Spain's evolving fiscal framework: implications for the sovereign and its regions

The Great Financial Crisis brought Spain's evolving fiscal framework, and in particular, the drive towards further regional autonomy to a temporary halt. As economic and fiscal pressures abate, while autonomous desires persist, Scope expects the reform process to gain momentum. The Spanish authorities, together with the autonomous regions, are likely to reform the fiscal framework on a national, rather than on a region-by-region basis, with rating implications for the regions and the sovereign over the coming years.

Spain's autonomous regions have two constitutional fiscal arrangements, diverse competencies and preferences for autonomy, and, given starkly different economic fundamentals, varying degrees of reliance on funding instruments, including central government facilities and market securities. In addition, the regional revenue-expenditure mismatch is not fully compensated via the equalization system. The legislative response to the crisis led to several changes which are explored in greater detail in this analysis:

- The region's financing system

The central government's partial bailouts of the regions with difficulty refinancing debt in the market have changed not only the means of regional financing but also the central-regional government relationship. In Scope's view, given that the financing facilities are now *de facto* becoming permanent, the central government's role has moved away from being the implicit guarantor of the regions to being their explicit financier. While the reliance on the central government facilities differs widely, with some regions still financing themselves directly in the market or via bank loans, the central government is in effect issuing debt not only to finance itself, but also the regions. Given that the revenue system is largely unchanged, this points to a growing divergence of direct control over public liabilities and revenues, particularly given the political-economy constraints of imposing fiscal penalties on the regions.

- Varying preferences for autonomy and solidarity

In addition to changes in the region's financing system, the crisis also led to increasing discontent with the prevailing financing model, with shifts in regional attitudes towards considerations of intra-regional solidarity and the desirable level of fiscal equalization between regions. In some regions, such as Catalonia which has persistently sought higher levels of self-government, support has grown for increased autonomy, including secession, while in others, support for greater centralization has risen. In Scope's view, while Catalonia will remain part of Spain, the continuing political crisis may provide the necessary impetus for Spain's fiscal framework to continue to evolve, not least given the fact that the respective reform has been postponed since 2014.

- Scope's baseline and credit implications

In Scope's view, the complexity of the matter, including constitutional differences, varying preferences for autonomy, the need for central and regional budgetary stability, the balance between access to favourable central government finance at the expense of budgetary control and the need to preclude perverse incentives, can only be addressed on a Spanish and not region-specific basis. Scope thus expects the Spanish authorities, along with all regions, including Catalonia, to address the shortcomings of the current fiscal framework, which, following reforms during the crisis is already one of the strongest in the euro area. Scope's baseline is a gradual and wholescale reform of the country's fiscal arrangements and underpins the rating of Spain (A-/ Stable) and the regions.

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Spain's asymmetric fiscal federalism

Varying speeds of autonomy and preferences for competencies

There is a three-tiered system of governance in Spain with the central government, 17 regions[1] and 50 provinces. The regions have neither direct participation at the central level of government nor are they represented in a separate parliamentary chamber. Spain is a highly decentralized country in terms of delivery of government services, with most of the power of delivery resting in the *comunidades autónomas* (autonomous regions, CCAAs). The constitution of 1978 guarantees the right to self-government for all nationalities and regions and lists 23 areas of competence for the regions[2] while residual competencies could be claimed in autonomy statutes submitted to the *Cortes Generales*. The national government has exclusive jurisdiction over foreign policy, defence, justice criminal and commercial law, customs and trade, the currency, as well as citizenship and immigration.

The constitution lays out two paths to regional autonomy: the four historical nationalities of Spain were granted a fast track and gained autonomy in 1979 (Basque Country and Catalonia) and in 1981 (Galicia and Andalusia). The remaining thirteen regions were required to negotiate a limited transfer of powers with the central government, which could be extended later. Because of this two-track system, competencies among regions vary, depending on the negotiations with the central government[3].

Two financing systems: the 'foral' system for the Basque Country and Navarra and the common system for all others

In addition to differences in competencies, Spain has two types of financing for its regions: the 'common' system and the *foral* or 'autonomous' system for the Basque Country and Navarra. Whereas the *foral* system is the result of a bilateral agreement between each of the two *foral* communities and the central administration, the common regime is the result of a multilateral agreement between the fifteen common autonomous communities and the central administration.

The *foral* system grants full tax control

In the *foral* system, the Basque Country and Navarra can levy, manage, settle and collect their own taxes, and then transfer a fixed quota to the central government, known as the *cupo* or *aportación,* 'to contribute to the finance of the general expenses of the State'[4].

The common system consists of shared taxes and equalization transfers

Conversely, the system of regional finance for the 15[5] common regime regions consists of shared national taxes, and a variety of equalization transfers to ensure the equalization of resources per unit of need, such that essential public services of the welfare state (education, health and other social services) can be provided by all regions at the same level despite differing fiscal capacity. In contrast to the *foral* system, ceded taxes do not cover the whole range of taxes accrued in the territory of the respective community. From 1997 onwards, several degrees of discretion were granted to regional governments vis-à-vis some of the ceded taxes, allowing autonomous regions to set tax rates and establish tax credits and allowances. Thus, ceded taxes have in fact, progressively, become taxes for regional governments[6].

[1] 19 since 1995. Until 1995 Ceuta and Melilla were special autonomous regions having extensive administrative powers, but administered as part of the provinces of Cadiz and Malaga respectively. In 1995 both enclaves received the status of comunidades autónomas. Ceuta and Melilla are two cities that participate in autonomous financing in accordance with their Statutes of Autonomy and also the local tax offices' financing system. They also have a special indirect tax system, by virtue of which they collect Production, Services and Import Tax, instead of VAT.

[2] These include education, healthcare, transport, economy, justice, universities, policy, infrastructures, environment, housing, local entities, culture, tourism, employment and social services.

[3] In 1998, Catalonia and Galicia gained additional competencies for labour market polices and, in June 2006, Catalonia passed a referendum that ratified increased Catalan control over justice and taxation. Hooghe, L. Schakel, A.H. and Marks, G. 'Profiles of Regional Reform in 4 Countries (1950-2006), Regional and Federal Studies, Vol. 18, No. 2-3, 1983-258, April-June 2008.
Finally, Catalan calls for full independence began in 2006 after both Catalonia and Spain agreed on a Statute of Autonomy only for the decision to be overturned in the Spanish High Court of Justice in June 2010.

[4] See article 41.2.d) of the Statute of Autonomy of the Basque Country (BOE 1979)

[5] There is also a different economic and tax system for the Canary Islands 'due to historical and geographical reasons' and in line with the EU's provisions for ultra-peripheral regions.

[6] http://web2011.ivie.es/downloads/docs/wpasec/wpasec-2014-02.pdf

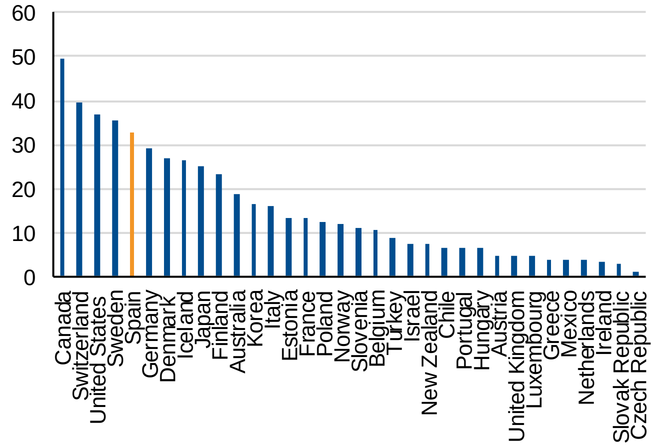
Transfers aim to ensure the same resources per unit of need

Taxes are collected and transfers distributed by the central government[7] via the Guarantee Fund for Basic Public Services[8]. In 2017, the transfers amounted to around EUR 100bn, equivalent to slightly above 60% of the region's total current revenues. As in the financing system for the states in Germany, (German Länder: Credit quality driven by strong institutional framework) the sharing of this large pool of resources generates sizable horizontal flows from rich to poor regions, greatly reducing regional disparities[9].

Spain's regions among the world's most autonomous

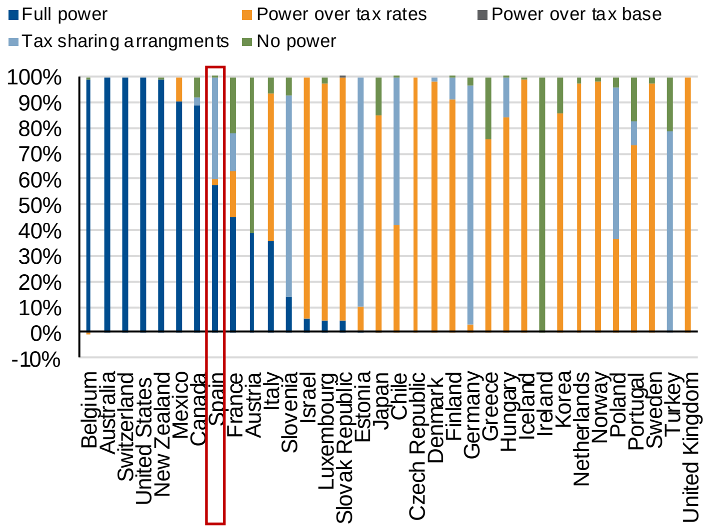
Overall, while the Basque Country and Navarra have full responsibilities over their taxes, the remaining regions have partial responsibilities on revenues including 50% income tax, 50% value added tax (VAT), 58% Special Taxes (alcohol, tobacco and gasoline), 100% electricity taxes, 100% inheritance tax, 100% stamp duty and 100% gambling tax. This regime places Spain's regions among the most autonomous ones when compared to other federal states. Based on OECD data assessing the level of regional autonomy up to the point prior to the crisis, Spain's regions were among the leading OECD countries for both, the amount of tax revenue as a share of total tax revenues and the extent to which the region has full power over those revenues.

Figure 1: Sub-central tax revenue
% total tax revenue



Source: Blöchliger, H. and M. Nettley (2015), "Sub-central Tax Autonomy: 2011 Update", OECD Working Papers on Fiscal Federalism, No. 20, OECD Publishing, Paris

Figure 2: Composition of sub-central tax revenues
% of total



Source: Blöchliger, H. and M. Nettley (2015), "Sub-central Tax Autonomy: 2011 Update", OECD Working Papers on Fiscal Federalism, No. 20, OECD Publishing, Paris

This degree of autonomy notwithstanding, shifts in Spain's fiscal framework over the past 30 years have resulted in two asymmetries: first, an *ex-ante* constitutionalized asymmetry between the *foral* regions and those of the common system; and second, an *ex-post* flexible asymmetry due to ordinary legislation accommodating different preferences for the desirable level of self-government[10].

The crisis forces changes to Spain's fiscal framework

The crisis imposed two fundamental changes to Spain's fiscal framework: first, it forced the central government to make fiscal consolidation the key objective for itself but also for

[7] Most revenues, including regional taxes, are collected by the central tax agency. The whole system is based on advances paid by the central government to regional governments. In year t+2 differences between advances and actual revenues in year t are compensated.
[8] This transfer is calculated annually from the 75% levelling of the tax resources, and adding a contribution from the State. Its amount is determined by the difference between the indicator of needs, in turn based on population, insularity, age of population and dispersion of municipalities, and the fiscal capacity.
[9] In addition, adjustments take place via i) the Global Sufficiency Fund based on the assessment of the fiscal gap between expenditure needs and fiscal capacity and ii) Convergence Funds aimed at fostering regional development via the Competitiveness Fund and the Cooperation Fund. http://economia.gencat.cat/en/70_ambits_actuacio/relacio_amb_inversors/fonts_de_financament/fonts_de_financament/
[10] Leiceaga, X. F., Penas, S.L. and Vaquero, A. 'Spanish Fiscal Federalism at the crossroad: a survey', GEN Working Paper A 2016 -1.

the regions; second, the crisis prevented the central government from being the implicit guarantor of last resort for the regions given that it itself had no margin for providing additional financing.

These circumstances led to the reform of Article 135 of the Spanish Constitution in September 2011 which kicked off a comprehensive revision of the legislation on budgetary stability, which was implemented by Organic Law 2/2012 of April 27th, 2012, on Budgetary Stability and Financial Sustainability (LOEPSF). The LOEPSF introduced significant changes aimed to increase the budgetary stability of the general government and the autonomous regions in particular.

The main pillars of the law include:

i) the establishment of a ceiling on public expenditures preventing these from outpacing nominal medium-term GDP[11];
ii) the establishment of a limit on general public debt as a percentage of GDP (60%), with the following distribution: 44% for the central government, 13% for regional governments and 3% for local authorities, to be applicable as of 2020;
iii) the substitution of the concept of total deficit by that of structural deficit[12], with a target of zero set for 2020;
iv) interest and public debt payments have priority over any other expenditure,
v) the disclosure of extensive budgetary information from each region, including monthly reporting on cash and accrual terms,
vi) intra-year pre-emptive controls to detect budgetary deviations by region under European Standards of Accounting (ESA) terms;
vii) corrective actions for regions not complying with deficit targets include meeting objectives as a pre-condition for debt issuance authorization and receipt of certain transfers.

This legislation led to comprehensive changes in the financing of the regions and the central-regional government relationship.

The regions' financing system

Central government financing mechanisms

Access to government financing mechanisms conditional and, at first, temporary

While LOEPSF includes a 'no bail-out' clause (Article 8)[13], under which the central government is not liable for the commitments of autonomous regions, local authorities or their linked or dependent bodies, it does allow the sub-national governments to apply to the State for access to financial mechanisms, in which case the law explicitly includes strict conditions on the budgetary activities of the sub-national government concerned. Specifically, Organic Law 2/2012 of 27 April 2012 establishes in its first additional provision that Regional Governments and Local Governments may request extraordinary liquidity support measures from the State[14].

Under these provisions the central government set up several mechanisms since 2012, such as the Fund for the Financing of Payments to Suppliers (FFPP), the Regional Government Liquidity Fund (FLA) and the extraordinary support measures aimed at

[11] Annual spending growth in year t < average GDP growth between t-5 and t+3.

[12] Maximum structural deficit 0.26% of GDP for central government and 0.14% of GDP for regions. Exceptions, which must be approved by Parliament include natural disasters, recession or extraordinary emergency situations beyond the State control.

[13] 'El Estado no asumirá ni responderá de los compromisos de las Comunidades Autónomas, de las Corporaciones Locales y de los entes previstos en el artículo 2.2 de esta Ley vinculados o dependientes de aquellas, sin perjuicio de las garantías financieras mutuas para la realización conjunta de proyectos específicos.' http://www.minhafp.gob.es/Documentacion/Publico/NormativaDoctrina/FinanciacionTerritorial/Financiacion%20Autonomica/Ley%202_2012.pdf

[14] Disposición adicional primera. Mecanismos adicionales de financiación para las Comunidades Autónomas y Corporaciones Locales. Las Comunidades Autónomas y Corporaciones Locales que soliciten al Estado el acceso a medidas extraordinarias de apoyo a la liquidez o lo hayan solicitado durante 2012, vendrán obligadas a acordar con el Ministerio de Hacienda y Administraciones Públicas un plan de ajuste que garantice el cumplimiento de los objetivos de estabilidad presupuestaria y de deuda pública. Source: MINHAFP

municipalities with financial problems. These were extraordinary liquidity support measures, and thus originally intended to be temporary. From the outset, taking part in the FLA was voluntarily and included accepting budgetary conditions in return for access to finance. This made the central government a creditor to the autonomous regions, as the sums paid take the form of bilateral loans from the central government to the regions and have become the main means of covering their funding requirements.

Since 2015 the liquidity mechanism is not explicitly temporary anymore

Since 1 January 2015, the sole liquidity support mechanism for the regional governments is the 'Fondo de Financiación a Comunidades Autónomas'[15] (Fund for the Financing of Regional Governments), resulting in the low financing costs currently enjoyed by the Spanish Treasury being passed on to the autonomous regions. The Fund is divided into three facilities: the Financing Facility, of which the regional governments that meet budgetary stability targets may voluntarily avail themselves; the new Regional Government Liquidity Fund, similar to the former FLA, for regional governments that have not met such targets; and the Social Fund, to finance regional governments' outstanding debts with local governments, in order to ensure continued compliance with the agreements on social spending.[16] Notably, the law does not refer to this mechanism as being 'temporary' which implies a permanent nature, not least given the importance of this source of financing for the regions.

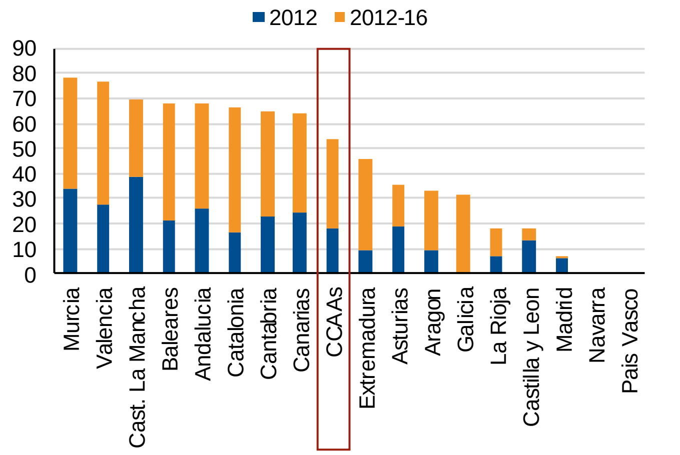
Evolving role of the central government

From implicit guarantor to explicit financier

In fact, between 1995 and 2007, regional total debt averaged around 6% of GDP. Half of this was in the form of debt securities and the rest loans from resident and non-resident entities. After the outbreak of the crisis, regional debt quadrupled to around 25% of GDP (on ESA basis), mostly in the form of loans from the government, reflecting the lead role that the central government has adopted as financier for the regional governments.

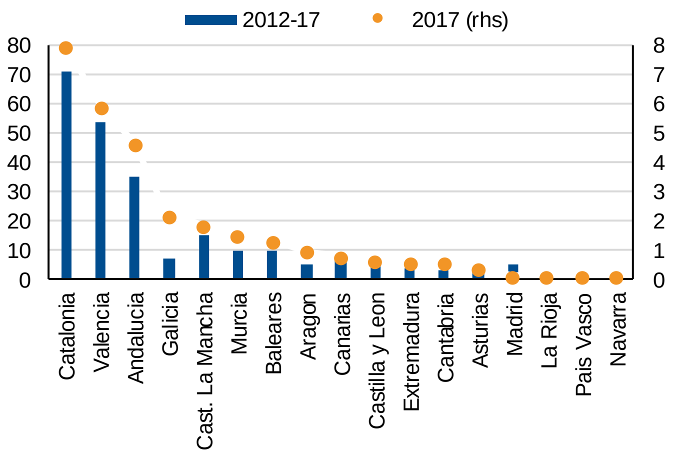
At the end of 2016, more than 50% of regional debt was owed to the State, compared to less than 20% in 2012. In absolute terms, since 2012, Catalonia is the region which has received the most liquidity by the central government (EUR 70bn), followed by Valencia (EUR 54bn) and Andalucia (EUR 35bn). La Rioja and Madrid rely the least on the central liquidity provisions while Navarra and the Basque Country decided not to join the liquidity arrangements.

Figure 3: Regional debt owed to central government
% of total, 2016



Source: MINHAP

Figure 4: Total central government liquidity provided
EUR bn



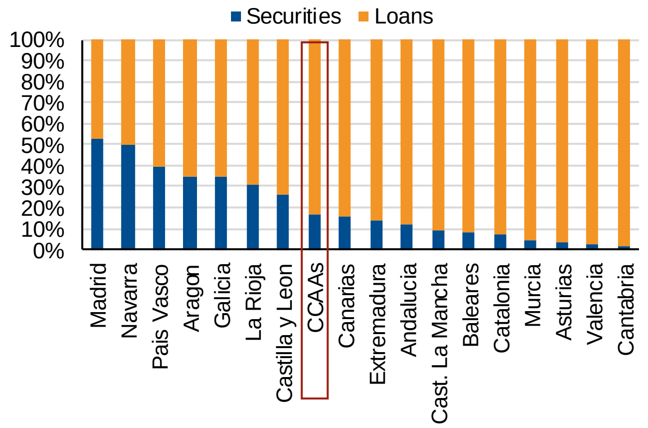
Source: MINHAP

[15] Under Royal Decree-Law 17/2014 of 26 December 2014, the Fund for the Financing of Regional Government was created, assuming the debt, as of December 2014, of the FFPP and the FLA, the latter two funds being dissolved.
[16] Banco de Espana, Economic Bulletin February 2016.

Varying degrees of access to the market

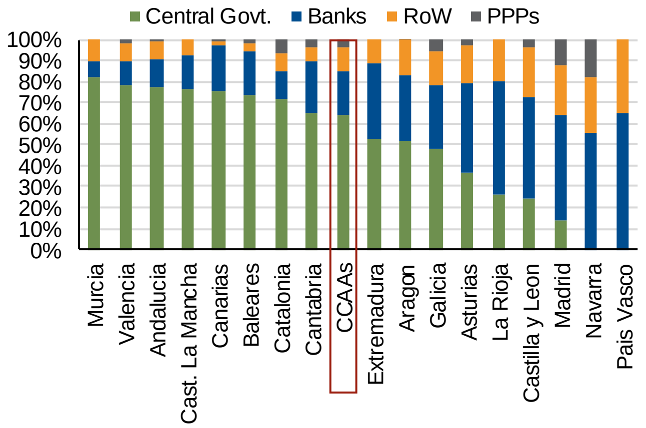
In addition to liquidity provided by the central government, the regions also finance themselves directly in the markets or via bank loans. However, the varying degree of autonomous regions' participation in the financing mechanisms has also resulted in differences in their ability to access capital markets. Notably, only Madrid has more than 50% of its debt financed in the capital markets, followed by Navarra and the Basque Country, both of which rely heavily on bank loans[17] given their decision not to participate in the government financing mechanisms.

Figure 5: Securities and loans
% of total debt 2016



Source: Banco de Espana.

Figure 6: Loans by source
% of total debt 2016

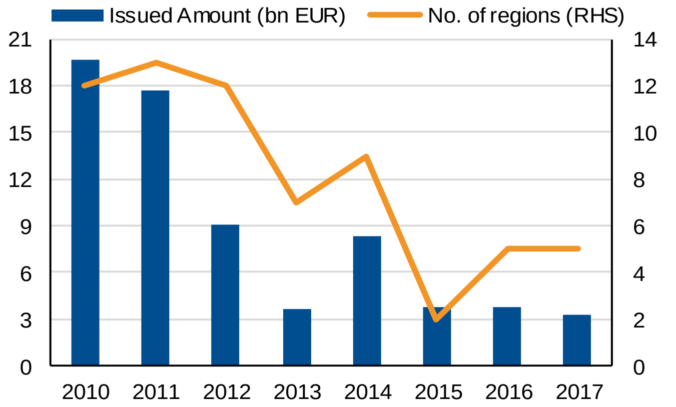


Source: Banco de Espana.

Reduced market access given greater reliance on the central government

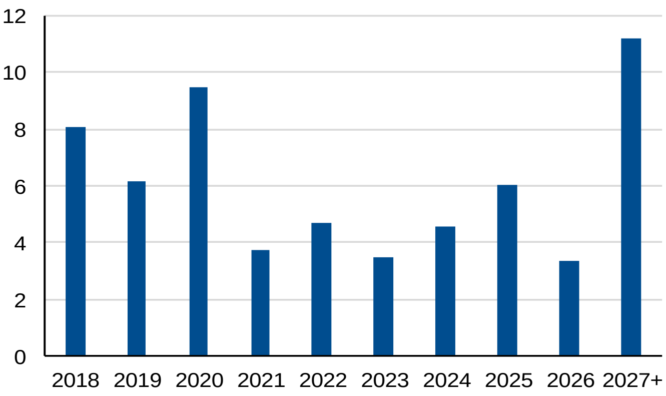
Regions taking part in the original FLA strongly reduced issuance from 2011 to 2014 to small amounts of debt or no debt at all, while those that did not take part maintained similar or higher levels, reflecting elevated levels of public debt to be refinanced. The low issuance in the markets has resulted in a relatively smooth and reduced redemption profile of the regions as a whole. Finally, Scope notes that issuance overall continued to drop from 2015, possibly as a result of the implementation of the new regional financing fund, which all the regions in the common system have joined[18].

Figure 7: CCAAs debt issuance 2010-17
EUR bn; number of regions (RHS)



Source: Bloomberg.

Figure 8: CCAAs redemption profile
EUR bn



Source: Bloomberg

[17] The maximum spread that regions can accept for bank loans has been subject to government limits since September 2012, through the so-called Financial Prudence Principle.
[18] Banco de Espana, Economic Bulletin February 2016. Regional government Access to market funding

Scope views continued market access as credit positive, even if it results in higher funding costs compared to accessing the central government's facilities. This reflects an ability to communicate directly with the markets. In addition, refinancing risks are mitigated by The Organic Financing Law of the Autonomous Communities (LOFCA, Article 14) which established that i) short-term credit operations must be earmarked for covering transitory cash needs while long-term credit operations (over one year) must be earmarked exclusively for investment expenses, ii) the total amount of the annual amortisation payments for capital and interest must not exceed 25% of the current income of the respective region and iii) regions require authorization from the central government for their credit operations abroad or for the issuance of public debt[19].

Varying preferences for autonomy and solidarity

Equity from a provision of service point of view

According to the Spanish constitution, the central government must guarantee both 'a minimum level in the provision of fundamental public services in the whole territory of Spain'[20] and likewise, 'the effective execution of the principle of solidarity' (Article 138.1 CE). Furthermore, the financial autonomy of the regions must be 'according to the principles of coordination with the State Treasury, and of solidarity among all Spaniards' (Article 156.1 CE)[21]. From a constitutional point of view, it is not the relative wealth of a region but rather the non-financial expenditure on a per capita basis that ought to provide the equity benchmark.

The *foral* advantage

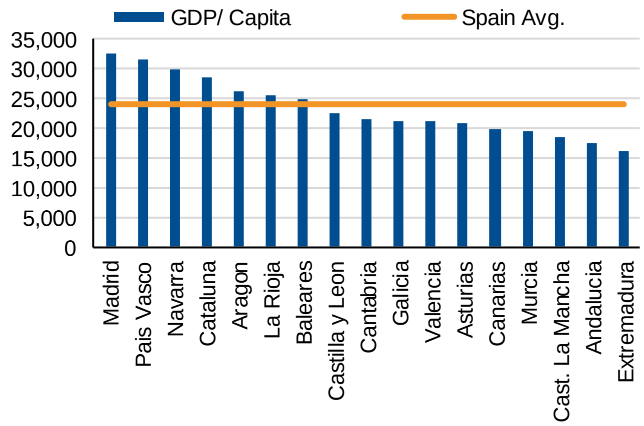
In this context, the constitutional asymmetry between the *foral* and the common system is important. While the Spanish constitution, 'protects and respects' the *foral* system, it also requires that no region, including the two *foral* communities, should enjoy economic advantages due to their financing arrangements. These two conditions can only be accommodated by, on the one hand, accepting the much larger degree of tax capacity that *foral* communities presently enjoy, but, on the other hand, redefining the actual *cupo* or *aportación* so that the *foral* communities obtain the same amount of resources per unit of need as that of non-*foral* communities[22].

For equal responsibilities, the *foral* regions enjoy greater fiscal space compared to the others

It is estimated that the 'allowance' from the *foral* regions to the central government is far below what would be required for equivalent treatment between the *foral* regions and the rest, allowing for improved services with lower fiscal pressure in those regions. Specifically, the amount of per capita finance provided by the *foral* system is believed to be much larger for equal responsibilities than that of the common system. With respect to non *foral* communities, estimates range from 32% to 47% in favour of *foral* communities[23]. This arrangement has resulted in a visibly higher non-financial expenditure per capita for the *foral* regions compared to the other 15 regions, which are much closer aligned with each other.

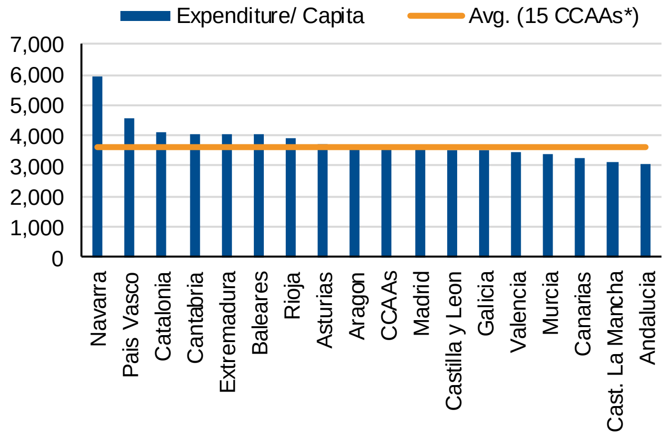
[19] http://www.minhafp.gob.es/en-GB/Areas%20Tematicas/Financiacion%20Autonomica/Paginas/Endeudamiento.aspx
[20] Article 158.1, in its connection with Articles 139.1 and 149.1.1 CE
[21] Articles 2, 138.1, 156.1 and 158 CE.
[22] Antoni Zabalza and Julio López-Laborda 'The Uneasy Coexistence of the Spanish Foral and Common Regional Finance Systems'. http://web2011.ivie.es/downloads/docs/wpasec/wpasec-2014-02.pdf
[23] Ibid.

Figure 9: Wealth of region per capita
EUR, 2016



Source: MINHAP

Figure 10: Non-financial expenditure per capita
EUR, 2014-16



Source: MINHAP; * Refers to common system only.

Growing discontent on the type of decentralisation

Different interpretations of fairness among the regions

Against this background, the crisis induced shifts in regional attitudes towards intra-regional solidarity and the desirable level of fiscal equalization between regions. It is noteworthy that in some regions, such as Catalonia, support has grown for increased autonomy, including secession, while in others, support for greater centralization has risen. In both movements, considerations of 'fairness' are at the heart of the matter: In Catalonia, fairness constitutes an approximation of the financial advantages provided by the *foral* model[24] while for others, fairness constitutes the standardization of the provision of services under homogeneous conditions throughout the entire Spanish territory.

Varying and changing degrees of feeling 'Spanish' or regional

In several regions, a marked mistrust of the virtues of decentralization arose and demands for greater centralization became dominant. However, in Catalonia the demand for the breakup for the common model remained strong and the *foral* model (or its financial results) became to be considered a second-best option after independence[25]. This shift in attitudes is reflected in opinion polls, showing that since the crisis, more respondents in Spain, except for those in Catalonia, feel 'only' or 'more' Spanish than their respective regional identity. In fact, in Catalonia, almost 50% of respondents feel 'only' or 'more' Catalan than Spanish while the percentage of Catalan respondents feeling 'only' Spanish has dwindled from around 15% in 2001 to 3% in 2017.

[24] The end of the terrorist violence in the Basque Country resulted in the foral asymmetry being a highly relevant net advantage, visible to Catalonia and other regions.
[25] Leiceaga, X. F., Penas, S.L. and Vaquero, A. 'Spanish Fiscal Federalism at the crossroad: a survey', GEN Working Paper A 2016 -1.

Figure 11: Feeling' Spanish
% respondents feeling only or more 'Spanish'

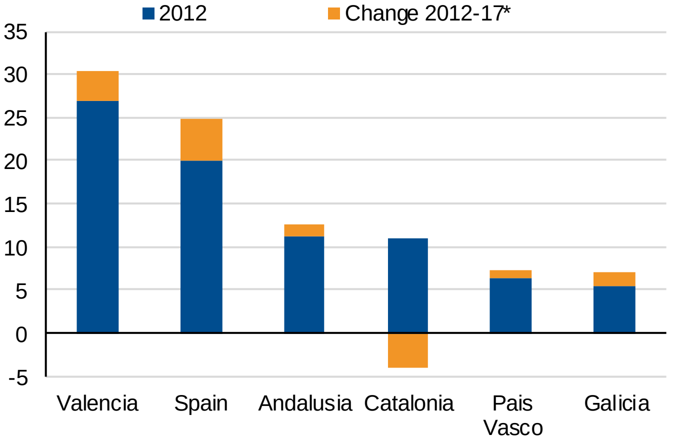
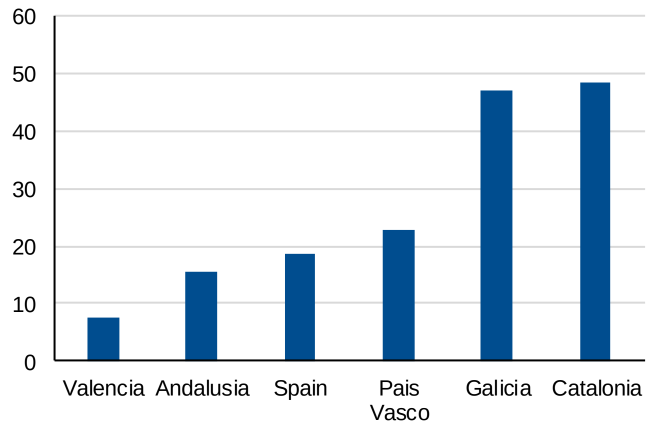


Figure 12: 'Feeling' Regional
% respondents feeling only or more 'Regional', 2017*



Source: CIS respective barometers. '¿Cuál de las siguientes frases diría Ud. que expresa mejor sus sentimientos?'; * 2017 or latest available.

The special case of Catalonia

The 2006 Statue of Autonomy of Catalonia was first approved by Parliament but then curtailed by the Courts

Catalonia has persistently sought higher levels of self-government, which, so far, have not resulted in comparable financial advantages, such as those enjoyed by the Basque Country and Navarra. In March 2006, the Spanish parliament approved the Statute of Autonomy of Catalonia with 189-154 votes, which was subsequently ratified by Catalan voters in a June referendum that year. After its official publication, the Popular Party filed an appeal to the Constitutional Court which, in its decision on 28 June 2010, struck down 14 and curtailed another 27 of the statute's 223 articles. The judiciary system, Catalan language status[26], powers on immigration, taxation, the right to call referendums and identity/ nationality[27] were most curtailed.

In terms of the fiscal arrangement, the Statute sought to i) limit inter-regional fiscal equalization by the centre and ii) obtain new powers without central government intervention. However, it was ruled that decisions regarding the regions' contributions to solidarity and service rest with the central government and that the State's investment policy remains independent of regional considerations[28].

High support for independence in non-binding, low-turnout referenda

Following this constitutional decision, Catalan leaders have successively sought to enhance their mandate for further autonomy via non-binding referendums, first for 'self-determination' in 2014 and more recently in October 2017 for 'independence'. While votes supported independence (81% in 2014 and around 90% in 2017), both referenda had low turnouts with about 37% in 2014 and 43% in 2017. In addition, neither of the referenda was recognised by the Spanish government or the European Union[29]. In fact, prior to the referendum, Spain's Constitutional Court judged the vote to be illegal, as such changes to the constitution can only be voted on by all of Spain's people.

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[26] The ruling struck down attempts to place the distinctive Catalan language above Spanish in the region.
[27] 'The interpretation of the references to 'Catalonia as a nation' and to 'the national reality of Catalonia' in the preamble of the Statute of Autonomy of Catalonia have no legal effect.'
[28] Specifically, it was ruled unconstitutional that 'the contribution to solidarity and service leveling [of Catalonia] will be made "provided that they [the Autonomous Communities] also make a similar fiscal effort"'. As the Court's decision clarifies: '…it is the State's task…to regulate the exercise of financial powers by the Autonomous Communities, and to establish their levels of contribution to leveling and solidarity…'. In addition, while the Statute's provision that '…State investment in infrastructure in Catalonia, shall be equal to the relative participation of Catalonia's gross domestic product in the gross domestic product of the State for a period of seven years' was deemed constitutional, the Court noted that it must 'be interpreted in the sense that it does not bind the State to define its investment policy nor does it infringe the full freedom of the National Parliament to make decisions regarding the existence and amount of such investments.'
https://www.tribunalconstitucional.es/ResolucionesTraducidas/31-2010,%20of%20June%2028.pdf
[29] http://www.catalangovernment.eu/pres_gov/government/en/infographics/303482/catalan-referendum-results.html

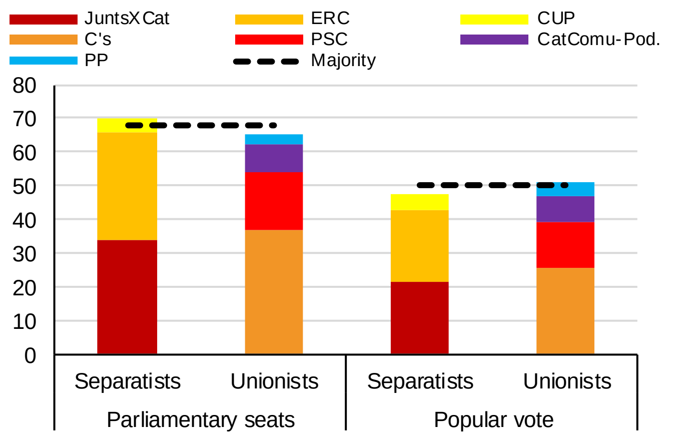
Push for 'independence' results in temporary loss of autonomy

After the vote, events escalated: on 21 October, the Spanish government suspended Catalonia's autonomy; on October 27, after the Catalan parliament unilaterally declared independence by 70 votes to 10, in a vote boycotted by the opposition, Spain's senate approved new powers for the central government to activate Article 155[30] of the national constitution by 214 votes to 47. The decision to impose direct rule on Catalonia and call for regional elections was agreed by the Partido Popular, together with the Spanish Socialist Party and the centre-right party Ciudadanos.

December 2017 election highlights persistent division of Catalan population on the issue

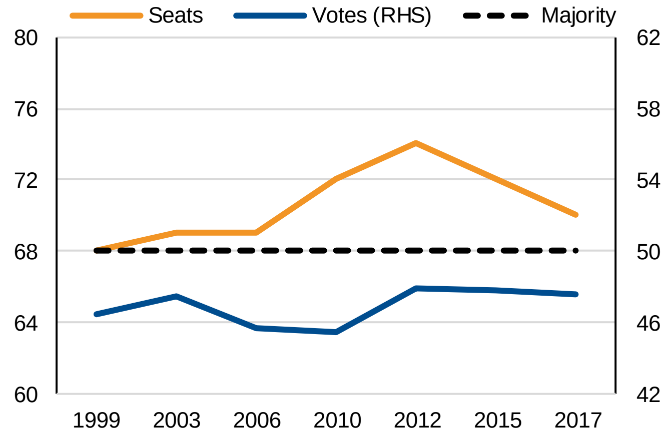
The December 2017 elections, with a 82% participation rate, cemented the status quo and highlighted the division within Catalonia: While Ciudadanos (pro-union[31]) won most votes (25.4%) and seats (37/ 135), together the separatists (ERC, JuntsXCat and CUP) won 70 of the 135 seats, but again only 47.5% of the popular vote. This is because the Barcelona province, which is generally more pro-union, is allocated slightly fewer seats than its population warrants. The popular vote for independence parties has thus remained unchanged since 1999.

Figure 13: Catalan election results
Seats (135 total), votes (%)



Source: Generalitat de Catalunya

Figure 14: Support for independence since 1999
Seats (135 total) and votes (%)



NB. Changing composition of pro-separatist parties. CiU, ERC, CUP, JxSI, JuntsxCat.

Catalonia to remain in Spain regardless of government formation

Regardless of the government formation, and mindful of the fact that new regional elections would be necessary if no government is formed by 7 April 2018, Scope's view is that it is highly unlikely that Catalonia will become independent in the near- to medium-term, owing to multiple institutional, economic and financial reasons as well as political reluctance which the electoral outcome has only confirmed. For a detailed account of the obstacles to Catalan independence, please see Scope's article 'Catalan election will not lead to the region's independence – regardless of the result'. It is Scope's view that the most likely outcome from Catalan secessionist desires is a negotiated further devolution, including greater fiscal and/or political autonomy. Notably, given the implications to the sovereign and other regions, Scope expects this negotiation to take place for all of Spain and not only for Catalonia.

[30] If an Autonomous Community does not fulfil the obligations imposed upon it by the Constitution or other laws, or acts in a way that gravely threatens the general interest of Spain, the Government, after lodging a complaint with the President of the Autonomous Community and failing to receive satisfaction therefore, may, following approval granted by an absolute majority of the Senate, take the measures necessary in order to compel the latter forcibly to meet said obligations, or in order to protect the above-mentioned general interests. With a view to implementing the measures provided in the foregoing clause, the Government may issue instructions to all the authorities of the Autonomous Communities.

[31] Pro-independence: ERC = Republican Left of Catalonia, JuntsXCat = Junts per Catalunya, CUP = Popular Unity Candidacy; Anti-independence: PP = Partido Popular, PSC = Socialists' Party of Catalonia, Cs = Ciudadanos

Sovereign credit implications

Even if political tensions were to re-escalate in 2018, Scope expects Catalonia will remain part of Spain, and consequently does not anticipate the Catalonia issue to result in a change to Spain's A-/Stable long-term sovereign rating and outlook. However, the fact that the central government has implemented partial financial bailouts for the regions through the creation of financing facilities, which are now taking a *de facto* permanent nature, is changing the central-regional government relationship. Specifically, in Scope's view, the central government's role has moved away from being the implicit guarantor of the regions to being their explicit financier.

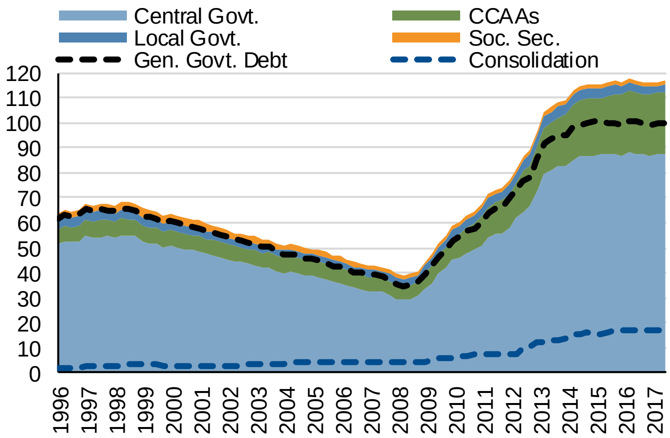
Central government now issues for the regions but revenue control remains unchanged

This change is leading to another asymmetry: while the Spanish central government issues debt on the markets to finance itself, as well as the regions, the revenue system remains largely unchanged. This asymmetry is reflected in a higher consolidation of general government debt accounts, which is driven by the loans of the central government to the CCAAs, while the share of central government revenue of total general government revenue has remained stable at around 45%.

Political-economy limitations for suspending autonomy for breaching fiscal targets

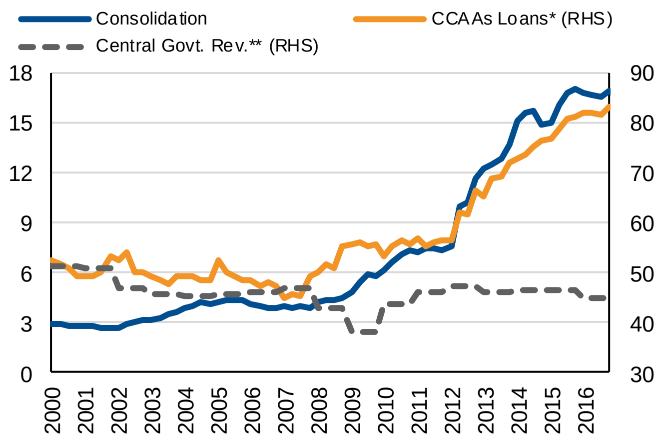
As a result, for 2016, the regions were responsible for about 25% of public liabilities (up from about 16% in 2007), while handling around 38% of total public revenues (the same level in 2007). While Scope is mindful of the preventive and corrective measures envisaged in the LOEFSP which the central government can take vis-á-vis non-complying regions, the political-economy reality is that the government used enforcement tools for the first time in 2016[32], despite numerous fiscal target breaches. Scope believes that it is one thing to enshrine in law the possibility of suspending regional autonomy when regional governments breach their targets, but another thing to actually enforce that decision[33].

Figure 15: General govt. debt by level of government
% of GDP



Source: Eurostat, Banco de Espana.

Figure 16: Consolidation of accounts and revenues
% of GDP; % of total (RHS)



Source: Eurostat
NB. *Loans as a share of total consolidated gross debt of the CCAAs. **Central government revenues as a share of general government revenues.

Experts recommend revision to existing framework

In 2017, the Spanish government created a committee of experts to promote the revision of the regional and local financing systems, which presented its report in July 2017[34] recommending, among other things, greater harmonization of tax bases and rates as well as an increase of the regions' revenue-raising capacity to better match the greater degree

[32] Extremadura and Aragón have seen some of their funds withheld to pay suppliers directly. http://www.minhafp.gob.es/Documentacion/Publico/CDI/EstrategiaPoliticaFiscal/2017/DRAFT%20BUDGETARY%20PLAN%202017_EFR.pdf
[33] Santiago Lago Peñas, 'Remaining challenges to budgetary stability in Spain', SEFO - Spanish Economic and Financial Outlook Vol. 4, N.º 2 (March 2015).
[34] ww.minhafp.gob.es/Documentacion/Publico/CDI/Sist%20Financiacion%20y%20Deuda/Informaci%C3%B3nCCAA/Informe_final_Comisi%C3%B3n_Reforma_SFA.pdf

of expenditure decentralization. At the same time, the IMF[35] also pointed to the need to strengthen oversight institutions and procedures, reinforce conditionality, and step up monitoring under the regional liquidity mechanisms for non-compliant regions.

Spain's fiscal framework expected to evolve holistically in coming years

Considering the identified asymmetries, Scope expects Spain's fiscal framework to continue to evolve and mature during the current legislature. The matter is complex. The central and regional governments must consider constitutional differences, varying preferences for autonomy, the need for central and regional budgetary stability, the balance between access to favourable central government finance at the expense of budgetary control, as well as the need to preclude perverse incentives.

In Scope's view, the only way these issues can be addressed is on a national and not regional basis. As a result, Scope expects the Spanish authorities, together with the autonomous regions, including Catalonia, to address the shortcomings of the current fiscal framework in a comprehensive manner over the coming years. In this context, Scope will monitor closely the evolving fiscal discussions and assess their credit implications for both, the regions and the Spanish sovereign.

[35] IMF Article IV, October 2017

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