

Editorial introduction

The book begins with an introductory section comprising Chapter 1 and is followed by three further parts, each one comprising three chapters. In Chapter 1, Bosch and Durán, from the University of Barcelona and the Institut d'Economia de Barcelona, offer an overview perspective of the regional financing system in Spain, pointing out the general features and the weak points that should be considered in future reform.

In the last 25 years, Spain has experienced a very important process of political and fiscal decentralization, with the creation of the so-called Autonomous Communities (ACs). The financing system first begins with the assessment of the expenditure requirements of three different areas of responsibilities: common, health and social responsibilities. To provide the corresponding resources, the financing system rests on two basic sources: taxes and equalization grants. The successive reforms have increased the weight of tax resources, raising the number of ceded taxes as well as the legal power to modify some of their parameters. With the aim of ensuring that all ACs have enough resources to carry out their responsibilities, the system envisages the sufficiency fund as the key element of fiscal equalization.

According to Bosch and Durán, in spite of the improvements introduced, the financing system of regions still suffers from significant weak points: a lack of fiscal co-responsibility, an insufficient financial autonomy and the application of a bad system of fiscal equalization. Most citizens still believe most taxes are only paid to the state. The lack of transparency behind some of the key elements of the system, which are a consequence of successive political agreements, means that there are significant differences in general resources per capita among ACs. The equalization mechanism inverts the ranking positions in favor of the ACs with less fiscal capacity.

Chapter 1 ends with an analysis of the future reforms that should be introduced to improve the system. First, an increase in the regional tax power and in the role of tax administration to enhance the fiscal co-responsibility of regions. At the same time, partial equalization, so that rich ACs should be able to retain some of the revenues exceeding the average. Finally, appropriate updating mechanisms should be introduced to provide a more flexible and valid system.

Part I deals with tax assignment, and consists of three different chapters written respectively by Jorge Martínez-Vázquez, from Georgia State

University (United States), Hansjörg Blöchliger, from the OECD and Juan A. Gimeno Ullastres, from the UNED (Spain).

In Chapter 2, Jorge Martínez-Vázquez analyzes revenue assignments in the practice of fiscal decentralization. According to Martínez-Vázquez, effective fiscal decentralization requires meaningful levels of revenue autonomy at the regional and local levels of government. However, besides adequate revenues to fund the public expenditure requirements of sub-national governments, what we most want from revenue assignments is accountability and political and fiscal responsibility for sub-national government officials. This is fundamentally achieved by granting sub-national governments a significant level of tax autonomy. Achieving a good level of tax autonomy has many other benefits including the imposition of hard budget constraints on sub-national governments.

Nonetheless, the author points out that the full financing of sub-national governments from autonomous tax sources is generally not feasible. The commonly accepted compromise is that sub-national governments need to raise their own funds at the margin and operate with hard budget constraints. Operationally, this translates into the golden rule for revenue assignment: own revenue sources should fund the expenditure requirements (net of conditional grants) of the wealthiest sub-national governments, and the revenue requirements of the relatively poorer sub-national government should be supplemented with equalization grants.

However, not all forms of tax autonomy are equally desirable. All things considered, Martínez-Vázquez believes the best way to provide sub-national governments with tax autonomy is to have a closed list of taxes for which sub-national governments can set tax rates within some minimum and maximum values that are nationally legislated. Good choices for sub-national governments include maximum use of fees and charges for excludable services under the benefit principle, plus a list of well-suited taxes such as the property tax, vehicle taxes and piggyback personal income taxes. Recent advances also make it possible to introduce a sub-national VAT in either its dual Quebec-style form, or under the CVAT (compensating VAT) or VIVAT (viable integrated VAT) forms.

The international experience clearly shows that there are no unique well-defined formulas for revenue assignments. More research is needed to understand the political economy behind some of the anomalies in the choices of revenue assignments. In particular, it is important to better understand why the wrong revenue assignments have proved so difficult to change in a significant number of countries and also why the little revenue authority provided to sub-national governments quite often goes unused even though these governments might, at the same time, demand more funding. Jorge Martínez-Vázquez concludes that future research

should be more heavily focused on the political economy of revenue assignments.

In Chapter 3, Hansjörg Blöchliger, from the OECD, offers an overall picture of tax assignment and tax autonomy in OECD countries. The degree of decentralization varies greatly across these countries. We can observe that the sub-central tax share and the sub-central expenditure share have diverged over the last ten years. While the share of sub-national expenditures generally increased, local taxing power – with a few notable exceptions – remained almost stable. In fact, in most countries, sub-central government expenditures exceed tax revenue by far, and this ‘fiscal gap’ has widened in the last decade. The difference between responsibilities and resources points to large intergovernmental transfer schemes.

Blöchliger shows that own taxes are a more important revenue source for sub-central governments than grants. With 60 percent against 40 percent, tax revenue accounts for a larger share of revenue. Nonetheless, only a part of tax revenue allocated to sub-central governments is under their control. Often their power to set and change tax rates and the tax base is restricted. In many federal countries and some unitary ones, sub-central governments take part in tax-sharing arrangements where the tax revenue allocated to a single jurisdiction is either determined by all sub-central governments together or by central government.

It is also interesting to note, indicates Blöchliger, that in some countries, despite having the right to vary tax rates, sub-central governments set the same rate across the country, a feature also pointed out by Martínez-Vázquez in the previous chapter. Such ‘unused taxing power’, concludes the author, invites a deeper look into fiscal institutions and the incentives they generate for tax competition. Fiscal equalization arrangements can partly explain why sub-central jurisdictions in many countries stick to a uniform tax rate although they have the right to vary their rates.

After the international view, Chapter 4 concentrates on tax assignment and regional co-responsibility in Spain. Juan Gimeno Ullastres, from the UNED (Spain) explains the recent evolution in that country. There, the rapid decentralization of competences from the state to the so-called Autonomous Communities was not accompanied by an equally rapid gain in financial competences. As a result, Spanish academia has insisted on the idea of co-responsibility for 20 years. Defining the suitable taxes for each territorial area and giving them the maximum autonomy is an approach, according to Gimeno Ullastres, that ensures genuine co-responsibility, effective financial autonomy and greater stability in the system, rather than making proportional allocations based on statistics.

The new proposals for the next reform of the financing system seem to point to effective use of retail VAT. Gimeno Ullastres believes that this

proposal is highly advisable in spite of the problems that it poses because of lack of experience and predictable EU obstacles. There are several ways to achieve the corresponding system, but it is necessary to remain clear that the final result must not rest on the value added at the retail stage but rather on the end consumption. Any participation in the total VAT collected should be based on the final bases effectively observed in taxation at the retail stage.

In addition, income, fuel, tobacco and gambling are further areas that also lend themselves to decentralization, under certain conditions. Specifically, it is assumed that all indirect taxes would fall on the retail stage, since suitability is low or very low at the other stages.

According to Gimeno Ullastres, there is no ideal solution or irrefutable alternative. But thought must be given to creating a system in which the territorial treasury offices gain autonomy and co-responsibility, thereby bringing about less complexity, more transparency and a guarantee of the principle of solidarity.

Part II comprises three chapters written, respectively, by Robin Boadway, from Queen's University (Canada), Thiess Buettner, from the Ifo Institut and Ludwig Maximilians Universität München (Germany) and Jesús Ruiz-Huerta Carbonell, from the Universidad Rey Juan Carlos and Instituto de Estudios Fiscales along with Ana Herrero Alcade, from the UNED and Instituto de Estudios Fiscales (Spain).

Robin Boadway, in Chapter 5, analyzes the Canadian experience as far as fiscal equalization is concerned. He affirms that there is no perfect equalization system. In a world in which provinces truly have discretion over their spending and taxing policies, heterogeneous outcomes are bound to occur. Indeed, according to Boadway, this is a strength of the federal system. This implies that designing an equalization system that achieves the objective of ensuring that the provinces have the fiscal capacity to provide roughly comparable levels of public services at roughly comparable levels of taxation is a difficult task.

Boadway affirms that despite the difficulties of implementation, the design of the equalization system should be guided by principles, and these principles should be reflected in a formula-based approach rather than one that relies on discretion. In the Canadian case, the emphasis on revenue equalization using a so-called representative tax system (RTS) agrees well with the principles. The main issues that arise involve conflicts between the principle of equalization and other principles. These include the provincial ownership of resources, the incentive effects of equalization, and affordability to the federal government. His view is that the issues of resources and affordability should be dealt with by adjusting the standard rather than by reducing the extent to which resource revenues determine equalization entitlements. Full equalization of all revenue sources for recipient provinces at least ensures

that fiscal equity is achieved among recipient provinces, although not necessarily between recipient and non-recipient provinces. In a federation as decentralized as Canada, full equalization among all provinces would be very difficult to achieve. That is one reason why the country should be very cautious about further decentralizing revenue-raising responsibilities. That would make horizontal balance even more difficult to achieve.

Finally, Boadway emphasizes that achieving a successful equalization system involves non-economic considerations. Institutions can be important in ensuring that the integrity of the equalization process is respected. Equalization policy is part of the broader set of federal–provincial fiscal arrangements and is not placed in a vacuum. The process requires that decisions be made from a long-term perspective and that the federal government behaves in a cooperative manner with respect to the provinces. Moreover, the ability of the federal government to commit to a formula-based approach to equalization that is not compromised by discretionary changes is important to ensure that problems of soft budget constraints do not emerge. Whether that level of commitment and cooperation requires some arm’s-length institution such as a grants commission, found in some federations, is an open question. At least, the importance of institutional considerations and process should not be overlooked in any discussion of reforming federal–provincial fiscal relations.

Thiess Buettner from the Ifo Institut and Ludwig Maximilians Universität München analyzes the German experience in Chapter 6. The German system of fiscal federalism puts a strong emphasis on fiscal redistribution by means of revenue-sharing and fiscal equalization among all levels of governments. At the municipal level the existence of a substantial degree of horizontal fiscal redistribution may be quite helpful in curbing local business-tax competition and providing some sort of insurance against revenue fluctuations. Nevertheless, this positive role is partly offset with disincentive effects, such as, for instance, the reluctance of municipalities to use the land tax to generate revenue.

At the state level, the role of fiscal equalization is much more problematic. The system provides the states with a substantial amount of public funds while it does not require the states to take responsibility for their policies towards the taxpayer by deciding about the tax burden. The state would rather live mainly on grants. At the same time, however, the extensive use of fiscal redistribution cannot be justified on efficiency grounds as is the case with municipalities. In fact, given tax collection at state-level, the fiscal redistribution actually provides additional disincentives that are not present at the municipal level.

Buettner considers that the German example offers some interesting conclusions for the evolving fiscal federalism in Europe. The example of the

German municipalities shows that under the protection of revenue-sharing, tax competition does not necessarily result in inefficiently low tax rates. At the same time, however, the example of the German states shows that fiscal redistribution should be used with caution, in particular in a situation where there is decentralized tax collection.

In Chapter 7, Jesús Ruiz-Huerta Carbonell, from the Universidad Rey Juan Carlos and Instituto de Estudios Fiscales, and Ana Herrero Alcade, from the UNED and Instituto de Estudios Fiscales concentrate on the Spanish equalization system, its characteristics and problems, and the main alternatives for its reform in the near future. To the authors, the search for a new equalization grant should deal with some restrictions. First of all, it should try to achieve more equitable results, responding to an explicit equity target. The central government plays the main role in deciding how much equalization should be achieved, but the regional governments should also participate in the decision process, to foster the stability of the system.

From the technical perspective, the two basic alternatives in choosing the intensity of equalization are a *net equalization*, which means that all regional differences are eliminated, and a *gross equalization* that tries to reduce, but not to eliminate, interregional differences. In the Spanish system there seems to be greater support for a net equalization scheme, although the current debate argues that equalization grants should be devoted to finance only essential, and not all devolved, public services.

The authors indicate that the equalization system should not generate great changes in the ranking of regional abilities to provide services, since its purpose must be to allow all territories to provide similar levels of public services with similar levels of fiscal effort. In addition, from a dynamic point of view, a good equalization system must address the evolution of regional fiscal capacity and expenditure requirements.

The aim is to build up a more stable regional financial system. Despite the fact that the proposals generate some costs to the central government and/or certain regions, they would achieve better results from the equity perspective. For that reason, Ruiz-Huerta Carbonell and Herrero Alcade believe that the gradualism of the reforms is a key issue.

The last three chapters of the book in Part III analyze tax administration. In Chapter 8, Paul Berg-Dick, Michel Carreau, Deanne Field and Mireille Éthier, from Finance Canada, explain how tax coordination works under the Canadian tax system. In Canada, provinces have considerable flexibility with respect to taxation. As a result of the joint occupancy of the three main tax fields (income tax, corporate tax and sales taxes), the federal government and many provincial governments have entered into administration agreements covering each of the tax fields. These administration

agreements represent one of the main components of tax coordination between the federal and provincial governments.

Tax Collection Agreements are the major instrument for coordinating the income tax systems in Canada, which exist in all provinces except Quebec. The provincial tax structure is required to be harmonized to a certain degree with the federal tax structure. For instance, provinces agree to adhere to a common tax base. This is the primary reason why the federal government absorbs virtually all of the administrative costs associated with the collection of provincial taxes. According to the authors, the single administration of federal and provincial income taxes benefits both taxpayers and governments. Taxpayers benefit from a reduction in overall compliance costs and both benefit from increased simplicity in the operation of the tax system.

Regarding sales tax, there are currently two arrangements in place between the federal government and some provinces that provide for coordination. The first arrangement is the Comprehensive Integrated Tax Coordination Agreements, under which the federal government is the administrator of the tax for Newfoundland and Labrador, Nova Scotia and New Brunswick. The second arrangement is between Canada and Quebec, under which the province is the administrator of federal and provincial value-added taxes within Quebec. The other provinces except Alberta have their own retail sales tax, which increases the complexity and the cost of doing business. For that reason the federal government is inviting these provinces to engage in discussions on the harmonization of their provincial retail sales taxes with the federal general sales tax. In this context, the Canada Revenue Agency plays a key role in administering provincial taxes that are subject to the coordination agreements, being the principal revenue collector for both the federal and provincial governments. It was created in 1999 at the instigation of the federal government to provide better service to Canadians, become a more efficient and effective organization and establish a closer partnership with the provinces and territories. Eleven of the 15 members of the Board of Management are nominated by the provinces, which, for the authors, is a clear example of the willingness of the agency to serve the various client governments properly.

The German experience is studied in Chapter 9, by Alexander Ulbricht, from the Bavarian State Tax Service. The author offers a brief overview of the main features of the German tax system, and focuses on the organization of the German tax administration, analyzing the consequences of a decentralized administration in the German case. In Germany the most important taxes (VAT, income tax and corporate tax) are managed by the state offices. The *Länder* are free to choose the organization of their tax administration and there is no federal rule concerning how to administer

taxes and organize the administration, regardless of a general principle of 'uniform taxation'.

Consequently, some problems may arise. The cross-state cases are sometimes difficult to control. Tax equalization is a disincentive for states to invest money and personnel in a more extensive auditing process. Due to different approaches to fighting tax evasion and encouraging compliance, and the lack of coordination in this area of tax administration, most of the measures lose their effectiveness the moment another state becomes involved.

Ulbricht believes that in order to work effectively, a centralized tax administration is not required, and is probably even more obstructive than a decentralized one. The only necessity is a superior coordinating authority with a greater influence on the way the states organize their tax administration: a federal tax office.

In Chapter 10, the final chapter, Alejandro Esteller Moré, from the University of Barcelona and the Institut d'Economia de Barcelona (Spain), concentrates on the current situation and proposals for reform of the tax administration in Spain. Over time, while assuming legal power over income tax, some Spanish regions have simultaneously begun to lay claim to a more important role in the administration of the taxes levied in their territory, at least over taxes shared with the state and administered by the AEAT (Agencia Estatal de Administración), the state's tax agency. In spite of some steps forward, certain regions call for greater involvement in tax administration, especially in income tax.

Indeed, the new Statute of Autonomy of Catalonia anticipates the creation of the Tax Agency of Catalonia (ATC; Agència Tributària de Catalunya), to encourage greater organizational flexibility and budgetary autonomy. This regional agency alongside the AEAT will set up a consortium (or equivalent entity) in which both agencies have an equal share of participation and that would take on the application of all taxes in Catalonia. Therefore, Esteller Moré affirms that the not yet fully defined formula would involve decentralizing income tax administration in Catalonia, in collaboration with the AEAT.

The author believes the reform is very positive, because, on the one hand, it guarantees a degree of uniformity in the tax processes, avoids the fragmentation of tax information generated in Catalonia that is of interest to other regions and obviously to the AEAT, and, finally, does away with any possible disincentives to efficient tax management, perhaps caused by questions of tax competence and/or horizontal equalization. This is all because membership on the consortium's board will be equally shared between the state and the regional agencies. However, the reform allows a degree of non-uniformity in the tax processes (e.g., permitting specific fraud detection filters and differing rules for taxpayer treatment). It allows for improvement

to the income tax assessment procedure used locally and gives the Catalan administration much greater access to tax information. Finally, it helps to set tax collection forecasts and assess the impact of envisaged tax reforms.

According to Esteller Moré, the most serious issue to be raised by the consortium in Catalonia is the extent to which taxes may, in fact, become non-uniform because of decentralization. Certainly, the drawbacks of non-uniformity should be contrasted with the benefits that decentralization may bring in terms of effectiveness. In any case, both factors seem difficult to quantify, especially more effective administration, in resolving this dilemma. As a result, the most reasonable assumption to make is that any factors causing non-uniformity in the application of taxes that are caused by decentralization will need to be reduced, especially with regard to income tax. Even so, the author affirms that decentralization in the form of a consortium seems to be an improvement on the present institutional structure of tax administration in Spain.

