

## THE EVOLUTION OF THE SUBNATIONAL PUBLIC FINANCES IN SPAIN AFTER THE GREAT RECESSION AND COVID-19 PANDEMIC AND FUTURE CHALLENGES (2008-2021)<sup>1</sup>

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### ABSTRACT

The 2008 financial crisis and the 2020 health crisis have profoundly disrupted Spain's public finances and multi-level governance system. The aim of this article is to analyse the evolution of the regional public finances and decentralisation system in Spain during the 2008 financial crisis and the 2020 health crisis. In light of the asymmetrical funding system that governs Spain, the article analyses and contrasts the evolution of the finances and indebtedness between the autonomous communities of the common and foral regime. The article concludes that both crises have driven a process of recentralisation, reinforcing the central government's role in fiscal and financial matters.

**Keywords:** Spain, fiscal decentralisation, asymmetric federalism, regional policy, regional funding system, tax autonomy, subnational debt, economic crisis.

## I. INTRODUCTION

Over the last forty years, Spain has evolved from a unitary to a highly decentralised state. Decentralisation has mainly benefited the autonomous communities (henceforth ACs), which emerged as new political entities around 1980. The Spanish model of territorial decentralisation is organized in 17 ACs and the autonomous cities of Ceuta and Melilla. The decentralisation process was not gradual, but responsibilities were transferred in several “waves”. Moreover, the process characterised by a structural tension between symmetry and asymmetry. In this regard access to self-government took place through different paths and speeds. While the Basque Country, Catalonia, Galicia and Andalusia already assumed during the 1980 important spending responsibilities, other ACs could only later on assume these responsibilities (Tudela, Kölling 2020).

The process of decentralisation received a decisive boost in the early 2000s, when powers on health and education were transferred to all the ACs. From this moment on, we can observe substantial homogeneity across expenditure powers among all ACs. Devolving health and education resulted in a substantial and gradual increase in the ACs public expenditure from then onwards. The system of revenue assignments to ACs also decentralised gradually, in an asymmetric and complex fashion. Overall, the degree of decentralisation in the field of revenues has been more modest in comparison with the expenditure side (Lago-Peñas et al., 2017).

Although the decentralisation process in Spain has been quite successful, questions related to the regional financing system have occupied a large part of the debates on the territorial organisation of power in Spain. The 2008 crisis first and the COVID-19 crisis afterwards have put great pressure on the public finances (De la Fuente, 2022). They have also exacerbated the shortcomings of the regional funding system, evidencing its limitations (Martínez, 2020b). The renewal of the regional funding system has been under consideration and debate for a decade, with no success to date.

As regards the political landscape, Spain has been in crisis-mode for a decade. The 2008 economic and financial crises have led to the so-called crisis of representative institutions in which there has been a huge loss of popular confidence in aspects of the democratic system (Erkoreka et al., 2021). The economic instability and the climate of political tension and polarisation prevented fundamental reforms to correct and improve the functioning of the decentralisation system – including the regional funding system.

The aim of this article is to analyse the state of art and future of the regional public finances and decentralisation system in Spain after the impact of the two great crises of the first quarter of the XXI century: the 2008 financial crisis and the 2020 health crisis.

The article uses the tools of fiscal and budgetary analysis to approach the subject, relying mainly on budgetary statistics and official fiscal and financial data. In addition, primary and secondary sources will be used to complement the analysis and integrate the political and institutional dimension. On the basis of the available information, the analysis ends in 2021 as it is when the effects of the pandemic on public accounts were already remitting. Where statistical sources have permitted this, statistical series have been elaborated from the 1990s, with the aim of developing the long-term perspective.

The article is structured in six sections. The first section contextualizes the evolution of the political and institutional framework during the 2008 financial crisis and 2020 health crisis. The second section explains the characteristics of the asymmetrical system of regional financing in Spain. The third and fourth sections analyse the evolution of subnational public revenue and expenditure. The fifth section analyses the evolution of subnational public debt. The sixth and last section draws some conclusions.

**II. THE POLITICAL AND INSTITUTIONAL FRAMEWORK DURING THE 2008 FINANCIAL CRISIS AND THE 2020 HEALTH CRISIS****1. The 2008 financial crisis**

The main cause of the 2008 crisis in Spain was the housing bubble and the accompanying unsustainably high GDP growth rate. The Spanish government faced the critical development by relaxing supervision of the financial sector. The ballooning tax revenues from the booming property investment and construction sectors kept the Spanish government's revenue in surplus, despite strong increases in public expenditure, until 2007 (Royo, 2020). While Spain started the crisis period with a relatively modest public debt of 36.2% of GDP, it sunk into a great economic depression as the consequences of the crisis were devastating (Martí & Pérez, 2016). After having completed substantial improvements over the second half of the 1990s and during the 2000s, which put a few ACs on the brink of full employment, in October 2008, the unemployment rate increased strongly, exceeding by far the unemployment surge of past economic crises like 1993. In spring 2012, Spain's unemployment rate reached 24.4% and Spain's public debt stood at 72.1% of GDP. The crisis and several corruption scandals (most cases had their origins in the housing bubble years) had a profound impact on public trust in democratic institutions and the model of territorial decentralisation. At the same time, the financial crisis coincided with the escalating secessionist conflict in Catalonia since 2012, which culminated in 2017 with a unilateral declaration of independence.

Moreover, the financial crisis seems to have contributed to polarise and fragment the party system. From the mid-1980s to the mid-2010s, Spain's party system was dominated by a straightforward competition between the social democratic Spanish Socialist Workers Party (PSOE) and the liberal-conservative People's Party (PP). Since 2014, however, the leftist *Podemos* party and the centre-right liberal *Ciudadanos* have entered the national arena, the moderate nationalist Catalan forces have collapsed, and a radical-right populist party, *Vox*, has emerged with strength. As a result, since 2015 no party has been able to form a stable governmental majority after elections.

**2. The 2020 health crisis**

Spain was one of the countries around the world most affected by COVID-19, both in terms of the number of infections and number of deaths. In this sense, data on zero prevalence and mortality indicate a very uneven spread of the pandemic during 2020 (Erkoreka & Hernando, 2022). The first two epidemiological waves affected ACs like Madrid or Castilla-La Mancha more intensely. Other ACs like Andalusia, Murcia or the two archipelagos presented figures that evince a lower level of incidence and diffusion of the disease. Although economic growth and job creation remained solid since 2014, Spain was still in political and institutional crisis mode. The fragmentation of the party system intensified since the November 2019 general elections, and polarisation proved to be a significant obstacle to cross-party agreement. 22 parties obtained representatives in the Congress of Deputies in 2019 - the lower house of the Spanish parliament. In January 2020, a minority left-wing coalition government consisting of the PSOE and *Unidas Podemos* ('United We Can') came to power. It was the first Spanish-wide coalition government since the Second Republic (1931–1939). Despite concerns about the stability of the coalition, the government pushed an ambitious legislative reform agenda through parliament while fending off a wave of hostility from the political right.

With the outbreak of the COVID-19 pandemic in spring 2020, the Spanish government opted for an initial response based on a centralised control, one that rapidly unveiled

the institutional weaknesses of the intergovernmental system. But the growing political contestation, the logistical inefficiencies derived from centralisation and the improvement of health indicators, brought a change of perspective (Erkoreka et al., 2021). In that way, the ACs gradually recovered the powers and functions that had been centralised, giving way to a scenario of co-governance, in which the central government and the ACs share responsibilities in the decision-making and management of the pandemic (Carmona, 2021).

The pandemic revealed the weakness of the healthcare system, both in terms of public health policy and patient care (Mattei & Del Pino, 2021). Funding cuts to healthcare following the 2008 crisis have led to increasing variability in the quality of healthcare services across the ACs that are responsible for the delivery of healthcare. The COVID-19 crisis has also revealed the structural weaknesses in and cyclical problems of the Spanish territorial model (Erkoreka & Hernando, 2022). It has become especially clear that intergovernmental coordination instruments and joint decision-making bodies were unable to respond to the crisis appropriately (Kölling, 2020). Moreover, tensions between the constitutionally determined framework legislation of the central government and the reality of a model consisting of heterogeneous regional healthcare systems became apparent. Due to institutional weaknesses, decisions were taken very late and slowly. However, as the crisis unfolded, intergovernmental coordination improved, and representatives of the various health authorities met frequently to exchange information and reach common agreements.

Still, it should be stressed that the model of decentralised organization has not in itself been a handicap when confronting the pandemic in Spain (Erkoreka & Hernando, 2022). The results of their management facing the pandemic differed significantly between ACs. There were some ACs that performed satisfactorily within the established framework of decentralisation. Irrespectively of the unequal territorial incidence of the virus, the key factor for analysing and evaluating these differences between ACs has not been the model of organization, but the sufficiency of resources and the quality and orientation of the public management developed by the different levels of government, both prior to and during the pandemic.

The pandemic has also shown the vulnerabilities of the Spanish economic structure (De la Fuente, 2021a; Felgueroso et al., 2021). At the beginning of 2020, Spain displayed weak productivity growth, while private investment in R&D continued to be low. Spain's business structure is highly fragmented. Moreover, Spain has been hampered by an excessive dependence on tourism, which prior to the COVID-19 crisis contributed to around 13% of GDP and employed three million people. Since the beginning of the pandemic the GDP declined by 10,7 % in 2020 and recovered by 8 % in 2021. The unemployment rate in the first quarter of 2020 was 14,4%, with more than 3,3 million people unemployed. Although the Temporary Lay-off Plans (*ERTE*) for companies affected by the coronavirus crisis cushioned the impact of the crisis on the labour market, the unemployment rate increased to 16,13% at the end of 2020<sup>2</sup>. But thanks to the economic recovery, the unemployment rate fell again to 13,3% by the end of 2021.

### III. THE ASYMMETRICAL SYSTEM OF REGIONAL FINANCING

As has been noted above, the system of financing the ACs in Spain has an asymmetrical character and is regulated by two differentiated types: the common and the foral types. The common type is applied uniformly in all the ACs on the peninsula<sup>3</sup>, except for the Autonomous Community of the Basque Country and the Foral Community of Navarre. Based on historical and political circumstances, these two ACs have preserved a singular and exclusive system of financing of a federal type, which is rooted in the pre-constitutional “historical rights” of the foral territories. Both funding types work completely different and are independent of each other. The characteristics of both funding systems are summarised below.

#### 1. The revenue structure of common regime ACs

The common financing system is regulated through the regional financing Law (*Ley Orgánica de Financiación Autonómica* – LOFCA), which is negotiated multilaterally between the ACs and the central government. The LOFCA was established in 1980 and was amended in 1986, 1992, 1996, 2001 and 2009 (León 2015). The completion of the process of decentralisation of education and health at the beginning of the 21st century made it necessary to update and strengthen the common regime’s system of regional financing. In this way, in the year 2001 a new Law of regional financing was approved that strengthened the revenues and the tax autonomy of the ACs.

In 2009, the Spanish government promoted a new law on regional financing. Although it was approved amid the economic crisis, the bases of the law clearly ignored such a context as it provided broad resources to the ACs. The law envisaged a revision of the criteria in five years-time, that is, in 2014, as a measure to correct possible imbalances and shortcomings. But the gravity of the economic situation and the growing political tensions resulted in the revision being placed on stand-by, a state in which it has remained up to the present.

According to the 2009 Law of regional financing, in addition to the debt, the sources of income of the ACs is based on three pillars: inter-governmental transfers, equalisation grants and conditional transfers; shared taxes, and own taxes (see Kölling, et al. 2023).

*Inter-governmental transfers, equalisation grants and conditional transfers.* These are designed to guarantee that all ACs have the same level of resources to provide public services. There are four such payments: the Guarantee Fund for Fundamental Public Services, the Global Sufficiency Fund, the Competitiveness Fund and the Co-operation Fund. The Guarantee Fund for Fundamental Public Services is the main equalisation instrument. It is calculated as the difference between the expenditure needs of each AC in the fundamental public services (education, health and social service) and 75 percent of their fiscal capacity, which is the potential revenue collected from shared taxes (taxes on income and VAT, see paragraph below) plus some fees and charges. According to de la Fuente, while the Guarantee Fund generates sizable horizontal flows from rich to poor ACs and greatly reduces regional disparities in terms of financing per adjusted head, the vertical transfers are distributed across ACs according to a large number of often conflicting criteria (de la Fuente et al. 2016). In general terms, the vertical Global Sufficiency Fund is calculated for each AC as the difference between the expenditure needs and the tax revenues and the transfers from the Guarantee Fund. However, the main objective of the Fund is the preservation of

3. The Canary Islands and the Autonomous Cities of Ceuta and Melilla have a special tax and funding regime.

the status quo at the time of the 2009 reform of the system, meaning that revenues for ACs are maintained by this Fund with respect to the year of reference, 2007.

To reduce the standard deviation of financial resources across ACs, the 2009 regional financing Law created two unconditional grants: the Competitiveness Fund, which offers resources for ACs that are below the national average or with a financing index below an adjusted index of fiscal capacity, and the Cooperation Fund, which provides additional financing for ACs with low income per capita, slow population growth or low density of population. In addition, ACs receive conditional grants from the central government to finance certain regional policies or joint projects (Instituto de Estudios Fiscales, 2018, p. 35). Lastly, some ACs receive grants from the Inter-Territorial Compensation Funds and conditional grants from the European Regional Development Fund, to reduce regional disparities in income.

*Shared taxes.* They are the taxes partially or totally ceded. Completely ceded taxes are taxes over which the AC governments are responsible for the collection and management, and over which they can apply regulatory modifications. This includes Property Transfer and Stamp Tax, Inheritance and Gift Tax, Special Tax on Certain Means of Transport, Taxes on Gambling, Special Tax on Hydrocarbons and Tax on Electricity. Partially ceded taxes are taxes over which the central government retains responsibility for collection and management, but over which ACs can increase rates and decide on tax deductions. We cannot designate ceded taxes as own-source because AC governments can marginally adjust rates, they do not determine the tax base or sharing formula. It was not until 1997 that ACs were allowed to set the tax rate and to establish tax credits and allowances. The 2001 reform expanded the proportion of shared taxes as the main source of revenue for ACs: 33.3 % of the personal income tax was shared and based on AC regulation. The reform also included the sharing of VAT (35%) and excise tax (40%). The 2009 reform increased the regional share to 50% of personal income tax and 50% of VAT (López Laborda, 2010).

*Own taxes.* These are those over which ACs have the power to introduce and abolish the tax, to define the tax base and rate, and to grant tax deductions (Blöchliger, Rabesona 2009). Moreover, the revenue from own taxes belongs entirely to ACs. There exists a broad constitutional basis for the establishment of 'own' taxes (Fernández Llera 2021). However, there is an important constraint: ACs cannot impose a tax on a base that is controlled by central or local governments. Since these two bodies had established taxes on most bases, there was in practice little tax room left to ACs (Zornoza, 2014). Moreover, the regional financing Law prohibits ACs from imposing barriers to the functioning of the internal market and further constraints are set by the EU competition law that interprets certain taxes as a state-aid. The establishment of own taxes has given rise to a high level of jurisdictional conflict, with frequent appeals to the Constitutional Court and the European Court of Justice (López Pérez, 2018).

Shared and own taxes are the main source of funding for the ACs. But they exercise limited regulatory and managerial capacity over these revenues (own taxes account for less than 15 % of revenue). In this way, most of the resources of the ACs depend on decisions taken exclusively by the Central government, which is also responsible for managing the bulk of the tax collection (Vilalta, 2020).

In addition, the system of intergovernmental transfers also affects the budgetary and financial autonomy of the ACs. Each year the ACs of the common regime receive in advance the funds from the regional financing system in application of the forecast existing at the time the draft bill for the general state budget is drawn up. These instalment payments are settled two years later on the basis of the definitive budgetary



results. If the settlement proves to be negative, the ACs must return the excess quantity they had received in advance.

The system of financing of the common regime has not resulted in the ACs developing a solid and decisive tax autonomy (Martínez, 2020a; Martínez-Vázquez & Lago-Peñas, 2020). The ACs continue to be notably dependent with respect to instalment payments and transfers by the central administration when drawing up their budgetary policies. Under this system of financing the ACs of the common regime suffer from a huge dependency with respect to the decisions of the central government – above all in circumstances of budgetary urgency that require a swift response – to the evident detriment of their financial autonomy. Similarly, the evaluation of the exercise of fiscal responsibility and accountability by the different administrations is also diluted and made more difficult (Comité de personas expertas, 2022; Instituto de Estudios Fiscales, 2018; Martínez-Vázquez & Lago-Peñas, 2020).

## **2. The revenue structure of foral system**

Within the system of foral financing, the Basque Country and Navarre function under a regime that is completely different from, and independent from the common system. The instrument that regulates the system of financing and the framework of tax and financial relations between these two territories and the central administration is called the Economic Agreement Law, in the case of the Basque Country, and the Economic Covenant Law, in the case of Navarre. Both laws are negotiated and updated bilaterally between each of the regional governments and the central government.

In contrast to the ACs of the common regime, the foral institutions of the Basque Country and Navarre exercise a broad tax, financial and budgetary autonomy. Within their respective territories, the foral treasuries manage and collect practically all taxes, both direct and indirect - including personal income tax, corporate income tax, taxes on inheritances and donations, and VAT (Zubiri, 2010). Foral institutions have regulatory capacity over most direct taxes. In this way, the Basque public sector is financed almost exclusively through autonomously managed tax revenues – the proportion of transfer from the central government or other administrations is residual. Foral institutions are amongst the sub-state entities with the greatest tax and financial power in Europe (Erkoreka, 2021). As a counterpoint, the Basque and Navarrese institutions pay an annual quota to the state in order to finance competencies and services that have not been transferred or decentralized and are developed by the central administration to the benefit of the Basque Country and Navarre. Consequently, it is the subnational government that transfers funds to the central treasury and not vice versa (Pereda, 2019). The system of foral financing assumes a high degree of fiscal responsibility and is governed by the principle of unilateral risk (Rubí, 2016). Under this principle, the foral institutions assume the risk of eventual lower tax revenues, whether as a result of the economic conjuncture, their fiscal and budgetary policies, or for any other exogenous or endogenous reasons.

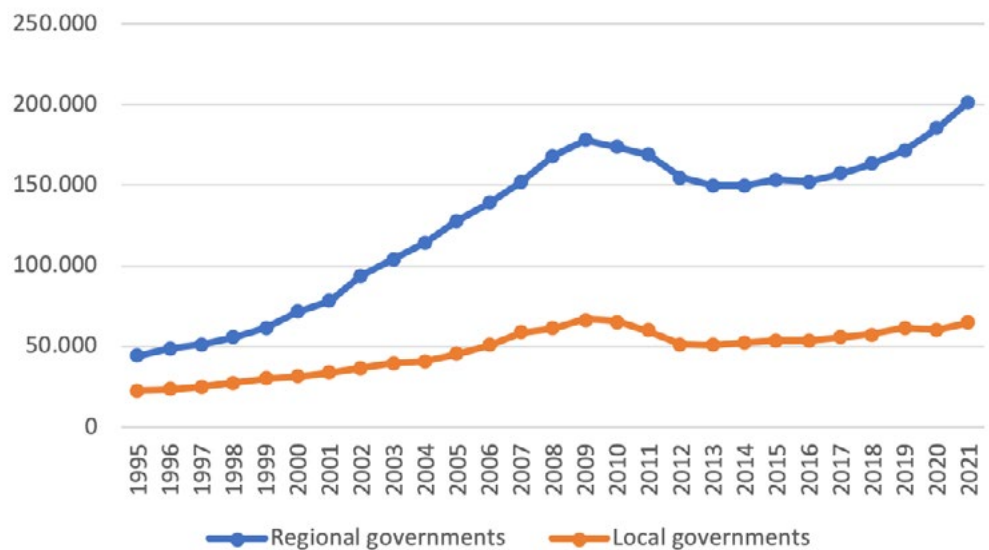
The confluence of two such different regimes of financing within the frontiers of the same state, makes Spain into an interesting laboratory for tests that analyse the sustainability and contrast the behaviour of the subnational public finances between highly disparate funding systems in terms of tax autonomy and fiscal responsibility.

#### IV. THE EVOLUTION OF SUBNATIONAL PUBLIC EXPENDITURE

In light of the progress in the decentralisation process, subnational public expenditure maintained an upward trend since the second half of the 1990s. The decentralisation of spending powers in Spain has relied heavily on bilateral intergovernmental relationships. If the central government and AC agreed on the amount of resources needed to provide a new spending responsibility service (the so-called *coste efectivo*), then the central government commits to cede them in the form of (larger) unconditional transfers. Due to political and institutional restrictions established in the early 1980s, the existence of separate political cycles in some territories, and the need of the central government to respond to some centrifugal forces, the whole process has been quite asymmetric. As a result, while some ACs started to manage important services such as education and health in the mid-eighties, others started doing so in 2002. Currently, more than 40% of public expenditure is managed between the ACs and local governments. These expenditures are mainly focused on health and education, the two largest components of the regional public expenditures (Lago Peñas, et al. 2017).

The 2008 financial crisis slowed this trend. At first, the pronounced deterioration in public finances due to the economic crisis of 2008 did not affect the budgets of the ACs due to the configuration of the new regional financing Law passed in 2009: initially, the central government chose not to transfer the effects of the fall in tax revenues to the instalment payments. In this way, the ACs were able to maintain their pre-crisis spending capacity (De la Fuente, 2022).

**Figure 1. Evolution of the subnational public expenditure in Spain (1995-2021) (in million euros at current prices)**



Source: OECD Fiscal Decentralisation Database, Consolidated government expenditure. Elaborated by the authors.

The ACs were brought down to earth from 2010 onward. The deterioration of public accounts due to the prolongation of the crisis and the coming to power of the liberal-conservative party (PP) in 2011, opened the door to a period of austerity and adjustments in public finances. Additionally, in the context of the European bailout of the Spanish banking system and the reform of Article 135 of the Spanish Constitution, the Spanish parliament approved a new Law on Budgetary Stability and Financial Sustainability (henceforth, LBSFS) in 2012. The aim of the LBSFS is to guarantee the budgetary stability and financial sustainability of all of the Spanish public administrations (Ruiz & Cuenca,



2014). By virtue of the LBSFS, the central government could set triannual objectives of budgetary stability and public debt, distributed across the different levels of the administration: the central administration, ACs, local entities and administrations of the Social Security. After 2012 the central government had made fiscal consolidation the key target of its economic policy, using the hierarchical nature of Spanish decentralisation to push through strong adjustment to the ACs, establishing control mechanisms on public spending and expenditure ceilings of the ACs, as well as creating a system of sanctions for ACs.

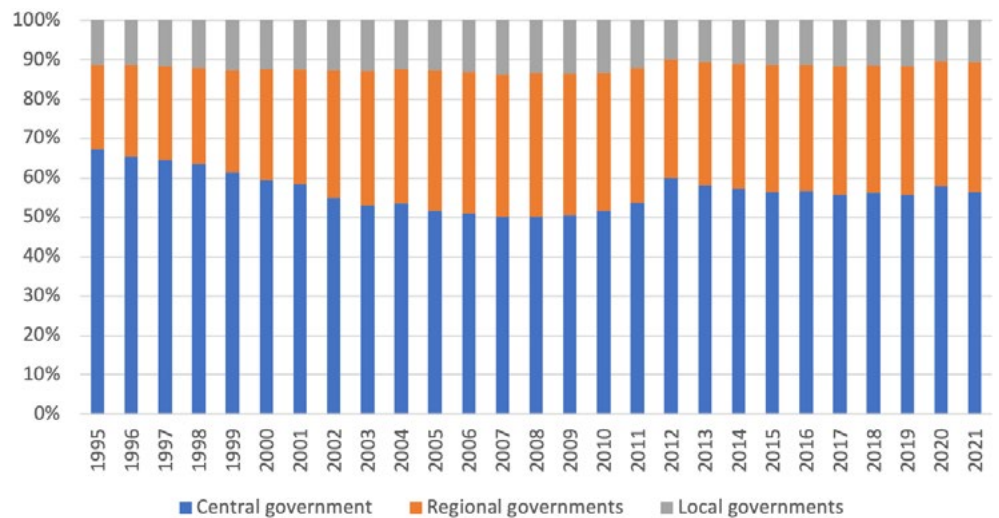
Thus, although with different intensity and orientation depending on the needs and political preferences of each government, regional and local administrations had to implement budget cuts to comply with the rules and policies of austerity and budgetary control. These cuts were reflected in sensitive areas such as health and education. Funding cuts to healthcare following the 2008 financial crisis have led to increasing variability in the quality of healthcare services across the ACs (Erkoreka & Hernando, 2022). The level of expenditure stabilised between 2013 and 2016.

Thanks to the economic recovery and also influenced by the change in the central government in 2018 (the Socialist Party returned to power), public spending increased again gradually since 2017. From this date, the central government gradually relaxed policies and measures of austerity and control of public expenditure. It should be noted that until 2020 the regional public expenditure ceiling reached in 2009 was not exceeded.

The COVID-19 crisis did not initially affect the evolution of subnational public expenditure. On the contrary, the latter increased in 2020 and 2021. The central government and the Social Security (which has a centralized character) assumed the greater part of the costs of the crisis, granting extraordinary resources to the ACs to finance their necessities and the increase in socio-health expenditure (AIReF, 2021).

If we analyse the evolution of public expenditure as a whole, we can appreciate the impact of the crises on the decentralisation process in Spain (see Figure 2). In the fiscal and financial sphere, the 2008 and 2020 crisis slowed down the process of decentralisation of public expenditure that had been developing since the 1990s. The central government (including social security) has strengthened its role during the management of the 2008 and 2020 crises, assuming greater intervention on expenditure and economy.

**Figure 2. Distribution of public expenditure, by administrations (1995-2021) (in percentages)**



Source: OECD Fiscal Decentralisation Database, Consolidated government expenditure. Elaborated by the authors.

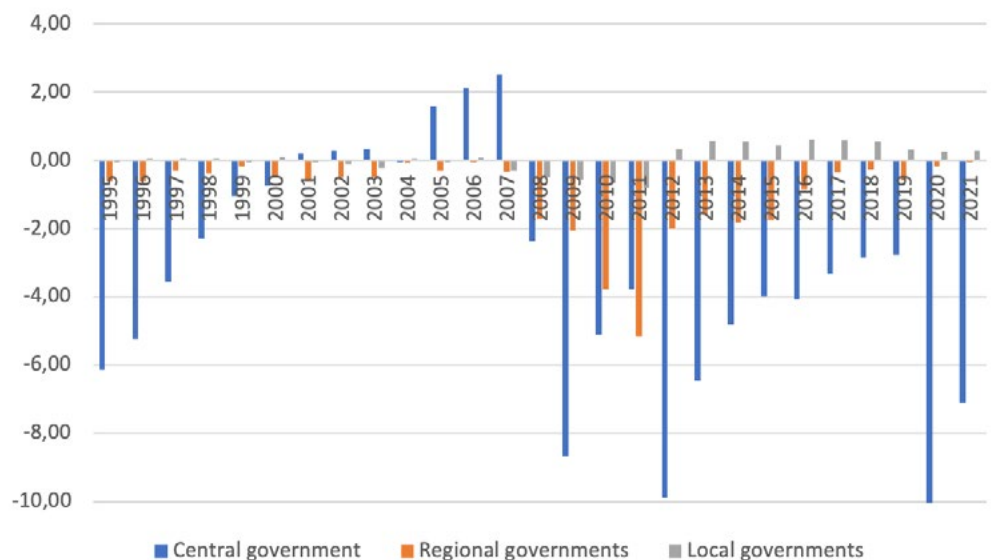
## V. EVOLUTION OF SUBNATIONAL PUBLIC REVENUES

Prior to the 2008 crisis, the Spanish economy enjoyed a period of economic growth, to a great extent stimulated by a large real estate bubble. In this context, and although the expenditure side also increased significantly as a result of the new powers transferred to the ACs, the finances of the ACs evolved positively and their level of indebtedness was in general reduced. The severe economic crisis that broke out in 2008 marked a turning point.

As explained above, the crisis did not initially affect the public accounts of the ACs because the central government chose not to transfer the effects of the fall in tax revenues to the instalment payments. The new Law of regional financing approved in 2009 deliberately ignored the state of crisis, providing broad resources to the ACs and thus removing the incentive for the latter to adjust their accounts in line with the change of economic cycle. This Law gave rise to inter-regional imbalances in matters of financing, which were aggravated as the economic crisis became prolonged over time.

The ACs received the impact of the crisis in 2010, when their revenues dropped above 10 %. The settlement of the 2008 and 2009 fiscal years, together with the worsening of the economic crisis, resulted in some of the ACs experiencing a severe liquidity crisis (Martí & Pérez, 2015). As a result of the crisis, the deficit of the central government and the ACs shot up.

**Figure 3. Net lending (+) or net borrowing (-), by administrations (1995-2021) (as % of GDP)**



Source: OECD Fiscal Decentralisation Database, Balances and debt of state and local government. Elaborated by the authors.

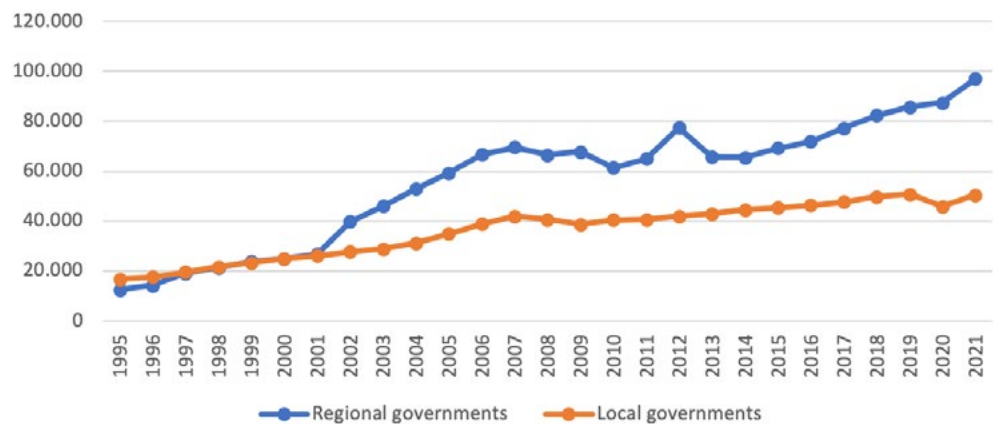
Facing the severe liquidity crisis experienced by some ACs, and the difficulties they encountered in being able to finance themselves on the financial markets, the central government decided to create the regional liquidity fund in 2012 (*Fondo de Liquidez Autonómico*) (Herrero-Alcalde et al., 2019). In this way, the central government extended a line of credit to the ACs so that they would be able to refinance their debt in very favourable conditions without having to turn to the market. Technically, having recourse to the liquidity funds was not considered to be a bailout, but the fact that access to the fund required serious readjustments in return, makes it possible to

assimilate the operation to an implicit bailout (Fernández-Llera, 2015). To participate in these mechanisms in support of liquidity, the ACs had to apply budgetary conditions and commit themselves to fulfil adjustment plans, negotiated and monitored by the central government. In this context, as will be studied in detail later, the foral ACs of the Basque Country and Navarre were the only ones that opted not to become indebted to the central government, turning to the financial market to finance themselves – albeit on less favourable terms – in order to safeguard their financial and political autonomy.

The liquidity fund was created as an extraordinary and temporary measure. It was assumed that the accounts of the ACs would be restructured and consolidated once the crisis had ended, making use of the revision of the regional financing system envisaged for 2014. But although its name and functioning has been adapted, the liquidity support mechanisms continue to be in effect at present (De la Fuente, 2020).

With the financing system still awaiting updating, in 2020 the COVID-19 crisis broke out. Prior to the pandemic, the Spanish economy had managed to achieve a six-year period of economic growth in GDP (2014-2019), thus escaping from the long shadow cast by the crisis of 2008. The economic recovery was reflected in the increase in tax collection and public revenues. But the pandemic altered deeply the growth forecasts and the policies for consolidating the public accounts implanted prior to the arrival of the virus.

**Figure 4. Evolution of the subnational public revenues in Spain (1995-2021) (in million euros at current prices)**



Source: OECD Fiscal Decentralisation Database, Consolidated government expenditure. Elaborated by the authors.

Measures taken by the central government to overcome the crisis caused an exceptional deterioration in Spain's public finances in 2020 and 2021 (Lago-Peñas, 2022). The public deficit reached 10,13 % and 6,87 % of GDP respectively in 2020 and 2021. In a similar way to 2008, the central administration (including social security) assumed the greater part of the deficit and public debt during 2020 and 2021 (AIReF, 2021). During the 2020 fiscal year, the central government brought forward payment of the settlement of the regional financing system for the 2018 fiscal year, established instalment payments with respect to 2020 on the basis of the pre-pandemic forecasts of 1.6% of the GDP (when the GDP fell by more than 10%, deliberately ignoring the effects of the crisis), and granted extraordinary resources to the common regime ACs to finance their socio-health costs and necessities (Lago-Peñas, 2021). Aside from the system of regional financing, the central government approved the creation of the COVID-19 Fund. This was the main extraordinary fund created by the central government in

2020 with the aim of supporting the ACs in financing expenditures deriving from the pandemic. The fund was endowed with 16.000 and 13.486 million euros respectively for 2020 and 2021. It had a non-repayable and unconditional character.

Thanks to the budgetary policy implemented by the central government, the revenue of the ACs not only did not fall during 2020 and 2021, but even increased; enabling them to increase their expenditure. The common regime ACs have not only had available a record level of resources to confront the pandemic, but, in addition, they closed 2020 with the best budgetary balance since 2006. Thanks to the financial safety net provided by the central government, the ACs as a whole showed a budgetary deficit of 0.21% of the aggregated GDP in 2020 – nine ACs obtained a surplus – considerably improving on the result of 2019, which closed with a deficit of 0.57% of the GDP. In 2021 they even improved their outcome, approaching the budgetary balance. This extraordinary injection of liquidity provided a short-term solution to the financing problems of the ACs of the common regime during the pandemic, postponing them until the settlement of the regional system of financing for 2020 and 2021 (De la Fuente, 2021b).

Although the behaviour on the expenditure side between the common and foral regimes ACs has been broadly similar, the evolution and management of the revenue side has been completely different. The ACs of the Basque Country and Navarre do not participate in the schema of flows and transfers of the system of financing of the common regime, nor do they receive instalment payments or advance payments from the central administration. The foral institutions, like the state, mainly depend on the tax revenues that they manage directly to finance themselves. Thus, the impact of crises has an immediate effect on their public accounts. For example, the tax collection of the Basque treasuries fell above 6% and 12% respectively in 2008 and 2009 (Erkoreka, 2021, p. 130). Similarly, it fell above 9% in 2020 due to COVID-19 crisis.

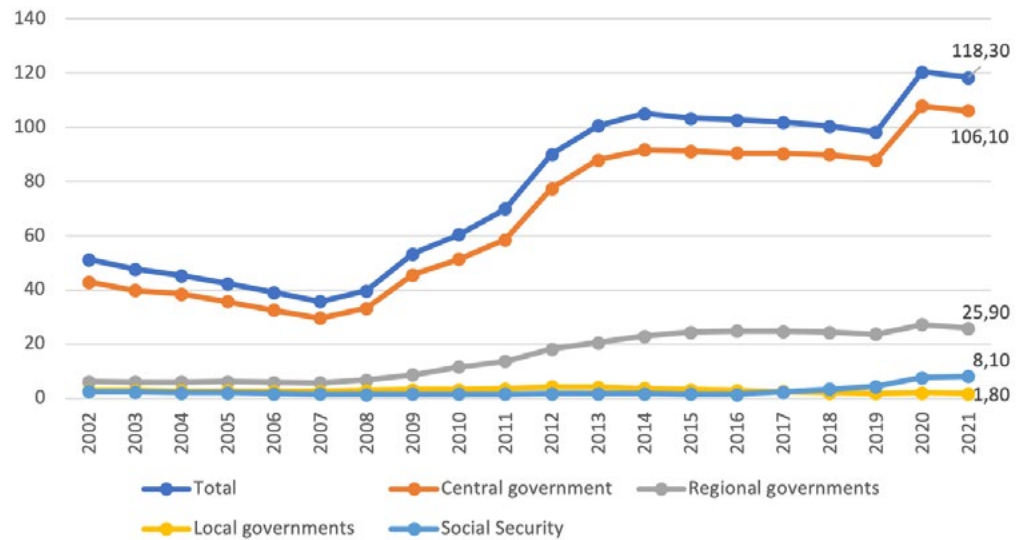
In spite the deep disturbances provoked by both crisis in the framework of decentralised governance of the ACs in Spain, the tax regulatory power and autonomy of tax management of the foral institutions were not affected (Erkoreka, 2021). The foral institutions have employed their fiscal and financial autonomy to meet the financing needs generated by both the 2008 and 2020 crises with their own resources. Among others, during the 2008 crisis, the foral institutions approved major tax reforms to increase their revenues, implemented anti-fraud measures to optimise tax collection and adjusted their expenditure policy. Regarding the COVID-19 crisis, the foral tax administrations took into account the OECD's roadmap and recommendations when designing and implanting their fiscal policies, including measures with both a normative and a management character (Martínez-Bárbara, 2020). In 2021, tax collection was fully recovered, exceeding even the level of revenue reached in 2019.

In contrast to the 2008 crisis, during the COVID-19 crisis, the foral ACs participated in the main extraordinary instrument implemented by the central government, albeit partially due to their singular tax regime: the COVID-19 Fund. Since this was an extraordinary fund, independent of the common system of regional financing, the Basque Country and Navarre participated partially in the COVID-19 Fund in 2020 and without restrictions in 2021. In addition to fiscal policy, as we will study below, the foral institutions had to take recourse to the debt market to cover their public deficit.

## VI. THE EVOLUTION OF SUBNATIONAL PUBLIC DEBT

Prior to the financial crisis of 2008, the level of indebtedness of the Spanish public sector was reduced. The indebtedness of the ACs was in general residual. As a consequence of the economic crises of 2008 and 2020, the public debt increased sharply. General government debt reached 120.4 % of GDP in 2020 and fell to 118.3 % of GDP in 2021 (Forte-Campos et al., 2022). As shown in the Figure 5, the central government has assumed the largest indebtedness. Still, the debt of the ACs has also increased considerably.

**Figure 5. Evolution of the general government debt according to the excessive deficit protocol in Spain (2002-2021) (as % of GDP)**

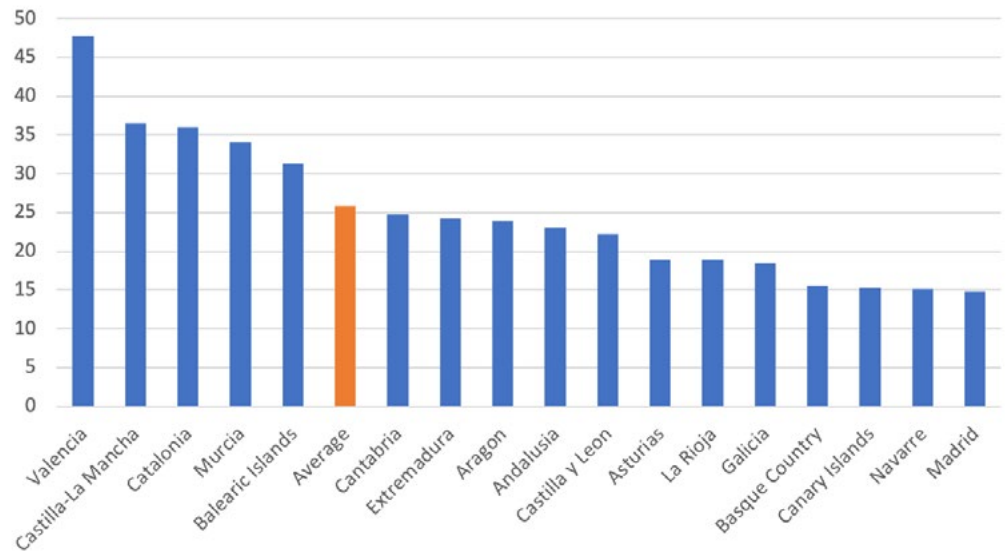


Source: Bank of Spain, General Government Statistics. Elaborated by the authors.

At the close of the 2021 fiscal year, the debt ratio of the ACs reached 25.9% of the GDP, placing Spain amongst the countries with the greatest ratio of subnational debt/GDP of the OECD (Lago-Peñas, 2023). Nonetheless, this figure requires two important nuances.

Firstly, there are important differences amongst the ACs: the ratio debt/regional GDP is situated between the 14,7% of the AC of Madrid and the 47,8% of the Valencian AC.

**Figure 6. Debt according to the excessive deficit procedure by ACs (2021) (as % of GDP)**

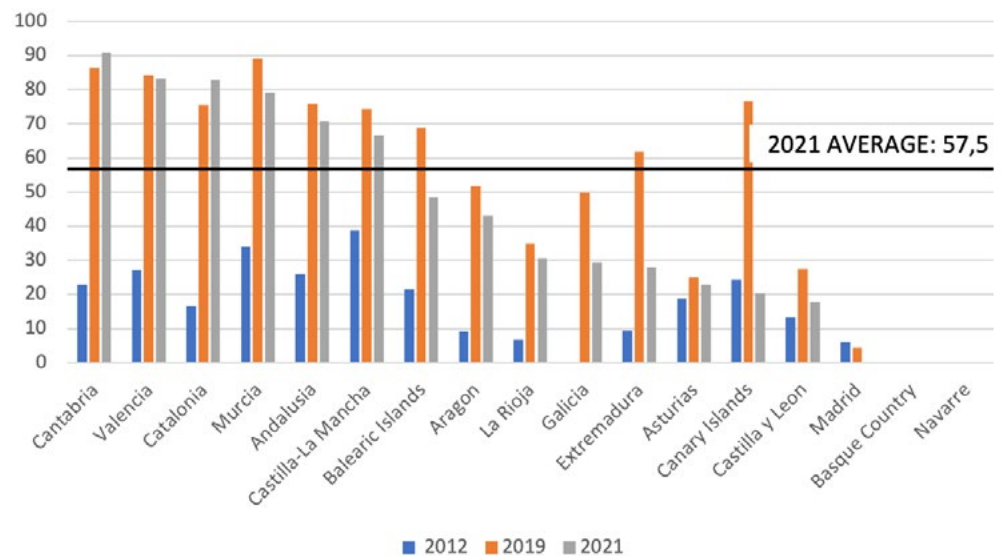


Source: Bank of Spain, Regional (autonomous) governments statistics. Elaborated by the authors.

These differences between regions respond to different factors, amongst which the following can be underscored: the imbalances generated by the financing system approved in 2009; the disparate impact of the crisis of 2008 resulting from inter-regional economic inequalities; and the orientation and quality of the political management of each region.

Secondly, it is worth underscoring that a large part of the accumulated debt of the ACs of the common regime since 2012 has been covered through liquidity support mechanisms at very low cost, made available by the central government. As a consequence of the liquidity support mechanisms, at the close of 2021, 57,5% of the accumulated debt of the ACs as a whole was in the hands of the central government:

**Figure 7. Regional government debt to central government arising from additional liquidity support mechanisms (2012-2021) (% of total debt of each AC)**



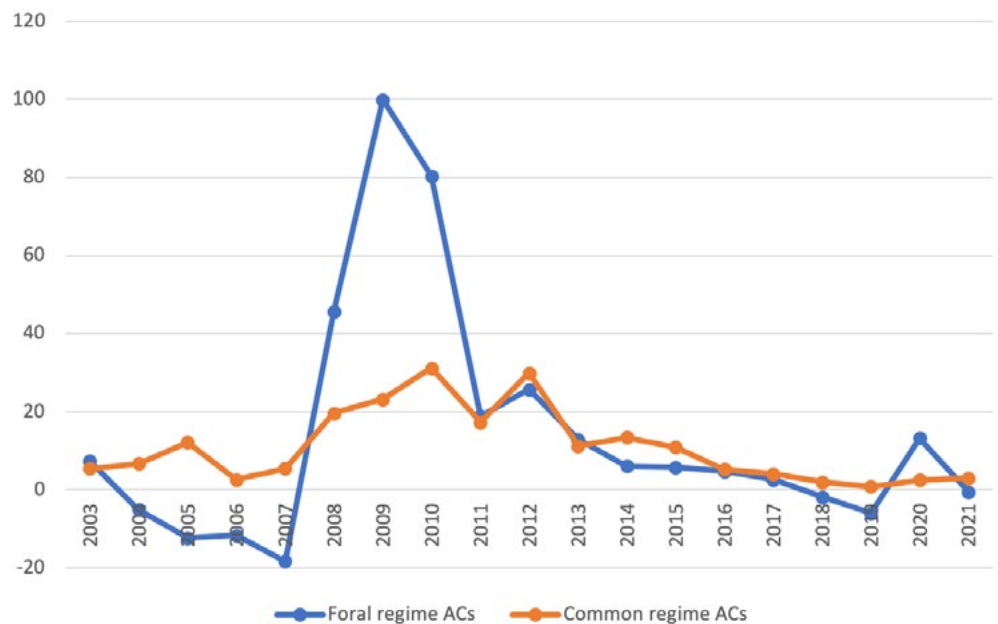
Source: (Forte-Campos et al., 2022, p. 15). Elaborated by the authors.



This certainly paternalistic response by the central government had repercussions on the financial and political autonomy of the ACs, diminishing the principle of fiscal responsibility (De la Fuente, 2020). These liquidity mechanisms could become a potential source of moral hazard in the future, in case the central government decide to cancel part of the debt in order to make the system operational again and facilitate the return of the ACs to the financial markets (Lago-Peñas, 2023; Zabalza, 2021).

The comparative behaviour of public debt evinces a clear disparity between the ACs of the common and foral regimes. In contrast to the ACs of the common regime, the foral institutions immediately assumed the repercussions on the foral treasuries of lower revenues and deficit provoked by the 2008 and 2020 crises, and had to take recourse to indebtedness for this purpose:

**Figure 8. Inter-annual variation of the debt of the ACs of the common regime and the foral regime (2003-2021) (in %)**



Source: Bank of Spain, General Government Statistics. Elaborated by the authors.

During the 2008 crisis, the Basque Country and Navarre were the only ACs that opted not to become indebted to the central administration through the liquidity support mechanisms and turned to the financial market to finance themselves – albeit on less favourable terms (Erkoreka, 2021). Thus, besides safeguarding their financial and political autonomy with respect to the central government, they also sought to show economic and political coherence in the application of the principles of fiscal responsibility and unilateral risk that govern the foral model of fiscal federalism. Similarly, it also supposes a message of strength and confidence facing the financial markets.

During the COVID-19 crisis, the governments of the Basque Country and Navarre bilaterally negotiated to update and increase the deficit and public debt targets with the central government (Erkoreka, 2021). In this way, the foral institutions assumed, with immediate effect, the repercussions on their public treasuries of the lower tax revenues and the deficit provoked by the COVID-19 crisis, taking recourse to the debt market to cover their needs of financing.

In the rating actions developed by the main international credit rating agencies after the COVID-19 crisis, the debt of the foral ACs maintained a qualification that was higher than or equal to that of Spain, as sovereign state. This circumstance, which is certainly unusual at the international level, is not found repeated in the common regime ACs. Apart from the macroeconomic, political and management variables, the main reason put forward by the credit agencies Moody's and S&P to qualify the debt of the Basque Country and Navarre above that of the sovereign is the strength of their institutional model and the characteristics of the foral model of fiscal federalism (Erkoreka & Ugalde, 2023). Exercising and safeguarding a high level of fiscal autonomy together with compliance with the principles of fiscal responsibility and unilateral risk stands out as the cornerstone for justifying that the foral subnational debt rating can be situated above that of the sovereign state.

Management of the public debt in circumstances of emergency and fiscal crisis is a key indicator when evaluating the principle of fiscal responsibility in the response of the systems of federalism and/or fiscal decentralisation (Herold, 2018). The application of the principle of unilateral risk is an incentive for guaranteeing the principle of fiscal responsibility. If we analyse Figure 8 on the evolution of the debt, it can be seen that the ACs of the foral regime have applied a policy with a counter-cyclical character, reducing their debt in the cycles of expansion to strengthen their solvency and margin for action facing the crisis. Fiscal and financial autonomy is an indispensable tool for designing and implanting their own long-term policies in debt questions, assuming future commitments and respecting the legal fiscal frameworks established by the European Union and the central government (Lago-Peñas, 2023). But the exercise of fiscal responsibility not only responds to the greater capacity of fiscal and financial self-government practiced by the foral institutions, but also to the risk that they assume in relation to the evolution of their finances.

Conversely, the ACs of the common regime must operate in a much more restricted framework of fiscal and financial autonomy, which limits their effective capacity to design and apply medium and long-term budgetary policies. In fact, the debt has in part been employed to compensate for, or cover the structural shortcomings of the common regime's system of financing (Zabalza, 2021). This system provides neither sufficient tools nor incentives to reward the exercise of fiscal responsibility by the subnational governments. The systematic non-compliance with the rules of fiscal discipline by certain ACs of the common regime reflects an important deficiency entailed in the common regime's system of financing.

In this sense, the confluence of two such different regimes of financing within the same state means that Spain is a laboratory of interesting tests for analysing and comparing the system of incentives and the behaviour of long-term subnational debt between highly disparate funding systems in terms of tax autonomy and fiscal responsibility.

## VII. CONCLUSIONS

The 2008 and 2020 crises had different origins and consequences for the Spanish economy and political landscape. Moreover, the starting points for dealing with the crisis were quite different. However, both crises put pressure on public finances. In the context of the 2008 and 2020 crises, the decentralisation system has undergone a process of recentralisation. Likewise, the crises of 2008 and 2020 together with other factors such as the political conflict in Catalonia or the crisis in the judiciary, have led to a deterioration of the institutional system and a political polarisation. The economic instability and the climate of political tension and polarisation prevented fundamental reforms to correct and improve the functioning of the decentralisation system.

In the fiscal and financial sphere, the 2008 crisis slowed down the process of decentralisation of public expenditure that had been developing since the 1990s. The central government (including social security) has strengthened its role during the management of the 2008 and 2020 crises, assuming greater intervention on expenditure. In addition, following the adoption of the Law on Budgetary Stability and Financial Sustainability in 2012, the central government has strengthened its capacity to monitor and intervene on subnational finances.

Both crises exposed the cracks and dysfunctionalities in the system for financing the ACs of the common regime and underscored their dependence on central government transfers in circumstances of budgetary urgency. The crisis of 2008 also caused an uneven but pronounced increase of the regional debt. But, as a consequence of the liquidity support mechanisms, at the close of 2021, 57,5% of the accumulated debt of the ACs as a whole was in the hands of the central government, with repercussions on the financial and political autonomy of the ACs, and diminishing the principle of fiscal responsibility.

Both crises underlined the need to renew urgently the regional financing Law to correct the imbalances of the system, strengthen the fiscal autonomy and responsibility, improve transparency and put the common regime ACs finances in order following the severe crises of 2008 and 2020. In addition, it is also necessary to articulate a solution to the liquidity support mechanisms in order to make the system operational again, facilitate the return of the ACs to the financial markets and safeguard the political and financial autonomy of regional governments. But as with other issues awaiting reform, economic instability and the current climate of political tension sketch a future panorama that is not favourable to providing a solution to this question which has been dragging on since 2014. The uncorrected imbalances of the financing system have given rise to inter-regional differences in matters of financing, prejudicing some regions while favouring others. These imbalances, and the deficit in transparency from which the system suffers, have helped to make the question of regional financing into a further issue of political confrontation, stirring up a partisan fight between regional governments, central-regional governments and political parties.

Under the asymmetrical funding system that governs Spain, the evolution and behaviour of public finances and debt in the foral ACs of the Basque Country and Navarre has been completely different. In spite of the deep disturbances provoked by both crisis in the framework of decentralised governance of the ACs in Spain, the tax regulatory power and autonomy of tax management of the foral institutions were not affected. In contrast to the ACs of the common regime, the foral institutions immediately assumed the repercussions on the foral treasuries of lower revenues and deficit provoked by the 2008 and 2020 crises. The foral institutions have employed their fiscal and financial autonomy to meet the financing needs generated by both crises with their own resources. On the one hand, the foral institutions approved major tax reforms and adjusted their expenditure policy. On the other hand, they also had to take recourse to indebtedness to cover their needs of financing. During the 2008 crisis, the Basque Country and Navarre were the only ACs that opted not to become indebted to the central administration through the liquidity support mechanisms and turned to the financial market to finance themselves –albeit on less favourable terms–, in order to safeguard their financial and political autonomy. Similarly, during the COVID-19 crisis, the foral governments negotiated to update and increase the deficit and public debt targets with the central government in order to cover their needs of financing in the financial markets.

The confluence of two such different regimes of financing within the frontiers of the same state, make Spain into an interesting laboratory for analysing, comparing and contrasting the behaviour, system of incentives and sustainability of the subnational public finances and debt between highly disparate funding systems in terms of tax autonomy and fiscal responsibility.

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