DEBATING THE FISCAL BALANCE OR TALKING AT CROSS-PURPOSES

Whether there is a best method for calculating the fiscal balance is not a technical debate. Quite simply there is no straight answer on this first question on what does best mean. Different methods seek to satisfy different goals and these goals typically reflect different motives. On one hand, from an individual point of view, the average taxpayer can feel hard done by at what he sees as an excessive fiscal residue resulting from the taxes he has to pay and the benefits he believes he receives in return. Here, an analysis of this fiscal residue can help clarify just who the tax burden falls on (not always the party that pays the tax, as the tax burden can be transferred to another economic agent) and just what the public service benefits are (often the taxpayer fails to appreciate the benefits he derives from externalities and other centralised services). Such an analysis is anything but a pedagogical exercise since it serves to dispel any fiscal delusions and makes clear the degree of redistribution implicit in the tax system. However, on the other hand, it is not only the taxpayer but also the territorial authorities that may question the legitimacy of fiscal unbalances. Here the question is what the spending capacity of the territory would be if instead of being financed through centralised tax transfers, it was to finance itself from its own resources. Note that in the first case – henceforth the benefit flow approach – the territories and the authorities do not enter into the equation: who does the spending is of no consequence and where the money is spent is similarly of little importance. Here the study centres on who the money is spent on and who ultimately benefits and bears the costs of funding (the inevitable loss of private resources due to taxation and the deadweight loss of the tax system affecting the economy). To this extent, such an exercise can be considered ignoring Part VIII of the Spanish Constitution – the Territorial Organisation of the State. If anything the analysis is more coherent (and, in fact, less complex) in a unitary State where distribution policies are not shared among jurisdictions, and it could be completed on individual income or functional lines, or even simply by age, sex or even surname!!.

The second question to be raised is far more political in nature: it has to do with the claim that the taxes/benefits paid/received by the citizens of a territory can be allocated to the institutions that represent those taxpayers and the authorities that defend that territorial sovereignty. The exercise is, as such, not neutral with respect to the legitimacy of the question: it is in the parliamentary seat that the representatives of the territory should assess the validity of the claim, which implicitly accepts that the internal redistribution is a matter for that parliament to decide, while the external or inter-jurisdictional redistribution is what is called into question. Territories that consider themselves to be unfairly treated by centralised tax/benefit transfers seek to restore the fiscal balance by having a greater say in these monetary flows. And it is precisely this greater say in the spending in a territory of all (or most of) the revenue generated within that territory that is appraised in the 'monetary flow' approach, concerned as it is with the impact of the budget on the territory, direct and additional economic side-effects, for the creation of income and wealth.

So, the 'tax-benefit incidence' and the 'monetary flow' approaches differ basically in the importance they attach to the territorial jurisdiction: in the case of the former, it is nothing more than a *cloak* behind which individual fiscal residues are summed, while in that of the latter, it is the basis for fiscal sovereignty. From the perspective of the first approach, the variance matters since tax progressivity shifts the total residue through the aggregation of individual residues; whereas from the perspective of the second, they are only means (with inequality being an internal affair). The tax-benefit incidence approach requires that many complicated hypotheses be formulated: thus, since the sixties it has been well known among tax scholars that incidence requires general equilibrium models (à la Harberger, at the very least), and so much the better if combined with the differential framework (where one tax or one expense substitutes another) and with that of the balanced budget (with its assumptions about the origins and applications of resources); applied then in autarkies or open economies, with either free or restricted movements of capital and labour (migration); in competitive, monopolistic or oligopolistic markets, be it from the supply side or the demand side of labour as well as capital. And all these hypotheses are formulated for a specific country at a given moment in time, with no universal validity, just an empirical validity depending on the respective elasticities of supply, demand, price, income and factor substitution effects for each specific set of circumstances. Yet most of these hypotheses are untested in the Spanish economy and so they are typically improvised in the studies undertaken. Thus, when De la Fuente (2014, *Manual sobre Cuentas Regionales Territorializadas*) admits that he allocates values in a rough and ready fashion in his computations for territorialized regional accounts or, when to avoid calculating the impact of corporate tax on the related business figures (as the monetary flow approach assumes and as occurs in the Basque Country under its economic agreement with the Spanish State), he improvises such surprising coefficients as the (arithmetic) mean (?) to be allocated either: (1) according to the gross operating surplus (GOS) at 100%, or (2) 30% (?) according to the (general) relative participation (considering all goods) of consumption (despite the informal economy, with no fiscal implications whatsoever) and 70% (?) according to the regional GOS (by summing the provincial figures); or even most surprisingly, (3) by third parts (?) of the GOS, household consumption and the relative wages in all sectors! Equally, assumptions regarding forward or backward transfers of social security contributions are more than questionable, as are the assumptions of VAT being shifted forward to prices or at backward to profits, in both instances without specifying the sector, the degree of exposure to competition or the price elasticity of demand. This contrasts with the allocation of VAT within monetary flow analyses, where it is treated proportionally to internal consumption, just as the Spanish National Institute of Statistics allocates it when dividing VAT among the territories in the financing of Spain's regions or its *Comunidades Autónomas* (henceforth, ACs).

In short, the tax/ benefit incidence approach is extremely ambitious, supposedly more scholarly, but quite overblown given the little we know of its actual impact when applied to the Spanish economy (indeed, one of the few published studies, focusing on just one tax – social security contributions – is the work of Melguizo and González Páramo, published in 2013 in the open-access journal *SERIEs* and in 2014 in VoxEU, which demonstrates the uncertainties and ambiguities by postulating a 50:50 division of the burden of social contributions between workers and employees). All in all, given its dependence on highly subjective suppositions, the approach may lack academic rigour.

In contrast, the monetary flow approach is more limited (as are its conclusions), but it remains closer to reality: expenditure is "territorialized", i.e., in the territories in which it has been allocated in the budget and where in accounting terms the expenditure occurs, in line with the capacity to decide where the services are to be delivered. Meanwhile, spending that is not allocated to the territories (above all the financing of the highly centralised services of defence, overseas services, prisons, work creation programmes and civil defence) is assigned according to the ratio between territorialized spending and total spending in each case (in keeping with the idea that centralised services support the decentralised services). In contrast, the benefit incidence approach would assign expenditure according to population, deeming irrelevant the effects of whether money is spent in one place or another under the assumption that these are 'public goods' that benefit everyone equally. Note the contradiction inherent in this last claim for those who argue against decentralising central state institutions for the provision of services, because to be coherent with those that accept the so-called territorialized regional accounts, who does the spending and where the money is spent should make no difference! Otherwise, the monetary flow approach would deal with R&D+i spending in a similar fashion, while the benefit incidence approach would improvise a 75% (?) share according to population and 25% (?) according to gross value added.

Against this backdrop, what question are we seeking to answer when we calculate the fiscal balance? In Catalonia, like it or not, since the Second Republic of the 1930s, is prone to be answered by the monetary flow approach: This is, what proportion of the tax resources raised within the territory are in fact returned to it or with another words what the State spends in the AC in providing its services plus what the State transfers to that AC to pay for decentralised services, in comparison withwhat would be the AC's spending capacity if it were able to collect these resources itself. Those that deny the very validity of the question base their claims (i) on a Constitution that provides for an indivisible and exclusive fiscal sovereignty in hands of central tax authorities, (ii) on the sociological argument that in fiscal terms "there are no Catalans, only Spaniards living in Catalonia", and (iii) on the notion that the ACs have no redistributive powers other than those which the State determines. However, in opposition to such arguments, stands the political reality of the claims of the Catalan Parliament and the fact that, even recognising that deficits are the result of personal redistributive fiscal flows, some authors (see López Casasnovas and Joan Rosselló in a recent paper in *Hacienda Pública Española*, 2014) have shown that this is simply not the case in Spain. Indeed, in terms of expenditure, empirically we do not observe a systematic pattern of regional flows that matches personal differences in income. ACs with similar income levels clearly receive discretionary levels of resources from the central government, contrary to what the supporters of the benefit incidence approach claim. When López-Casasnovas and Rosselló (op.cit) test this hypothesis to determine whether it has a purely random political bias or whether it derives from compensation for supply costs (that take into account the existence of scale economies, the additional costs associated with being an island, population density, etc.), their analysis does not allow any definite conclusions to be drawn either.

In summary, the debate concerning the best methodological approximation for calculating fiscal balances is a fallacy, since what those who would deny the validity of the monetary flow method are in fact denying – with their supposedly scholarly arguments – is the very question that this methodology seeks to answer when it calculates the fiscal balance, at least in our country. The subject has become tiresome, as the two sides do little more than talk at cross purposes. In this ongoing debate one of the parties does not want to hear what a fairly substantial sector in the Catalan parliamentary assembly (almost 80% of the MPs), is arguing for. The opposition, drawing on their supposedly scholarly arguments, initially concluded that it was impossible even to perform the calculation of those fiscal unbalances; later, they claimed that there were a surprising number of possible methods and forwarded a multiplicity of hypotheses, including that of the 'non-neutralization' of public deficits, all aimed at invalidating the calculations. Despite this, two methods were subsequently validated, with the full endorsement of a broad-based commission of experts from the Spanish Institute of Fiscal Studies. This brings us to the situation today, in which the validity of the very question is again denied, now without recourse to euphemism, but by replacing the question by the presentation of newly drawn up *territorialised regional accounts* bounded to create even more confusion.

Guillem Lopez i Casasnovas

Professor in Public Economics at Pompeu Fabra University in Spain. The author has served on a number of Fiscal Balance Commissions, including the commission convened by the Spanish Congress of Deputies (2005-2007) and, over the last ten years and under different governments of the *Generalitat* of Catalonia. In 1992, together with M Colldeforns and E Martinez, he pioneered the Catalan fiscal balances, commissioned by the *Institut d'Estudis Autonòmics*. In 1996, he and E Martinez were awarded the Sardà Dexeus prize for the best book in the field of Economics. He is the author of "Equity and efficiency aspects of the regional redistribution policies in Spain" (1995) published in *Economic Union and Federal Systems* (Eds. Mullins & Saunders, Federation Press, Melbourne, Australia) and on the subject of fiscal balances he has contributed to *The political economy of inter-regional fiscal flows* (Eds. Bosch, Espasa & Solé-Ollé, 2010, Edward Elgar Publishing Ltd, Cheltenham) and, more recently, with J Rosselló: *Fiscal Imbalances in Asymmetric Federal Regimes. The Case of Spain* (forthcoming, Hacienda Pública Española, IEF, 2014).