

Economic Research Note

Catalan challenge asks real questions of Europe

- **An independent Catalonia might be credible in the long term, but major fiscal and political questions remain**
- **Transition costs of a move toward independence would be high, and trigger broader worries about Spain**
- **Elections on November 25 will likely start the move towards an eventual referendum**
- **We don't expect the issue to crystallize in the near term, but to remain a source of uncertainty for several years**
- **There are larger questions: Why should Germans support poorer Spanish regions if Catalans object?**

The debate over Catalan nationalism has been played out repeatedly since the restoration of democracy in Spain in 1978. It has only become a broader issue of concern this year because of the political leverage which Catalonia's nationalist movement has gained from the fiscal crisis. The crisis has also limited the ability of the region to fund fiscal transfers through debt issuance, and made the deficiencies of the Spanish transfer system more obvious. In doing so it has made a shift toward independence seem more attractive. These dynamics create a politically sensitive challenge for both Spain and the Euro area as a whole; highlighting the lack of any consensus on the need for wealthy areas to support poorer parts of a union – whether that union is the Spanish state, or the EU.

For investors, there are five key questions (some of which are beyond the scope of this note). First; is the idea of an independent Catalonia actually credible; politically, legally, and fiscally? Second, how seriously should markets take the current challenge from the Catalan nationalists, and over what time frame are the risks likely to materialize? Third, what will the broader impacts of a move toward independence or autonomy look like, for Catalonia, for Spain, and for the broader Euro area? Fourth, could Catalonia's separatist agenda materially impact Spain's overall fiscal position, or its possible request for ESM-ECB support? Finally, what are the chances of broader separatist pressures emerging in other wealthy European regions? These questions are set to remain center-stage with forthcoming regional elections on November 25, which will test the degree of popular support for the Catalan government's push toward greater autonomy. We think many of the issues around independence (or autonomy) will remain unaddressed for some years to come; investors should expect continued low-level uncertainty – a referendum may not, in practice, come until late 2014 or beyond.

How real is the independence push?

Is there public support for independence?	A significant number of voters appear to support full independence (53%), but we don't think this figure is reliable. There would be a clear majority for significant autonomy within Spain (probably the most likely long-term outcome)
What is the legal basis for action?	The Spanish constitution forbids regional plebiscites and would need to be changed for a Catalan vote (although this could be done). An independent Catalonia may also need to reapply for EU and EMU membership
How serious are the separatists?	The governing party (CiU) probably wants eventual independence but is careful about its public pronouncements, and may ultimately accept a compromise on fiscal autonomy
What are the timeframes?	The November 25th election should see more support for separatists, but expect them to play a long game. We see a possible referendum at the end of 2014 or later
Is it fiscally credible?	Over the long-term an independent or autonomous Catalonia may be fiscally credible, but there are doubts and real transition costs in the near-term. Catalonia is unlikely to significantly improve its fiscal path
What are the implications for Spain?	It will be difficult to impose central discipline on the regions if Catalonia is allowed the freedom to go its own way. Ultimately this will open further questions about Spain's fiscal path
What are the implications for the Euro area?	It is hard to find a rationale for wealthy European countries to provide transfers to Spain if Spain's own constituent parts reject a transfer union. The question of popular support for EMU wide transfers will be opened up by Catalan nationalism

An unstable equilibrium

Regionalism in Spain has a long history; part of the response to the centralism of the Franco years was to embed a strong degree of regional autonomy after the restoration of democracy in 1978. The fiscal aspect of this settlement left revenue-raising largely subject to central control, with expenditures on most social programs primarily deferred to the regions. This has led to both fiscal and political distortions and satisfied no one. It has been difficult for the central government to control total public expenditure when the regions account for more than 38% of government spending, and historically have had little, if any, political incentive to deliver fiscal restraint. For many of the regions themselves, the lack of an effective revenue-raising capacity, and the need (in many cases) to make net fiscal transfers to Madrid, has been a source of tension.

The problem of Spain's fiscal structures is particularly sensitive when viewed from a Catalan perspective—the region is among Spain's wealthiest (with 16% of the population, contributing 18.6% of GDP in 2009), and makes net fiscal transfers to the central government in the range of 7%-8% of regional product (outside recession periods). Catalonia has been attempting to secure a "better deal" from the central government for decades, and agreed a regional statute in 2006 that would have balanced fiscal transfers and regional spending.

The measure was ultimately struck down by the Constitutional Court, after a request by the Partido Popular (Prime Minister Rajoy's party) to review the measures.

Spain's fiscal design problem is made more complex by the fact that the regions making the largest total net fiscal transfers, including Catalonia and Valencia, are also the most indebted, and have historically issued debt heavily in order to meet growing regional shortfalls. The fiscal crisis has limited their ability to cover obligations to the central government through debt issuance, and has forced consolidation. Both regions (as well as other wealthy areas such as the Balearics) have recently needed to access support from the central government's regional aid fund, the FLA. This has been politically sensitive; nationalists argue that they are effectively being bailed out with their own money (though there are reasons to be skeptical about this view).

Whatever the rights and wrongs of Catalonia's position, it is clear that the current division of fiscal responsibilities is unsustainable politically (this has been becoming increasingly obvious for some time). The proposed solutions have been very different, however, with the central government now seeking to reassert centralized control of fiscal matters across Spain (notably with the implementation of the Budget Stability Law earlier this year), while many of the regions pull the other way. For Catalonia in particular, the solution has always been about securing more fiscal autonomy, not less.

Autonomy and independence are very different things, but even support for full independence has been rising, to a little over 53% this month according to the latest polls (rising further to 62% if EU membership can somehow be "assured" for an independent Catalonia). We think these polls may be unreliable (the 53% figure comes from a single source, Catalan newspaper *La Vanguardia*), and they have shown support for independence above 50% only since late September. We doubt whether a majority would really favor independence in a referendum at this stage, but the polling numbers are certainly trending in a direction that is worrying for Spain. More importantly, there is clearly a widespread call for renegotiating the terms of Catalonia's relationship with the Spanish state. A survey at the beginning of this month found that 74.1% of Catalans were in favor of holding a referendum on the issue of precisely what their relationship with the rest of Spain should look like.

Getting ready to ask the question

The Catalan government, led by separatist party *Convergència i Unió* (CiU), is in favor of moving to a position where Catalonia holds the "levers of a state," although it has yet to specifically call for full independence. Catalan President Mas has already given notice that he will treat sup-

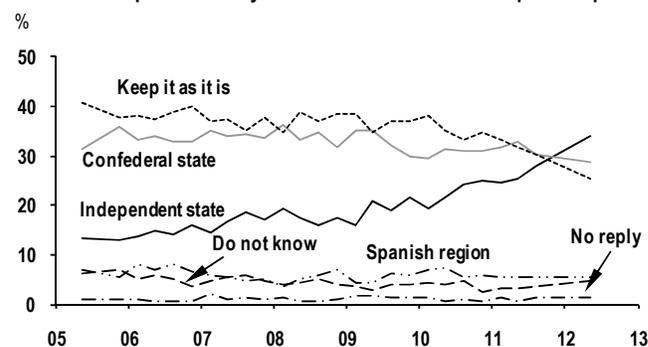
Support for independence (*El Periodico*)

%	Yes	No	Other
October 2007	33.9	43.9	22.3
December 2009	39.0	40.6	20.4
June 2010	48.1	35.3	16.6
January 2012	53.6	32.0	14.4
September 2012	46.4	22.0	25.7

Support for independence (*La Vanguardia*)

%	Yes	No	Other
November 2009	35.0	46.0	19.0
March 2010	36.0	44.0	20.0
May 2010	37.0	41.0	22.0
July 2010	47.0	36.0	17.0
September 2010	40.0	45.0	15.0
April 2011	34.0	30.0	35.0
September 2011	54.8	33.5	10.2

Which kind of political entity should Catalonia be with respect to Spain?



port for CiU on November 25 as a mandate to begin negotiations with the central government on holding some form of plebiscite during the Catalan parliament's next term (within the next four years). The latest polling suggests that the CiU will increase its share of seats in the Catalan Parliament and gain the mandate that Mas seeks. Nonetheless, our sense is that the CiU is likely to want a vote to be held closer to the end of the next Parliament's term than to the beginning. There are several reasons for this. First; expressed support for independence still hasn't passed the 50% mark for a sustained period, and he can only be confident of a result once it is sustainably at 55%-60% or above. Second; if Catalonia were to become independent in the near term, it would have to take responsibility for an ongoing economic crisis. It would be far more advantageous for the region to achieve independence in more benign economic circumstances. Finally, even without CiU's own political preferences, we expect the functional issues around agreeing and preparing a referendum vote could take some years. Investors should therefore expect the issue to be crystallized around the end of 2014 at the earliest, and to remain a source of uncertainty until then.

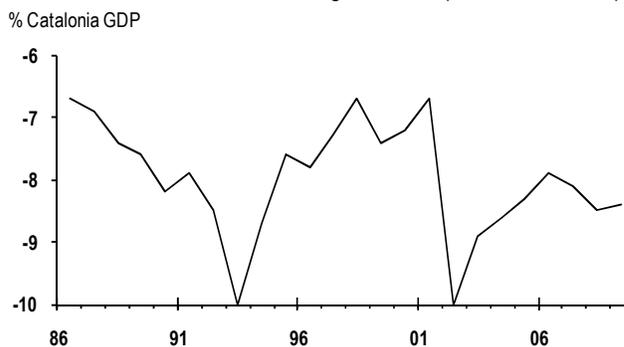
A legal and political maze

The quest for independence, or autonomy, is likely to run into severe political and legal difficulties. There are substantive doubts about whether a referendum is even possible. The Spanish Constitution of 1978 does not permit regional referenda; under the Constitution as it stands, there is no way that Catalan voters could even be asked about their views on greater fiscal autonomy, let alone independence. In practice, the constitution could be changed; the Spanish government has recently amended it to introduce the budget rules implied in the European Fiscal Pact, which was instituted through the use of a constitutional amendment. President Mas will have a strong political case for securing a referendum if CiU performs well in November; if Madrid hides behind constitutional objections we expect this simply to lead to an escalation of pro-independence sentiment in Catalonia (although we do not discount the possibility of the Rajoy government handling things poorly).

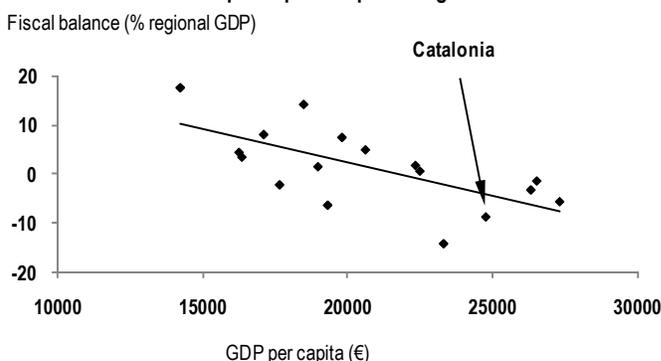
A more substantive issue surrounds the legal questions over Catalonia's role within the EU (and EMU). Were Catalonia ever to achieve independence it would likely need to reapply for membership of both the Euro area and the European Union as a whole (the Catalan government has indicated that it would wish to be a member of both). The process of applying for membership, under Article 49 of the European Treaty (TEU), could present significant difficulties. An application would take considerable time, even under the most benign scenarios, and impose significant transition costs. Comments from European Justice Commissioner Reding over the past few weeks do suggest however that the EU institutions would be ready to take a constructive attitude toward a Catalan membership application (there is some possibility that the EU might allow the ground-work for an application to be laid before formal independence is secured if this were the route the region takes).

The larger political uncertainty is the way in which Catalan voters would move in any plebiscite. We expect the referendum question to ultimately be about extensive autonomy rather than independence, and think that polling data point strongly in the direction of a "yes" vote. If however the region does move more clearly in the direction of full independence, there are slight risks around the margin of a negative reaction from other political forces within Spain having spillover effects. Elements of the Spanish military have hinted that they could intervene in the case of Catalan independence but we think a violent reaction is very unlikely (at least on a wide-spread basis). Although we expect Catalonia to have a difficult ride, we do think that the political and legal impediments to independence or greater autonomy are surmountable with time, providing that a significant majority within the region wants to move in that direction.

Catalonia fiscal balance with central government (net fiscal transfers)



Fiscal balance and GDP per capita of Spain's regions in 2005



Cost of taking on national commitments

% Catalonia GDP, 2005 data used

	Proportion of total cost covered		
	100%	50%	25%
Administration	7.8	3.9	1.9
Defense	0.1	0.0	0.0
Domestic security	0.9	0.4	0.2
Economics/development	1.4	0.7	0.3
Environment	0.1	0.0	0.0
Housing	0.0	0.0	0.0
Health	0.2	0.1	0.1
Culture	0.3	0.1	0.1
Education	0.0	0.0	0.0
Social protection	1.0	0.5	0.2
Total	11.6	5.8	2.9

Fiscally credible (just about)

A second core question underpinning this debate is whether an independent, or quasi-independent, Catalonia could be fiscally credible. This question is highly politicized, but it is possible to get a sense of the financial benefits and costs associated with a move toward independence. Back in 2009, the Spanish government approved a new financing system for autonomous regions. This change gave more fiscal autonomy to the regions as the central government conceded ground on

collecting a number of taxes (or at least a proportion of such taxes). In return, the autonomous regions are now receiving fewer transfers from the central government. But this complex system remains one where the provision of public services and economic convergence in poorer regions are partly financed by richer regions.

One way to look into this issue is to use regional fiscal balances data that attempt to provide regional net contributions to the Spanish budget. In 2005, the latest year for which data are available across regions, these figures showed that Catalonia transferred 8.7% of its own GDP to the central government. This compares with values of 6.3% and 5.6% for regions like Valencia and Madrid, respectively. The 2005 data thus show that Catalonia is effectively one of the largest regional contributors to the central budget. From this angle, a move toward independence would be beneficial. On the methodological side, however, the calculation of such fiscal balances suffers from well-known issues: corporate taxes are paid in regions where headquarters are located, although activities may be located elsewhere, and VAT is levied where consumption occurs. Catalonia is a region that both attracts headquarters (Barcelona is the sixth most populous urban area in the European Union) and consumption (via tourism). It is not clear how much these effects actually distort Catalonia's fiscal balance, but there is little doubt that the bias is negative, thus showing larger net transfers to the central government. An important additional point is that debt issuance can be done at a lower cost to the extent that Catalonia is part of Spain. An independent entity would face an uncertain founding environment.

The cost associated with a move toward independence would also be substantial as the central government provides public services that would need to be covered by Catalonia. These services include areas such as administration, defense, or domestic security, to mention a few. We thus looked at the Spanish central government budget to get a sense of the costs associated with Catalonia and we specifically used the 2005 data to make comparisons with the available fiscal balances data possible. In 2005, the Spanish government spent €133.2 billion in public services for the entire economy. As 16% of the population lived in Catalonia at the time, a starting point in our analysis could assume that a proportional share of the government spending was allocated to this region, or €21.5 billion. But one needs to keep in mind that government spending would not be proportional, as infrastructure or social security needs may differ, while the policy choices about what an independent Catalonia may choose to spend on, for example, defense or environment, are very unclear at this stage. We assumed that administration expenses would not be fully duplicated, as the existing Catalan administrative capacity could probably take the burden of a significant proportion of the

costs of governing an independent state. If we assume that only half of such a cost would be supported by Catalonia, the amount required would reach 5.8% of GDP.

To the extent that the fiscal balance numbers can be trusted and that our assumptions about independence costs are correct, it looks like a Catalonian state-like transition is a plausible fiscal option, but the financial benefits of independence may not be large (likely 3% at most under a benign scenario). This also assumes that transition costs are minimal, and that there is no significant disruption to trade with the rest of Spain.

Autonomy is the most likely outcome

Given the scope of the political, legal and fiscal difficulties ahead of it, we think the path ahead for Catalonia is more likely to see a shift toward greater fiscal autonomy rather than full independence—but the fact that the independence option appears credible (if not necessarily attractive) will increase the likelihood of the region securing strong autonomy arrangements. It is unclear what these will look like in practice, although we expect an extended version of the 2006 regional statute to form a starting point for discussions – if a referendum does ultimately provide a clear negotiating mandate. Other regions, Navarre and the Basque country, have negotiated a separate model that limits net fiscal transfers to Madrid, and we expect Catalonia to move toward a similar model, potentially with other political powers attached.

Long-term implications

We think there is real chance that Catalonia will secure significant changes to its relationship with Spain; if correct, this would have major implications. Should Catalonia be able to renegotiate the terms of its relationship with the centre in a way which limits fiscal transfers this would have an impact on the Spanish central government's fiscal path. It would also set a further precedent, which would have an impact on Madrid's ability to control the other 16 regions, the wealthier of which may also be encouraged to request greater fiscal freedoms. This would pile further pressure on the sovereign if, as is likely, it is the transferring regions which choose to renegotiate the terms of their relationship with the centre. More broadly, this opens a larger political question for the Euro area as a whole; namely that if Catalonia is unprepared to subsidize Spain's poorer regions, why should Germany or other countries of the European north? This is the same question that IMF members (e.g., China) ask of the Euro area as a whole in its management of the crisis. We expect this question – of the political mandate for transfers – will ultimately need to be tested in referenda across other parts of the Euro area; Catalonia could simply be leading the way.

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