

**Some random thoughts on
EQUALIZATION SYSTEMS IN REGIONAL FINANCING**

Angel de la Fuente

Instituto de Análisis Económico (CSIC)

October 2013

Two preliminary remarks

- *European dimension?* European fiscal union should have no effect on internal regional equalization systems.

It is not clear to me what is meant by European fiscal union. The real thing seems rather unlikely for at least one more generation. Increased fiscal monitoring at the EU level should tighten budget constraints also at the regional level, but it is hard to see how it might affect the design of regional equalization systems.

Loss of EU funding for regional policies may increase the need for national schemes to support regional development, but again this has little to do with regional equalization, which is aimed at public services, not at regional development.

- *Negative incentive effects?* I don't think so (if properly designed)

Widespread idea that too much equalization can have adverse effects is based on a misleading analogy with individual disincentives arising from excessively progressive tax schedules.

But regional equalization schemes don't equalize net regional incomes, only public services.

Even at the individual level, universal access to decent public services can hardly be seen as a major source of disincentives.

Governments still have incentives to choose growth-promoting policies. Voters will be happy if the economy is doing well, even if that does not give them better public services than their neighbors.

The role of equalization schemes

- Equity rationale: Equality in the access to public services.

Most federal countries have equalization schemes that supplement the finances of relatively low income jurisdictions so that they can provide services that are at least roughly comparable to those of richer territories.

- The degree of redistribution and the way to achieve it vary widely across countries. E.g. USA, Australia, Canada ...
- I will look briefly at the Spanish and German models and argue that they share similar problems: unnecessarily complicated and anything but transparent + they generate rather arbitrary distributions of resources across regions.

Calculation of expenditure needs/adjusted population

- **Spain:** We use a relatively simple formula to adjust population for the relative per capita costs of regional services.

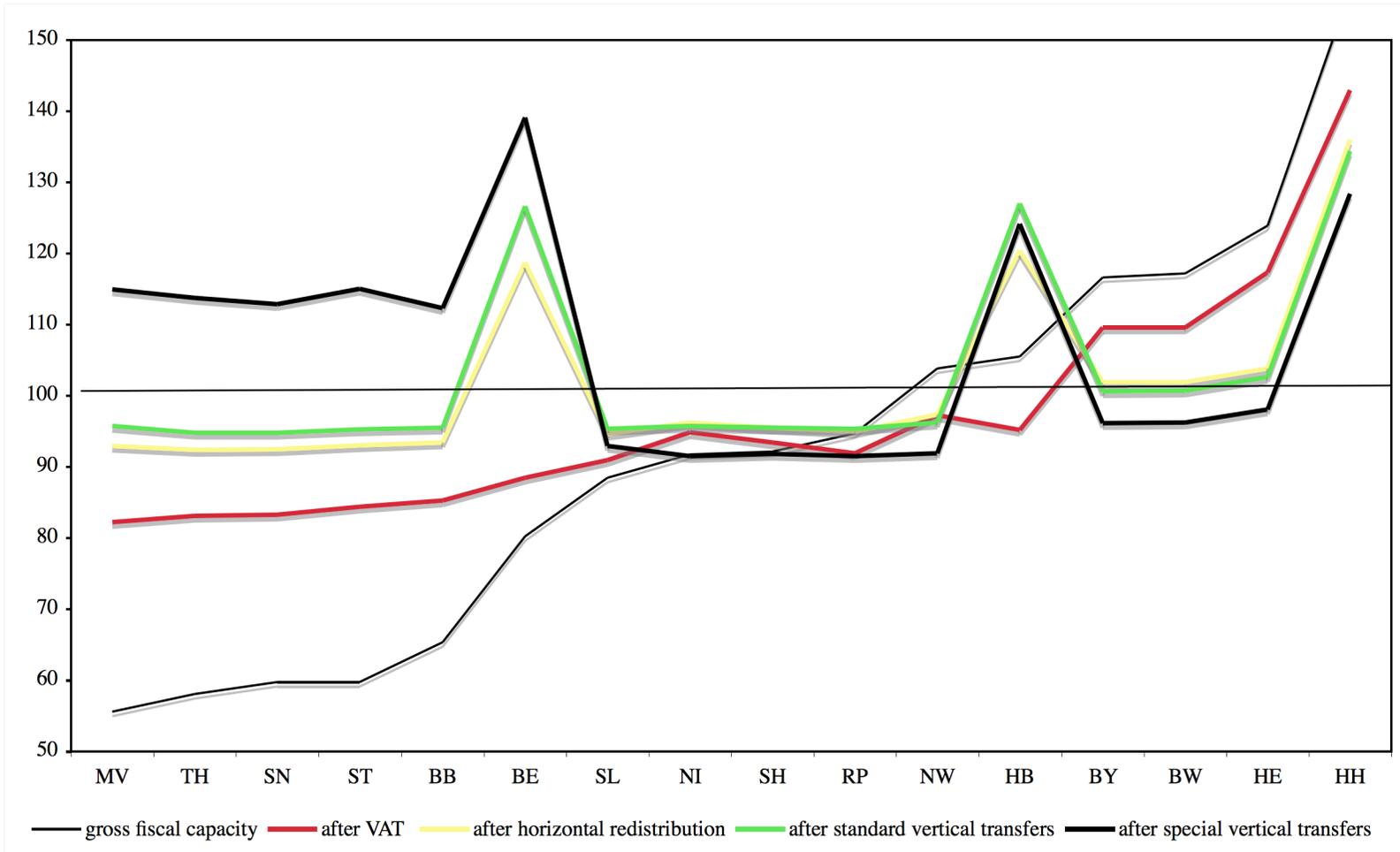
It takes into account the main cost factors: population age structure, extension of the territory, population dispersion, insularity.

- **Germany:** large ad-hoc adjustment for city states (+35%), minor corrections for less densely populated states. Highly questionable and introduces large distortions.

Redistribution mechanisms, Germany:

- *Allocation of VAT* favors poorer regions. Mostly by population + up to 25% is reserved for states with below average financing. Top-up rates decrease from over 90% to 60%.
- *Horizontal transfers across states*: from tax revenue-rich to poor states, taking into account municipal taxes. Also falling top-up rates and limits to redistribution. Respects original ordering of regions only in per adjusted person terms, not otherwise.
- *Vertical transfers from the Federation*: Poorer states raised (almost) to the mean + additional transfers for special needs. The second go mostly to the East and tend to invert the regional ranking, but follow a declining path over time.

Allocation of resources per capita at various stages in the German system (not including municipal taxes) 2008 data



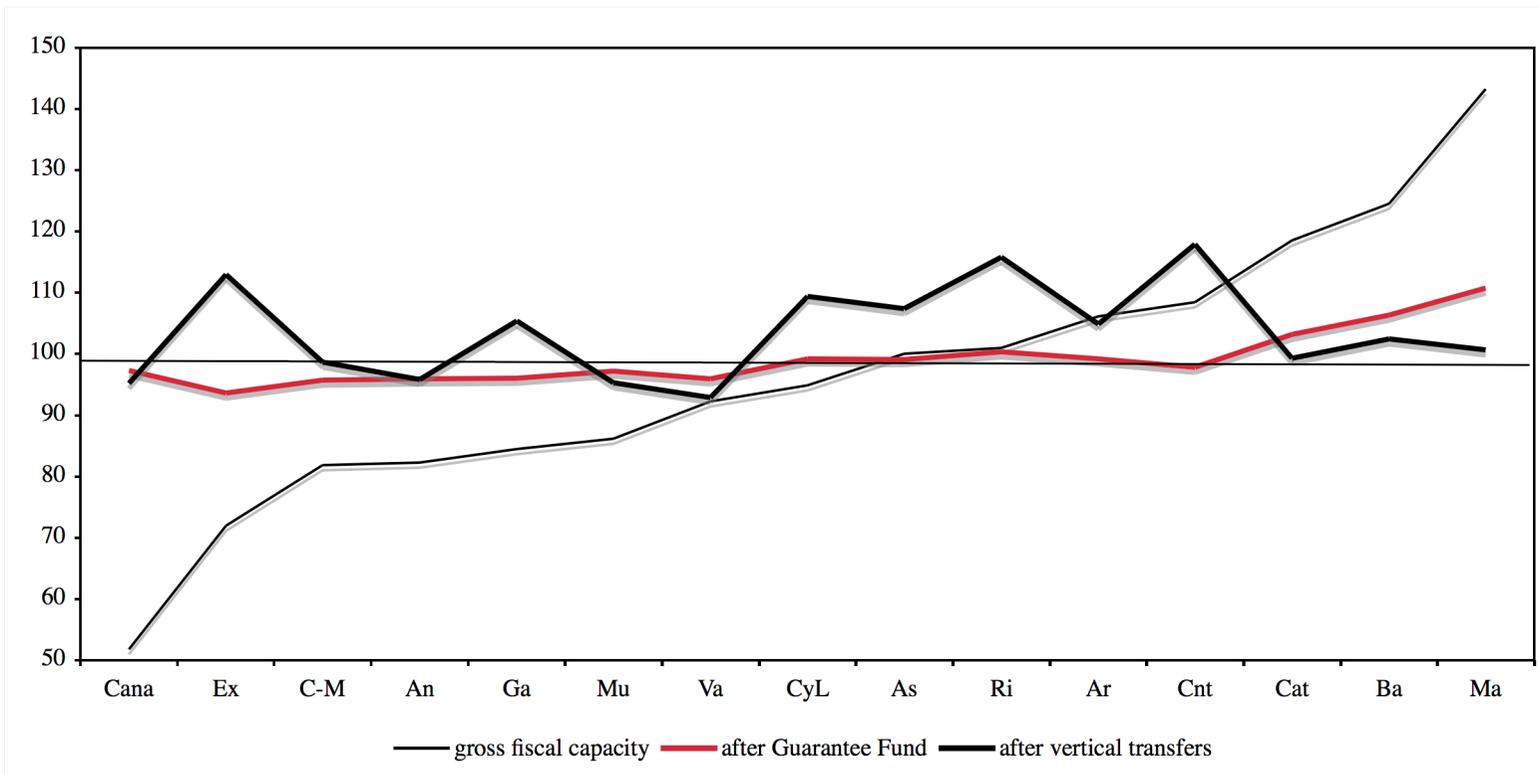
Redistribution mechanisms, Spain:

- *(Mostly) Horizontal transfers: Fondo de Garantía*

75% of the homogenized tax revenues of the regions (+ a federal contribution) go into a common pool that is then redistributed in proportion to needs (adjusted population). Reduces inequality considerably and does not alter the ordering of regions.

- *Vertical transfers:* several funds, allocated according to different and even contradictory criteria, including the *status quo*. Play havoc with the system: increase inequality and modify the regional ordering, turning the system into a sort of lottery with no clear rationale and large differences in financing per unit of need.

Allocation of resources per capita at various stages in the Spanish system (using adjusted population), data for 2010



Comparison of the two systems

	<i>[1] gross fiscal capacity</i>	<i>after VAT</i>	<i>after horizontal transfers</i>	<i>after standard vertical transfers</i>	<i>after special vertical transfers</i>
Germany					
<i>Std. deviation</i>	27.6	15.6	12.2	13.0	14.7
<i>Inequality index</i>	100.0	56.5	44.3	47.0	53.2
<i>corr with [1]</i>	1.000	0.945	0.692	0.545	-0.132
Spain					
<i>Std. deviation</i>	21.6		4.4		7.6
<i>Inequality index</i>	100.0		20.2		35.1
<i>corr with [1]</i>	1.000		0.854		0.168

correlation with [1] captures changes in regional ranking

- Overall, both systems

reduce initial disparities in financing per capita

and introduce important changes in the ranking of regions in terms of resources per capita

- In Germany, the ad-hoc population adjustment dampens the redistributive impact of the system and introduces an important element of arbitrariness.

Aid to the new Eastern states at the last stage tends to invert the ordering, putting the poorest states in the first positions, but it does have a logic and will be gradually phased out.

- In Spain, the vertical transfers are the main problem. Adopting the German system (without special transfers and keeping our expenditures need rule) would yield a much more reasonable allocation.

So would just about any logical scheme for the distribution of vertical transfers. One possibility is to keep the current system except for the vertical transfers, which would be distributed so as to eliminate the highest possible fixed fraction of the difference with the best-treated region in terms of financing per adjusted capita after applying the Guarantee Fund.

(Main difference is at the upper tail: German system would benefit Madrid by allowing it to keep more of its advantage and would hurt Balears through the redistributive allocation of VAT)

Regional financing per adjusted capita in Spain Observed Spanish system vs. two hypothetical alternatives

