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Fiscal Discipline in a Decentralised Administration: The Spanish Experience

by
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This article analyses the experience of the Spanish government in achieving financial equilibrium between 1998 and 2003 and the institutional mechanisms for maintaining budget stability. Spain has a high degree of fiscal decentralisation; thus compliance with the budget discipline requirements of the European Stability and Growth Pact is somewhat complex. To ensure that all levels of government contribute to fulfilling Spain's commitments under the SGP, budget stability legislation was passed in 2001. Main features are the prominent role of the central government in setting objectives and the responsibility of all levels of administration for those objectives. Though the public sector deficit has been significantly reduced in the period under study, some reforms to the legislation are currently being envisaged.

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1. Introduction

In recent years, the budgetary activity of the governments of the European Union has been driven by the commitment, contained in the Maastricht Treaty, to co-ordinate their economic policies so as to avoid excessive public deficit. Following the European Councils of Dublin in 1996 and Amsterdam in 1997, the Stability and Growth Pact (SGP) developed the terms of this commitment which is configured around three basic pillars: the broad guidelines of the economic policies, the multilateral surveillance of budget positions, and the excessive deficit procedure.

In the SGP, the Member States pledged to respect the medium-term objective consisting of achieving budgetary positions close to balance or in surplus and to correct excessive deficits as quickly as possible when they occur. The need to maintain deficit and public debt levels within certain pre-set values has given rise to budget regulation reforms in several countries in order to reinforce the control mechanisms that make it possible to maintain the stability of public finances and detect and correct imbalances as they occur.

Compliance with the budget discipline demands established in the SGP is particularly complex in countries like Spain with a high degree of fiscal decentralisation, where sub-central governments have broad autonomy to decide on budget policies. In these countries, fiscal discipline requires greater co-ordination efforts among the different government levels.

This article analyses the Spanish experience in achieving the financial equilibrium of public administrations between 1998 and 2003 and the institutional mechanisms implemented so that once that equilibrium was achieved, the balanced budget of all public administrations could be maintained with the levels foreseen in the SGP.[1] The term "public administrations" refers to all government entities within the Spanish public administration as a whole.

The first part of the study looks at the relative weight of the different levels of government, expressed in terms of the volume of expenditure managed at each level. It then analyses the process that led to the financial balance of the public sector, from the point of view of the contributions from the central and sub-central governments to this process and from the perspective of the budget income and expenditures items which have been adjusted. Finally, it looks at the tools developed in recent years to co-ordinate the budget policies of the different public administrations in order to preserve fiscal discipline. The article culminates with some conclusions about the economic context that enabled the discipline of the public administration’s accounts and an assessment of the legal initiatives undertaken to preserve the stability achieved.

2. Institutional distribution of public spending in Spain

In Spain there are two levels of sub-central government: autonomous communities and local administrations. Under the Constitution, they have the autonomy to manage their respective interests.

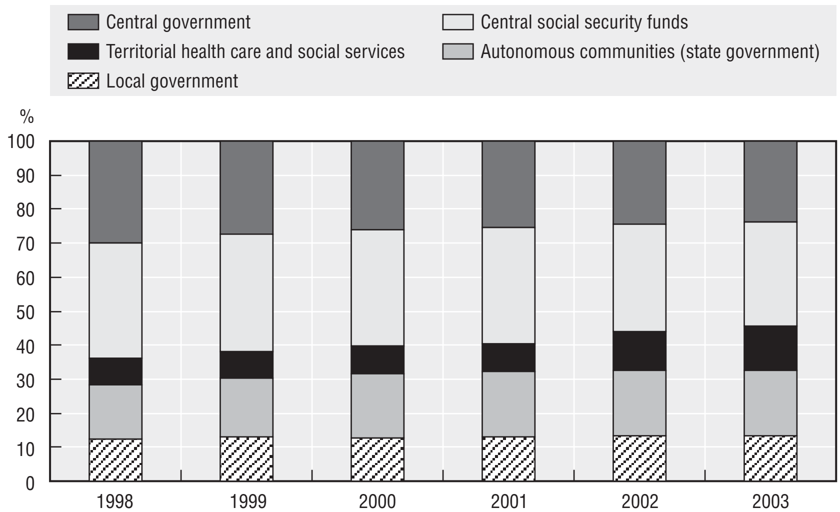
Autonomous communities are regional entities created under the 1978 Constitution. There are 17 autonomous communities and two autonomous cities whose functions, since their creation, have been broadened, assuming the responsibility for areas formerly falling under the jurisdiction of the central administration.

The economic and administrative weight of autonomous communities varies significantly from one to another, since not all of them have the same administrative competencies and the size of their populations is very diverse, from 290 000 inhabitants in La Rioja to 7 600 000 in Andalusia. In addition to this diversity, in some autonomous communities there are strong feelings of national identity among the population which have earned them some degree of constitutional recognition as “historical communities”. In practice, this translates into greater political clout.

The other level of territorial government is **local administration**, where the differences in the political, administrative and economic influence from one entity to the next are even more pronounced. In Spain there are more than 8 000 municipalities, but 85% of them have fewer than 5 000 inhabitants and account for only 14% of the population, while 40% of the population is concentrated in the 58 municipalities with more than 100 000 inhabitants. Within this group, only six municipalities have more than a half million inhabitants.[2]

To analyse the relative size of the different levels of government in Spain, we will use the participation of each one of them in the management of total public spending as a reference. This participation and its evolution between 1998 and 2000 is shown in Figure 1, which shows the percentage of public spending managed by each sub-sector making up the institutional sector of general government, as defined in the European system of national and regional accounts (ESA). Given that, for the purposes of our analysis, we are interested in the breakdown of spending among the different territorial levels, the spending by social security administrations, which in the ESA is treated as an institutional sub-sector, has been broken down into two different groups depending on whether it is managed by the central government or by the autonomous communities.

Figure 1. Institutional distribution of general government expenditure in Spain, 1998-2003



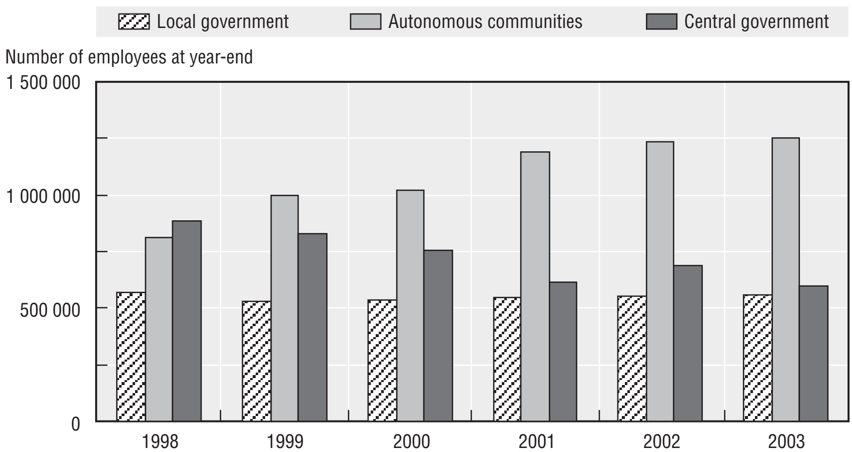
At first glance, without considering who handles the social security spending, we see that in 1998 the central government was responsible for 29.9% of public spending while in 2003 that participation had been reduced to 23.9%. During the same period, the participation of the autonomous communities rose from 16% to 19.4% and that of local government rose from 12.5% to 13.3%.

If we now take into account the level of government responsible for managing social security spending, we see that while decentralisation is less intense than in other components of public spending, in this area too spending capacity has been transferred from the central government to the territorial level. In particular, the process of decentralising the management of health care services was completed in 2002. Until that time, these services were still being managed by the central government for certain territories.

As a result of these processes, in five years the total expenditure managed by sub-central administrations, including health care and social services managed at the territorial level, has risen by almost ten percentage points (from 36% to 45.7%). This means that maintaining the budgetary stability of the public administration as a whole requires, with increasingly greater intensity, the right co-ordination mechanisms among all levels of government.

To complete our analysis of the relative size of the different levels of government, Figure 2 shows the change between 1998 and 2003 in the number of employees at each level at the end of each fiscal year. The employees of the social security system are included in the group to which they pertain – *i.e.* either central government or autonomous community.

Figure 2. General government employees, 1998-2003



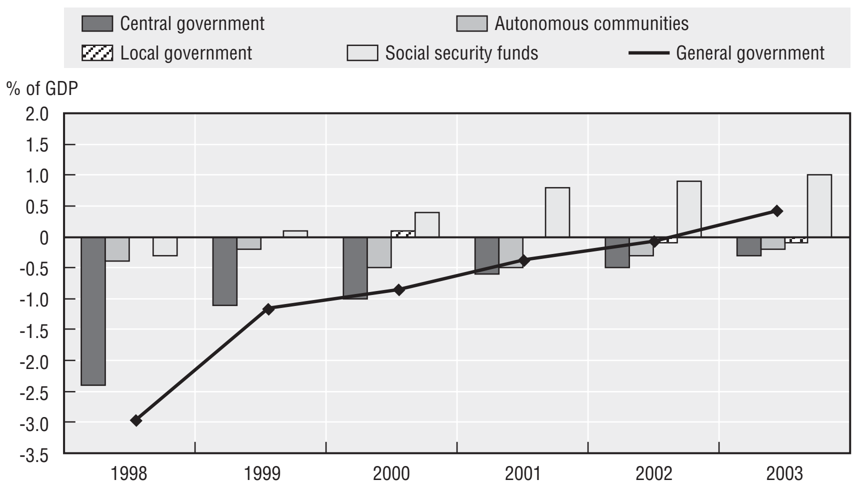
Source: Taken from the "Statistical bulletin on public administration employees" published every six months by the Ministry of Public Administrations.

While the level of decentralisation was close to 50% from the perspective of the volume of spending administered, from the perspective of the number of public employees, the decentralisation of the Spanish administration exceeds 75%, with autonomous communities being the sub-sector with the highest number of employees. These data are the result of a decentralisation process in which the sub-central governments have become specialised in the provision of services to citizens (in 2003, 45% of employees worked in education and 31% in health care) while the central government has retained control over capturing financial resources and reassigning them to social sectors and regions.

3. The contribution of different public administrations to the achievement of budget stability

Throughout the 1980s and the early 1990s, the Spanish economy suffered from serious imbalances which, in terms of public administrations' budgets, took the form of significant budget deficits that reached amounts in excess of 5% of GDP and which did not fall within the limits established in the Maastricht Treaty until 1998. The bulk of the responsibility for this situation lay with the central government which, as seen in Figure 3, was responsible for 80% of the overall public deficit in 1998. A peculiarity of the central government's deficit was the high financing cost at interest rates which remained above 10% until 1995, as seen in Figure 4, which reflects the changes in the interest rates on public debt issues of three and ten years between 1990 and 2003.

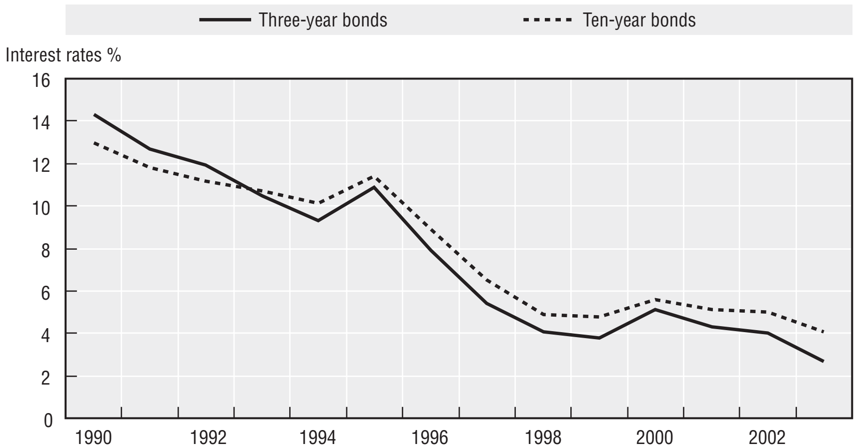
Figure 3. Institutional distribution of general government deficit or surplus in Spain, 1998-2003



This situation began to be adjusted in the mid-1990s and reached its apex starting in 1998 when the public deficit dropped below 3% of GDP. Figure 3 shows that in 2001 the books were closed with a slight deficit of less than 0.5% of GDP, a practically balanced budget in 2002 and a budget surplus of 0.4% of GDP for the first time in 2003.

The two sub-sectors that have contributed most to the achievement of this equilibrium are the central government, which reduced its deficit by 2.1% of GDP between 1998 and 2003, and the social security funds which went from a deficit of 0.3% of GDP in 1998 to a budget surplus of 1% in 2003. The autonomous communities sub-sector, whose joint deficit in 1998 was low, had cut it in half in 2003, but this reduction represented only 0.2% of GDP and was achieved erratically over the period. Finally, local government, whose overall budgets were balanced in 1998, has begun to show minor deficits of 0.1% of GDP in 2002 and 2003.

Figure 4. Interest rates on government debt in Spain, 1990-2003



Source: Prepared from the information published by the Banco de España (Central Bank of Spain) in the "complementary statistics" attached to the Financial Accounts of the Spanish Economy.

If we focus on which components of the public administration's revenues and expenditures have experienced an adjustment, Table 1 shows that the main contribution has come from increased fiscal pressure (up to 1.95% of GDP) and a reduction of interest payments (up to 1.8% of GDP).

Table 1. Components of fiscal consolidation in Spain, 1998-2003

Revenues and expenditures of general government as percentage of GDP	1998	2003	Contribution to fiscal consolidation
Fiscal pressure	33.71	35.66	+1.95
Other revenues	4.59	4.34	-0.25
Interest	4.30	2.50	+1.80
Social benefits	12.80	12.20	+0.60
Wages and salaries	10.70	10.30	+0.40
Other expenses	13.60	14.60	-1.0
Total			+3.5

With regard to increased fiscal pressure, Table 2 provides the details of the changes in these items. The main contributors to this increase were taxes on production and imports (0.71% of GDP) and the social contributions (0.68% of GDP) used to finance the social security system.

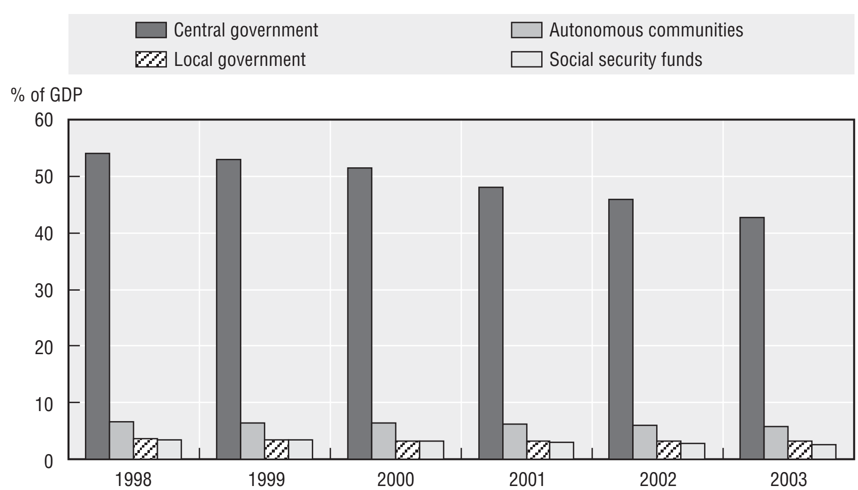
The first explanation for the reduction in interest payments can be found in lower interest rates which started to decline in 1996, as seen in Figure 4. The effects of lower interest rates on the financial burden supported by the budget are exacerbated as the composition of the debt in circulation begins to change when the debt issued years before is gradually replaced by the new debt issued at much lower interest rates.

Table 2. Details of increased fiscal pressure in Spain, 1998-2003

General government revenues as a percentage of GDP	1998	2003	Contribution to increased fiscal pressure
Current taxes on income and wealth	10.18	10.59	0.41
Taxes on production and imports	11.76	12.47	0.71
Capital taxes	0.37	0.42	0.05
Social security contributions	12.14	12.82	0.68
Adjustment for doubtful tax collection	-0.73	-0.63	0.10
Total			+1.95

Figure 5, which details the outstanding debt of public administrations by sub-sector and its evolution between 1998 and 2003, demonstrates that the principal beneficiary of the reduction of the interest burden should be the central government, as the one responsible for most of the debt. As the central government's deficit is reduced, the effect of lower interest rates is combined with the effect of the loss of the relative weight of the debt and interest charges with respect to GDP, as the latter increases at a higher rate than the outstanding debt.

Figure 5. Institutional distribution of the outstanding government debt in Spain (unconsolidated), 1998-2003



Besides interest, the other two components of expenditure upon which the adjustment rests are social benefits and the wages and salaries of public employees which, as indicated in Table 1, together are responsible for spending equivalent to 1% of GDP. On the other hand, the rest of the components of public spending, as a whole, have the opposite effect.

4. Mechanisms developed in Spain to maintain budget stability

Throughout the 1990s, Spain made certain reforms to the central government's budget procedure designed to reinforce the mechanisms for containing public expenditure, but it was not until 2001 that a first attempt was made to approach the problem of stability from a global perspective, considering it a question of balancing revenues and expenditure (not just a cost containment problem) and treating it as something which affects all public administrations, not just the central government.

In December 2001, budget stability legislation was passed, composed of two laws, one for the central and local government and another for autonomous communities. One of the main objectives was to determine "the procedures necessary for the effective application of the principle of budget stability in accordance with the principles of the Stability and Growth Pact".[3] Because of this connection to the SGP, the law directly incorporates some of the elements of the Pact, such as the objective of reaching nearly balanced or surplus budget situations, the formulation of budget forecasts with time horizons of several years, the reference to national accounting indicators measured according to the *Spanish National Accounts*, and the express obligation of correcting non-balanced budgets.

The law defines the budgetary stability of public administrations as "a situation of equilibrium or surplus, computed in terms of net lending in accordance with the definition contained in the European System of National and Regional Accounts, and under the conditions established for each Public Administration".[4]

The achievement of stability by the general government is organised around a process whose most significant elements are:

- The setting of budget stability objectives by the central government for the entire public sector and partial objectives for each one of the sub-sectors of the public administration (central government, social security, autonomous communities and local government): These objectives are set by the central government unilaterally, but the partial objectives of the autonomous communities and local governments must be shared with the bodies responsible for co-ordination between the central government and those entities. These bodies are the Fiscal and Financial Policy Council of the Autonomous Communities and the National Commission of Local Administrations. In the case of the autonomous communities, once the central government has set the stability objectives for the sub-sector, the Fiscal and Financial Policy Council of the Autonomous Communities has to determine the individual objectives for each community. The law states that if an agreement is not reached in this regard within one month, all communities will have to prepare and settle their budgets in a situation of budget equilibrium, at least.[5] The law does not establish guidelines for setting the partial stability objectives of the different sub-sectors or for assigning individual objectives to the entities in each sub-sector, which has given rise to tedious debates among different communities or between the communities and the central government regarding how those partial objectives should be set.

- Verification of compliance with stability objectives by an agency of the central government: This is the mission of the General State Comptroller Office, which is the entity responsible for public accounting. To facilitate this task, all public administrations are obliged to provide the information requested of them for this purpose.
- The financial responsibility of the public administrations that contribute to a breach of the commitments assumed by Spain in connection with the SGP: The law holds that those administrations that provoke or contribute to the non-fulfillment of the financial commitments assumed by Spain under the Stability and Growth Pact shall assume the proportional part of the responsibilities derived from such non-fulfillment. It does not establish the procedures for actually doing so. Rather, it merely guarantees the right of the affected entity to be heard in any proceedings initiated against it in this regard.
- The obligation to correct situations of disequilibrium: This obligation requires that the public administration(s) with the imbalanced budget prepare a financial-economic plan to enable them to straighten out their finances in future fiscal years. The plan itself and the implementation of the plan are supervised by the Ministry of the Economy and Finance in the case of local entities, or by the Fiscal and Financial Policy Council of the Autonomous Communities in the case of autonomous communities.

The budget stability law has been in force for too brief a time to make a general assessment of its results, since the law took effect in 2002 for the

2003 budgets, but it is possible to offer some preliminary evaluation based on the experience thus far. The most conflictual aspect so far has been the setting of stability objectives by the central government. Some autonomous communities considered that this authority on the part of the central government encroached upon their financial autonomy and filed an appeal with the Constitutional Court, in addition to expressing their opposition to its application to the Fiscal and Financial Policy Council of the Autonomous Communities.

Table 3 shows the objectives assigned to each sub-sector of the general government during the years since the law took effect. The initial approach consisted of maintaining the budgetary equilibrium of autonomous and local entities and offsetting the central government's deficit with the social security administration’s surplus. This approach was harshly criticised by some communities, which then demanded the opportunity to present their budgets with deficits as well. As a result of this opposition, the resolutions of the Fiscal and Financial Policy Council of the Autonomous Communities regarding the stability objectives proposed by the central government have always been approved with the dissenting vote of a significant number of communities.[6] Behind the complaints by some autonomous communities lies their disagreement with the lack of transparency in setting the stability objectives and the absence of guidelines for establishing the specific objectives of each administration.[7]

Table 3. Stability objectives set by the central government for the public sector as a whole, 2003-2006[1]

Budget balance as percentage of GDP	2003	2004	2005	2006
Central government	-0.5	-0.4	-0.5	-0.4
Social security funds	0.5	0.4	0.7	0.7
Autonomous communities	0.0	0.0	-0.1	-0.1
Local government	0.0	0.0	0.0	0.0
General government	0.0	0.0	0.1	0.2

1. For each year, the objective set the year before is shown. The resolutions of the central government always set stability objectives for the next three years. When preparing this table, we considered the objectives for each year contained in the resolution passed by the government in the previous year.

With regard to the verification of stability objectives by an agency of the central government, since this mission was assigned to an agency with a good reputation as far as its professional solvency and independence is concerned, the provision of information by local government and autonomous communities has not been a problem. In fact, a resolution of the Fiscal and Financial Policy Council of the Autonomous Communities regulating aspects relative to the provision of information was passed with no votes against.

The only complaints with the provision of information are related to the ignorance of the methodology that was being used to verify compliance with stability objectives. In response to this problem, the central government has promised to draft and distribute a manual on deficit calculation under national accounting standards adapted to local governments and autonomous communities.[8]

During the time since the budget stability law was enacted, there has been no non-compliance with the commitments assumed by Spain in relation to the SGP and therefore it has not been necessary to apply the provisions of this law relative to the responsibility assumed by the administrations that contribute to such non-fulfillment. It has, however, been necessary to apply corrective measures to situations of disequilibrium. In November 2004, the Fiscal and Financial Policy Council of the Autonomous Communities unanimously approved the compensation plans presented by three communities that had either settled their budgets for the previous year breaching the assigned objective, or approved budgets for the next year with a deficit forecast. The approval of these compensation plans implies the acceptance of a certain level of deficit for two of the communities affected, which has led the central government to rethink the initial deficit objectives and allow for the possibility that in 2005 and 2006 the autonomous communities could have deficits of 1% of GDP.

5. Proposed reforms of the budget stability law

Bearing in mind the staunch opposition from some autonomous communities to certain aspects of the budget stability laws, in mid 2005 the central government presented to Parliament its proposed reforms of these two laws. The purpose is to implement a new mechanism for interaction between the different levels of government which was more respectful of the financial autonomy of the autonomous communities and to establish a more flexible and transparent process for determining stability objectives and verifying compliance.

One of the most significant aspects of the reform is the new definition of budget stability, which could be compatible with deficit situations provided that financial equilibrium between revenues and expenditures is achieved during an economic cycle. Thus, the requirement that financial equilibrium be achieved annually, which could have procyclical effects during times of reduced economic activity, is abandoned and the adaptation of budget policy to the evolution of economic cycles is fostered.

In keeping with this new concept of stability, the reform project establishes criteria for determining stability objectives based on the economic progress forecasts, linking deficit, equilibrium or surplus positions to the expected evolution of GDP for the fiscal year in question. The reform also establishes criteria for setting the partial objectives of the different sub-sectors and encourages the participation of the autonomous communities in this process by introducing a bilateral consultation phase between the autonomous communities and the central government and reinforcing the role of both the Fiscal and Financial Policy Council of the Autonomous Communities and the National Commission of Local Administrations.

The search for greater transparency is another of the reform's objectives: all public administrations must include, both in their initial budgets and in their budget settlements, sufficient and adequate information for verifying the stability principle and the specific objectives assigned to them in application of that principle. The reform projects of the stability laws were presented to Parliament in August 2005 and are currently in the Chamber of Deputies.

6. Conclusions

Since the mid-1990s, Spanish public administrations have been correcting the budget deficits which had persistently occurred for years before. Despite the fact that the public administration in Spain is heavily decentralised, to the extent that in 2003 the sub-central administrations were responsible for nearly 50% of public spending and more than 75% of public employees, the deficit problem affected the central administration primarily, since the situation of the autonomous communities and local government was one of a nearly balanced budget.

Thanks to the process of correcting budget imbalances in the public sector, the deficit of the central administration has been reduced sharply from 2.4% of GDP in 1998 to just 0.3% in 2003, and there has been a change of direction in the budget balance of the social security funds which went from a deficit of 0.3% to a surplus of 1% of GDP in the same period.

The two factors that best explain these changes in the public sector's budgets are the economic growth of recent years and lower interest rates which are consolidated with Spain's access to the third phase of the Economic and Monetary Union. On the one hand, strong economic growth and reduced unemployment have permitted a notable increase in the taxes and social contributions paid, giving rise to an increase in fiscal pressure equivalent to 1.95% of GDP. On the other hand, the effect of reduced interest rates on the financial burden of the central administration has made it possible to reduce the part of GDP allocated to the payment of interest, which in the period under study dropped from 4.3% to 2.5%. The other items, on the spending side, which have contributed to the change include the social benefits and the wages and salaries paid to public employees, the containment of which has made it possible to increase the resources allocated to other components of public spending.

In 2001, in a context in which the financial situation of the public administration as a whole was one of equilibrium, budget stability legislation was enacted to ensure that all public administrations contribute to the fulfillment of the commitments assumed by Spain under the Stability and Growth Pact. To do so, the new legislation develops co-ordination procedures between levels of government in order to determine the budget stability objectives and to control compliance, while at the same time establishing the mechanisms for detecting and correcting possible deviations. The most salient features of the new legislation are:

- The prominent role of the central government which has the authority to set the stability objectives for the entire public sector and the partial objectives for each sub-sector and to verify their compliance with those objectives.

- The responsibility of public administrations for the results of their budget actions, which takes the form of the obligation to establish compensation plans to correct budget imbalances and to assume, on a proportional basis, their responsibility for Spain's non-fulfillment of the commitments assumed under the Stability and Growth Pact.

From the limited information available at this time, it can be said that the prominent role of the central government in setting stability objectives is, for the moment, the most debated aspect of the budget stability law, with greater transparency and participation in the establishment of those objectives being requested by some autonomous communities. On the other hand, the verification of compliance with the objectives by an agency of the central government has not caused any controversy other than the request, which is in the process of being resolved, to make public the methodology used to determine the budgetary balance of the different administrations.

Regarding the responsibility of all administrations for the non-fulfillment of their individual stability objectives, this has not been a source of conflict, although it is important to note that the budget stability law has thus far been applied in a context of strong economic growth and financial sufficiency of public administrations, in which the few autonomous communities that have incurred budget imbalances have not had any problems drafting the pertinent compensation plans.

Finally, bearing in mind that some aspects of the stability law had been questioned by various autonomous communities, Parliament is in the process of passing a reform of the stability law in order to make it more flexible and transparent and to foster the participation of sub-central governments in setting the pertinent stability objectives.

Notes

1. This work originated from a paper presented at the "Symposium on accountability and control of decentralised and delegated public spending" organised by the OECD in Madrid in June 2005. The format of the presentation was based on data in graphic format and outlines. The sources for most of the graphs are the annual publications of the Intervención General de la Administración del Estado (General State Comptroller) on the economic and financial activities of public administrations. The references to GDP are taken from the *Spanish National Accounts, Base 1995*, prepared by the Instituto Nacional de Estadística (National Statistics Institute). In those cases where other sources are used, this is indicated in a specific note.

2. The data on population and number of inhabitants refer to 1 January 2004 and are taken from the *Statistical Yearbook of Spain 2005* published by the National Statistics Institute.

3. Article 1 of the General Act on Budgetary Stability.

4. Article 3.2 of the General Act on Budgetary Stability.

5. Article 6.4 of the complementary Organic Act to the General Act on Budgetary Stability.

6. In 2002, six autonomous communities opposed the proposal of the central government and cast a special vote. In 2003, seven autonomous communities voted against the proposal, and in 2004 the proposal was opposed by five autonomous communities and the two autonomous cities.

7. The special vote presented in 2002 by the Autonomous Community of Castilla-La Mancha, which was joined by five other communities, proposes the establishment of criteria for the assignment of the stability objectives of the different autonomous communities based on the outstanding debt of their respective administrations, their deficit reduction and indebtedness history, the investment needs derived from the assumption of new responsibilities, and the level of economic development and existing infrastructures.

8. Resolution of the Government's Delegate Commission for Economic Affairs on improvements to the transparency of the economic and statistical information provided by the government.

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