



# Better off on their own?

## Economic aspects of regional autonomy and independence movements in Europe

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With the independence referendum in Scotland and unofficial polls in Catalonia and Veneto, separatist aspirations in Europe were recently given a boost. The desire for greater autonomy in several regions of Europe is not about to ebb in the coming years either.

In regions seeking greater self-determination or even full secession, not only emotional and cultural aspects play a role but also concrete financial motives. Even though autonomy movements are, by definition, regional phenomena, there are interesting correlations on the economic side.

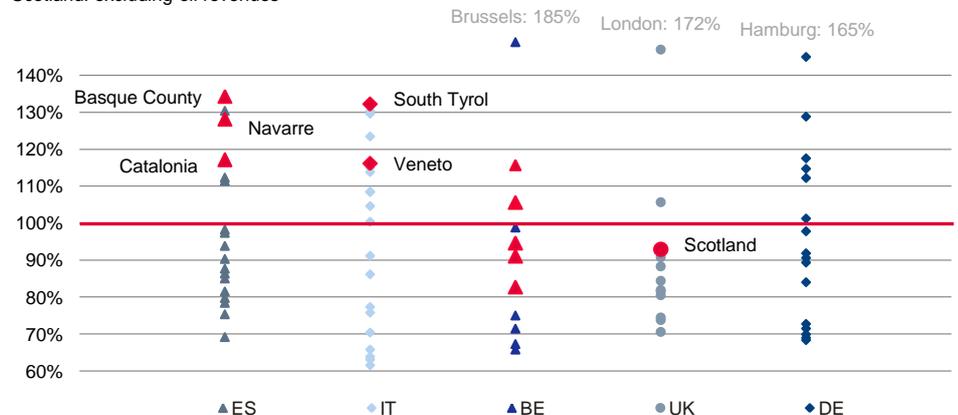
Nearly all the regions seeking greater autonomy are among the wealthiest in their respective countries and far outstrip the national average in terms of per capita income. This comes as no surprise, since secession from an existing federation goes hand in hand with sizeable risks which economically weak regions can scarcely afford to take.

Moreover, some of these regions are substantial net contributors in regional redistribution systems. However, here too there are notable exceptions.

It is striking that there are very persistent regional income disparities within the countries examined. Most of the regions that have a high per capita income in relation to the rest of the country have ranked at the top or at least near the top of the standings for decades. This aspect might have reduced acceptance of the idea of horizontal redistribution between regions.

Per capita income: Regions with autonomy movements versus other parts of country

% of national average, 2011; regions with autonomy movements in red; Belgium: Flemish provinces; Scotland: excluding oil revenues



Sources: Eurostat, Deutsche Bank Research



## The new European regionalism

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2014 will be remembered as a year of resurfacing regionalism movements in Europe. Voting on the possibility of independence for their regions – with each having a differing constitutional character – the people of Scotland, Catalonia and Veneto have expressed their desire for a greater degree of regional self-determination. In other regions, too, such as the Basque Country and Flanders, a substantial part of the population advocates far-reaching autonomy or even full secession from the current structure of government. What is behind this desire for more independence, behind the conviction that a region is stronger on its own than in an entity including the other regions of the country?

Many European regions have preserved a cultural identity of their own. The sense of belonging that this has created extends, in fact, in some cases across national borders (take, for example, the Basque Country, which today is split between Spanish territory and French territory). Cultural differences that have grown over time are also to be found in Scotland and Catalonia, for instance, yet these alone are not sufficient to explain the emergence, or resurgence, of independence movements. Finally, there are also regions which today, despite centuries of sovereignty or unity with another nation, no longer show any interest in changing the status quo. Nationalists occasionally assert that they face discrimination in a centralised state, but their reasoning often seems very hard to follow. At any rate, these regions are a part of pluralistic democracies, and the right to enjoy fundamental freedoms is guaranteed, moreover, by the EU and the European Court of Human Rights. The emotional dimension of this aspiration for independence often has a very specifically regional background and therefore does not play a central role in this report.

However, the economic dimension is likely to play a role of presumably equal importance. While there are few reasons, from an objective point of view, why Scotland or Catalonia should gain a substantial degree of prosperity via independence, nationalist parties cite this very issue as being one of the most important arguments. Secession from an existing state structure harbours huge economic risks, though. However, these risks have decreased for smaller countries; paradoxically, this is especially due to European integration. After all, access to the single European market and the option of eurozone membership reduce some of the fundamental disadvantages that would otherwise be faced by countries such as Luxembourg, Malta, Cyprus and the Baltic states. Even though a seceding region would probably have to officially apply for EU membership, this very prospect no doubt makes it much easier for supporters of independence to paint a positive picture of a future as a sovereign nation.

This report will focus on examining the extent to which economic determinants could provide an explanation of why autonomy movements are emerging or becoming reinforced. On the one hand this includes the question of whether the citizens of a given region might have the impression that it is so strong economically compared to the rest of the country that it could form a functioning and internationally competitive state even if it were independent. On the other hand, a role is also played by whether extensive interregional transfer systems compel wealthier regions to share their prosperity with poorer regions. If the subsidisation of other parts of the country reaches a high level or there is not a very pronounced sense of solidarity with other regions, this can also serve as a motivation for greater autonomy.

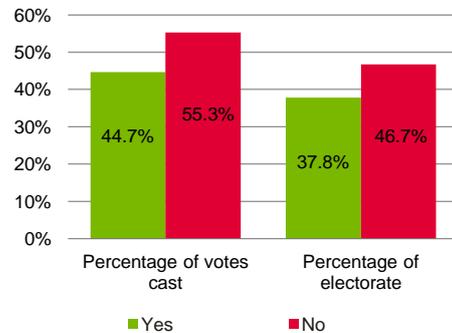


## Better off on their own?

### Autonomy or independence? Regions have varying starting conditions, motives and objectives

Referendum on Sep 18, 2014: "Should Scotland be an independent country?" **1**

Turnout: 84.6%



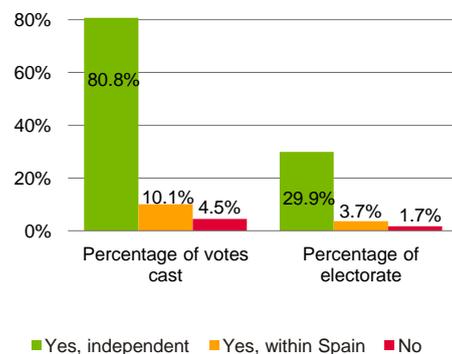
Source: Electoral Management Board for Scotland

Autonomy movements are, by definition, regional phenomena and thus comparable to an only limited extent, especially since the regions discussed here enjoy differing degrees of autonomy. While the demand for greater self-determination is borne everywhere by a broad swath of the population, the basis for seeking actual independence varies in breadth.

In Scotland some 44.7% of the vote in the September 18, 2014 referendum was in favour of independence, on a turnout of nearly 85%. While the unofficial poll in Catalonia on November 9, 2014 showed an overwhelming majority of 80.76% in favour of the pro-independence camp, the turnout came to merely 37%, corresponding to "only" about 30% of Catalonia's eligible voters. An unofficial referendum without a legally binding effect is a difficult benchmark for comparison anyway. Catalanian voters could vote for independence also to express general dissatisfaction without triggering any immediate consequences. The opponents of separation largely boycotted the referendum, and the absence of legal binding is likely to have kept many other voters from casting their ballot. This provides only limited grounds for predicting what the outcome of a constitutionally binding referendum would be like.

Referendum on Nov 9, 2014: "Do you want Catalonia to become a State?" **2**

Estimated turnout 37% (no official figures)



Source: Generalitat de Catalunya

Another Spanish region with a strong autonomy movement is the Basque Country. Unlike Catalonia it has much more extensive autonomy rights, not least in terms of financial matters. The Basque Country is the only one of the regions analysed here whose desire for independence has manifested itself in the formation of a terrorist movement (ETA). In the neighbouring region of Navarre a part of the population feels it belongs historically to the Basque Country. There, it is not only a matter of nationalism in its own right, but also a sense of having a common Basque identity. The political spectrum includes not only Basque parties but also parties claiming autonomy for the region itself. Like the Basque Country – but unlike Catalonia – Navarre also enjoys special autonomy status within Spain.

The relationship between Flanders and the rest of Belgium is a special case. For one thing, this is the biggest region of the country in which a substantial share of the electorate desires secession while, for another, Belgium does not even have a common national language that creates a sense of identity. This linguistic segmentation differentiates it from Spain, where several regional languages are recognised (e.g. Basque, Catalan, Galician) but in principle everybody grows up with Castilian Spanish as their (at least additional) mother tongue.

The language component also plays a part in Italy's South Tyrol (Alto Adige), where German is still the most widely spoken language. Our references to South Tyrol in the following pertain to the "Provincia autonoma di Bolzano-Alto Adige", which together with the "Provincia autonoma di Trento" forms the region of Trentino Alto Adige. Over the past few years the region of Veneto has also seen the development of a movement calling for a right to self-determination and a binding referendum on its affiliation with Italy. In an unofficial online referendum organised by private groups in March 2014, unconfirmed reports from the organisers say that 89% (or 57% of the total electorate) voted in favour of independence.



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Per capita income versus other regions in given country

3

% of national average, 2011



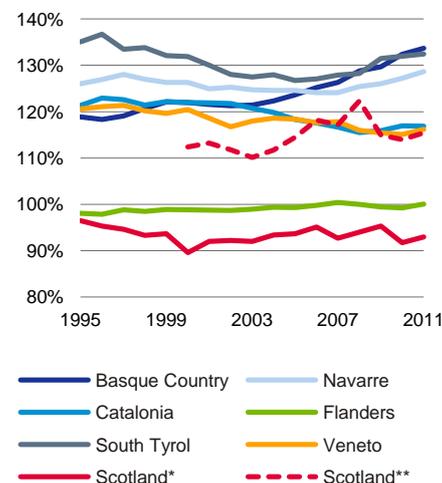
Regions marked in red; Belgium: Flemish provinces; Scotland: excluding oil

Sources: Eurostat, Deutsche Bank Research

Growth of per capita income in relation to national average

5

% of national average



\*Excl. oil revenues, \*\*Incl. oil revenues  
Source: OECD

Overview: Regionalism and economic vitality

The regions seeking greater independence differ very considerably in terms of geographical size and economic importance. Both very small as well as very much bigger regions desire greater autonomy. Their weight within the given country is correspondingly uneven. Flanders (58% of Belgium's GDP) and Catalonia (19%) are regions, for instance, that are of huge economic relevance, while South Tyrol (2.3%) and Navarre (1.7%) play a relatively minor role in their respective countries.<sup>1</sup>

Independence movements in Europe: An overview

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Comparison of various regional indicators in relation to the rest of the country

Country	Region	Pop. (abs.)	Pop. (%)	GDP (abs.)	GDP (%)	GDP/capita	GDP/capita (%)	Unempl. (pp)*
ES	Basque Country	2.18 m	4.7%	64.9 bn	6.2%	30,500	134.4%	-9.5
	Navarre	0.68 m	1.4%	18.1 bn	1.7%	29,100	128.2%	-8.2
	Catalonia	7.49 m	16.1%	194.3 bn	18.6%	26,600	117.2%	-3
IT	South Tyrol	1.02 m	1.7%	35.8 bn	2.3%	34,385	132.3%	-6.7
	Veneto	4.85 m	8.2%	149.5 bn	9.5%	30,200	116.2%	-4.6
BE	Flanders	6.36 m	57.5%	212.4 bn	57.5%	33,600	100.0%	-3.4
UK	Scotland**	5.28 m	8.4%	137.9 bn	7.8%	26,200	92.9%	-0.4

\* Difference in unemployment rate to national average

\*\* Excluding oil revenues

Source: Eurostat

The most striking common characteristic of these regions is the usually high level of prosperity compared to the rest of the country. Nearly all the regions rank higher than the national average in terms of per capita income (see chart 3 and table 4).<sup>2</sup> This is particularly noticeable in Spain and Italy, where the Basque Country and South Tyrol, the most prosperous regions in their respective countries (with GDP at over 130% of the average), already enjoy special autonomy status. Belgium presents a comparable picture – if one disregards the capital region of Brussels nearly all the Flemish provinces outstrip the national mean. Per capita GDP is 37% higher in Flanders than in the provinces of Wallonia.

The situation is similar in Scotland: while the income level is somewhat lower than the British average, Scotland follows London and the neighbouring south east as the third-richest of twelve regions. One further special feature also has to be taken into account: the North Sea oilfields are currently not assigned to any region of the UK in the official statistics. When the GDP generated by oil deposits is allocated on the basis of geographic share, Scotland's per capita income rises from EUR 26,200 to roughly EUR 32,000 and would thus equal some 115% of the British average<sup>3</sup>. On the basis of records available since 2000, Scotland would thus be the second richest region of the UK by far after London.

<sup>1</sup> The following abbreviations are also used for the regions: Basque Country (BC), Catalonia (CT), Navarre (NA), South Tyrol (ST), Veneto (VE), Flanders (FL) and Scotland (SC).

<sup>2</sup> For Germany (DE) and the United Kingdom (UK) we look at the NUTS 1 level, and for the other countries NUTS 2.

<sup>3</sup> Shares are allocated according to a geographical division based on what is known as the "median line". In this procedure, every point on the maritime boundary is equidistant from the shores of the two countries. This system is also used to divide the coastal fishing areas in the UK, for instance. This means that around 85-90% of the oil deposits are on Scottish territory (for more on this topic see Kemp & Stephen, 2008). The method is used by the Scottish government, with the value representing an upper limit.

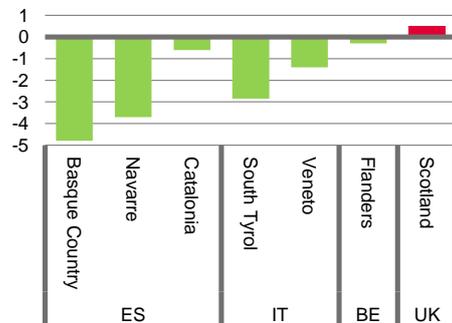


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Unemployment rate: Region vs rest of country; 2008-2013

6

Difference to increase in national average (pp)

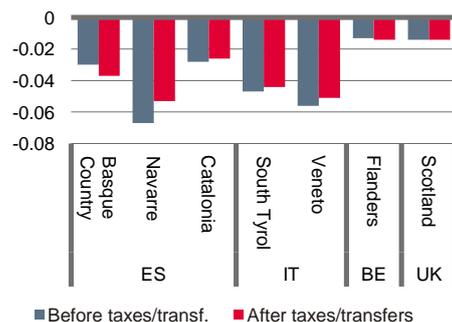


Sources: Eurostat, Deutsche Bank Research

Income inequality: Difference to national average in 2011

7

Gini coefficient before and after taxes and transfers

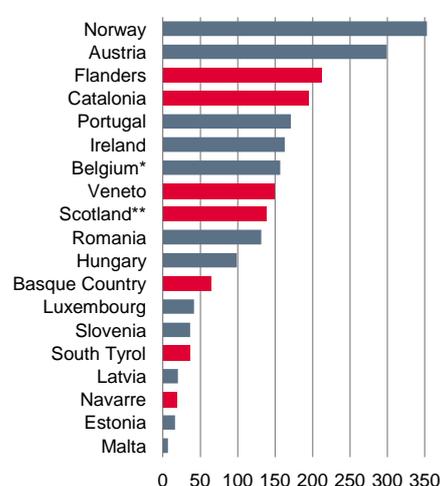


Source: OECD

Comparison of selected countries and regions

8

GDP, EUR bn, 2011



\*Belgium excl. Flanders, \*\* Excl. oil

Source: Eurostat

The regional income disparities within a country are very persistent (see chart 5 as well). Since 1995 the ratios have shifted only slightly in many cases. The Basque Country has gained most in relation to the national average and boosted its per capita income from 118.9% to 133.7%. In the other regions the ratio has remained relatively constant: Navarre and Flanders are up slightly (with +2.6 percentage points and +1.9 pp, respectively), while South Tyrol (-2.7 pp), Scotland (-3.6 pp), Veneto (-4.4 pp) and Catalonia (-4.5 pp) have lost ground.

Due to their higher prosperity levels these regions score much higher on many economic and social indicators than the rest of their country. Whether unemployment, poverty, education or research: in some cases there are sizeable differences to the national average in these areas. For example, all the regions score better on unemployment and poverty rates. Since the start of the crisis the unemployment rate has not risen as much, as a rule, as in the other regions. In the Basque Country the rate rose by 4.8 pp less than in Spain as a whole from 2008 to 2013. Navarre (-3.7%), South Tyrol (-2.9%) and Veneto (-1.4%) are also positive outliers in their countries. Catalonia (-0.6%) and Flanders (-0.3%), as well as Scotland (+0.5%), performed in line with the average (see chart 6).

Income inequality within these regions is much less pronounced than in the rest of the respective country (see chart 7), which does not automatically have to be the case despite usually higher per capita incomes. The Gini coefficient<sup>4</sup> is smaller in all the regions than in the country as a whole – both before as well as after redistribution via taxes and transfers. The largest disparity is to be found in Navarre, where the Gini coefficient is 0.07 lower (before taxes and transfers) and 0.05 lower (after taxes and transfers) than the coefficient for Spain as a whole. A similar picture emerges with regard to the income ratio between the 80% quantile and the 20% quantile. Only in Scotland is the gap between the fifth of the population with the highest incomes and the fifth with the lowest incomes minimally larger than the national average, while in the other regions the difference between the population groups is smaller.

The regions analysed score above average not only within their countries but also in a European comparison of per capita incomes (EU-27). South Tyrol was the leader of the group in 2011 with GDP per capita of 137% of the EU mean, followed by Flanders at 134%. At the lower end of the scale are Catalonia (106%) and Scotland (excluding oil, 105%), which – just like the rest of the UK – had suffered a severe slump due to the financial crisis. In 2006, Scotland still boasted a reading of 132%.

The regions are not only affluent in relative terms though. Their absolute economic output also makes them a force to be reckoned with even at the European level (chart 8). A recurring theme used as an argument against the separatist movements is that the resultant countries would be relatively meaningless at the national level because of their small size, apart from other problems. A glance at the EU shows, however, that many of the regions would not be such lightweights at all in comparison with existing members. In fact, in terms of GDP, Flanders and Catalonia even have bigger economies than Portugal or Ireland. The medium-sized regions of Veneto and Scotland outperform countries such as Romania and Hungary, and even the Basque Country has a larger GDP than nine other EU members. In terms of population, too – a factor of significance for voting procedures in EU bodies in particular – a host of regions indeed boast critical mass.

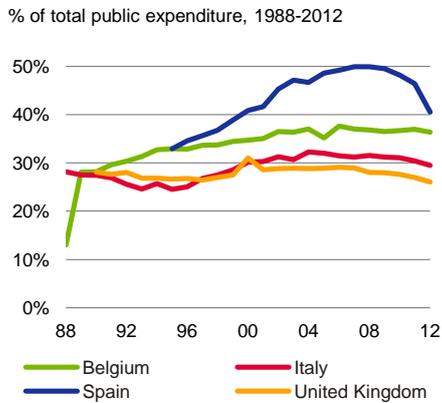
<sup>4</sup> The Gini coefficient is a measure of income inequality and has a value between 0 and 1. A reading of 0 means that all incomes in the respective region are distributed evenly. If a region has a lower Gini coefficient than the rest of the country the inequality of income distribution there is not as pronounced.



Better off on their own?

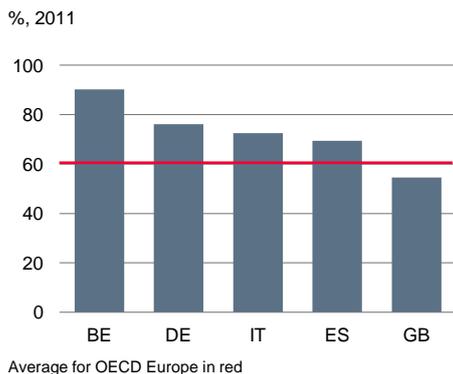
Differences regarding scope of regional autonomy

Public expenditure at the regional level 9



A very mixed picture emerges as regards the extent of regional autonomy in the countries analysed. While both Spain and Belgium have already devolved many competences to the regional level, this is much less the case in Italy and the United Kingdom. This can also be seen in the data on record: the share of government spending authorised at the regional level is much higher in Spain (40.5%) and Belgium (36.4%) than in Italy (29.5%) and the UK (26.1%). This trend became manifest in the past: in Spain, the shift had resulted in 7 pp of higher outlays at regional level since 1995, hitting 49.9% before the 2007 crisis in fact. In Belgium the rate rose by 14 pp from 1985 to 1990, jumping in the wake of the State Reform of 1988/89 in particular. However, little has changed in Italy or the UK since the turn of the millennium. This also holds for Germany, where the share of the regional level in total government spending has hovered at close to 40% for a long time.

Public expenditure on investment at regional level 10

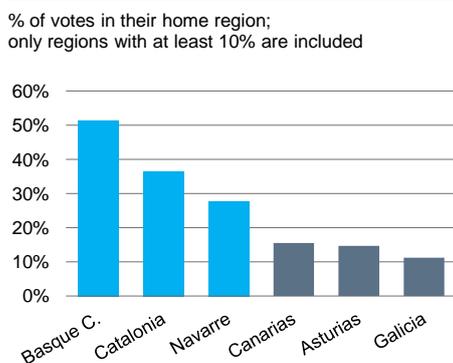


The situation is similarly mixed in respect of tax revenue distribution, too. In Spain, some 33% of total tax revenues are generated at the regional level; in this respect, the special status of the Basque Country and Navarre no doubt has a noticeable impact. In the other countries the share is much smaller: Italy comes second at 16%, Belgium follows at 10% and the UK at 5%. The share in Belgium is expected to rise owing to the State Reform in 2014 (by comparison: the reading in Germany is over 29%).

With regard to public expenditure on investment, it is striking that a particularly large share is commissioned at regional level. The shares in Belgium (90.2%), Italy (72.5%) and Spain (69.4%) considerably outstrip the average for the European members of the OECD (59.5%). Only in the UK is there a slightly lower share at 54.6%. Local and regional governments thus appear to be particularly responsible for public investment in the countries analysed (by comparison: the reading is about 76% in Germany).

To sum up: the regions discussed generally report above-average economic output, but the importance of the regional level is not equally pronounced everywhere. There are also major differences in respect of regional funding and fiscal equalisation systems. So each case has to be assessed on its own merits.

Share of regionalist parties in the 2011 general elections 11



Many regions in Spain have a distinct cultural identity, but only in a few of them did this feeling of regional unity develop into broad support for movements claiming greater autonomy or independence. This is also reflected in the importance of regional parties in the political system. The Basque Country, Navarre and Catalonia have strong regional parties, but Asturias, Galicia and the Canary Islands also have such parties that were able to attract more than 10% of the votes in the 2011 Spanish parliamentary elections in their specific region. The share of these parties is usually even higher in regional elections. However, in the latter regions not many voters support the demand to become fully independent. A major factor to explain this is presumably that their GDP per capita is below the national average, and it is hard to find convincing reasons why they should be better off alone. In contrast, the Basque Country, Navarre and Catalonia are among the economically strongest regions in Spain – only the capital Madrid can compete in terms of per capita income and unemployment. In 2013 the per capita GDP of the Basque Country was almost twice that of the poorest region, Extremadura, while its unemployment rate was only half as high (see chart 12).

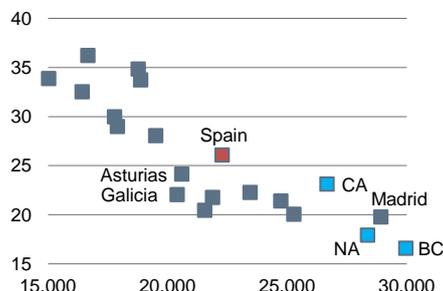


## Better off on their own?

### Catalonia, Basque Country and Navarre among the strongest regions

12

X-Axis: regional per capita GDP, 2013, EUR  
Y-Axis: unemployment rate, 2013, %

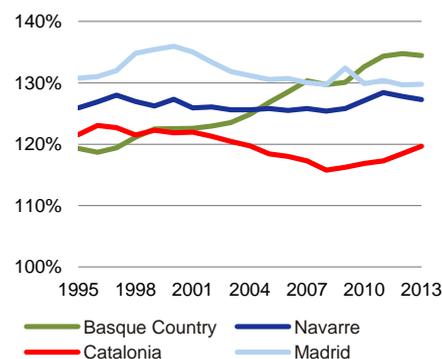


Source: Instituto Nacional de Estadística

### Regions with autonomy movements more affluent than the rest of Spain

13

100% = national average



Source: INE

While there are some similarities between the Basque Country and Catalonia in their desire to gain greater (or full) autonomy, it is crucial for an understanding of the Catalan dilemma that the two regions are treated differently within Spain's fiscal architecture. Like most other regions Catalonia has the status of an Autonomous Community (Comunidad Autónoma), while the Basque Country and Navarre have had the status of a so-called "Comunidad Foral" since 1979 and 1982, respectively. This special status not only grants a much higher degree of fiscal autonomy, but also accords preferential treatment within the horizontal equalisation scheme between regions.

The objective of the equalisation mechanism is to establish a comparable level of public services across Spanish territory. As a result of marked income differences but also due to geographical factors, this is much more difficult for some regions than for others. Consider the two neighbouring regions of Madrid and Castile La Mancha. Income per capita in Castile La Mancha is almost EUR 10,000 lower than in Madrid. At the same time, the population of Madrid is three times larger (6.5 m vs 2.1 m) but the inhabitants of Castile La Mancha are spread across an area ten times larger (roughly twice the size of the Netherlands). Obviously, it is much more difficult and more expensive for such a large and thinly populated region to maintain a comparable network of public infrastructure, healthcare and educational institutions than for regions such as Madrid, Catalonia or the Basque Country. However, the problematic design of the regional equalisation scheme is a permanent cause of dispute.

## The intricate mechanics of Spain's fiscal equalisation scheme

The fiscal competences and financing schemes of the Spanish regions have been reformed several times, most recently in 2009. The fiscal equalisation scheme, the so-called "common system" (Régimen Comun), redistributes financial resources across regions. However, as the Basque Country and Navarre have special autonomy status as a "Comunidad Foral" this scheme does not apply to them. Funding for the fiscal equalisation scheme mainly comes from shared taxes, for example from 50% of the income tax and 50% of the VAT. Both components are strongly linked to GDP, which means that richer regions pay more. In addition, the common system receives 58% of taxes on alcoholic products, tobacco and fuels, and 100% of taxes on capital transfers, inheritances and donations, or gambling, as well as some special low-volume taxes.

The main instruments for redistribution are the Public Guarantee Fund (Fondo de Garantía de Servicios Públicos Fundamentales) and the Global Sufficiency Fund (Fondo de Suficiencia Global), whose purpose is to ensure that all regions in the common system have the same per capita financing for public resources. Two additional funds (Fondo de Competitividad, Fondo de Cooperación) provide additional resources for structurally weak regions according to different criteria (e.g. for those with GDP per capita of less than 90% of the average). With a volume of EUR 69 bn (6.8% of Spanish GDP) in 2012, the Public Guarantee Fund was by far the largest fund. The disbursement is based on a region's "adjusted population", i.e. the actual population adjusted for certain factors which justify additional financial resources to mitigate structural disadvantages (box 14).<sup>5</sup>

Some complications arise when comparing net financial flows across regions. One reason is that some regions can decide whether to assume certain competences or leave the responsibility to the central state. For example, Catalonia is the only region in the common system in charge of a police and

<sup>5</sup> This compares with what is referred to as "Einwohnerveredelung", the population weighting approach used in Germany for the Länder financial equalisation system.



## Better off on their own?

### Calculation of the "adjusted population"

14

The "adjusted population" concept is based on the logic that regions with a higher share of children and pensioners or a low population density have higher spending needs to guarantee a comparable level of public services.

The following weights and variables are used for the calculation of the "adjusted population":

VARIABLES	WEIGHTING
Population	30.0%
Population younger than 16	20.5%
Population older than 65	8.5%
Economically dependent	38.0%
Population in seven age groups	
Surface area of region	1.8%
Dispersion of population	0.6%
Insularity	0.6%

In order to illustrate the effects of the calculation let us consider the example of Catalonia.

In 2012, the share of Catalonia in the total population of the regions in the common system was 17.10%. The share of the population below age 16 was only slightly higher (17.71%), while the share of those older than 65 was marginally lower (16.82%). However, the surface area of Catalonia corresponds to only 6.52% of the total, which enters with a weight of 1.8%. The result is an adjusted (i.e. weighted) population of 7.51 m.

Thus, Catalonia receives financial resources as if it would have to provide public services for a population of 7.51 m – or 99% of the actual 7.57 m inhabitants. Thus, the adjusted population concept results in a marginal disadvantage for Catalonia. For the other regions, the adjustment factor usually ranges between 0.95 and 1.05.

Source: Ministerio de Hacienda y Administraciones Públicas

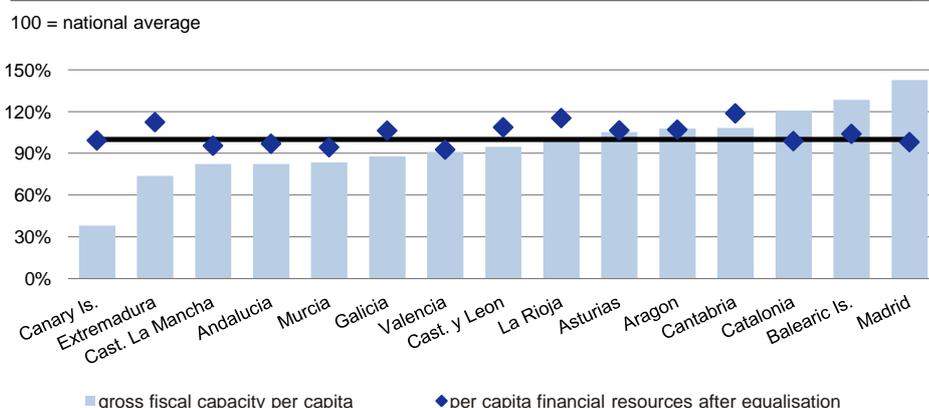
penitentiary system, for which it receives financial compensation from the central state. Another reason is that there are some differences in regional and local taxes. Furthermore, due to their isolated location the Canary Islands have a reduced local sales tax instead of the regular VAT, and also the two north African enclaves Ceuta and Melilla benefit from some exceptions.

Chart 15 illustrates the result of this opaque combination of redistributive elements.<sup>6</sup> The regions in the common system, i.e. excluding Navarre and the Basque Country, are ranked according to their gross fiscal capacity, which is the per capita amount of taxes collected in that region. It also plots the per capita resources after fiscal equalisation between regions. Both measures are normalised such that a value of 100 corresponds to the national average. It is evident that the fiscal equalisation scheme indeed achieves the objective of reducing the disparities across regions (the standard deviation of per capita GDP is 25%, but that of per capita financial resources after adjustment is only 12%).

A remarkable aspect is that the three richest regions in the common system – Madrid, the Balearic Islands and Catalonia – are not on top any more after horizontal redistribution. The change in the ranking is partly the consequence of accounting for different financing needs, but it is an undesirable feature from the perspective of incentive compatibility. The seemingly arbitrary distribution gives rise to claims of richer areas that their contribution is disproportionately large. Preserving the ranking is a key Catalan demand for fiscal reform. The reformed regional statute of Catalonia (approved by the Catalan parliament in 2006 but partly rejected by the Constitutional Court in 2010) stipulates: "The State shall guarantee that application of the levelling mechanisms shall in no case alter the position of Catalonia in the pre-levelling ranking of per capita earnings."<sup>7</sup>

Winners and losers of the regional fiscal equalisation scheme

15



Source: FEDEA (2014)

## Regional asymmetries: Navarre and the Basque Country

Thanks to their special autonomy statute, the Basque Country and Navarre have the power to collect most taxes themselves. They do not participate in the fiscal equalisation scheme but instead transfer a certain share of their tax revenues to the central state in order to contribute to the financing of functions which are located at the national level. Both regions also have more discretion in setting tax rates than the regions operating in the common system, which further complicates a comparison across regions. Comparable data are only

<sup>6</sup> For details on the calculations see FEDEA (2014). La financiación de las comunidades autónomas de régimen común en 2012.

<sup>7</sup> See Article 206(5). Ley Orgánica 6/2006, Reforma del Estatuto de Autonomía de Cataluña. (Organic Law 6/2006 on the Reform of the Statute of Autonomy of Catalonia).

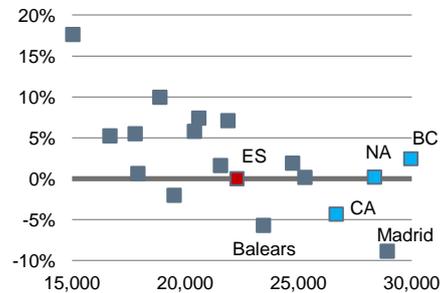


## Better off on their own?

Regions with fiscal autonomy have lower contribution levels

16

X-Axis: GDP per capita, EUR, 2012  
Y-Axis: fiscal balance after equalisation, % GDP



Sources: de la Fuente et al. (2014), INE

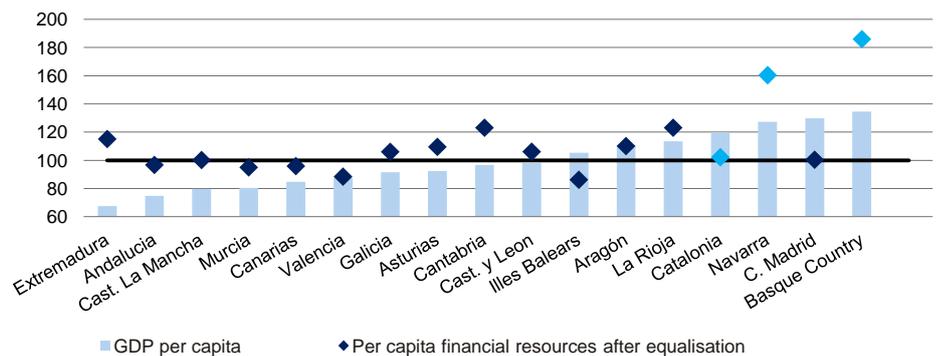
available for the regions within the common system, but a study on behalf of the Spanish Finance Ministry has recently made an attempt to quantify the financial flows when the two above regions are included.<sup>8</sup> These calculations reveal that Catalonia and Madrid, the wealthiest regions in the common system, are net contributors to the equalisation scheme but not Navarre and the Basque Country.

According to these calculations, Catalonia made a net contribution of -4.35% of its GDP, ranking third behind Madrid (-8.87%) and the Balearic Islands (-5.71%) in 2012 (see chart 16).<sup>9</sup> Compared to a situation of fiscal neutrality, i.e. without any form of horizontal redistribution, these findings imply an additional cost for Catalonia of EUR 8.5 bn. By contrast, Navarre and the Basque Country had a surplus of 0.19% and 2.43% of GDP, respectively. Figure 17 expresses the same in per capita terms. Regions are ranked according to per capita GDP in ascending order. The diamonds indicate the per capita financial resources of a region after redistribution; a value of 100 again corresponds to the national average. Once again it becomes clear that Madrid and Catalonia are at a disadvantage compared to the two regions outside the common system.<sup>10</sup>

Asymmetry between regions with/without fiscal autonomy

17

100 = national average



Sources: de la Fuente et al. (2014), Instituto Nacional de Estadística, Deutsche Bank Research

## Reforming a conflict-ridden system without creating or reviving other conflicts: A mission impossible?

A system of interregional redistribution will always have to strike a balance between providing support for structurally weaker regions and preserving the legitimate interests of the net contributors. However, the patently unequal treatment of regions appears detrimental to the general acceptance of the system. Concerning the regions with important autonomy movements, a few central facts clearly stand out:

- **Catalonia is a long-running net contributor to a system which achieves substantial redistribution.** This is hardly surprising given that the *raison d'être* of a system based on solidarity is that the richer regions support the poorer ones. Of course, a different – political – question is what degree of fiscal solidarity is acceptable to the majority of Catalans. In light of the complexity of the system, the barely comprehensible directions of flows and the asymmetry between regions with different fiscal regimes, the discontent of many Catalans becomes more understandable.

<sup>8</sup> See de la Fuente, Barberán and Uriel (2014); information only available in Spanish. [http://www.minhap.gob.es/en-GB/Paginas/20140723\\_scpt.aspx](http://www.minhap.gob.es/en-GB/Paginas/20140723_scpt.aspx)

<sup>9</sup> Other sources reach considerably differing conclusions in some cases. Pro-independence groups usually claim that Catalonia has a much larger fiscal burden in the order of -6% to -8% of its GDP.

<sup>10</sup> In addition, the tax burden is slightly lower in Navarre and the Basque Country.



## Better off on their own?

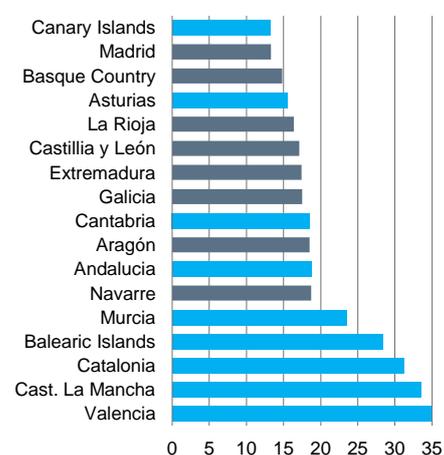
- Even though the issue is central in the political debate, there does not appear to be a specific anti-Catalan bias. At least concerning fiscal redistribution, the often heard claim among Catalan nationalists that the Spanish state systematically exploits Catalonia's economic strength hardly appears justified. After all, Madrid and the Balearic Islands contribute more both in per capita terms and in terms of GDP.
- Special autonomy status generates significant financial advantages for the Basque Country and Navarre. As both regions would be net contributors if they were treated like the rest, this arrangement is clearly unfavourable for all the other prosperous regions.

Despite the problematic aspects of the current regional equalisation scheme, any attempt to achieve a substantial reform is bound to encounter strong resistance. In principle, three approaches appear conceivable, but all of them are problematic as well:

Regional debt in % of GDP

18

Q2 2014; FLA-regions in light blue



Sources: Banco de España, Deutsche Bank Research

- i. Other regions have repeatedly demanded a reduction of the advantages for Navarre and the Basque Country stemming from their not being part of the common system. However, both regions would fiercely resist any attempt to alter the status quo to their disadvantage.
- ii. A “small” solution, which would keep the ranking of the regions and only aim at reducing the payments of the net contributors, would obviously be opposed by the net recipients. However, as Catalonia is not the largest net contributor in per capita terms, the scope for readjusting the system in Catalonia's favour is limited and the net effect would hardly be sufficient to appease the pro-independence camp.
- iii. Finally, Catalonia could be granted special status similar to that enjoyed by the Basque Country and Navarre. While this would presumably be the preferred solution of many Catalans it would inevitably trigger similar demands from other wealthy regions (Madrid, La Rioja, the Balearic Islands). However, such a solution would not only effectively eliminate the regional equalisation mechanism but also undermine the Spanish national state.

How the issue of regional finances and fiscal autonomy can be resolved in a way that is satisfying for all groups involved will remain one of the key questions for the territorial unity of Spain.

The indebtedness of Spanish regions during the crisis and the role of the Fondo de Liquidez Autonómico (FLA)

19

Since the peak of the financial and sovereign debt crisis, an additional – but often overlooked – dimension has been added to the fiscal links between the highly indebted regions and the Spanish central state.

During 2010 and 2011 the risk premia of regional government bonds were rising even more steeply than for Spanish government bonds. Highly indebted regions such as Catalonia almost completely lost access to capital market funding and needed to ask for emergency liquidity from the Spanish government. In early 2012, Catalonia and eight other regions applied for government funding from the newly created Fondo de Liquidez Autonómico (FLA). This new instrument centralised the raising of new capital for the regions and reduced their refinancing costs. Participation in the FLA provides regions with long-term loans (10 years plus a 2-year grace period) at almost the same rate as the central government (10 basis points above Treasury bonds). At the peak of the sovereign debt crisis, this was equivalent to an advantage of well over 100 basis points for all the participating regions. In return, they had to accept strict fiscal conditionality and financial monitoring by the central government, which was a politically contentious issue especially in Catalonia.<sup>11</sup> The Spanish government has also imposed a ceiling on the costs of bond issuance by the regions. If an Autonomous Community has to pay a premium which exceeds a certain threshold over Spanish government bonds of identical maturity, it can only obtain financing via the FLA.

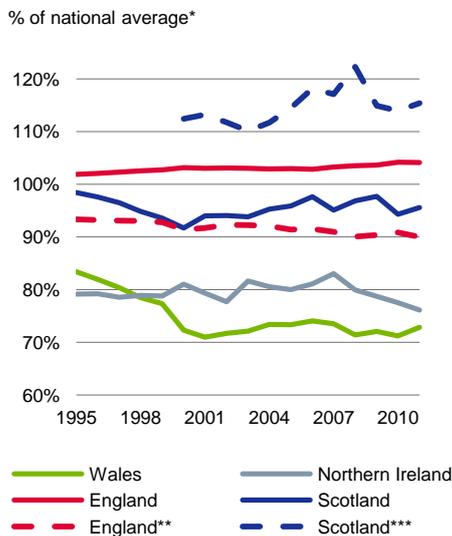
Catalonia is currently the largest borrower from the FLA (around 40% of the total volume) and received EUR 23.8 bn in various instalments during 2012, 2013 and 2014. Creating the FLA was not a cheap solution for the central government, though, since it resulted in risk being transferred from the regions to the central authority and hence to higher risk premia for Spanish sovereign bonds. The fact that the central government increased its own borrowing in order to lower the financing costs of Catalonia represents a direct fiscal transfer from the central government to Catalonia (and other regions) due to the preferential borrowing rate of the FLA. In contrast, Navarre and the Basque Country did not need to apply for funding via the FLA. Compared to Catalonia their debt level is much lower and they have a much better credit rating, not least due to the higher degree of fiscal autonomy.

<sup>11</sup> For more details on the establishment of the FLA see Vetter, Zipfel and Fritsche (2014). Small is beautiful? Capital market funding for sub-sovereign authorities on the rise. Deutsche Bank Research.



## Scotland: Increasing autonomy

Regional income per capita in the UK 20



\*Offshore income stripped out  
\*\*Excl. London \*\*\*Incl. oil revenues

Sources: Deutsche Bank Research, data from Eurostat, OECD

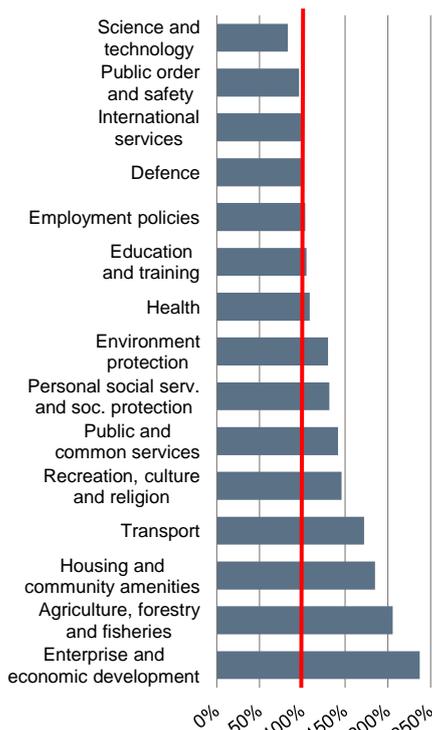
Despite the existence of three levels of government, i.e. local authorities, counties and the regions of England, Scotland, Wales and Northern Ireland, the United Kingdom has historically always been a very centralised country. In recent times, however, especially Scotland (and to a lesser degree Wales and Northern Ireland) has gained considerable autonomy. Yet, surprisingly, this does not apply to England, the largest region of the UK by far.<sup>12</sup> The desire for more autonomy and self-administration had already manifested itself very early on in the founding of regional parties – in Wales, for instance, back in 1925 and in Scotland in 1934. Until the end of the 1990s, though, non-regional parties invariably dominated the elections in the different regions.

The strongest autonomy and/or independence movements are in Scotland – as evidenced by the latest referendum. Driving this trend are not only emotional but above all economic/financial factors, the latter in particular being the discovery of North Sea oil in the late 1960s and its intensive exploitation after the 1973 oil crisis. An initial referendum in 1979 on greater autonomy and establishment of a local parliament produced no change. A Scottish parliament was not created until 1999, only after a further referendum. Since then, its significance has grown steadily. It has powers especially in the areas of education, agriculture, health and justice. In Scotland's wake, Wales and Northern Ireland have also been granted greater autonomy and self-administration. Comparable aspirations to gain independence have scarcely been visible there to date. The relatively poor economic performance is likely to have played a major role in this respect.

## Scotland already largely autonomous with regard to expenditures

Per capita expenditure in Scotland 21

Expenditures in Scotland in relation to UK average



Sources: Phillips, David and Tetlow, Gemma (2014), Deutsche Bank Research

A look at the fiscal level finds that Scotland still only has very limited autonomy on the revenue side. However, this is set to change in future (see below). On the expenditure side, though, Scotland already enjoys far-reaching autonomy. This enables differing emphasis on issues in various areas of its remit. For example, in a host of areas – on the largest items of health and education in particular – the Scottish government spends a per capita amount similar to the national average.<sup>13</sup> However, in some fields – such as business promotion, agriculture and transport – it spends much more per capita than the national average. Accordingly, though, it expends much less on science and technology, for instance.<sup>14</sup>

All in all, it must be noted that in the area of public services Scotland reports substantially higher spending than the rest of the United Kingdom. At last reading (fiscal 2012/2013) total spending in Scotland came to around GBP 65 bn<sup>15</sup> or roughly 9% of national expenditure of GBP 701.7 bn. This means that total per capita spending in Scotland is also about 11% higher than at the national level. The relatively higher expenditures in Scotland are not a short-

<sup>12</sup> See Gwilym, Eurfyl ap (2014). United Kingdom, in: Lütgenau, Stefan (2014). Fiscal Federalism and Fiscal Decentralization in Europe, pp. 61-73.

<sup>13</sup> See Phillips, David and Tetlow, Gemma (2014). Taxation, government spending and the public finances of Scotland: updating the medium-term outlook, IFS Briefing Note 148. June 2014, p. 10.

<sup>14</sup> The reasons there are exceptions to the regional governments being able to decide freely on the allocations available emerge partly from the fact that funds for investment cannot be converted into current expenditure. However, conversion in the opposite direction is possible. See Gwilym, Eurfyl ap (2014), p. 64.

<sup>15</sup> Even though the Scottish government is responsible for a large portion of the expenditures there are certain areas – such as defence and foreign relations – where related expenditure is the responsibility of the central government (and is funded via the national budget). The Scottish government therefore also factors in the expenditures at national level that benefit the inhabitants of Scotland. All the data cited here are based on figures calculated by the Scottish government under this definition. Expenditures calculated on this basis are published under the heading of total managed expenditure (TME).



## Better off on their own?

The "Barnett formula"

22

Even before the formula was introduced at the end of the 1970s Scotland in particular reported higher allocations per capita, so the expenditure level per capita was also higher than in England. The formula was designed at the time in such a way that on equal population growth in Scotland and England this initial difference would have been neutralised over the course of time. Owing to the longlasting relatively smaller growth of the Scottish population, however, this effect has so far failed to materialise.

The differing degree of decentralisation is taken into account by various factors. To this end, a value between 0% (not decentralised) and 100% (fully decentralised) is set for all ministerial sub-programmes. This is to take into account that certain expenditures are only incurred in England, for example. This is the case if these expenditures are decentralised and not funded from the national budget in all regions. For instance, the national transport ministry is the competent authority only in England and Wales when investment in the railway network is increased. Wales is thus given the value of 0% in this category and therefore does not obtain extra funding if there are plans to increase this item in the (UK) national budget. Scotland and Northern Ireland receive the factor 100% and are therefore accorded higher funding for investment to the same extent as England and Wales. Therefore, there are numerous different factors in a national comparison.

\*See Phillips, David (2014) for a detailed discussion. Business as usual? The Barnett formula, business rates and further tax devolution. IFS Briefing Note BN 155, chapter 2 in particular.

term phenomenon; the difference or gap of about 10% has existed since the 1980s at least.<sup>16</sup> A well-developed system of fiscal equalisation as in Germany, for instance, does not exist in the United Kingdom.<sup>17</sup> Expenditures in Scotland (as in Wales and Northern Ireland) have so far largely been funded via lump-sum allocations from the (UK) national budget. Estimates show that the Scottish government was responsible at the latest reading for around 70% of public expenditure in that region (Wales 56%, Northern Ireland: 53%)<sup>18</sup>; however, this was generally not funded via local taxes, but via the allocations discussed.

The size of the allocations and thus the total expenditure level hinge on the respective decisions taken in the framework of the (UK) national budget and of the expenditures determined in England.<sup>19</sup> The reason for this is that the annual changes in the lump-sum allocations to the regions are largely based on a mechanistic formula – the so-called “Barnett formula”. This formula, which came into existence at the end of the 1970s, focuses on redirecting to the inhabitants of Scotland (and also the other UK regions) the identical absolute per capita changes (in GBP) of comparable services when there is a change in the provision of services in England. It makes absolutely no attempt to determine local needs, but instead considers to what extent tasks are decentralised, i.e. delegated to the corresponding regional government.<sup>20</sup> Since part of the task is already funded by regional taxes, this is also taken into account when funds are allocated.

The allocation formula has been heavily criticised for some time, both because of Scotland's still relatively favourable position as well as the formula's problematic reciprocal and/or incentive effects with taxes collected on a decentralised basis. This reciprocal effect also influences the debate about greater tax autonomy, because without a simultaneous change of the “Barnett formula” an increase in tax autonomy can lead to greater regional disparity on increases or cutbacks in lump-sum transfers and therefore on public expenditures in relation to the different parts of the country.

### Revenue autonomy being expanded

The decentralisation of expenditures and administration achieved since 1999 is not (yet) mirrored on the revenue side. This is problematic from an economic standpoint since it involves a violation of the principle of fiscal equivalence – i.e. the linking of autonomous decisions via both expenditures and their funding – and thus encourages the trend of steadily increasing expenditures. Until recently, all taxes – except for those at the local authorities level – were collected by the national tax authority. Moreover, the Scottish government – alone among the regional governments – has had the right to raise the standard rate of income tax by up to 3 pp. However, it has never made use of this right.<sup>21</sup> Given that so far most taxes have been collected and administered at the national level it is difficult to determine exact figures on the revenue volume raised in the individual regions. This also applies to the tax revenues generated on gas and oil production in particular. Relevant figures have become available only recently from both the Scottish government and the national tax authority.

<sup>16</sup> See Phillips, David and Tetlow, Gemma (2014), p. 6.

<sup>17</sup> To a certain degree – this varies according to the region – the volume of local tax revenues (such as the council tax) is collected and then distributed or redistributed between the local bodies of government. See also IFS Green budget (2011), p. 13ff.

<sup>18</sup> See Trench, Alan (2014), p. 321, in Lütgenau, Stefan (2014). Fiscal Federalism and Fiscal Decentralization in Europe, pp. 321-341.

<sup>19</sup> The following discussion applies in principle also to Wales and Northern Ireland.

<sup>20</sup> For a more detailed discussion of the following two sections see Phillips, David (2014), p. 17ff, Trench, Alan (2014), p. 322 and box 22.

<sup>21</sup> See Gwilym, Eurfyl ap (2014), p. 65f and Stuart, A. et al., p. 332ff. Taxing an independent Scotland, in: Oxford Review of Economic Policy, Volume 30, No. 2, pp. 325-345.



On the basis of the recently published Smith Commission Report (Nov. 27, 2014), compiled by a commission comprising representatives of all of Scotland's political parties, further taxation powers, inter alia, are to be devolved to Scotland in response to the September referendum.

Firstly, the report proposes to enable the Scottish parliament to largely set income tax rates and brackets itself (while all other aspects of income tax remain in the hands of the national parliament, including income tax on savings interest and dividends, personal tax allowance, deductions etc.). The lump-sum allocations are to be reduced accordingly.

Secondly, in future the first 10 pp of VAT will flow to the Scottish budget. Here, too, allocations are to be cut back accordingly.

All the other taxes and duties, including social security contributions, corporation tax, taxes on oil and gas production and consumption taxes in particular, remain unaffected by these changes and will continue to be dealt with in the national parliament.

With presentation of the working paper *Scotland in the UK: An enduring settlement* (Jan. 22, 2015), the legislation process for a new Scotland Bill has been launched.

For a detailed discussion see: *The Smith Commission (2014). Report of the Smith Commission for further devolution of powers to the Scottish Parliament. 27 November 2014.*

However, these generally differ from one another. This problem is all the more acute when the issue is distributing the tax revenues generated on North Sea oil and gas production.

Disregarding these “offshore” revenues, per capita tax receipts in Scotland, at 98.3%, are slightly below the national average.<sup>22</sup> By contrast, including the “offshore” revenues (defined according to Scotland's geographic share of the North Sea), the latest reading puts the share at 108.5% (2008/2009: still 122.6%). The offshore revenues are very volatile, with their share most recently having nearly halved within a year (fiscal 2011/12 to 2012/2013); the same applies to the share in total Scottish taxes (from 21% to 12%). From a fiscal standpoint Scotland's public finances thus depend heavily on oil and gas production. Proponents of independence should keep that in mind, particularly in light of the recent drop of the oil price. In fiscal 2012/13 the offshore receipts – unlike in most of the preceding years – were unable to plug the gap between expenditures and revenues excluding offshore.

Autonomy in the area of tax policy is to be significantly expanded in the coming years (2015 and 2016)<sup>23</sup>. In 2012 (as part of the Scotland Act 2012), the region saw the establishment of a local tax authority (Revenue Scotland) and Scotland was given the right to impose taxes on land and property transfers<sup>24</sup> as well as to introduce new taxes (with the authorisation of the UK Parliament in London).

As of 2016 the Scottish government will also be able to have a say on the use of a share of the national income tax (SRIT). The related law defines who is a Scottish income taxpayer: put simply, this depends on the taxpayer's place of residence. Income tax will continue to be administered by the national tax authority. However, the Scottish government may make autonomous decisions on a Scottish income tax rate. This will be like a surcharge on the national income tax. In turn, the national tax rate will be cut across the board by 10 pp. So if the Scottish government sets a rate of this magnitude, the full tax burden on the Scottish taxpayer will not change at all. If the rate is higher, the tax burden for Scottish taxpayers will increase in relation to the national rate. If it is lower than 10%, the Scottish taxpayer will have a smaller burden. So if, for example, the Scottish rate of income tax (SRIT) is 9%, the tax load on Scottish income taxpayers will be 19%, 39% or 44% (the current rates in the UK are 20/40/45%, depending on the level of taxable income). The Smith Commission set up at the time of the Scottish referendum recently proposed, inter alia, even further-reaching plans for more tax autonomy. The statutory requirements for this have been mapped out just recently (see box 23).

If the additionally planned changes are adopted, the concessions made to Scotland should – at least from a financial perspective – actually suffice to address key demands being made by independence advocates.

<sup>22</sup> For more on the numbers see David and Tetlow (2014). Particularly the per capita volume of income tax falls short of the UK average in Scotland.

<sup>23</sup> Ibid. From 2015 Scotland is also be allowed to issue its own bonds worth up to a maximum of GBP 2.2 bn and thus borrow at its own discretion.

<sup>24</sup> These will replace the UK Stamp Duty Land Tax (SDLT) and the UK Landfill Tax.

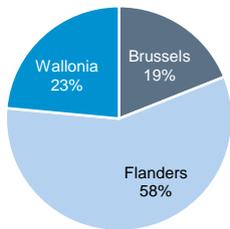


## Belgium: Increasing division

Belgian GDP: Regional shares

24

%, 2011

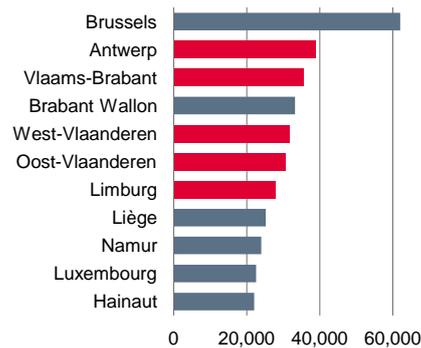


Source: Eurostat

GDP per capita in the provinces of Belgium

25

GDP per capita



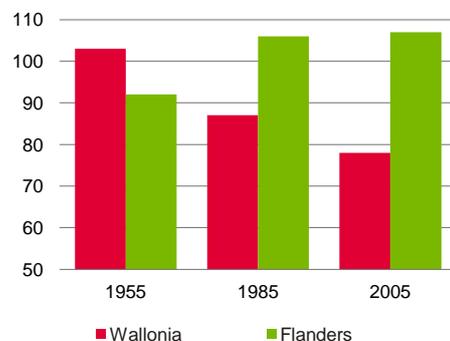
Red: Flemish provinces

Source: Eurostat

Wallonia and Flanders switch roles

26

GDP per capita, % of EU-15 average



Source: Leibfritz (2009)

Belgium is a deeply divided country, both politically and socially. Following the parliamentary elections in 2010 it took 541 days to form a government. The underlying political conflict has been smouldering for much longer, though. In the Flemish parts of the country a substantial swath of the population calls for independence for Flanders. In Belgium's 2010 parliamentary elections some 44% of the votes in Flanders were cast for the independence parties N-VA (31.7%) and Vlaams Belang (12.3%). By contrast, in the French-speaking parts of the country a majority of the parties, such as the Socialists, who are the strongest political force, call for a strong central state and no further division of the country.

The country's empty public coffers – public debt came to 104.5% of GDP in Belgium in 2013 – further exacerbated the conflict in the course of the financial crisis. In the economically thriving northern part of the country (58% of economic output) the view is widely held that ultimately the north always has to foot the bill for the south. Besides Flanders in the northern half and Wallonia in the southern half, Belgium also comprises the Brussels-Capital Region, which has a special role. Even though the Brussels-Capital Region is completely surrounded by Flanders, its population is largely francophone.<sup>25</sup>

The country is split noticeably along economic lines: per capita income in Flanders (at EUR 33,600) is more than one-third higher than in Wallonia (EUR 24,600). Brussels (EUR 62,000), as a city region in its own right and seat of the European institutions, has a special position in this context. The unemployment rate in Flanders is also much lower than in Wallonia (5.0% to 11.3%), as is the poverty rate (9.8% to 19.2%). There are even marked differences in life expectancy (81.4 years to 78.9).

Today's diverging economic conditions between north and south only developed in the course of the past 60 years. In 1955, Wallonia was still the more affluent part of Belgium. Rich in iron and coal, this area prospered economically following World War II. The 1960s saw the start of the downturn there, with Flanders subsequently assuming the leading economic role from the 1970s. In a comparison with other European countries (EU-15) it is striking that the gap that was opened up between the two regions is mostly due to the poor performance in Wallonia and not so much to the economic success in Flanders. Since 2000 the gap between the two regions has not grown any larger.

On a societal level, the situation in Belgium has eased of late. Following the formation of a government in 2011 the constituent parties concluded negotiations agreeing the so-called "sixth State Reform"<sup>26</sup>. Its main focus is on the continuation of decentralisation efforts that got underway with an initial reform in 1970. The new arrangement came as a direct result of the political conflicts and accommodated the Flemish desire for greater self-determination. Thanks to the far-reaching concessions of the central government the independence debate temporarily lost some of its momentum. In the parliamentary elections of 2014 the share of the vote for the N-VA and Vlaams Belang in the Flemish regions also decreased by around 6 pp, to 38.3%.

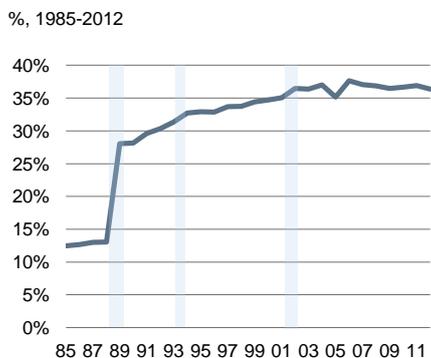
<sup>25</sup> In 57% of the households in Brussels French is the only language used for everyday interaction, while 9% speak French and Dutch and 11% speak French and a different language. By contrast, Dutch is the sole language spoken in only 7% of Brussels households, and neither of the two languages is used in the other 16%.

<sup>26</sup> "State Reform" has taken place in different stages, beginning in 1970. The initial reform was followed by programmes in 1980, 1988/89, 1993, 2001 and 2014.



Better off on their own?

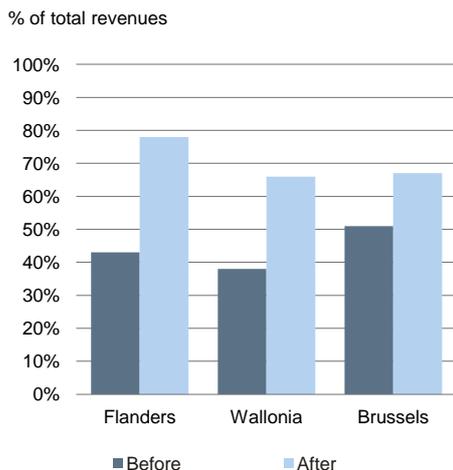
Belgium: Public expenditure at regional level 27



Shaded area: State Reform

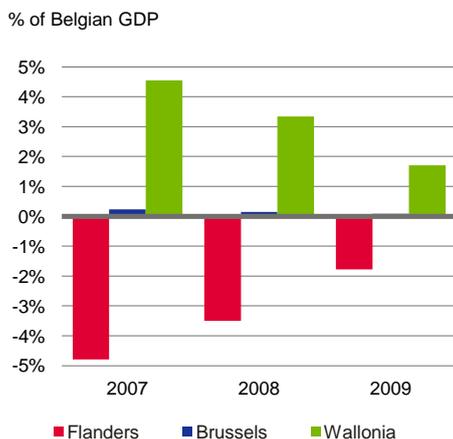
Source: OECD

Revenues from regionally imposed taxes before/after State Reform 2014 28



Source: NBB

Net interregional transfers 29



Source: Buyst et al. (2012)

Decentralisation continuing apace

Efforts to decentralise state structures have been underway for a long time. The biggest changes came with the State Reform at the end of the 1980s. At that time, the ratio of public expenditure at the regional level increased from 13.0% to 28.1%. Since then, the percentage has climbed almost continuously, driven partly by further reforms in 1993 and 2001, and reached 36.4% in 2012. The ratio is expected to increase further in future. The recently adopted “sixth State Reform” additionally reinforces the tax-collecting competences of the regions and guarantees the municipalities<sup>27</sup> higher transfers from the central government, expanding the responsibilities of the regions at the same time. The amended version of the “Loi spéciale de financement” only took effect in summer 2014 and therefore its impact will not materialise until sometime in future. All in all, it will transfer further budget funds equalling 4.7% of Belgian GDP from the central government to the regions.

The bulk of tax revenue to date has been generated at the central level, although a substantial portion has automatically flowed to the regions. In 2013 these funds added up to 64.6% of regional receipts, mainly from shares in income tax and value added tax. The latest reform changes the existing mechanism with regard to income tax: from 2015 the regional governments will receive about 25% of the income tax volume collected. This will be implemented by a type of surcharge, i.e. the regions will have a limited right to set tax rates, tariff/tax classes and deductions themselves. As a result, the share of receipts from local taxes in the regions will rise to 73.3%. Value added tax will continue to be collected entirely by the central government and about 50% of receipts will be handed on to the regions according to a given formula.<sup>28</sup> As regards lower-volume taxes, the regions often already have a far-reaching level of autonomy.

Regional transfers: Flanders pays, but how much?

An equalisation mechanism has been in place between the regions since 1988. The equalisation payments are transacted by the central government. At present, transfers flow to both Wallonia (approx. 0.2% of GDP) and Brussels (approx. 0.1% of GDP), but not Flanders. In fact, ever since the system was introduced no funds have been transferred to Flanders, whereas Wallonia has been receiving annual transfers since 1988 and Brussels since 1997. This system, too, was tweaked in the framework of the latest State Reform, which will lead de facto to a slight decrease in the transfers to Wallonia in the medium term. The decisive factor for the calculation is income tax per capita and the extent to which it deviates from the national average. If a region falls short of this average, it receives transfers.

The volume of the total interregional transfers cannot be measured directly. Since, unlike in Germany, for instance, payments between the regions are not reported, their volume can only be estimated using workaround methods. The estimates are often already slightly outdated, since important indicators on tax and social security transfers are only published with a time lag. A study conducted by the KU Leuven (Buyst et al., 2012) puts the transfers from Flanders in 2009 at 1.78% of national GDP, of which 0.08% went to Brussels and 1.7% to Wallonia. In methodological terms, the difference is taken between the income generated in the regions as a result of taxes and social security deductions and the allocations that return via transfers from the central

<sup>27</sup> Apart from the regional governments there are also linguistic communities which shoulder certain tasks of state – such as education in particular – and receive funds from the central government for doing so. To simplify matters, we shall not differentiate explicitly in the following between the two and shall group them under the term “regions”.

<sup>28</sup> Besides the tax revenues generated in a region, a role is also played by population distribution.



Better off on their own?

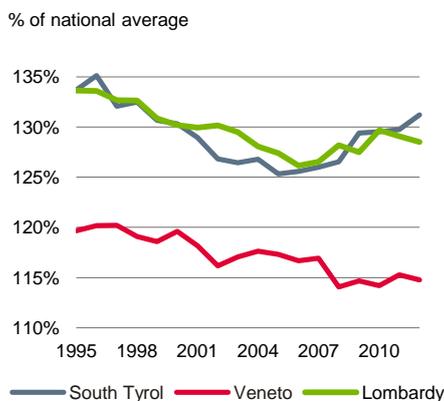
government and the social insurance plans. The authors refer to the years 2008 and 2009 as exceptions since at the time funds were retained at the central level to finance efforts to manage the crisis. In future, the transfers are to run again in the dimensions seen in 2007 when Flanders transferred 4.79% of GDP to Brussels (0.23%) and Wallonia (4.55%).

According to a different study conducted by the National Bank of Belgium (Dury et al., 2008), however, Flanders' payments in 2005 were only equivalent to 1.9% of national GDP. Hence, the exact volume of interregional transfers is difficult to pinpoint. The fact that Wallonia benefits from the Belgian system more than Flanders at least in financial terms is obvious, though, considering the economic differences.

Even though the latest State Reform pledges greater autonomy to the regions, at least the direction of the transfer flows is surely not about to change in the foreseeable future. Whether the temporary easing of the conflict as a consequence of the ongoing decentralisation of government will continue in future remains to be seen. It is also doubtful whether Flanders will be able to maintain the scale of its large economic lead over Wallonia in the first place. Forecasters expect the population to age more quickly in the Flemish region, meaning that in future lower tax receipts there may possibly be set against higher pensions and social security claims, so the payment streams could decrease in this way.

GDP per capita in South Tyrol, Veneto and Lombardy

30



Source: Istat

## Italy: Large gulf between north and south

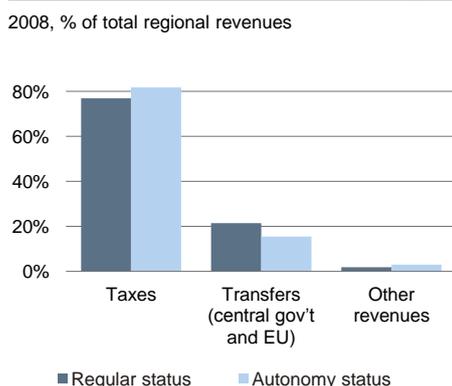
Like in Spain, there are asymmetries also in Italy in terms of the constitutional position of its regions. Italy is composed of 20 regions in total, five of which (Valle d'Aosta, Friuli-Venezia Giulia, Sardinia, Sicily and Trentino Alto Adige [=South Tyrol]) have special autonomy status. This means that, unlike in Spain, there are regions at both the upper end and the lower end of regional income distribution that enjoy this special status. The regions in question have additional powers and greater financial autonomy in respect of healthcare and education as well as public infrastructure. Trentino Alto Adige is a special case again in this context, as the regional level of government there has mainly a coordinating role. With the special status for Trentino Alto Adige the core competences were essentially handed to the next-lower level, i.e. to the autonomous provinces of Bolzano-Alto Adige and Trentino. By contrast, Veneto only has the status of a "normal" region, such as Lombardy or Emilia-Romagna, which are also among the regions with the highest per capita income.

Since 1995, South Tyrol, Veneto and Lombardy have lost a bit of ground in income terms on a national comparison. This is to be explained in particular by catch-up effects among the economically weaker southern regions during this period. Recently, however, the gaps between South Tyrol and Lombardy vis-à-vis the rest of the country have widened again (see chart 30).

Regional outlays are mainly funded via pro rata and locally imposed tax receipts. Among the regions with regular status these accounted for about 77% of total revenues in 2008, and among those with autonomy status about 82%. Nearly 50% of this total is attributable to the share in the value added tax. However, this share is not proportional to the regional receipts and has a horizontal redistribution component, equating it in principle with a transfer.<sup>29</sup>

Revenues in regions with regular status and autonomy status

31



Source: Longobardi (2011)

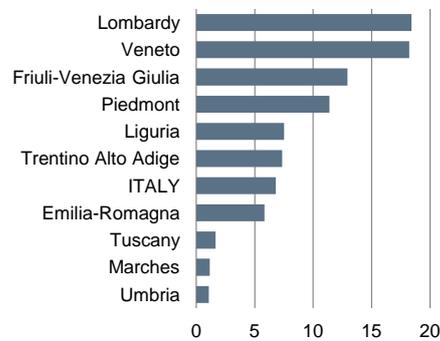
<sup>29</sup> See E. Longobardi (2011). From transfers to tax "co-occupation": the Italian reform of intergovernmental finance. Working paper, p. 9.



## Better off on their own?

### Northern League performance in elections to Italian parliament, 1992-2013 32

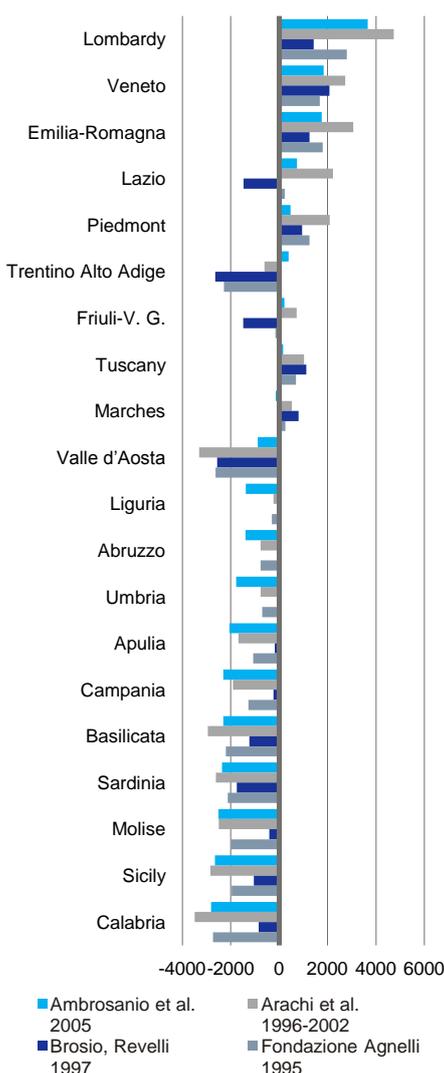
%, average for all elections



Sources: Italian Ministry of Interior, Deutsche Bank Research

### Lombardy and Veneto highest net payer regions in Italy 33

EUR per capita; positive balance = net payer; data based on year(s) indicated below



Sources: Ambrosanio et al. (2010), Arachi et al. (2006), Revelli (2003), Fondazione Agnelli (1998)

Generally, the regions have little freedom to impose their own taxes, even though their tax autonomy was slightly expanded in the wake of the constitutional reform of 2001. On the apportionment side, they also have little latitude since they have to expend the lion's share on funding the health system, which is a regional-level duty.

Given the differences firmly established for decades between the economically strong northern part of the country and the weak southern part, the issue of regional redistribution has long been a matter of heated controversy. In some areas of the northern region parties aiming for autonomy have at times been the strongest political groups. The Northern League, which called for the secession of the northern half to form the "Republic of Padania" in the 1990s, is currently in power in the regional governments of Lombardy and Veneto. There, dissatisfaction with Rome and the impression that they have to subsidise the rest of the country are very widespread. In each and every one of the seven parliamentary elections held in Italy since 1992 this has been manifested in an average share of over 18% of the vote for the Northern League.<sup>30</sup> In Friuli-Venezia Giulia and in Piedmont the Northern League has likewise averaged over 10% of the ballot. The League does not have a strong base in South Tyrol because the electorate there usually cast over half their votes for the region's own political parties.

## Transfers from northern Italy to the "mezzogiorno"

It is undisputed that northern Italy carries the main burden of regional equalisation. This is the conclusion reached despite methodological differences in diverse politically independent studies that have sought over the past few years to calculate the net flows in Italy's financial equalisation scheme. Chart 33 illustrates the regional per capita payments, with a positive value signifying a net payer position. In all these analyses, Lombardy, Veneto and Emilia-Romagna rank in first, second or third place. All the regions south of Rome are net recipients.

Given the absence of comparable datasets, differing base years and the fact that different methods were used to calculate the net fiscal transfers, the concrete per capita payments vary appreciably in some cases, although the ranking is usually very similar. The most recent study and at the same time the most convincing one in methodology terms was conducted by Ambrosanio et al. (2010).<sup>31</sup> This holds especially since the per capita transfers (in light blue) are indeed calculated as a zero-sum game between the regions, i.e. produce a per capita transfer of 0 on average.<sup>32</sup> The scale of the resultant redistribution is huge. It suggests that (on average) taxpayers in Lombardy see about 30% of their taxes go to the poorer regions via transfers. Conversely, the residents of Calabria receive 55% more than they pay in taxes themselves.

It is striking that among the first five regions there are none with autonomy status. The first of these is South Tyrol in sixth place which, according to calculations by Ambrosanio et al., is a borderline net payer.<sup>33</sup> As in the case of

<sup>30</sup> In the last two elections, however, the Northern League had a rather poor showing. In the European elections in 2014 it obtained merely 6.16% (combined with the South Tyrol party called "Die Freiheitlichen"), and at the last Italian parliamentary election in February 2013 only 4.09%.

<sup>31</sup> Ambrosanio, M., Bordignon, M., and Cerniglia, F.M. (2010). Constitutional reforms, fiscal decentralization and regional fiscal flows in Italy. In N. Bosch, M. Espasa and A. Solé Ollé (eds.). The Political Economy of Inter-Regional Fiscal Flows, pp. 75-107. Cheltenham, Edward Elgar.

<sup>32</sup> Given differing calculation methods the other studies show a positive overall balance, which might partly result from factoring in EU transfers.

<sup>33</sup> The fact that most of the studies rank Trentino Alto Adige and the Valle d'Aosta among the largest net recipients is due to the complex calculation method and the relatively small population. The difference can be largely explained by Ambrosanio et al. having used what is known as the "benefit approach". This means that expenditure categories showing public goods that benefit all



Better off on their own?

Bavaria and the Federal Republic of Germany

34

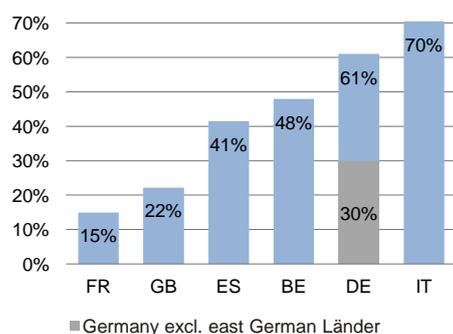
Bavaria is Germany's largest Land (federal state) in terms of area and the second largest after North Rhine-Westphalia in terms of population with roughly 12.6 m inhabitants. It has the highest per capita GDP of all the territorial states at 114% of the average. Bavaria generates nearly 18% of German GDP. In a comparison of the regions discussed in this report (and disregarding the city regions of London and Brussels) there are only two subregions (Antwerp in Flanders [BE] and South Tyrol [IT]) with a higher GDP per capita. In absolute figures, Bavaria is a key player also in a European comparison. By population, it would rank at No. 10 among all the EU states and thus ahead of countries such as Belgium, Czech Republic and Portugal. This applies to GDP in absolute figures, too: Bavaria would rank 7th in the EU, after the Netherlands. Bavaria's comparatively dynamic economic growth especially since the end of the 1970s has fed through positively also from a fiscal standpoint. While Bavaria, among others, had always been a recipient Land in Germany's financial equalisation system until 1988, it has been a donor ever since 1993. Since 1995, Bavaria has paid about EUR 2.4 bn annually on average (equalling roughly 0.6% of Bavarian GDP on average) or around EUR 200 per capita into the actual Länder financial equalisation programme in the narrow sense.

The Bavaria Party, which advocates an independence referendum, has not been represented in the state parliament since the 1970s. However, in Bavaria's first postwar elections (back in 1949 and 1954), the party gained no less than 17.9% and 13.2% of the vote respectively.

Relationship between 20% and 80% of regional per capita GDP

35

Differences in %, 2011



Sources: Eurostat, Deutsche Bank Research

## Germany and France: Autonomy movements have no major political significance

In connection with European autonomy movements it is of no small interest to see where such movements fail to attract a major following, as in France and Germany for instance. This is noteworthy because the two largest EU member countries may be seen as opposite poles in terms of decentralisation and federalism – with France and its centuries-long tradition of strong centralisation set against historically fragmented federal Germany. Indeed, France has both "Basque" and "Catalonian" areas on its border to Spain, although there the desire to secede from France does not enjoy broad-based support. The more or less Bilingual Alsace does not have any strong autonomy movement either. One of the main exceptions is Corsica. There has been a string of separatist attacks there over the past few decades. In the meantime, though, the largest separatist organisation has declared its intention to abandon its armed struggle for independence. The Brittany region has also been home to autonomy efforts – albeit with varying intensity – for centuries. However, separatist parties and movements do not play any significant role there at present. In Germany's case, Bavarians are probably the population group with the greatest awareness of their regional heritage, yet this has not led to a significant independence movement. No doubt a major reason for this is that the Länder have extensive competences in key policy areas and play an important part in national legislation via the Bundesrat, the second chamber of parliament.

Germany and France are at opposite ends of the spectrum also with regard to income disparity. Chart 35 illustrates the percentage difference between the 20% quantile and the 80% quantile of regional per capita GDP.<sup>34</sup> It indicates the amount by which GDP per capita in a region that just barely qualifies for inclusion in the best 20% outstrips GDP in a region that falls by a whisker into the lowest 20%. This measure of disparity thus eliminates distortions caused by outliers such as Paris, Brussels or metropolitan London with their far above average incomes. Going by this metric, France is the country with the most egalitarian society. This naturally provides less fertile ground for horizontal distribution conflicts than in other countries, which probably reduces the economic motivation for independence.

Excluding metropolitan London, regional income distribution would be relatively egalitarian in the United Kingdom, too. In Spain and Belgium, the income disparities are considerably bigger, but by no means do they play in the same league as Italy. Germany is a special case on account of the country's reunification, because if the east German states were excluded the regional income disparities would actually not be excessively pronounced by European standards.

In Germany there is a large degree of financial integration between the Federation, the Länder (the individual federal states) and the municipalities. This is the result of the division of responsibilities prescribed by the Basic Law, the

Italians are not charged to the geographical area where they are incurred, but instead are allocated to all the regions on a proportional basis. This applies to, say, public administration, which is primarily linked with the capital city of Rome, but also to national defence, which causes disproportionately high spending in border regions and given the small population in South Tyrol and the Valle d'Aosta appears there as a high net transfer in the so-called "cost approach".

<sup>34</sup> To obtain a comparable number of regions for analysis, we look at the NUTS 1 level for Germany and the United Kingdom, and the NUTS 2 level for Spain, France, Italy and Belgium.

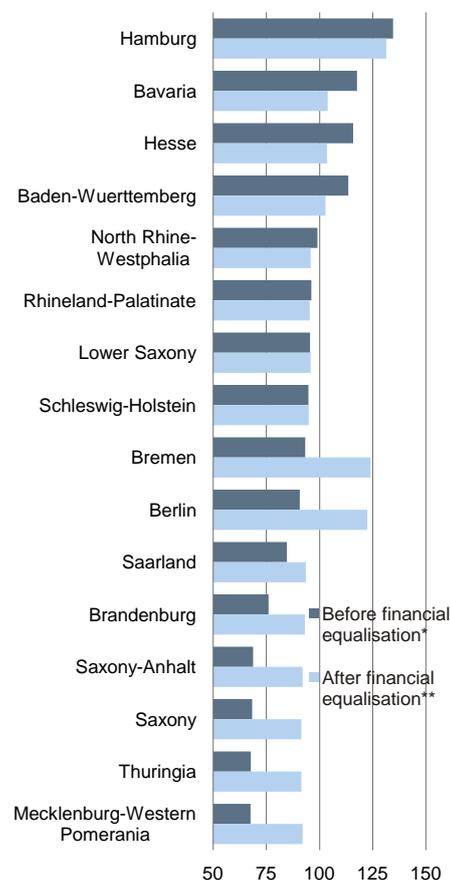


## Better off on their own?

### Strongly diverging fiscal capacity in Germany

36

% of per capita average, values for unweighted population, incl. municipal taxes



\* VAT shares fully distributed by population

\*\* After preliminary (horizontal) VAT equalisation, Länder financial equalisation and general supplementary federal grants

Sources: Bundesbank, Deutsche Bank Research

sharing of tax revenues, their redistribution between the different levels of government and the co-financing of many tasks. On balance, about 70% of total tax receipts are split up and redistributed between the different levels of government in a four-stage process. The basis of allocation, in principle, is the ratio of actual revenues<sup>35</sup> to a notional income. The system harbours substantial incentive problems owing to the high absorption rates for recipient countries; these undermine their own efforts to bolster their economic strength and/or revenue-generating capacity.<sup>36</sup> Unlike in Spain though – as long as certain direct transfers from the Federation to several Länder are stripped out of the equation – the financial equalisation system does not alter the pecking order of the Länder by fiscal capacity.

A reform of financial relations in the German federal system and thus also of the redistribution mechanisms – which is also a statutory obligation that must be fulfilled by 2020 at the latest owing to the expiry of current arrangements – requires overcoming the Gordian knot as well. As there are significant differences in economic strength, every change will produce winners and losers. Chart 36 shows that especially the east German Länder continue to exhibit a significantly lower revenue-generating capacity than the west German Länder. The city-states assume a special role. The extent of losses and gains depends on the degree of redistribution, which ultimately has to be determined politically. Despite this extensive redistribution system, though, there are no aspirations to achieve autonomy or even independence.

## The financial illusion of independence

The desire for special rights, far-reaching autonomy or even independence is supported to a relatively large extent by a belief in the economic strength of the given region. The financial implications resulting from de facto independence go beyond the savings achieved by exiting the regional financial equalisation scheme of the respective country. Despite the fact that advocates of independence like to gloss over the potential risks, even in the event of immediate membership of the single European market and the eurozone there would be a number of potential financial disadvantages:

- **Higher costs of borrowing:** The disadvantage of small countries may be illustrated by comparing Germany and Austria. Even though Austria has a higher per capita GDP, lower sovereign debt and a nearly identical unemployment rate, the risk premium on Austrian bonds is higher. Due to the much lower issuance volume Austrian bonds are perceived to be less liquid, so investors demand a liquidity premium. If Scotland had attained independence it would also obtain a good rating, but nonetheless it would have to pay a premium on British bonds.<sup>37</sup> For Catalonia, which according to the several rating agencies currently does not even rate as “investment grade”, it would be a much more expensive undertaking. While the Basque Country and also Navarra currently has a better rating than Spain with some agencies, in fact, in the event of independence the implicit central government guarantee would disappear, possibly also weighing negatively on the rating. Conversely, though, a loss of economically strong regions would also jeopardise the Spanish rating and entail higher funding costs.

<sup>35</sup> The definition of actual revenues in this context, i.e. of fiscal capacity, is itself subject to huge discretionary latitude, however, so a purely objective determination of the degree of redistribution is extremely difficult.

<sup>36</sup> See also: Bundesbank (2014). The reform of financial relations in the German federal system in: Monthly Report. September 2014, pp. 33-52.

<sup>37</sup> If Scotland were independent it could reckon with an A rating, i.e. down several notches on the UK's Aa1 rating. See Moody's (2014). Rating Scenarios for an Independent Scottish Sovereign.



## Better off on their own?

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- **Financial burden from assumption/distribution of legacy debt.** Both Spanish regions would have to assume a considerable share of Spain's sovereign debt. Scotland would also have to shoulder a share of national debt. Whether this would be calculated on the basis of relative GDP figures, population or past financing balances, would ultimately be decided by a political negotiation process. Depending on the division, though, this would result in substantial fiscal burdens for the then independent regions.
- **Disruptive trade effects:** The rest of Spain is by far the largest trading partner for the Basque Country and Catalonia; the same applies to the United Kingdom in the case of Scotland as well as to Italy with Veneto. This shows that despite the single European market national borders often continue to play a significant role. Even though trade between Spain and Catalonia would of course not stop altogether, it seems exceedingly unlikely that the intensive trade relations would survive a (possibly discordant) separation without sustaining any damage whatsoever. The fact that about three times as many Catalanian goods are "exported" to other regions of Spain as to the geographically comparable and much larger France impressively shows that borders (whether political, linguistic, cultural ...) still play an important part in a united Europe.

### It has to be affordable!

At this point it is not our objective to do the sums for every region on how much it could gain, or perhaps lose, in the event of separation. However, it is important to understand that such an emotionally charged issue may occasionally cloud the view of the economic realities. Setting up an independent administration, international representative offices, a military defence organisation etc. naturally comes at a price. Objectively speaking, there are not many channels via which independence can actually generate financial advantages. One of the few, and perhaps the most obvious, is the disappearance of financial transfers to other parts of the country. Thus, only in a prosperous region (relative to the rest of the country) is it possible to maintain the fiction that going it alone would be the better option. In other words: one has to be able to afford it.

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