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THE DEBATE OF FISCAL BALANCES: TWO DIFFERENT QUESTIONS, TO DIFFERENT METHODS, TWO DIFFERENT RESULTS

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INTRODUCTION. THE CURRENT STATE OF AFFAIRS OF THE DEBATE IN SPAIN

Whether there is a *best* method for calculating the fiscal balance is not a technical debate. Quite simply there is no straight answer as to what *best* in this context might mean. Different methods seek to satisfy different goals and these goals typically reflect different motives. On the 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 imbalances. 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 ‘tax-benefit incidence’ 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 who 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 undertaken 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 along 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.

TWO METHODS

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 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.

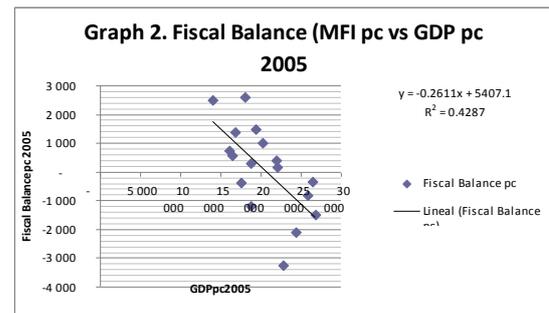
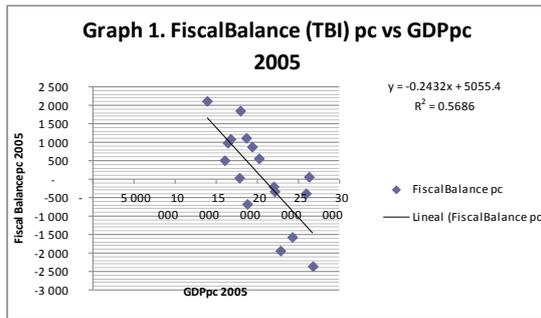
In contrast, the monetary flow approach is more limited (as are its conclusions), but it remains closer to reality: expenditure is “territorialized”, i.e., in the territories in which it has been allocated in the budget and where in accounting terms the expenditure occurs, in line with the capacity to 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 tax-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 spending in a similar fashion, while the tax-benefit incidence approach would improvise a 75% (?) share according to population and 25% (?) according to gross value added.

QUESTIONS AND RESULTS

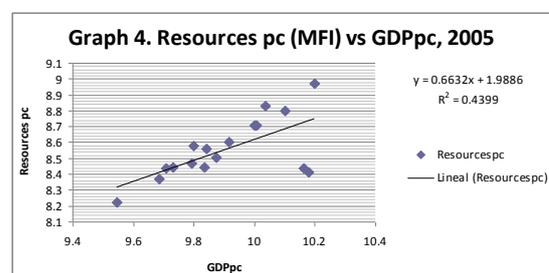
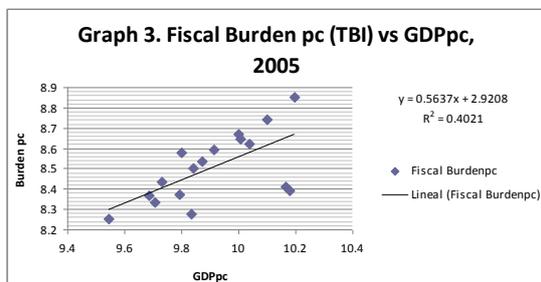
Against this backdrop, what question are we seeking to answer when we calculate the fiscal balance? In Catalonia, like it or not, since the Second Republic of the 1930s, the question prone to be answered by the monetary flow approach has been: What proportion of the tax resources raised within the territory is in fact returned to it? In other words, the approach compares what the State spends in the AC in providing its services plus what the State transfers to that AC to pay for decentralised services with what the AC's spending capacity would be 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 the 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, Spanish data show that this is simply not the case in Spain.

Cross-section data on fiscal balances corresponding to fiscal year 2005 (the only one available) suggest that there is a negative correlation between fiscal balances and per capita GDP, regardless of the methodology (see graphs 1 and 2).

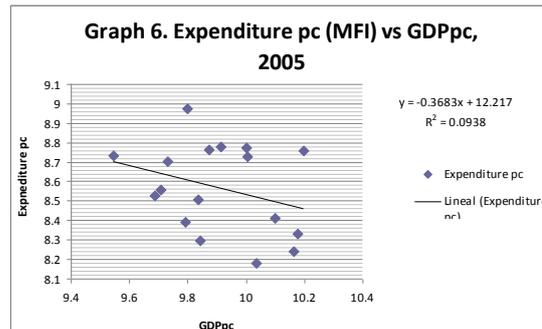
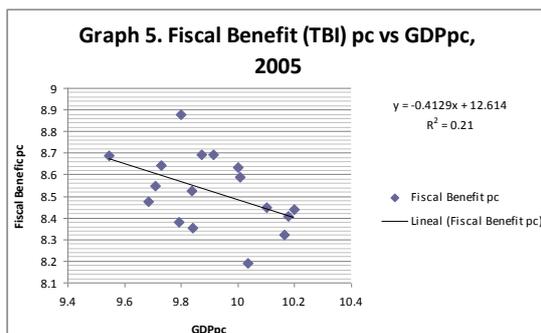


Nevertheless, this result deserves a deeper analysis because data indicates also that while some rich regions present negative fiscal imbalances, others record positive ones. This suggests that fiscal balances do not depend exclusively on the level of regional wealth.

López Casanovas and Rosselló in a recent paper in *Hacienda Pública Española* (2014) analyze the components of fiscal imbalances and their relationship with regional wealth. They find that fiscal revenues of ACs (regardless of the methodology) are correlated with GDPpc (see graphs 3 and 4, in which the data correspond to logarithms).



However, in terms of expenditure, (see graphs 5 and 6) they 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 tax-benefit incidence approach claim. When López-Casanovas 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 addition to these results, data available for 2005 indicates that the implemented methodology has an impact on the position of a region in the ranking of the group of regions with positive or negative fiscal balances, but it would not mean (with some exceptions) that one region would shift from one group to the other. Data in table 1 show that although both estimation procedures do indeed have a different impact on the size of fiscal flows and that the tax-benefit analysis significantly reduces the size of fiscal balances (imbalances), the group of regions of Madrid, Catalonia, Balearic Islands and Valencia present unbalanced fiscal flows regardless of the methodology while the group of Extremadura, Asturias, Canary Islands, Castilla-León, Castilla-la-Mancha, Cantabria, Andalusia and Galicia, always present positive fiscal balances.

Table 1 . Fiscal Balances, alternative methodologies. 2005					
Monetary Flow analysis Fiscal Balance pc (euros)			Cost-Benefi analysis Fiscal Balance pc (euros)		
	2005	Rank		2005	Rank
BALEARIC ISLANDS	- 3 246	1	MADRID	- 2 381	1
CATALONIA	- 2 117	2	BALEARIC ISLANDS	- 1 955	2
MADRID	- 1 494	3	CATALONIA	- 1 587	3
VALENCIA	- 1 188	4	VALENCIA	- 680	4
NAVARRRE	- 823	5	NAVARRA	- 392	5
BASQUE COUNTRY	- 357	7	LA RIOJA	- 330	6
MURCIA	- 374	6	ARAGON	- 209	7
LA RIOJA	145	10	MURCIA	27	10
CANARY ISLANDS	300	9	BASQUE COUNTRY	53	9
ARAGON	402	8	CANTABRIA	548	7
CASTILLA-LA MANCHA	582	7	ANDALUSIA	491	8
ANDALUSIA	730	6	CASTILLA-LEON	862	6
CANTABRIA	1 015	5	GALICIA	1 081	4
GALICIA	1 378	4	CASTILLA-LA MANCHA	981	5
CASTILLA-LEON	1 470	3	CANARY ISLANDS	1 118	3
ASTURIAS	2 582	1	ASTURIAS	1 839	2
EXTREMADURA	2 486	2	EXTREMADURA	2 098	1

Source: IEF (2008)

Therefore the debate on methodologies to calculate fiscal unbalances may be relevant on academic grounds, but differences arise on the intensity of the deficits, not on their signs. At the end of the day this is the debate in the political arena: whether this is actually compatible with the exercise of self-governance.

CONCLUDING REMARKS

In summary, the question ends being a talking at cross-purposes. 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 these fiscal imbalances; 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 with the presentation of newly drawn up *territorialised regional accounts* that are bound to create even more confusion.

(x) An earlier summarised version of this paper was published in Institut d'Economia de Barcelona, July 2014, by Guillem Lopez i Casasnovas, entitled *Debating the fiscal balance or talking at cross-purposes*.

Additional references are G.Lopez-Casasnovas "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), *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).

