

# **Inter-governmental transfers to local governments in Spain: an assessment of their virtues and perils\***

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## **1.- Introduction**

In most countries, local governments are important players in the provision of public services that have a strong impact on community's quality of life. They use to be responsible for refuse collection and recycling, water delivery and sewerage, street lighting and maintenance, public transportation, capital improvement construction, police, planning and land use regulations, and recreational and cultural facilities and programs. In some places, they are also involved in the provision of education, health and social services. Many scholars and international organizations currently advocate the benefits of the provision of these services by sub-national governments (see, e.g., the contributions in Brosio *et al.*, 2009). Particularly, local governments are said to be more accountable and more responsive to local demands and needs (e.g., Seabright, 1995; Faguet, 2004). However, there is less agreement as to how these local services should be funded. Traditional advice from 'fiscal federalism' scholars (see, e.g., Oates, 1972) recommends relying primarily on property taxes and user charges, but the U.S. experience with the imposition of property tax limitations has demonstrated the problems associated with this approach (e.g., Downes *et al.*, 1998; Bradbury, 2001). And yet, other major taxes (e.g., income taxes) are often inappropriate given either the size of local governments or its inability to cope with cyclical fluctuations in revenue (as the recent California crisis demonstrates). The solution in the end is either the decentralization of minor and inefficient taxes or grant financing. In these circumstances, general (non-earmarked) intergovernmental transfers serve to attenuate the inefficiencies of local tax systems and (may) help smooth spending and tax policy (Sala-i-Martin and Sachs, 1992, von Hagen and Eichengreen, 1996). Besides this stabilization function, general grants are often used to equalize differences in fiscal capacity and/or spending needs, ensuring residents in different localities enjoy similar levels of public services (Le Grand, 1976).

Yet these prescriptions are based on the implicit premise that the functional domains of different layers of government are clearly delineated. This need not be the case in practice, for several reasons. First, sometimes constitutions and laws are ambiguous regarding which layer of government has some concrete responsibilities. Second, different layers of government might be assigned responsibilities regarding different aspects of a policy (e.g., upper layers legislating and lower layers executing the policy). Third, the complexities of many social problems cause policies of different layers to be inter-dependent. Fourth, in some policy domains, layers of government differ in knowledge, expertise and administrative capacity. So, in cases where policies of different layers are really intertwined, effective solution to social

problems require inter-governmental co-operation. (Earmarked) grants are a crucial ingredient of such co-operation policies. Under this view, earmarked grants are not an imposition of upper layers but the result of an agreement between layers in order to best solve social problems<sup>1</sup>. Of course, in the real world earmarked grants are used also as a control device, probably reflecting lack of confidence by the citizenship on the above mentioned virtues of decentralization. In fact, some authors have recently warned about the effects over service quality of local government corruption (see, e.g., Shah, 2006).

However, recent studies also emphasize the perils of grant financing. First, grants can create a moral-hazard problem, with local governments, aware that intergovernmental grants insure against budget shocks, pursuing overly risky policies (Persson and Tabellini, 1997). This problem is often associated to (earmarked) discretionary grants (e.g., disaster relief, see Wildasin, 2009) but some authors also claim is present in the case of (general) equalization transfers (see, e.g., Buettner, 2009). Second, grants might soften the local budget constraint (e.g., Wildasin, 1997; Rodden, 2000; Inman, 2001), creating incentives to run up excessive local deficits expected to be covered by future grants. Also here, examples refer to discretionary grants but also to equalization (Rodden, 2000). Third, grant financing may diffuse accountability (Rodden, 2000; Joanis, 2009) and foster rent-seeking and clientelism (Weingast, 2009; Weingast *et al.*, 2007), thus eroding the very benefits gained from spending decentralization. Funding with general grants reduces the price of local services and so the efforts of citizens in controlling local governments (Peralta, 2005). At the same time, local politicians argue that bad quality of services is the fault of upper layers not providing an adequate amount of funds. Funding with earmarked transfers seems even more problematic, since these grants restrict the spending autonomy of local governments, facilitating blame-shifting to upper-layers (Devarajan *et al.*, 2009). Also, depending on its concrete design, these transfers could be more prone to manipulation and therefore more affected by clientelism (Solé-Ollé and Sorribas, 2008).

With its virtues and perils, any final evaluation of grant financing has to be country specific, with the system depending on the particular details of the whole local government financing system (see, e.g., Rodden *et al.*, 2003). This being the case, in this paper we will perform a preliminary evaluation for the Spanish case, focusing on the local government layer. The paper is organized as follows. In section 2 we provide a brief description of the organization of local governments in Spain, describing both responsibilities and funding system. In

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<sup>1</sup> See Brousseau and Marciano (2007), for an methodological analysis of intergovernmental contracting.

section 3, we concentrate on the transfer system, describing the main general and earmarked grants received by Spanish municipalities (which are the main local government). In section 4 we assess the performance of Spanish grants according to the following aspects: (i) Equalization power, (ii) Role in Fiscal adjustment, (iii) Effects on Inter-governmental co-operation, and (iv) Use for Rent-seeking and Clientelist purposes.

## **2.- Spanish local governments: a brief introduction**

### **2.1.- Organization of Spanish Local Governments**

*How big they are?* Spanish Local Governments are of a modest size. By 2006, they represented just 18.4% of Total Spending (Current+Capital) by Spanish Public Administration, pensions aside. This number is just 13.1% if one restricts attention to Municipalities, the main player of this layer of government. This share is very similar to the one of European federal countries like Germany or Austria (Bosch and Espasa, 2006), but is lower than in federal countries where education is a local function (e.g., US, Switzerland and Canada) or than in unitary countries, which do not have regional governments (e.g., France, UK, and the Scandinavian countries). This share has remained relatively stable during all the democratic period, with some modest growth since mid 90's. Figure 1 plots this variable for the years 1992-2006, a period that follows the main local financial law (see section 2.3. below). The local spending increased from a 15.8% in 1992 to the aforementioned 18.4% in 2006. However, this contrast with the sharp increase in the spending share by regional governments (the so-called Autonomous Communities, AC's from now on) whose share grew from 21.1% to 30.9%, as a result of the Transfer of Education and Health to some of the AC's that still did not have them<sup>2</sup>. The figure also plots (left axis) the ratio of Local to Local + Regional spending which, as a result of these developments, has decreased from 42.9% to 37.3%. Figure 2 plots the local share of Capital spending; note here that Local Governments are main players in this respect, with a share which in 2006 amounted to 27% of public capital spending and 77% of capital spending made by sub-central governments. During the period 1992-2006, the share in total capital spending has increased both for Local Governments and for AC's, although the share of AC's in sub-central capital spending has also increased a bit since the last round of responsibility transfers.

(Figures 1 and 2 about here)

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<sup>2</sup> Following a Constitutional provision, some AC's accessed these important spending responsibilities early in the 80's, while others had to wait to a 1992 pact between the two main political parties which allowed for its extension to the remaining ones (see Solé-Ollé, 2007).

The explanation for the (relatively) small size of Spanish Local Governments rests on the reduced list responsibilities by Spanish Local Governments, which are limited to the traditional functions performed elsewhere by this layer but not to other services consuming more resources, as education, health or social services, which in Spain are in the hands of regional government (see Solé-Ollé, 2007). Keeping this in mind, the evolution and performance of Spanish Local Governments during this period has been quite positive. In some sense, what has happened is that the Spanish central-to-regional decentralization process has been so intense during the 1980's and 1990's which has obscured what happened in the local sector. Actually, when the regional decentralization process is probably arriving to an end, voices are that demand a second wave of decentralization towards local governments.

*Who are they?* In addition to the 17 AC's, the Spanish Constitution recognizes two different types of Local Governments: Municipalities (*Ayuntamientos*) and Upper-Municipal Governments (*Diputaciones, Cabildos* and *Consells*). Municipalities (*Ayuntamientos*) are huge in number (see Table 1) and are the main local player, concentrating most responsibilities and spending (see Table 2). There are 40 *Diputaciones* with a jurisdiction over a *Provincia*, which is also the district used for central legislative elections. There are 50 *Provincias* in Spain, but in 10 of them the jurisdiction corresponds exactly with that of one AC, so the *Diputación* has been amalgamated with the government of the AC. The main responsibility of *Diputaciones* is to provide assistance to Municipalities, a task also performed by AC's (exclusively where there are no *Diputaciones* and concurrently where there are). This is also a responsibility of *Cabildos* (in the Canary Islands) and *Consells* (in the *Balearic Islands*), which are the parallel to *Diputaciones* in island AC's. There are 10 of these governments, one for each island, which also perform other tasks delegated by the corresponding AC. Table 3 illustrates the different nature of Municipalities and the other Local Governments; note that *Diputaciones* (and to lesser extent *Cabildos* and *Consells*) are 'transfer-giving' governments, the share of transfers in spending raising to 30-40% (depending on the concrete government and spending type), quite high compared to the 10% of Municipalities<sup>3</sup>.

(Tables 1, 2 and 3 about here)

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<sup>3</sup> Another relevant difference between Municipalities and the other Local Governments rests on the method of election of governing bodies. Representatives at the Municipal Council are directly elected, with elections held simultaneously in all the country every four years; elected representatives vote then for the Major, which chooses the executive among the representatives. The representatives to the governing bodies of Provinces and Islands are chosen indirectly, using the results of the Municipal elections belonging to the jurisdiction of this upper layer of government.

In addition to these three ‘constitutional’ local governments, the basic law which regulates the organization of Local Governments (*Ley Reguladora de Bases de Regimen Local*, 1985) allows AC’s and Municipalities to create other Local Governments (see Table 1). Counties (*Comarcas*) are Upper-Municipal Governments created in a few AC’s which perform tasks delegated by the AC. Metropolitan entities are in theory possible but they have not been developed in practice, due to the hostility of AC’s . Local governments can engage in co-operative agreements, creating an Upper-Municipal body (the so-called *Mancomunidad*) in order to provide specific services. There are plenty of them, but some of them are not operative. Finally, Local governments are able to de-concentrate responsibilities to Lower-local entities, which are high in number but irrelevant in practice.

*Municipal size.* Municipalities concentrate most of the responsibilities and spending of Spanish Local Governments, and given its election method, have a higher political legitimacy. However, most of them are too small to be able to provide public services in an effective and efficient manner. As Table 4 shows, nearly 85% of Spanish municipalities have less than 5,000 inhabitants, and 95% have less than 20,000 inhabitants, proportions which are similar to the ones in Germany and are only lower than in France or Austria, amongst EU countries.

(Table 4 about here)

As a result of this, the smallest municipalities have difficulties in keeping the local administration running, and the vast majority of them could not manage effectively some of the responsibilities which could be candidates to be decentralized from the AC (e.g., education). Moreover, local fragmentation appears also in urban areas, making municipal jurisdictions very economically un-functional. In these places, high labor and residential mobility generates all sorts of inter-jurisdictional spillovers from local policies (Solé-Ollé, 2006). Both types of problems (diseconomies of scale and spillovers) could be addressed by amalgamating municipalities, but in Spain this is simply anathema. It is true, however, that the small size of Spanish municipalities allows local interests to be represented effectively.

*Municipal regulation.* Contrary to what happen in federal countries, Spanish municipalities are not the ‘creatures’ of the AC’s. According the Constitution, the most relevant competences regarding organization, responsibilities and funding of municipalities (and other local governments) belong to the Spanish central government. In practice, AC’s are only able to regulate minor aspects as, e.g., municipal amalgamations, metropolitan and county governments, and financial control. This does not seem very convenient, since (as we will see below)

local responsibilities use to conflict with the AC's ones. The main opportunities for delegation of new responsibilities to the municipalities (or for any other form of intergovernmental cooperation) involve these two layers of government. Despite of this, in the event an AC would initiate a major decentralization project (e.g., education), she would be severely constrained in the type of funding mechanisms she could design (i.e., local taxes and general equalization grants are regulated by the central government), being forced to focus on earmarked grants. Also, with more than 8,000 thousand municipalities, the central government finds difficult to adequate the organizational design to the peculiarities of different types of municipalities. The reason for this situation is municipal fear to regional intromission; municipal political elites seem to prefer to manage a very autonomous (but with few responsibilities and poorly funded) government than a bigger and more efficient organization subject to the supervision of the AC.

## 2.2.- Responsibilities and revenues of Spanish municipalities

*Municipal responsibilities.* The basic law which regulates the organization of Local Governments in Spain (*Ley Reguladora de Bases de Régimen Local*, 1985) differentiates among two different kinds of municipal responsibilities. On the one hand, there are the so-called 'Compulsory responsibilities' (art. 26), which the municipality is obliged to provide to its residents and which grow in number with population size, as illustrated in Table 5 below. Note that these are very traditional responsibilities assumed by local governments elsewhere.

(Table 5 about here)

Second, the so-called 'Own responsibilities', which are areas in which the municipality is allowed to intervene inasmuch the AC has not passed a specific law limiting local action. So, these are cases of concurrent responsibilities. In some cases (e.g., local police, kindergartens, elderly care, recycling) municipalities have been providing the service quite autonomously till the AC has passed a law. In others, it is difficult to constraint local action with a regional law, so in practice both layers are performing the task (e.g., culture and sports). Lack of clarity blurs accountability, the two layers of government (i.e., municipality and AC) engaging in a permanent blame-shifting game. Municipalities use to argue that proximity to citizens forces them to provide services which are the competence of AC's, who do not provide any funding to cope with these burdens. However, having a low level of resources, municipalities use to make interventions of high quality but low coverage. Then they claim that they do a good job, but that the service can not be extended to all the needed population

because the AC does not provide the funds. So, in Spain, conflicts over responsibilities translate to conflicts over funding. Studies commissioned by the Spanish Federation of Municipalities (FEMP) estimated that spending in this type of responsibilities to amount to around 30% of all non-financial spending (see Vilalta, 2007). This number is actually used by the FEMP to lobby the central government for more general funds. Although the claim is legitimate, the number is probably over-estimated, since not all this spending is due to unfunded mandates, a great share being caused by spending in areas which are not the exclusive competence of the AC and where the AC has decided not to intervene yet. In addition to this, the solution is not to provide more central funds to the municipalities, but to reach a co-operative arrangement between the AC and the municipalities regarding the best way to provide and fund each service. Earmarked grants and inter-governmental contracts could play an important role here.

*Municipal revenues.* Spanish municipalities obtain a substantial share of revenues from own sources (nearly 3/5 of non-financial revenues, see Table 6) but transfers also play an important role (2/5 of non-financial revenues). In addition to this, approximately 3/5 of own revenues come from local taxes, 1/5 from user charges and prices and 1/5 from revenues generated by local assets. The main local tax is the Property tax, which generates approximately 1/2 of local tax revenues. This is a tax paid on the assessed value of land plots and structures owned both by residents and business; assessment is performed by an agency of the central government, but the proportional tax rate is chosen by the municipal council. The other taxes are the Vehicle tax (*Impuesto sobre Vehículos de Tracción Mecánica*, IVTM), the Construction tax (*Impuesto sobre Construcciones, Instalaciones y Obras*, ICIO), the local Business tax (*Impuesto sobre Actividades Económicas*, IAE) and the Land transactions tax (*Impuesto sobre Incremento del Valor de los Terrenos de Naturaleza Urbana*, IIVTNU); the first two of these taxes generate approximately 15% of tax revenues each, and the last two, 10% each<sup>4</sup>.

(Table 6 about here)

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<sup>4</sup> The Vehicle tax is a tax paid by residents owning a vehicle and the tax base depends on a combination of potency and age. The Construction tax is paid both by the owners of a construction being undertaken at that time in the jurisdiction of the municipality and they are charged a proportional tax on the project's budget. The Business tax is a presumption tax charged on all firms (individual or societies) doing business in the municipality; the tax rate is proportional and the tax base is estimated from objective parameters (surface, electricity power, number of workers, and sector of activity). The Land transactions tax is paid by the seller of a land plot (empty or build-up); the tax rate is proportional and the tax base is estimated based on the assessed value of the property and the number of years since buying.



A few comments are in order. First, in all these taxes the local council can choose the tax rate, but subject to minimum and maximum tax rates set by the central legislation. Both tax freedom and these limits were established by the main law regulating municipal finances (*Ley Reguladora de las Haciendas Locales*, approved 1988 but applied 1990). That law fixed the same minimum tax rates for all the municipalities, but allowed the maximum tax rates to grow with population size, with the argument that bigger municipalities have more compulsory responsibilities. A late reform of this law in 2002 set the maximum tax rate to be equal for all the municipalities. Second, during the years following this law, Spanish municipalities have been quite active in using tax autonomy, accepting the political cost which these decisions entail (see Solé-Ollé, 2003). Third, the main tax change occurred during this period was the reform of the Business tax in 2000, which abolished the tax for all the individual firms and for societies with sales lower than one million euro. This reform reduced the number of tax returns by 90% and business tax revenues by 50%. Fourth, all these taxes are very rudimentary, its calculation being based on very rough parameters. They are often accused of being unfair and are not very popular. In the case of the Property tax, the main problem is related to the political costs of performing value reassessments; because of this difficulty, reassessments are delayed many years and this worsens the fairness of the tax, making more difficult its use. Fifth, some of these taxes are quite volatile, providing considerable extra revenues during booms, but few funds during recessions. This is the case of the two taxes tied to the building industry, namely the Construction tax and the Land transactions tax. Moreover, most of the Asset revenues are also related to the building industry<sup>5</sup>.

## **2.- Transfers to local governments in Spain: basic facts**

### **2.1. Some recent trends**

*How important are they?* In 2006, Total transfers to Local Governments represented a 32% of non-financial revenues and this number was even higher for Municipalities (37.3%). In the case of Current transfers, the numbers are similar: 29.0% and 34.2, for all Local Governments

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<sup>5</sup> In particular, Spanish municipalities obtained in 2006 nearly 3,000 million euro by selling part of the land plots that the developers are obliged to cede to the local council. They also obtained nearly 1,300 million euro from Charges to developers. This added to the 4,000 million of the two above mentioned taxes, makes a total of 8,394 millions of euro, which is a 20% of own revenues and 33% of tax revenues, even exceeding the revenues provided by the Property tax (7.394 million). These volatile revenues are justified as needed to fund the investment costs associated to urban expansion; in fact, in 2006 these revenues were able to fund a 70% of all local capital spending. With these revenues actually vanishing due to the real state crisis, municipal capital spending will drop abruptly. Some municipalities which channeled part of these resources to the current budget could face even stronger difficulties.

and Municipalities, respectively. We can retain the idea that grants represent approximately 1/3 of local revenues. This number is amongst the lowest of the EU, is similar to that of Denmark, France or Germany, and only Sweden, Austria or Finland have a grant share substantially lower (Bosch and Espasa, 2006). Capital spending is funded in a similar proportion by Capital transfers: 29.3 and 33.1% in the case of Local Governments and Municipalities.

(Figure 3 about here)

Figure 3 illustrates the evolution of the share of Total transfers in Non-financial revenues for the period 1985-2006 for the aggregate of Local Governments. This share has been relatively stable, fluctuating from a minimum of 31% in 2005 to a maximum of 38% in 1987. The figure also shows the share of Current transfers on Current revenues which shows a similar stable trend. Besides this stability, it is possible to appreciate some changes. The period 1985-88, previous to the enactment of the main local financial act (*Ley Reguladora de Haciendas Locales*, 1988) shows a lot of instability. During the eighties, the upcoming socialist government in Madrid tried to fix the enormous funding problems of Municipalities, which were working under the same financial framework that pre-democratic local governments. The initial strategy of the central government, consisting of giving more tax autonomy found some problems (i.e., opposition of the Constitutional court) and was retarded till the enactment of the aforementioned law in 1988. Also, as will be explained below, the main unconditional transfer was not tied to the evolution of central revenues until that moment. The period following the enactment of the law saw a very high increase in transfers to Local Governments, probably reflecting the commitment of the central government with the project. After the new local Business tax was applied in 1992, the share of transfers began to drop, due to the extra revenues provided by this tax and to the effect of the use of tax autonomy. This drop in the share of transfers on revenues continued until the reform of the Business tax. As explained above, this reform reduced business tax revenues by 50%. This loss, however, was compensated with an additional transfer by the central government in the following years, probably causing an increase in the share of transfers. Finally, the last period coincides with the real estate boom, which produced an abrupt increase in some taxes and in asset-related revenues, which grew much more than transfers<sup>6</sup>.

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<sup>6</sup> As we will explain below, some transfers as, e.g., the main unconditional transfer received by municipalities, are tied to the growth of central government's revenues. Central taxes (i.e., income tax, VAT, excises) use to be much more sensitive to economic grow than local taxes, but less than taxes related to the building sector (e.g., Construction tax, Land transaction tax, in the case of Local Governments, and Wealth tax and Gift and Death tax, in the case of AC's).

*Where do they come from?* Table 7 illustrates which are layers of government providing these transfers. We can say that, for the aggregate of Local Governments, Current transfers are provided basically by the Central government (57,3%) and to a lower extent from AC's (25.5%) and *Diputaciones* (10%). Capital transfers come mainly from AC's (51.5%) but also from *Diputaciones* (15.3%), the central government (12.2%) and other agents (21%) as, for example, the EU. These proportions are very similar for Municipalities, but not for the other Local Governments. Most current transfers received by *Diputaciones* are provided by the Central government (84.6%), and Capital transfers to this layer come in similar proportions from the AC, the central government and other agents. In the case of *Cabildos* and *Consells*, most capital grants come from AC's, although also substantial Current grants are provided by the Central government.

(Table 7 about here)

*Which kind of transfers?* Most Current transfers are non-earmarked. Nearly all current transfers coming from the Central government are of this kind. For example, in 2006, the Central government assigned approximately 10,000 million euro in grants to Municipalities. Of these, the 92.2% corresponded to the main unconditional transfer received by this layer, a Revenue sharing grant called *Participación en los Tributos del Estado* (PTE). The remaining amount included the compensation for the abolition of the Business tax (6.7%), a compensation for local tax revenue lost due to fiscal benefits mandated by the central government (0.5%), and a special grant that subsidized public transportation in big cities (0.6%). Most current transfers from the AC's are earmarked. These are transfers with open calls appearing sometimes regularly (same moment each year) but sometimes not. The overall amount of funds is allocated yearly during the budget process and to access this money the municipality should apply first. Most AC's also have some non-earmarked current transfers in the form of Revenue sharing grants or special grants to ensure some types of municipalities receive enough funds. However, since responsibilities over the general local funding system rests on the hands of the central government, AC's use not to provide a substantial amount of funds to these programs<sup>7</sup>.

(Figure 4 about here)

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<sup>7</sup> For example, the Unconditional grant provided to Municipalities by the AC of Catalunya (*Fons de Cooperació Local de Catalunya*, FCLC) amounted in 2006 to just a 4% of the funds received by Catalan municipalities from the Central revenue sharing grant (*Participación en los Tributos del Estado*, PTE).

Figure 4 illustrates the trend followed by the share of these non-earmarked transfers over current transfers during the period 1992-2006. The grey line shows the plot for the entire Local Government sector and the black line the plot for Municipalities. The share is very stable over the period. However, in both cases (although more markedly in the first one), the share of unconditional grants grow slightly till the end of the century and then decreases, a trend which is very similar to the one identified by a recent OECD report (OECD, 2009). One possible explanation of the growth in the first sub-period might be the increased amount of funds provided by the central government around the enactment and application of the main municipal financial law. The explanation for the drop experienced more recently is less clear, but it might be due to the use of earmarked grants to fund the delegation of some responsibilities from the AC's to the local sector. There are no data to assess the validity of this claim, but we can find some examples of (possibly) limited quantitative relevance. For example, during that period, the AC of the Balearic Islands created the new island governments, called *Consells Insulars*, and transferred some responsibilities to them which were funded with earmarked (non-matching) grants of an amount equivalent to the past cost of the services transferred to each island. It is not clear, however, that this explanation is really relevant, since in Spain it is quite common to use specific grants only as a temporary device to fund the transferred services. After some years, all these specific grants are usually amalgamated in one unconditional grant. This is precisely what that AC did at the end of the period<sup>8</sup>. Other examples can be found in the decentralization of social services in some AC's. For example, as a result of a popular initiative in the Catalan parliament, the government of this AC was forced to start a program to increase substantially the supply of kindergarten. The AC decided to rely on the Municipalities (which were the main actor involved in the provision of these services up to that moment) for provision, funding 1/3 of the (standard) cost of each of student with an earmarked grant.

(Figure 5 about here)

All Capital grants, independently of the layer of government allocating them, are earmarked. No general funds to pay for facilities and infrastructure are provided in Spain,

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<sup>8</sup> This procedure has been applied during all the decentralization process to the AC's during the 1980's and 1990's. All the responsibilities transferred during the first half of the 1980's were initially funded with earmarked grants covering the previous cost of the service. All these grants were amalgamated in 1986 into a unique Revenue sharing grant with equalization properties. Similarly, other responsibilities decentralized after-wards to some AC's were first funded by earmarked grants and consolidated into the general grant once received by all AC's.

although current funds can be saved for this purpose<sup>9</sup>. Given their high degree of conditionality, the share of Capital transfers on Total transfers is also informative of the relative weight of earmarked grants. Capital transfers represented approximately the 20% of grants in 2006. As Figure 5 shows, this share increased abruptly at the end of the 1980's (from 13% to 20%, probably due to the arrival of EU funds) and then fluctuated during the rest of the period to reach again this value at the end. This impression is corroborated by looking at the share of Capital transfers over Capital spending, which also increased abruptly at the beginning (from 14% to 32%) and then decreased slightly. In any case, the lesson of this figure is that the share of earmarked transfers reflects most of the times of the introduction of new programs which are different in nature rather than being the result of an explicit decision to change one grant for another.

## 2.2. Revenue-sharing grant

The main unconditional grant received by Spanish municipalities is a Revenue sharing grant called *Participación en los Tributos del Estado* (PTE). This grant was created soon after the arrival of the new democratic councils in 1979 (albeit with a different name, *Fondo Nacional de Cooperación Municipal*, FNCM). During the eighties, the amount of funds devoted to this program was decided yearly during the budget process. However, from the very beginning, the grant was universal, automatic and allocated by formula. The 1988 financial law recognized these principles and tied the size of the fund to the evolution of central revenues. With this purpose, the amount of money is set every five years and then this quantity is actualized every year using the rate of growth of central taxes. To that quantity, an amount for Barcelona and Madrid (and also for the municipalities belonging to the metropolitan area of Barcelona) was subtracted. Then, an allocation formula is applied for the other municipalities. This formula suffered two reforms during the period, in 1999 and 2003. Table 8 below shows the structure of the formula in each of these periods. The formula used is a polynomial one, with 3-4 variables (depending on the period) and weights adding to 100%.

(Table 8 about here)

The main variable used is Weighted Resident population, with weights growing according to population size. Before 1999, these weights were 1 for residents in municipalities with less than 5,000 inhabitants, steeply growing till 2.85 for residents in cities with more than ½ million inhabitants. This means that the population fund allocated nearly three times more

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<sup>9</sup> We provide more details on the workings of these grants in section 2.3 below.

funds (per capita) to big cities than to small municipalities. The rationale behind this formulation are spending responsibilities (and/other needs or costs) increasing with size. As we will discuss below (see section 3.1), empirical evidence suggest this is not really the case. Following the recommendation of an expert working group this weight was (slightly) reduced to 2.8 in 1999-2002. Note that after 2002 the upper weight is 1.4 for the 50,000 to 100,000 population bracket. This does not mean that the problem has been solved, but is due to the fact that bigger municipalities are no longer eligible for this transfer. Since 2003 municipalities >75.000 residents and Tourism municipalities are funded with a share of revenues from the Income Tax, VAT and Excises on Tobacco and Alcohol, plus a lump sum fund (*Fondo Complementario de Financiación*, FCF), computed as the difference between PTE and tax sharing revenues in the base year, growing yearly with central revenues.

The second variable used is Fiscal effort, computed as the Ratio between Local Tax Revenues from the three main taxes (Property, Vehicle & Business) and Potential Local Tax Revenues (those obtained if applying the maximum tax rates allowed by the law<sup>10</sup>). The weight of this variable was 25% before 1999, but was reduced to 14% in 1999-2002 and to 12.5% after 2002. The alleged reason was the lack of effectiveness in increasing municipal reliance on taxes. The third variable, with a 12.5% weight, is and Inverse of Fiscal Capacity and was introduced in 2002 after the recommendations of an expert working group that warned against the lack of equalization power of the grant. This variable has been computed as the inverse of the ratio of Local Tax revenues per capita coming from the three main taxes, on Average Local Tax revenues per capita of the corresponding population size bracket. However, as we will show in section 3.1, both the small weight given to this variable and the way it is computed, make its equalization power still very low. Finally, the last variable is the number of public school units, with a 5% weight before 1999. Municipalities are responsible for providing land plots to build public schools and for the maintenance of the infrastructure, so there is some basis for this variable. However, some experts alleged that this is a minor source of spending needs, compared to other influences (e.g., poverty, immigration, dispersion), so its removal seems also justified.

The operation of this formula generates a very low degree of dispersion in per capita revenues from this transfer, at least for municipalities of a similar size. Of course, bigger

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<sup>10</sup> Recall that before 2003 maximum tax rates grew with population size, meaning that two municipalities of different size but with same per capita tax bases and same tax rates (same per capita tax revenues) will have different values of this variable, the smallest one making a higher Fiscal Effort, because it has a higher maximum tax rate.

municipalities obtain more per capita resources (see Bosch and Solé-Ollé, 2005). Also, because of the Fiscal Effort variable, before 2003, and because of the Inverse of Fiscal Capacity afterwards, tax base rich municipalities obtain (slightly) lower per capita transfers. We defer a complete evaluation of the equalization power of this grant till section 3.1.

### 2.3. Capital grants

As said above, in Spain, all Capital Transfers are Earmarked. The most important programs of this type are in the hand of the AC's and of the *Diputaciones*. Both layers have Local Works Programs which purpose is to co-operate in the provision of facilities and services which are of municipal competence. The justification of the intervention of the higher layer of government is related to the need to avoid spillovers and better exploit economies of scale. These transfers are disproportionately directed to small municipalities, which expertise and technical capability is sometimes limited.

The design of most of these programs is quite similar. First, the overall amount of money use to depend also on annual budget decisions, although the planning horizon of some programs is biannual or even by term-of-office. Second, sometimes municipalities are allocated a minimum amount of funding they should obtain over the year and/or the planning horizon. The aggregation of these minimum amounts over all municipalities uses to be much lower than the overall amount of funding, giving freedom of action to the grantor. Third, municipalities should present projects in response to a regular call, published at the beginning of that planning horizon. These projects might or might not be funded and, in any case, the funds are earmarked not only to capital spending but to the project approved. If accepted, a proportion of the costs of the project are covered by the grantor; the municipality can apply for more funding to other institutions, but the overall amount of funds obtained should be lower than the cost of the project. Fourth, the criteria used to compute the minimum municipal transfer (if there is), to select the projects to be funded or to choose the funding rate, use to be published in a law and developed in the call. Most times, however, they are rather vague. The decision of which projects have been funded is made public, but most of the times it is very difficult to ascertain the objective motives of the decision. The level of discretionarity in the allocation of these transfers is thus rather high. Fifth, although sometimes the laws and calls make explicit reference to local autonomy (recall that the facilities and services funded are a local responsibility) the AC tries to direct funds towards regional priorities. The way the AC does that is by setting selection criteria according to the type of project presented or by channelling a proportion of funds to specific programs related to its own policies.

To understand better these programs it could be useful to describe in more detail two of them. I chose the two Local Work Plans executed in Catalunya, one of the Spanish AC's. The first one is the so-called Unique Plan of Works and Services (*Pla Únic d'Obres i Serveis*, PUOSC), is managed by the AC's government, and follows very closely the above description. The second one is the so-called Barcelona Network of Quality Municipalities (*Xarxa Barcelona Municipis de Qualitat*, XBMQ), managed by the *Diputació de Barcelona*, and designed (at least in theory) differently than traditional programs, according to inter-governmental contracting principles. These two programs are concurrent, so the municipalities belonging to the province of Barcelona can apply to both. The Local Works Plans (*Planes de Obres Locales*) of *Diputaciones* were the most important programs until some AC's started to claim that they have the legal responsibility of coordinating and managing all the funds devoted to that purpose in its jurisdiction. In Catalunya, the AC passed a law in 1987 unifying all the Local Public Works Plans in the region, belonging either to the AC or to each of the four *Diputaciones*. The new unified plan (i.e, the PUOSC), was funded by the resources previously devoted by *Diputaciones* to that purpose, by the money the AC started to receive from the Central government, and with additions coming from the general budget of the AC. However, the strongest *Diputació of Barcelona* decided not to participate in the new program, waiting for the opinion of the Constitutional Court on the AC's taking of this responsibility. The sentence was delayed since 1998, and the Court decided that the AC's can in fact run this type of program, but that *Diputaciones* are able to continue funding co-operation with Local Governments with the condition of starting a brand-new program. This was one of the reasons that led the *Diputació of Barcelona* to switch to a different approach.

*A Traditional Grant Program: Catalunya's PUOSC.* That program is funded with money coming from *Diputaciones* (actually, only those that decide to participate) and the AC. Nowadays, the planning horizon is a five-year period, but funding is allocated bi-annually. The allocation of the PUOSC proceeds in steps. First of all, the amount of money budgeted for a given year is divided in different programs, the most important being the General Program, but the law allowing also for other Specific programs. The law allows reserving a 15% of funds to be allocated to programs covering the geographic jurisdictions of the *Diputaciones* or the Counties (*Comarcas*), and 10% to emergency relief. In addition to this, some of the funds are also allocated to programs that reflect the priorities of the AC government.

(Table 9 about here)



Second, as illustrated in Table 9, there is a primary allocation of the General Program by county (*Comarca*), which uses some objective criteria indicated by the law as, for example, number of residents or number of municipalities. If this amount is not covered by the projects presented by the municipalities of that county, the excess of funds is lost. The criteria used in this step, as defined by the law, are very vague. The open call use to fix the criteria with more clarity<sup>11</sup>. Third, there is a Minimum Transfer for each municipality, which is the minimum aggregate amount of funds it can get during the planning period from all the funded projects. Of course, in order to obtain this minimum the municipality has to present enough projects which fulfill some minimal formal prerequisites (e.g., written technical project, own money to match the transfer). These minimum transfers are computed as a fixed amount plus a per capita one. Of course these minimum transfers do not exhaust the budget of the transfer program. Fourth, the municipality must present projects to the County government (*Consell Comarcal*) which will write an assessment report used by the AC's government to take a decision. In this report, each project is evaluated using the criteria stated in the call, which should follow those fixed by law (and presented in Table 9). There are three main groups of criteria: (i) Type of project, (ii) Municipality's traits, and (iii) Actual level of provision. Inside the first two groups, there are many specific criteria. Note, however, that the way they are defined by the law is too vague to ensure objectivity in their application. In some of the calls (e.g., 2000-03) the criteria set by the law are translated into more concrete terms, and a maximum number of points to be obtained during the evaluation are assigned to each of them<sup>12</sup>. However, in more recent calls (e.g., 2004-07 & 2008-12), the articles containing the selection criteria refer directly to the law. Finally, also the funding rate of each project depends on a set of criteria and, similarly to what said above, they are more or less concretely specified depending on the call.

*Inter-governmental contracting: Barcelona's XBMQ.* During the period 1988-1999, the *Diputació de Barcelona* ran its own program of Capital Transfers, called Plan of Coope-

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<sup>11</sup> For example, in the calls for the period 2000-03 the county allocation (CoA) was calculated with a formula using: number of municipalities with less than 20,000 residents (N-20), number of municipalities with more than 20,000 residents (N+20), and population in municipalities with less than 20,000 residents (P-20). The exact formula was:  $CoA = 8,750 \times (N-20) + 38,750 \times (N+20) + 1.5 \times (P-20)$ , where the weights are measured in *pesetas*. Note that the three criteria are included in the law but, at the same time, the number of criteria provided by the law is much wider.

<sup>12</sup> For example, the 2000-03 call gives a maximum of 10 points to projects related to Compulsory responsibilities, 5 to Supramunicipal projects, 4 to projects that are Complementary of AC's policies, 5 to Urgent projects, 8 to municipalities with high Fiscal Effort, and 2 to 10 points decreasing with population size (Decree 74/2000, of the Call of the PUOSC 2000-03, Generalitat de Catalunya). Note that, even in this case, there is enough room for subjective interpretation.

ration with Local Administrations (*Pla de Cooperació amb l'Administració Local*, PCAL). This plan was implemented using a Traditional Grant Program and was very similar to the PUOSC of the AC administration. Obligated to close this program and start a brand-new one, the *Diputació de Barcelona* decided to use a different organization model, based on Intergovernmental contracting. Table 10 summarizes the main differences between the two models. On the one hand, the Traditional Grant model: is oriented towards the design of the bureaucratic procedure to be used to award and manage the transfer, the relationship between actors is hierarchical, decision-making is unilateral, the kind of aid received is only financial, and the working system is based on several fragmented programs. On the other hand, the Intergovernmental contracting model: is oriented towards the accomplishment of goals established in the contract, the relationship between actors is based on equality and collaboration, decision-making is bilateral and bargained (since the proposal for collaboration originates in local entities), the municipality can receive different kinds of aid (financial but also technical advice, since the intervention is integral), and the working system is transversal.

(Table 10 about here)

Table 11 describes the organization of the XBMQ. The first step consists in setting the goals of the program, and the instrument here is the General Contract, called *Protocol General* in Spain. This document is very general and its development will require, first, that the municipality signs it<sup>13</sup> and then a further development in the form of a Specific contract (*Conveni Específic*). The second step consists in the implementation of co-operation between the two layers, and the instruments are: (i) the Needs registry (where each municipality has to submit all the projects for which demands co-operation from the *Diputació*), (ii) the Contracting forum or *Mesa de Negociació*, where both layers sit and bargain over the content of the contract, (iii) the Pre-agreements registry, which includes all the political compromises arrived at with different municipalities, (iv) the Activities registry, which includes a list of all the projects to be implemented during the program's horizon (here is 4 years, which coincides exactly with the term-of-office of both the municipalities and the *Diputació*), (v) and the Specific contract, which translates into a legally-binding document the political agreements arrived at before.

(Table 11 about here)

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<sup>13</sup> For the period 2004-08, 311 municipalities and up to 486 Local Governments and other Local entities (e.g., Public societies, Consortia) have signed the *Protocol General XBMQ*.

To my view, the main virtue of this new model is that the relationship between the two layers of government is less bureaucratic. This allows both the needs of the municipality and the policy preferences of the *Diputación* to be better satisfied. Note that in the Traditional Grant model, the upper layer tries to influence the type of projects implemented through the allocation of funds to specific programs and through the criteria set for the selection of projects. The municipality has no voice in this process, and the only means of funding the most needed projects is to look at the call and try to adapt the project to the criteria set by the grantor. Sometimes this means that municipalities are demanding funds for projects their citizens do not consider a priority or that they change the design of the project only to please the grantor. A more effective strategy for both the municipality and the *Diputación* would be simply to sit on a table, communicate their goals, and then arrive (or not) at an agreement regarding which projects to implement and by which means. This is precisely what XBMQ does. Of course this is more time consuming, since at the beginning of the term-of-office, the *Diputación* organizes meeting with each of the Local Governments under his jurisdiction.

### **3.- Transfers to local governments: a preliminary assessment**

This section will perform a preliminary assessment of the virtues and perils of transfers to Spanish Local Governments. We will focus on the various elements identified in the introduction, asking: (i) Do these transfers serve in practice to equalize differences in spending needs and/or fiscal capacity and so, do they help in guaranteeing equal access to local public facilities and services across the country; (ii) Which role do they play in the adjustment of local budget to different sorts of unforeseen fiscal shocks? If this is the case, do they induce a bad financial management, fostering excessive spending and deficit?; (iii) Do they help in improving the effectiveness and efficiency of public spending, helping to overcome the inter-governmental co-ordination problems derived from spillovers, lack of scale economies or inappropriate local administrative capacity?; (iv) Are these transfers affected by rent-seeking efforts of local politicians and by clientelism?.

#### **3.1.- Equalization power**

*Needs equalization?* Besides resident population, there are other municipal traits that influence the spending needed to ensure a given level of service provision. Among these, we could cite: (i) the number of potential users (e.g., socio-demographic groups, non-resident population, daily visitors, or employment) or other variables defining the scale of the service (e.g., land area); (ii) variables influencing unit costs, as for example, population size, disper-

sion, and wages; (iii) the level of responsibilities. As explained in section 2.2, the main unconditional transfer (PTE) does take into account needs differences by including resident weights rising with population size. However, an investigation by Bosch and Solé-Ollé (2005) showed that actual per capita needs have a profile which is very different than the one implicit in the weights used in the formula. The estimated per capita needs-to-population profile is shown in Figure 6. Note that per capita needs drop till 5,000 inhabitants and then increase until 50,000, reaching a maximum of 1.17, and stays constant for higher sizes. This pattern is different than the one implicit in the PTE weights, which increase from the beginning and are very high for medium, and specially for very big cities (with a maximum of 2.8 after 1999). So the PTE seems to be biased against very small municipalities and in favor of the big ones.

(Figure 6 about here)

Contrary to what happens in the case of current transfers, capital transfers flow disproportionately to small municipalities. Of course this makes sense given the fixed costs of many capital projects, and there does not seem to be evidence that the bias towards small municipalities goes beyond the degree of scale diseconomies observed. In Table 12 we present the results of estimating two equations explaining both capital transfers per capita and capital spending per capita<sup>14</sup>. Note that the inverse of resident population is a statistically significant determinant of both transfers and spending, and is the variable which has more explanatory power in the case of spending. Comparing the first two columns we realize that the coefficient of this variable is much higher in the case of capital spending than in the case of capital transfers, which can be interpreted as a signal that these transfers only compensate for part of the scale diseconomies of small municipalities.

But what about other needs elements not related to population size? As explained above, the PTE does not take them into account. However, an empirical investigation performed by Solé-Ollé (2001) shows that spending needs depends in practice of a great variety of factors, which explain a substantial share of the variation in spending. In particular, aspects as the number of daily visitors, tourists, employees, immigrants and poor people, and the dispersion of population have a very strong effect in some spending categories<sup>15</sup>. We must conclude,

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<sup>14</sup> The table has been taken from a report commissioned by the Diputació de Barcelona, evaluating the appropriateness of minimum municipal transfers as computed for the XBMQ (see Solé-Ollé and Sorribas, 2007)..

<sup>15</sup> Spending needs factors and Fiscal capacity and Transfers explain roughly a 45% of cross-sectional spending variation each, the remainder being explained by political and institutional traits. These results were obtained from a cross-sectional regression of current spending versus needs, resources and other

therefore, that Spanish non-earmarked grants are in general not sensitive to specific needs factors. This is not difficult to understand, since the formula is allocated to more than 8,000 municipalities and the diversity of situations is very high. In fact, there is no single variable in the analysis by Solé-Ollé (2001) which accounts for a considerable proportion of the variation in spending.

What about capital transfers? Do they take into account differences in other need factors, aside from population size? If one looks at the Municipalities' traits used for the selection of capital projects (recall the example of Table 9 above), only the Number of towns appear as an additional needs variable. However, sometimes there are specific programs devoted to some type of municipalities with special needs<sup>16</sup>. One could argue that even without formal criteria the grantor is sensitive to projects which municipalities justify are really needed because actual facilities are clearly insufficient. In any case, the only needs variables (aside from inverse of population) found in the study by Solé-Ollé and Sorribas (2007) were *Growth in Population and Houses* and *Growth in Employment* (see Table 12). None of the level variables (measured in 1999) which were found as significant needs factors in Solé-Ollé (2001) for the case of current spending, were statistically significant in the case of capital spending. The interpretation given to that finding is that there were not big infrastructure disparities at the beginning of the period analyzed (i.e., 2000-04), but that the enormous urban expansion experimented made the existing capital stock insufficient. Therefore, the conclusion is that there is little evidence that capital transfers are actually allocated according to specific needs factors, aside from the new demands related to urban growth. And it is not clear at all that upper layers of governments should pay a part of the costs of urban expansion, since this could foster even more the natural tendency to overexpansion of Spanish municipalities (Solé-Ollé and Viladecans, 2007).

*Fiscal capacity equalization?* Traditionally, the main unconditional transfer (PTE) did not have a fiscal capacity equalization component. The only component that contributed mildly to this end was the Fiscal Effort variable, since municipalities with low tax bases use to have higher tax rates. The analysis performed in Solé-Ollé (2001) for 1996 confirms this nearly zero equalization power. The introduction of the Inverse of Fiscal Capacity variable in

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factors, using a sample of 100 municipalities from the province of Barcelona for the year 1996 (see Solé-Ollé, 2001, for details).

<sup>16</sup> For example, in the 2008-12 call of the PUOSC there is a special program for municipalities with sprawled housing and another one for mountain municipalities. In fact, the regression analysis in Solé-Ollé and Sorribas (2008) finds that capital transfers are higher in municipalities with more urbanized area per capita.

2002 should have changed this outcome. However, the weight assigned to this variable is quite low (12.5%) and the reduction in fiscal capacity disparities is very low at reasonable values of the fiscal capacity index, the reason being the non-linear relationship between both variables, which is illustrated in Figure 7. This figure shows why in the relevant range of values (Fiscal capacity index higher than 0.5) the slope of the function is very low (its equalizes around the 10% of fiscal capacity disparities) and, in any case much lower than the 100% and 50% equalization lines, which correspond to a typical equalization grant where fiscal capacity enters linearly but with a negative sign<sup>17</sup>. Figure 8 illustrates this effect with real data corresponding to current transfers received by a sample of municipalities of the province of Barcelona during the period 2000-04 and shows that the slope of the fitted line is in fact much lower than that of a 100% fiscal capacity equalization transfer.

So, Spain's non-earmarked transfers do not equalize, but what about the earmarked ones? In general, capital transfers also have a very low equalization power. The criteria used for the selection of projects use to include both fiscal capacity and fiscal effort (see Table 9). The analysis of Solé-Ollé and Sorribas (2008) showed that capital transfers were in fact higher in municipalities with low assessed property values (the tax base of the property tax, which is the main local tax in Spain) and lower the higher the property tax rate, although these variables added very little to the explanatory capacity of the equation. However, a plot of capital transfers per capita against the Fiscal Capacity index (using the same database than in Figure 8) has a positive slope, not a negative one. Both findings can be reconciled since the effect of fiscal effort can counteract in this case that of fiscal capacity, given that fiscal effort use to be higher were fiscal capacity is lower. Moreover, the money received form capital transfers should be matched with a local contribution of at least 50% of the cost (with some exceptions, see Table 9), reducing the amount of funding solicited by the fiscally poor.

This lack of equalization power has not been a problem in the past, given the kind of services delivered by Spanish municipalities. However, care should be taken in the future with this aspect of the transfer system if municipalities continue to gain more relevance in the provision of social services.

### 3.2.- Fiscal adjustment

How do municipalities react in front of a budgetary shock which generates an unforeseen deficit? Do they adjust some of the budget components in order to balance the budget

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<sup>17</sup> That is Index of Transfers per capita. = ( $\alpha$  Per capita needs index -  $\beta$  Per capita Fiscal Capacity index), where  $\alpha$  and  $\beta$  are weights that depend on the average degree of tax autonomy, see Solé-Ollé (2001).

again or do they let the deficit grow uncontrolled? How many years are needed in order this adjustment takes place? Does the burden of this adjustment fall entirely on own budget instruments as, for example, spending and taxes? Or, is the adjustment possible only when higher layers of government provide more transfers? Which transfers play a more relevant role in the adjustment? Do they respond to shocks which affect all the municipalities at the same time (as the actual economic crisis), to idiosyncratic shocks, or to both? Finally, does this adjustment via transfers provide bad incentives to mismanage local public finances? Recent research tries to answer these questions using tools employed previously by macroeconomists (i.e., VARs and Impulse Response Functions). The work by Buettner and Wildasin (2006) and Buettner (2007) find that both US and German local governments do adjust after different types of budget shocks, but that transfers from higher layers of government are needed to ensure this adjustment is made. The share of transfers in adjustments to revenue shocks is quite modest in the U.S. but very high in Germany. Buettner (2007) suggest that this is due to the role played by fiscal capacity equalization grants and speculates that this is one of the reason German municipalities rely so much on the very volatile local business tax.

A similar analysis performed by Solé-Ollé and Sorribas (2009) for Spain obtained some different results. First, as in US or Germany, local budget do adjust after a shock, so the authors conclude that the Spanish system of local finances is viable. Second, in Spain grants do not respond to a shock in revenues, which is absorbed by cutting spending. This result is consistent with the low equalization power of both current and capital grants (see section 3.1). Third, the response of grants to spending shocks is much higher in Spain than in the other two countries. Fourth, the adjustment is similar in the case of general than for idiosyncratic shocks, although grants are slightly more responsive to an idiosyncratic shock and in this case they respond even to a revenue shock. Fourth, capital grants are more responsive to spending shocks than current grants. They are also more responsive to shocks affecting small municipalities. Overall, the authors conclude that the differences between Spain and the other countries are probably due to the greater reliance on earmarked capital grants in Spain. Finally, the authors speculate that this greater reliance on grants might have given rise to another type of moral-hazard problem: additional infrastructure needs generated by population growth are funded by higher tiers of government, inducing municipalities to foster urban expansion without considering the full fiscal consequences of these policies.

### 3.2. Inter-governmental co-operation

Spanish municipalities are quite small, meaning that most municipalities face severe diseconomies of scales and lack administrative (and sometimes financial) capacity to provide some facilities and services. This small municipal size, coupled with a high degree of mobility of people and business, also generates considerable spillovers between close municipalities. An unclear division of responsibilities, and/or the intertwined effects of policy instruments located at different layers, cause vertical coordination problems between the municipality and the AC. Does the actual design of Spanish transfers to local governments contribute to solve these co-ordination problems?

Theoretically, both the AC's and the *Diputaciones*, develop inter-governmental cooperation problems which objective is to cope with these problems. The main instruments of these cooperation policies are the transfer programs, and most of these transfers are earmarked capital transfers. Some of the Traditional Grant programs use in the selection process some criteria with this purpose. For example, the PUOSC (see Table 9) takes into the account the fact that the project is a supra-municipal one, also that the municipality is an amalgamation, gives special attention to disaster relief and to municipalities suffering externalities from power plants. However, the effectiveness of the inclusion of these criteria is unclear. The other program analyzed, XBMQ, based on a model of inter-governmental contracting, seems better suited to deal with these co-ordination problems. Given that the projects are selected after a process of bargaining with each municipality, the grantor will probably be better able to detect which are the projects whose benefits will spread more to other municipalities.

In any case, another purpose of these transfers should be to fund projects that fit better with local demands and needs of each municipality. And it is pretty clear that the bureaucratic procedure used to detect which are the best projects to fund (in theory in order to fulfil co-ordination purposes, as described above) interfere a lot with local autonomy. A local politician puts it this way:

“The system of grants to municipalities is disastrous. The amount contributed by the *Generalitat* (i.e., the AC government) and the *Diputaciones* is very high. But there are two problems. On the one hand, the earmarking of most transfers; that is, they give you money to do something concrete that they want and you have to add an important share. Sometimes, it has sense, I do not mean that this system has to be completely abolished; but many times an ‘enlightened’ that never set foot on the ground decides from her office to subsidize things that are of no interest or are not a priority of the local council. And many of them ends up making things simply because they are subsidized, without being neither needed nor a priority; it



is like buying on sales (...). The worst one is the PUOSC, which is a joke. The PUOSC funds municipal investments, sometimes with a very low share; what's more, they say what you have to do, and what not, what is good and bad for you, what you need and what you don't..." (<http://blocs.mesvilaweb.cat/sbaulida>)

In general, the procedure used to select these projects does not ensure that the projects implemented are the best ones and even does not ensure that these projects have a net payoff to society. In theory, the use of Transfers based on Inter-governmental contracting, as the XBMQ, can attenuate these problems. By sitting together and bargaining on the projects to be funded, the grantor is better able to identify the project which are better suited to local demands and needs. The General contract of the XBMQ makes a lot of emphasis on the goal of making compatible the respect of local autonomy with the need to coordinate policies. Of course, one thing is discourse and the other facts, and there is not enough evidence for the moment to reach a definitive conclusion regarding the differential performance of both grants.

### 3.3. Rent-seeking and clientelism

The second problem is described by that local politician as follows:

"The other problem is the 'old-boy network' and the 'partisanship' of grantors. Nobody dares to touch this issue, for fear to enter the black list, and receive less than usually has, but the reality is that the criteria 'friend in the right place' and 'of the party' weight much than what they have to weight in the awarding of transfers" (<http://blocs.mesvilaweb.cat/sbaulida>)

This problem is referred exclusively to earmarked transfers. There are some key facts of the design of these transfers which facilitate its discretionary use. First, the vagueness of the criteria used to select capital projects to fund or to choose the matching rate (Table 9), which in some calls are detailed but in others are referred to the general principles stated in the law. Two, a substantial amount of funds is reserved for disaster relief, for urgent interventions, and for other discretionary actions. Third, the use of minimum transfers is not enough to avoid this behavior, given that their aggregate amount uses to be far from the overall amount of funds. These problems might be even more acute in the case of Transfers based on Inter-governmental contracting. These transfers are the result of a bilateral contract between the municipality and the grantor, and thus are not compared to the ones awarded to other municipalities. In this case, there is no selection criteria specified in the General contract. The theory is that contracts are bargained bilaterally and the agreement is freely accepted by the municipality, and this should not be a priori subject to any constraint. But reality is that bargaining bilaterally with each municipality gives more possibilities to the grantor to offer more funds where they are more politically productive. In order to avoid excessive criticisms,

the *Diputació de Barcelona* also calculates a minimum aggregate transfer for each municipality, but again their amount is much less than the funds being distributed.

The literature on the political economy of grant allocation names ‘clientelism’ the behavior described above by our local politician (Weingast *et al.*, 2007). This is a situation where a politician controlling the instruments of power (in this case the upper layer allocating grants) threatens citizens (residents of a community), saying that they will be punished (in this case by receiving less transfers) if they do not support the municipal candidate belonging to the same party<sup>18</sup>. There is some informal evidence that this argument is sometimes discussed in small municipalities during local electoral campaigns. Put it in words, the idea is just: “this guy is the candidate we prefer, but he will not be able to extract funds from the grantor government, because it is controlled by the opposition.”

There is a very clear-cut empirical prediction associated to this behavior: a municipal government aligned with the grantor upper-layer (i.e., controlled by the same party or coalition) should receive more transfers than a municipal government which is not aligned. A recent research by Solé-Ollé and Sorribas (2008) shows that this is indeed the case in Spain. Aligned Spanish municipalities do receive on average 40% more per capita capital transfers than unaligned municipalities. We have to say, however, that this empirical regularity is consistent with other theories besides ‘clientelism’. For example, aligned municipalities could receive more transfers simply because, belonging to the same party, have policy preferences which are similar to those of the grantor. Then, the municipality will be more inclined to apply for projects and will select the type of project that has more possibilities of being funded. So, the unequal allocation of funds will be simply a reflection of the ideological differences existing between parties.

Current grants are less amenable for this discretionary use. In practice, it is very difficult that a grantor gives a special treatment to one concrete municipality. In the case of PTE, there have been a couple of exceptions to this rule. The cities of Cádiz and Sta. Coloma de Gramenet have a special status that makes them deserve more funds. The reason is their low fiscal capacity coupled with the limited land area that impedes any future economic development to solve this financial problem. Being this true, what happens is that there are other municipalities in Spain which have similar problems and do not receive more monies. Recall

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<sup>18</sup> This theory also provides a positive explanation of the increase in the use of earmarked grants (or in any case its survival): grantor governments will be reluctant to transform earmarked into non-earmarked grants (or even worse, into tax decentralization) because this will erode their power to punish/reward municipalities (see, e.g., Weingast *et al.*, 2007).

that the PTE has a very low equalization power, so the formula does not solve these fiscal capacity disparities. The special status was awarded after rent-seeking efforts by the mayor of Cádiz, which at that moment was aligned with the right government in Madrid. The same treatment was awarded at the end to Sta. Coloma de Gramenet (with a left mayor) to avoid accusations of partisanship. The PTE formula, like any other formula, can be manipulated to give a preferential treatment to some groups of municipalities. There are suspicions that this is what happened in Spain with big cities. Recall the higher population weight they had in the formula since 2002; this was probably due to their higher rent-seeking capabilities. The situation was criticized by many experts and politicians of medium and small municipalities. But the 2002 reform split the system in two, municipalities with more than 75.000 residents and tourism cities being financed now by tax-sharing and a lump-sum grant which is completely detached from the one funding the smaller municipalities. Although the change was revenue-neutral in the first year and has provided more or less the same resources afterwards, the separation of the system insured big municipalities against the possibility of a reform of the formula reducing their population weights.

#### **4.- Conclusion**

Local Governments in Spain are relatively small. Municipalities, the main player of the local system are numerous, and its responsibilities are rather limited and often concurrent with those of the AC's. Despite of this, local governments are rather autonomous, with transfers representing approximately 1/3 of revenues and having tax powers over all local taxes. Most current taxes are non-earmarked, and all capital transfers are earmarked project grants. Municipalities, specially the smallest ones, are quite dependent on these transfers in order to fund capital spending.

Overall, the Spanish local transfer system has some weaknesses. First, it is not effective in reducing disparities related both the spending needs and to fiscal capacity. This lack of equalization power has not been probably entirely problematic in the past, where the services provided were non-redistributive, but should be taken into account as the municipalities increase its involvement with the provision of social services (e.g., kindergarten, elderly care). Second, transfers play a limited role in the adjustment of local budgets to revenues shocks, but are important to help them cover spending shocks. Capital transfers are important for this purpose; since capital spending is mainly influenced by population growth, we speculate that the involvement of higher layers of government in local infrastructure funding might have fostered urban expansion. Third, it is not clear that project transfers really help in coping with

the co-ordination problems that affect the Spanish local sector. What it is clear is that these projects interfere a lot with local autonomy and contribute to the selection of projects that are not so valued by citizens. Fourth, there is strong evidence that earmarked capital transfers are disproportionately allocated to co-partisans, casting doubts about the fairness of the procedures used in the selection of projects. Given these considerations it would be interesting to consider the possibility of: (i) increasing the amount of current unconditional funds to municipalities, (ii) increasing the equalization power of these grants and clarifying its effects, and (iii) limiting the amount of funds to be allocated as capital transfers, and trying to improve the transparency of the its allocation process.

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