117; *The Economist*, 2018). We briefly test these claims in the following section.

25 Referred to as *convenios* and *acuerdos de cooperación*. See: http://www.seat.mpr.gob.es/portal/areas/politica_autonomica/coop_autonomica/Convenios_Colaboracion.html (accessed 11 November 2018).

26 *Ley 30/2012 del régimen jurídico de las administraciones públicas y del procedimiento administrativo común*. Available at: https://www.boe.es/boe/dias/1992/11/27/pdfs/A40300-40319.pdf (accessed 11 November 2018).

27 So far there are 47 operating sectorial conferences covering a diverse range of topics, ranging from sport, gender equality, and public administration to productive, economic, and financial policies. For a detailed discussion see *Ministerio de Política Territorial y Función Pública* (2018).

5. Assessment of the Spanish Fiscal Federalist Framework

5.1 Data and variables

Do these cooperation agreements improve fiscal discipline in the Spanish regions, or do politics explain better than rules the movement in regional budget balances? To answer this question, we analysed the regional budget balance evolution in 17 autonomous communities since the year 2003. This exercise used official data provided by central government expressed as the budget balance as a percentage of regional GDP as our dependent variable.

Our first key independent variable 'cooperation agreements' coded the number of such agreements between central government and the autonomous regions. This is a variable we created specifically for this paper. The Ministerio de Política Territorial y Función Pública reports the number of mutual agreements between central government and each region since 2008, and we were able to reconstruct the data from other governmental sources since 2006. These agreements consist of mutually signed cooperation ventures concerning certain policies (i.e health, employment, education, etc.) between the two levels of government and constitute the main instrument of policy coordination and shared goals construction (Ministerio de Política Territorial y Función Pública, 2018). In addition, they are subject to monitoring through a common working group consisting of representatives at both governmental levels. The government only reports the number of agreements signed, which limited the level of scrutiny of the monitoring actions conducted. However, their number indicates a level of specificity of central government involvement in the affairs of a regional government.[28] Presumably, more involvement is deemed necessary when a regional government veers off course. Moreover, it is specified in law that the agreements are binding.[29] If this coordination is effective, it should be correlated with improvements in the budget balance the following year.

The Spanish coordination system governs the relationship between central and regional governments in the context of their financing system.

We also included central governmental transfers and financial liquidity assistance provided since 2012 that might have contributed to regional fiscal consolidation. The former consists of transfers by central government to each region to fund policies previously agreed in bilateral negotiations. The second is an emergency fund to cover the liabilities of the regions in light of the 2008 financial crises meant to reduce their fiscal deficit. Data for both variables come from governmental sources: the Ministerio de Política Territorial y Función Pública, and the Ministerio de Hacienda.

There are political variables that play a crucial role in the politics underlying the budgetary processes, namely regional parliamentary polarisation and political opposition (Weingast, 2014; Jessop, 2014). The former is a Herfindahl-Hirschmann (HEE) index based on the measure of party

28 *Capítulo IV, Ley 40/2015, 1 de octubre de Régimen Jurídico del Sector Público.*
29 ibid.

concentration relative to the number of seats in an autonomous region's parliament. For interpretation purposes, we considered the inverse HEE index (1-HEE) as the variable of our model, which means that the closer to 1, the higher the polarisation. The variable 'political opposition', in turn, depends upon whether the president of an autonomous region—elected by its regional parliament—belongs to the coalition of the party in power in the Spanish central government (0, no opposition) or not (1, there is opposition). Previous research into Spanish regional politics shows 'party convergence' (similar parties both at the central and regional government levels), rather than whether the party is from the left or right, is associated with negative fiscal balances independent of their political orientation (see Delgado-Téllez et al., 2016; Simon-Cosano et al., 2013).

Finally, we expected to find that the health of the economy affects regional budget balances, so we included the variable 'regional economic growth'. The region's economic performance might act as an explanatory factor since regions could benefit from a substantial amount of income leading us to potentially overestimate the role of coordination, financial assistance, or the local politics over our dependent variable. These data were collected from the Instituto Nacional de Estadística and described the gross regional economic GDP growth per year and region since 2003.

In total we analysed 17 autonomous regions from 2003 to 2016, which makes a total of 238 observations. The summary of the variables, their typology and sources can be found in Table 1.

Table 1: Summary of variables

	Overall (within and between)				
Name	Min.	Max.	Mean	Std.	Source
Regional budget balance (GovBB)	–7.87	.4	–1.0	1.3	Ministerio de Hacienda (2018a)
Coordination between regions and central government (Coordination)	11	105	45	22.9	Ministerio de Política Territorial y Función Pública (2018)
Log of Transfers (Transfers)	12.23	21.67	17.48	1.87	Ministerio de Hacienda (2018b)
Log of financial liquidity assistance (Liquidity)	3.25	9.6	7	1.5	Ministerio de Hacienda (2018b)
Political polarisation (Polarisation)	.04	.9	.6	.15	Junta Electoral Central (2018)
Political opposition (Opposition)	0	1	.49	.5	Junta Electoral Central (2018)
Regional economic growth (Growth)	–5.6	6.23	1.16	2.72	Instituto Nacional de Estadística (2018)

5.2 Model specification

Having defined the set of explanatory variables, the regression model for region *i* and year *t* is the following:

$$GovBB_{i,t}=\alpha+\beta_1 GovBB_{i,t-1}+\beta_2 Coordination_{i,t-1}+ \beta_3 Transfers_{i,t-1}+ \beta_4 Polarisation_{i,t-1} +\beta_5 Opposition_{i,t}+\beta_6 Growth_{i,t-1} +\beta_7 Liquidity_{i,t-1}+\theta_{i,t} + \varepsilon_{i,t}$$

In our model, the variable qi,t is a fixed effect per region while ei,t is the error term. We considered the lagged versions (t–1) of some explanatory variables because of concerns about reverse causality. We have other reasons to lag some variables—we expected that the previous year's budget balance, due to intricate budget rigidities and incremental budget patterns among other reasons, was positively correlated with the following year's budget balance (Lago-Peñas et al., 2016). A similar case occurs with coordination agreements since they normally take a few months (or up to a year) to be fully implemented.

We proceeded with our analysis by first evaluating the relationship between each explanatory variable with the regional budget balance until we obtained the full claimed model. We used a linear regression analysis with fixed effects since we considered some environmental features of the regions would play an important role in explaining the improvement of their respective budgetary balances.

Finally, we also assessed the stationarity of our variables through a unit-root test which employed the Levin-Lin-Chu (Levin, Lin, and Chu, 2002) estimator. This test's null hypothesis is that the series (panels) contain a unit root, while the alternative hypothesis is that the variables are stationary. This analysis also controls for the potential impact of cross-sectional correlation. Moreover, for robustness we used the Generalised Methods of Moments (GMM) suggested by Arellano and Bond (1991).[30]

5.3 Results

Table 2 shows that coordination agreements between central government and the regions are statistically significant but with the opposite sign (negative) than expected—more agreements are correlated with worse budget balances the following year. It is possible that central government anticipates future trouble and requires bilateral agreements. In this case, bilateral agreements are a leading indicator of future trouble. But this result indicates that fiscal bilateral agreements were not an effective way of ensuring fiscal discipline in these regions.

30 See Tables A-3 and A-4 in the Appendix.

Table 2: Results from fixed effects panel regression

Regional budget balance (GovBB)	(1)	(2)	(3)	(4)	(5)
Lagged regional budget balance (L.GovBB)	.54**	.48**	.47**	.47**	.44**
Lagged coordination between regions and central government (L.Coordination)	-.005	.002	.002	.002	–.022**
Lagged log of monetary transfers to regions (millions of euros) (L.Transfers)		–.16**	–.14**	–.13**	–.08**
Lagged political polarisation (L.Polarisation)			2.7**	3.03**	-1.8*
Political opposition (Opposition)				–.12	–.43*
Lagged log of regional economic growth (L.Growth)					.31**
Constant	–.43*	2.0**	–.08	–.24	2.9**
R-sq	.3**	.3**	.27**	.27**	0.6**
Observations	170	170	170	170	170

**p<0.05, * p<0.1

Political variables affect the budget balance (albeit at the p<.1 level), but also in part in unexpected ways. If a region's president comes from a different party from that of central government, the budget balance worsens (rather than improves). An autonomous region ruled by the opposition has, on average, a lower budget balance of –.43 percent of GDP than those governed by a party in coalition with the central government. In relation to political polarisation, this variable has negative effects on a region's budget. This is consistent with the 'opposition variable'—presumably the more fragmentation, all else being equal, the harder it is to pass a budget that may potentially help central government.

Other variables fit our expectations. The results shown in Table 2 indicate that the lagged budgetary balance presents inertial patterns in line with the previous findings from Delgado-Téllez et al. (2016: 25) and Lago-Peñas (2016). In fact, the state of the previous year's budget balance explains around half of the current year's balance. Bilateral transfers have a significant *negative* association with the dependent variable. Once again, it appears that a variable is a leading indicator of future trouble. It is also possible that the knowledge that a regional government would receive additional funding led it to spend even more than it had without this assistance. The variable economic growth is significant and positive, with 1 percent economic growth in a given year (*t–1)* leading to a positive fiscal balance of about +.3 GDP of a region's budget balance in the next year (*t*).

6. Conclusion

In 2010, Spain had a fiscal deficit of 11 percent of GDP, and scholars, analysts, and politicians worried about the implications of Spain's fiscal problems for economic governance of the eurozone. In 2018, the Spanish case also attracted international attention, yet this time for its surprising recovery. Until now, most media analysis on the topic has speculated on the politics underlying the country's fiscal consolidation.

In this context, our paper provides initial evidence concerning the impact of coordination mechanisms in ensuring discipline and eventually contributing to curb Spanish regional fiscal deficit. The bilateral (coordination) agreements did not prevent the erosion of fiscal discipline in the regions. At the same time, political variables, such as the polarisation of regional parliaments and whether the same party was in power at the central and regional levels, were associated with changes in budget balances.

So what lessons does the Spanish fiscal federalist framework have for the European Union?

In many ways, the Spanish Council of Finance and Tax Policy (CPFF), which sought to monitor and coordinate fiscal policies, resembles the current EU economic framework. The recent inclusion of fiscal councils in member states under the 'Two Pack' reforms, as well as the Commission's ability to check fiscal plans, are meant to increase the monitoring of draft budgets. At the same time, the Spanish cooperation agreements, which arise out of the process, are supposed to be legally binding. Yet we find no evidence that these agreements led to more positive budget balances.[31]

Rather than suggest that more monitoring necessarily leads to better outcomes, the lesson from this exercise is that politics remain important. Regional governments of the same political party as the one in power in the centre are more likely to produce results that make central government look good, while more polarisation also leads to worse budget outcomes. One should remember that 'debt' under European Union accounting rules is 'general government' and not just 'central government', so poor performance at the regional level hurts the reputation of the central government on debt matters. How the finding that 'politics matters' translates at the European level is more complicated. There is not a clear partisan government at the European level; that is, Christian Democrats in Germany are not trying to help a Christian Democratic government in Brussels. What this exercise does suggest is more attention to member state specific factors is needed when thinking about European economic governance. Increased monitoring of Italy's public finances, for example, will on its own not lead to an improved budget balance in the country. Rather, one should consider the incentives facing that government if one is worried about the externalities of poor Italian fiscal performance on other member states.

31 It is possible that the agreements are more effective after reforms in 2012. We checked this possibility in unreported regressions. We found that this variable was no longer negatively associated with budget balances in the truncated sample, but it was also not statistically significant.

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Appendix

Table A-1: Summary of the major changes to the preventive and corrective arm of the SGP

Section	1997/1998 1466/1997 and 1467/1997 EC regulations	2005 reforms 1055/2005 and 1056/2005 EC regulations	2011/2012/2013 reforms 'Six Pack' and 'Two Pack'
Coordination mechanisms	Multilateral surveillance set in the Maastricht Treaty (Art. 103 Medium-Term Objectives (MTO)[32] for all countries close to balance or surplus	Multilateral surveillance set in the Maastricht Treaty (Art. 103) Country-specific Medium-Term Objectives (MTO) considering 1% of the GDP to balance or surplus	Multilateral surveillance set in the Maastricht Treaty (Art. 103) Country-specific Medium-Term Objectives (MTO) with a safety margin of 3% (Art. 1.5) European Semester Regulation and enhanced monitoring ('Two Pack')
Preventive arm	Early warning system consisting of: Submission of information concerning a budgetary position, economic assumptions, budgetary measures and economic changes or challenges (Art. 4 EC 1466/97) Two months' examination period of programme concordance with the MTO (Art. 5.2.) In case the Council finds divergence between the MTO and the budget of the member state, an early warning message should be issued. If it persists, a corrective measure should proceed (Art. 6)	Early warning system remained similar, but with the following specifications: The Council analyses the information submitted if the country complies (or adjusts) to the MTO with a threshold of 0.5% of its GDP. Deviations from MTO can be allowed in case of pension reforms, or other major productive reforms (Art. 1.3/1055/2005) Three months' examination period of programme concordance with the MTO (Art. 1.3b) In case of divergence from the MTO, the Council should consider the reforms carried out by the government in relation to pensions and others. Countries implementing those reforms can be allowed temporary deviations (Art. 1.5)	Early warning system remained similar, but with the following specifications: The Council analyses the information submitted if the country complies (or adjusts) to the MTO with a threshold of 0.5% of its GDP. For countries with more than 60% of GDP, the Commission must evaluate if the annual improvement is higher than 0.5% of the GDP (Art. 1.5) Three months' examination period of the stability programme (Art. 1.5.2) In case of deviation from the MTO, the Commission addresses a warning message within one month which should set a maximum of five months for a country taking action (three in the case of an emergency situation) (Art. 1.9). The Council, upon suggestion of the Commission and in case non-action persists, shall make the recommendation public.

32 The EU describes an MTO as an instrument which constitutes a budget balance in structural terms cyclically adjusted for one-off and temporary measures. See: http://www.europarl.europa.eu/RegData/etudes/note/join/2014/528745/IPOL-ECON_NT(2014)528745_EN.pdf (accessed 11 November 2018).

Corrective arm	Excessive deficit procedure consisting of: Excessive deficit can be considered exceptional if a country's GDP deficit fall 2% The Council evaluates in three months the existence of an excessive deficit (Art. 3.2) In case a member does not take effective measures, there will be a two-month period for the Council to impose a sanction (Art. 6) Four months' period for a country to take action in case of effective deficit found (Art. 3.4)	Excessive deficit procedure consisting of: Excessive deficit can be considered exceptional if the country has a negative value growth rate, accumulated loss of output, or very low annual GDP growth (Art. 1.1). In addition, when considering whether there is an excessive deficit, the country's mid-term economic position and budgetary position should be considered (Art. 1) The Council evaluates in four months the existence of an excessive deficit (Art. 3.2) Six months' period for a country to take action in case of effective deficit found (Art. 3.4). Also, the country is required a minimum annual improvement of 0.5% of its GDP Countries can claim 'exceptional circumstances' to delay the implementation of corrective measures by one year more (Art. 1.5) In case a member State does not take effective measure, there will be four-month period for the Council to impose a sanction (Art.1.2)	Excessive deficit procedure consisting of: The Commission analysis should consider policies implemented to correct macroeconomic imbalances, common policies for EU growth strategy, and pension reforms, among others (Art. 1.6) The Council communicates within in two months the existence of an excessive deficit (Art. 1.6) Six months' period for a country to take action in case of effective deficit is found (three in the case of an emergency). This includes a deadline of one year for the correction of excessive deficit (Art. 1.4). The country is required to demonstrate a minimum annual improvement of 0.5% of its GDP. Within the six month's deadline, the country must report the measures taken to curb its deficit (Art. 1.4) In case a member does not take effective measures, there will be four-month period for the Council to impose a sanction (Art. 1.7)
	Sanctions: Ten months' period for a country to take action (Art. 7) Deposit of 0.2% of the country's GDP and one-tenth of the difference between the deficit and the threshold of 3% (Art. 12) in case of non-compliance The deposit converted into a fine if in two years no action was taken	Sanctions: After the sanction, there is a 16-month period for a country to take action (Art. 1.5) Deposit of 0.2% of the country GDP and one-tenth of the difference between the deficit and the threshold of 3% (Art. 12) in case of non-compliance The deposit converted into a fine if in two years no action is taken	Sanctions: After the sanction, there is a 16-month period for a country to take action (Art. 1.7) Deposit of 0.2% of the country's GDP and one-tenth of the difference between the deficit and the threshold of 3% (Art. 1.10) in case of non-compliance The Council will evaluate every year if the member state has taken effective action and decide if new sanctions might be imposed. Those sanctions cannot surpass the 0.5%of the country's GDP (Art. 1.10)
Fiscal deficit ceiling	Within 3% deficit of the GDP (Art.4 EC 1466/97)	Within 3% deficit of the GDP (Art. 4 EC 1466/97)	Within 3% deficit of the GDP (Art. 4 EC 1466/97)
Public debt ceiling	60% of the GDP.	60% of the GDP	60% of the GDP

Table A-2: Summary of the major changes to the financing system of the Spanish regions

Sections	2001 Organic Law 2001 'internal stability pact'	2006 Reform of the organic law of 2001	2012 Law on budgetary and financial stability
Central government coordination powers	The CPFF establishes *common* agreements on fiscal deficit limits	Bilateral negotiations between each region and the central Ministry of Economics and Finance. Parliament (Cortes Generales) has the power to modify fiscal deficit agreements	Empowers central government to take any action to reduce deficit and debt (Art. 10)
Fiscal deficit targets	Established by the government yearly (Art. 8.1)	Agreed bilaterally between Ministry of Economics and Finance and regions	Constitutionally defined that no region can incur in structural deficit. Zero deficit target –0.4% if structural reform with long-term effects are taken (Art. 11.2)
Sanctions due to non-compliance	Not clear. Mentions that regions will equally share sanctions if applied by the EU (Art. 11)	Warning messages to regions in risk of non-compliance through the CPFF (Art. 10.1) The formulation of an economic reform plan for three years (Art. 10.2)	Warning messages within one-month period prior to sanctions The region will require permission from central government in case of further debt issue processes In case of non-compliance, further transfers via agreement will be considered (limited) by central government (Art. 19, Art. 20)
Debt ceilings	Not established	0.25% GDP regional debt allowed for financing productive programmes (e.g. industry promotion policies)[33] (Art 8.5)	Public debt cannot be more than 60% of Spanish GDP and only 13% in the case of autonomous communities (Art. 13)
Vertical imbalance (VI)	*Fondo de Suficiencia* to cover global financial necessities of the regions[34] Shared taxes system: 33% of individual tax, 35% IVA, 40% for beer, hydrocarbons, tobacco, alcohol, etc., 100% electricity and other juridical and administrative procedures including patrimony. *Fondo de garantía de servicios públicos fundamentals,* which equates the monies received by each community per inhabitant	Reformed in 2009[35] Similar instruments as 2001, yet with an increase in the shared taxes collection consisting of: 50% rent tax of the inhabitants of the regions, 50% of IVA and 58% of alcoholic and beer taxes, 100% of electricity tax	

Table A-3: Summary of unit root test for the panel (Levin-Lin-Chu test)

Variables	t-statistic (adjusted)
Dependent: Regional budget balance (GovBB)	–4.4**
Coordination between regions and central government (Coordination)	–2.8**
Log of monetary transfers to regions (millions of euros) (Transfers)	–4.7**
Political polarisation (Polarisation)	–4.85**
Political opposition (Opposition)	–3.8**
Regional economic growth (Growth)	–3.7**
Log of the financial liquidity assistance (Liquidity)	–5.95**

**p<0.05, *p<0.1

33 This amount (.25%) was not considered in the accounts of the autonomous regions' yearly fiscal deficit. See: http://www.minhafp.gob.es/Documentacion/Publico/CDI/Estabilidad%20Presupuestaria/Informe%20Completo%20EP%202008.pdf (accessed 11 November 2018).

34 Ley 21/2001, *Ley por la que se regulan las medidas fiscales y administrativas del nuevo sistema de financiación de las Comunidades Autónomas de régimen común y ciudades con estatuto de autonomía*. Available at: https://www.boe.es/boe/dias/2001/12/31/pdfs/A50383-50419.pdf (accessed 11 November 2018).

35 Ley 22/2009, *Ley que regula el sistema de financiación de las Comunidades Autónomas de régimen común y ciudades con estatuto de autonomía*. Available at: https://www.boe.es/boe/dias/2009/12/19/pdfs/BOE-A-2009-20375.pdf (accessed 11 November 2018).

Table A-4: Summary of models calculated through Arellano-Bond GMM

Regional budget balance (GovBB)	(6)	(7)	(8)	(9)	(10)
Lagged regional budget balance (L.GovBB)	.43**	.43**	.42**	.41*	.36**
Lagged coordination between regions and central government (L.Coordination)	–.014**	–.007	–.008	–.008	–.03**
Lagged log of monetary transfers to regions (millions of euros) (L.Transfers)		–.13**	–.1*	-.1*	–.1**
Lagged political polarisation (L.Polarisation)			3.1**	3.1**	–2.6*
Political opposition (Opposition)				–.04	–.46*
Lagged log of regional economic growth (L.Growth)					.32**
Constant	–.17	2**	–.41	–.5	3.65**
Instruments	74	75	76	77	79
Observations	153	153	137	153	153

**p<0.05, * p<0.1

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