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Tax Harmonization

The Case of the Economic Agreement between Spain and the Basque Country

Edited by
Carlos Lámbarri
Aad van Mourik

FUNDACION BBV

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Table of Contents

	Page
Preface	*ix*
1. General Overview	1
1.1 Identification	1
1.2 Wealth and Business Activity	3
1.2.1 Per capita GNP	3
1.2.2 Distribution by sector of the Basque GNP	3
1.3 Economic Activity	3
1.3.1 Opening of the Basque economy to external markets	3
1.3.2 Growth in GNP	4
1.3.3 Inflation	4
1.3.4 Employment	5
2. The Economic Agreement with the Basque Autonomous Community	9
2.1 The Economic Agreement	9
2.2 Guidelines for Interpretation	11
3. The Institutional and Historical Setting	13
3.1 Institutional Framework	13
3.2 Origin of the Economic Agreement. Historical Development	20
3.3 Constitutional Framework	26
3.4 Economic Implications of the Agreement System. With Special Reference to the Quota	35

4.	**The Economics of Tax Harmonization**	41
	4.1 Objectives and Guidelines for Tax Harmonization	41
	4.2 Harmonization of Indirect Taxes	43
	4.3 Harmonization of Direct Taxes: The Case of Capital Income	54
	4.4 The Scope of Tax Harmonization: Alternatives	68
	4.5 Distortions to be Rectified by Means of Tax Harmonization	73
	4.6 Conclusions	77
5.	**Measuring the Tax Burden: The Legal Issues**	81
	5.1 Introduction	81
	5.2 Specific Rules	85
	5.3 General Regulations	93
6.	**The Measurement of Tax Burdens: The Economic Issues**	141
	6.1 Introduction	141
	6.2 The Tax Burden – Initial Overview	142
	6.3 Measuring the Tax Burden	151
	6.4 Various Possible Concepts of Tax Burden: Effective Burden vs. Nominal Burden	162
	6.5 Tax Burden vs. Tax Balance	163
	6.6 Analysis of the Harmonization Rule: Introduction	167
7.	**The Overall Effective Tax Burden in Spain and the Basque Country**	177
	7.1 Introduction	177
	7.2 Overall Effective Tax Burden	179
	7.3 Detailed Analysis of the Tax Burden Tax by Tax	193
	7.4 Analysis of the Frank Index	206
	7.5 Tax Balance	209
	7.6 Final Comments	209
8.	**Conclusions**	211
	8.1 Conclusions on Measuring the Tax Burden	211
	8.2 Possible Adjustments and Their Quantification	217

Note on the Editors

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Preface

Relations between the Basque Autonomous Community and the Spanish State on a financial and tax plane are governed by a unique system referred to as the Economic Agreement.

As part of its constant efforts to probe the major economic and social matters of the moment (crystallized in numerous surveys and publications), *Fundación BBV* suggested to us the possibility of a book on the Economic Agreement between the Basque Country and the Spanish State.

The matter was of great interest to us from the outset, since it had been discussed by the European Commission, which, in 1993, issued a decision on the subject which highlighted the system's uniqueness "*... having regard to the peculiarities of the case and, in particular, to the historical nature of the tax relations between the State and the Basque Country ...*" Moreover, we were further predisposed to publish a survey of the subject since we had been monitoring current affairs in Spain, focusing particularly on Autonomous Community financing.

Hence our considerable interest in the matter, tempered initially by a degree of concern due to the great complexity of the subject and the depth of treatment required to address it rigorously, considering that it deals with a unique web of tax and financial relations between a State and one of the autonomous regions which co-exist in it.

We commenced with an analysis of the nature of the system of Economic Agreements, which proved to be extraordinarily rich and complex, since many different aspects had to be considered in order to obtain an overview. We studied the system's origin, its deep historical roots and its development up to its position within the current legal and political framework in Spain, while taking account also of the European Community context.

Another basic feature of the work was an examination not only of the broad financial and tax autonomy enjoyed by the Basque Country, but also the system of limiting or, rather (as described in the book), *harmonization* rules arising in the Economic Agreement itself. Consequently, considerable work was devoted to analyzing the significance, motivation and scope of these provisions as a whole and individually, and to attempting to attribute a meaning to them without voiding the content of the Economic Agreement

in terms of the tax powers which it grants to the Historical Territories of the Basque Country. It was also necessary to resort to comparative law in order to further refine the concept of harmonization itself.

Finally, special emphasis was placed on one of the harmonization rules contained in the Economic Agreement, a rule which deals with the *overall effective tax burden* to be maintained in the Basque Country and which has been the focus of most of the debates about how the system of Economic Agreements fits into the context of the State. One of the principal difficulties encountered in writing this book was precisely the calculation of the aforementioned parameter, since many factors must be considered in order to express it in figures, without ignoring the need to define the concept clearly beforehand. As a result, the need to compare and use data from a variety of sources and to draw conclusions from them on a subject which is neither defined in the law nor pacifically accepted in economics made for a complex and lengthy task whose results, consequently, need to be viewed in relative terms.

Accordingly, we were finally able to examine the subject with the maximum level of scientific rigour and a high degree of pragmatism and contact with the actual social, economic, legal and political situation in Spain and the Basque Country, thanks to the in-depth knowledge of the persons and entities which collaborated in this book.

We would like to reiterate our gratitude to the *Fundación BBV*, particularly to its President, Mr José Angel Sánchez Asiáin, and its Director, Ms María Luisa Oyarzábal, and to Mr José Manuel González-Páramo, Director of the *Centro de Estudios sobre Economía Pública*, for giving us the opportunity to undertake this work and for the resources which they placed at our disposal.

Thanks are also due to Professor Dr Hans Maks of the Department of Economics at the University of Limburg (The Netherlands), who made a significant contribution to the concept of the tax burden.

Lastly, we are pleased to have had the invaluable assistance of a team of professionals from the various areas of Coopers & Lybrand in Spain, who made it possible to write this book from a position of greater familiarity with the complexities of the system.

We would express our sincere gratitude to all of them for collaborating so decidedly in this study which, we hope, will be useful at a time when the question of autonomous regional finance, and specifically the Economic Agreement, has acquired considerable importance in Spain and will, as far as possible, serve to clarify certain matters which are currently the subject of intense debate on a social, political and legal plane.

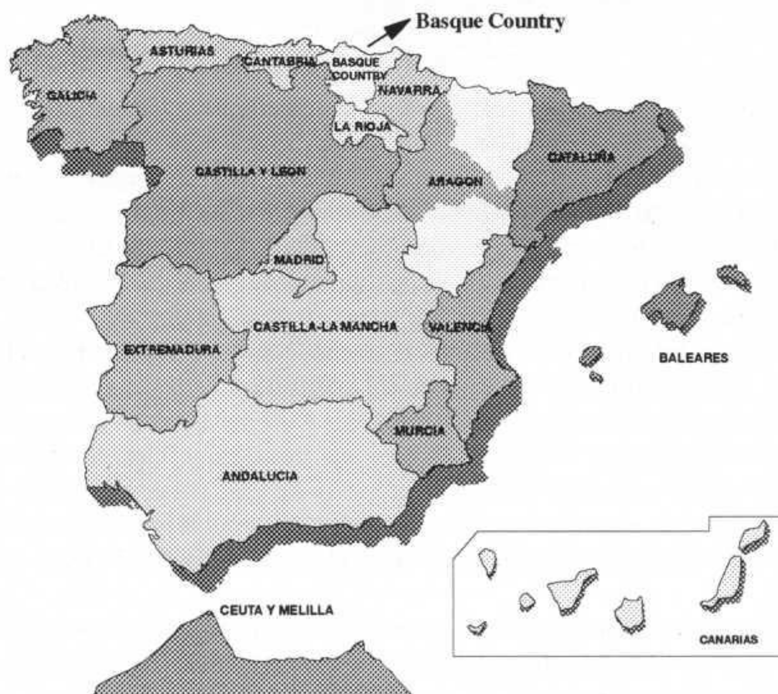
Isabel Corte-Real
Director General, EIPA

1. GENERAL OVERVIEW

1.1 IDENTIFICATION

The Basque Country is one of the 17 Autonomous Communities or Regions of Spain. It occupies 7,261 square kilometres on the Atlantic coast in the north of Spain, and shares a border with France.

Figure 1:
Spain



5,4% of the Spanish population lives in the Basque Country (2.1 million inhabitants), and its population density is relatively high at 296 inhabitants per square kilometre.

Figure 2:
Basque Country

Bilbao is the main city in the Basque Country, the home of approximately 40% of the region's population even the capital city is Vitoria.

The Basque Country is governed by its own system and has political autonomy which is deeper than the limited autonomy granted to the remaining Spanish regions, as well as to most of the comparable regions.

The special position is the result of the Basque Territory Historical Rights, guaranteed by the 1978 Spanish Constitution.

In tax matters, the Economic Agreement with the Basque Autonomous Community regulates the relations between the Basque Country and the Spanish State. Although there is a single Economic Agreement with the Basque Country, the subjects of the main tax powers are each of the three Historical Territories, whose regulations are, in most of the cases, very similar.

The Basque Country is one of the most economically developed regions in Spain. Its economy is markedly industrial in nature and based on technological development.

1.2 WEALTH AND BUSINESS ACTIVITY

1.2.1 Per capita GNP

The Basque Country is one of the regions with a higher per capita income in Spain, significantly higher than the Spanish average and almost attaining the European average.

Growth in per capital income since 1980 has been significant, similar to the European average.

The Basque Country is fourth in the ranking of Spanish autonomous regions in terms of per capita income, second if only industrial regions are taken into account (only exceeded by the capital city of Spain, Madrid). With only 5.4% of the Spanish population, the Basque Country provides a higher proportion of Spain's GNP (6.6% in 199%), and its per capital GNP is between 20 an 25% higher than the national average.

1.2.2 Distribution by sector of the Basque GNP

The Basque Country has a predominantly industrial economic structure. The industrial sector generated 43% of the GNP in 1995, as compared with 33.3% in Spain and only 31.2%, on average, in the European Union.

The process of tertiarization observed in the developed countries is not foreign to the Basque Country. In addition to being the heart of the Spanish manufacturing industry, the Basque country also has a significant service and financial sector.

Industry, however, continues to maintain a relative importance which is much higher than the Spanish and European averages and has even grown since 1993.

Furthermore, the productivity of the industrial sector is clearly higher than the Spanish average and was 24% higher in 1995, after the easing of the 1993 recession.

1.3 ECONOMIC ACTIVITY

1.3.1 Opening of the Basque economy to external markets

The opening of the Basque economy to external markets is the key to Basque business. Import and export activities are very intense. In addition the balance with external markets, excluding energy, is positive historically and has increased greatly over the past few years to attain a level of 7% of GNP in

1995.

The European Union is the principal destination of Basque exports: 61.1% of Basque exports in 1995 went to EU member countries (excluding trade with Spain). The implementation of the EURO as the EU common currency, eliminating transaction costs involving European currencies, will be of great benefit to Basque external trade.

1.3.2 Growth in GNP

The industrial nature of the Basque economy, dependent on relatively mature sectors has historically given rise to increased sensitivity in times of recession and notable drops in growth rates during these times.

Comparing the GNP growth trends in the Basque Country over time, it may be observed that they are in line with European movements, although with more pronounced cycles. However, although the recession of the first part of the 80's was especially serious for the Basque economy, in the case of the recession at the beginning of the 90's (which affected the US two years previously), it's effects were much more moderate in the Basque Country than in Europe or Spain. This is due to a necessary industrial restructuring and reconversion which was carried out between 1980 and 1987, thereby recovering competitiveness and growth capacity. Indeed, the recovery from the effects of the 1993 recession has been significant and the perspectives of stable growth for the coming years are very optimistic, even exceeding 3%.

1.3.3 Inflation

The Basque Country has historically recorded high inflation rates, in line with the ones in Spain, as a result of its dependence on Spain with respect to currency matters, as it has no autonomous powers in this respect. In addition the industrial nature of its GNP make it sensitive to the monetary effect of industrial products and raw materials, both with respect to Spain and internationally.

However, the guidelines of the Spanish monetary policy over the past few years, reinforced by the convergence criteria of monetary and economic union, mark a clear trend towards controlling prices and reducing interest rates, to the point of guaranteeing compliance with maximum inflation rates permitted by the Maastricht Treaty for 1997.

1.3.4 Employment

The Basque Country shares with Spain a principal economic problem: high unemployment. Both Basque and Spanish unemployment rates are close to double those of the European Union. However, the foreseeable rate of sustained growth in the Basque Country for the coming years could lead to the progressive reduction of these unemployment rates, although by no means radically or immediately.

In this connection the necessary reform in the job market, with the intention of providing increased flexibility, will be implemented shortly after having already reached a consensus between the government, unions and business organization leaders.

The Basque Country has shown its capability for higher levels of job creation (although conditioned by economic realities due to its structural sensitivity) than Spain and much higher than the European average, and only exceeded by the United States. Indeed, between 1985 and 1997, the accumulated job creation rate in the Basque Country is 19%, as compared to 13% in Spain and only 6% in the EU.

Figure 3:
Wealth and Business Activity
GNP distribution by sector in 1995

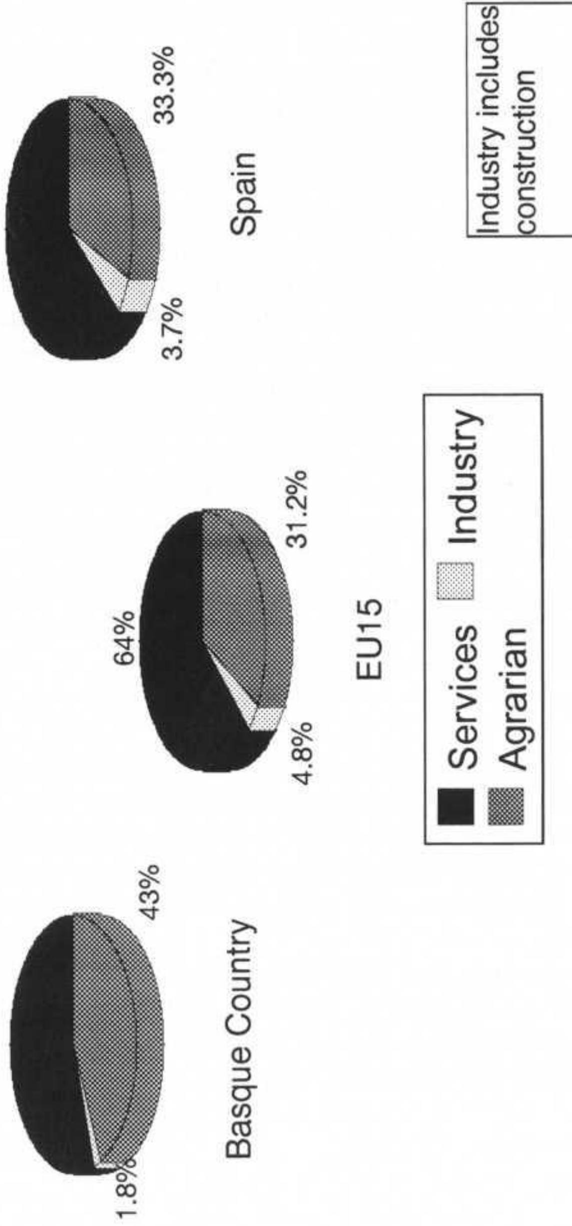
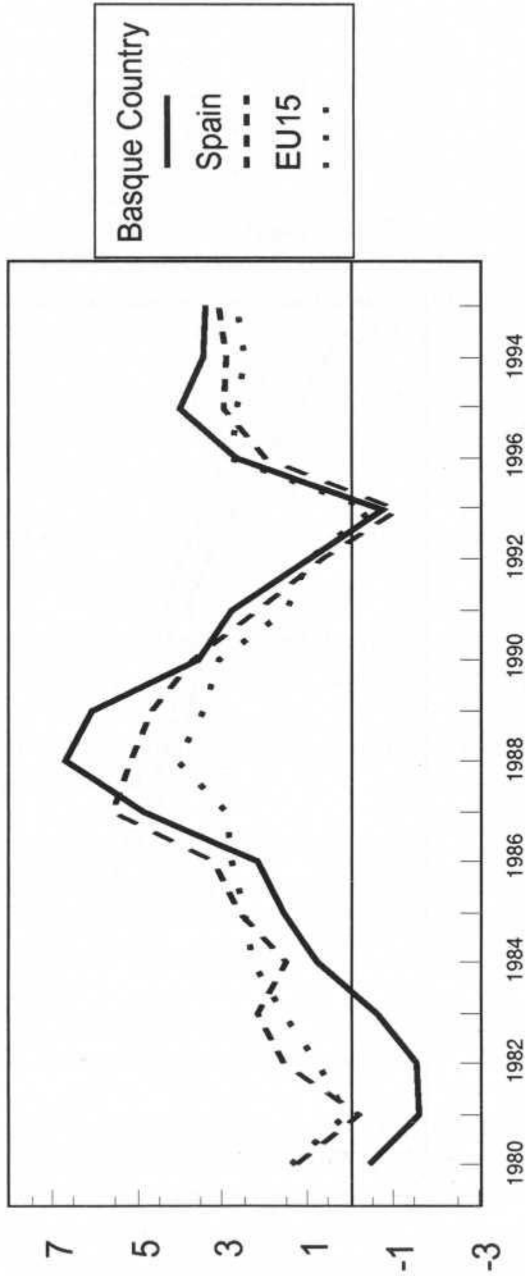
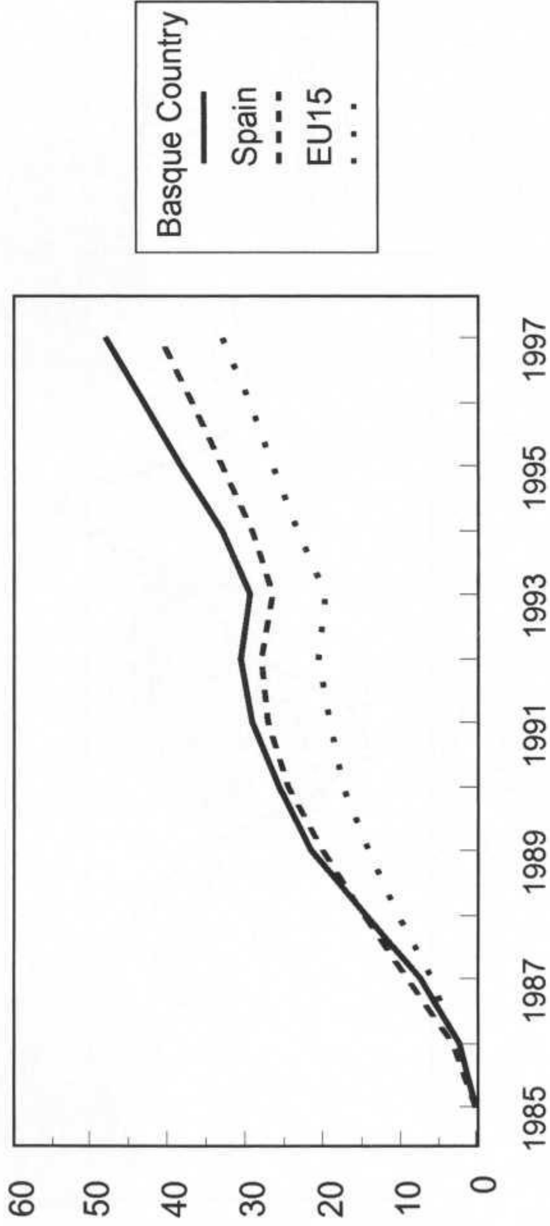


Figure 4:
Economic Activity
GNP Growth
Annual change in GNP (%)



Includes forecasts for 1997 and estimates for 1996

Figure 5:
Economic Activity
GNP Growth
Accumulated growth in GNP (%)



2. THE ECONOMIC AGREEMENT WITH THE BASQUE AUTONOMOUS COMMUNITY

2.1 THE ECONOMIC AGREEMENT

The Economic Agreement with the Basque Autonomous Community (EABAC) is an instrument with a given duration which regulates the tax and financial relations between the Spanish State and the Historical Territories comprising the Basque Country, as defined in Article 1 of the Agreement:

> "This Economic Agreement arranged between the State and the Basque Country, as provided in the Statute of Autonomy, shall be in force until 31 December 2001".

This wording is the result of the provisions of Article 41 of the Basque Country's Statute of Autonomy:

> "1. The tax relations between the State and the Basque Country will be regulated under the traditional system of an Economic Agreement.
>
> 2. The content of the system of the Agreement will respect and conform to the following principles and bases:
>
> ...
>
> d) The Basque Country's contribution to the State will consist of an overall quota, comprising all the quotas corresponding to each of its territories, as a contribution to all the burdens of the State which are not borne by the Autonomous Community."

As can be deduced from the foregoing, the relations are regulated basically on two levels, namely taxation and finance:

- *Taxation:* Through the assignment, to the competent institutions of the Basque Historical Territories, of regulatory and administrative powers in all their phases (including exaction, management, settlement, inspection, revision and collection) for all taxes comprising the Spanish tax system *(devolved taxes)*, excepting the taxes which form part of Customs Duties,

those currently regulated through monopolies, and the tax on alcohol *(non-devolved taxes).*

Table 1:
*Division of taxes on the basis of the applicable regulations**

Devolved	*Autonomous Community Regulations:* Personal income tax, wealth tax, corporation tax, inheritance & gift tax, transfer tax & stamp duty, local taxes *Common Regulations:* Value added tax
Not devolved	Excise taxes, customs duties and taxes collected through monopolies

* This division of powers was applicable during the analyzed period (1981-1985). However, in 1997 the Economic Agreement was renegotiated, agreeing the transfer to the Basque Country of the collection powers on the excise duties when they are produced in the Basque Country. Taxation on non-residents was also transferred regarding the income obtained within Basque territory. Therefore, financial autonomy is now even larger in the Basque Country.

- *Finance:* The establishment of a *quota* as consideration for the tax-raising capacity of the Basque Provincial Governments, through which they obtain a volume of funds which, in principle, is in excess of the amount needed to finance the powers devolved to the Basque Autonomous Community. This quota represents the Basque Country's contribution to all the burdens of the State which are not borne by the Basque Autonomous Community.

In fact, if we view Spain as a set of Autonomous Communities, the Agreement is no more than a special way of financing a given autonomous community (the Basque Country) in a non-privileged way (since a number of principles such as harmonization, co-ordination and solidarity, as described later, must be observed).

Nevertheless, a fundamental qualification is in order in this general description of the Agreement: although there is a single Economic Agreement with the Basque Country, it regulates the relations with the institutions of the three Historical Territories comprising the Basque Country (Basque Provincial Parliaments and Provincial Governments, whose powers are regulated by Basque Parliament Law 27/1983, governing relations between the Common Institutions of the Autonomous Community and the Governing Bodies of its Historical Territories).

For greater clarity, it should be noted that throughout this book we refer not to relations between the State and each Historical Territory but between the State and the Basque Country as a whole.

2.2 GUIDELINES FOR INTERPRETATION

Firstly, note that the Economic Agreement is no more than a law and that, in principle, its interpretation should be subject to the general principles for the interpretation of laws, as set out in Article 3.1 of the Civil Code, which outlines basically the following methods:

- *Grammatical:* according to the meaning of the words themselves in the legal text. This is a "philological" interpretation in that it establishes the various meanings and significances of each of the words in the regulation.
- *Systematic:* in relation to the general context of the regulation which is being interpreted.
- *Historical:* based on the precedents, both historical and legislative.
- According to the *social reality* of the period when it must be applied, such that the provisions have meaning even under circumstances which arose after they were drafted.
- Based essentially on its *spirit and goal*, which takes us beyond the literal wording of the law to the need to analyze it *"ratio legis"*, as an abstract relation both between the parts of the regulation and between the specific regulation being interpreted and the entire body of law.

However, although the aforementioned rules are to be observed on a general basis when interpreting regulations, Article 3.2 of the Economic Agreement Law itself contains a specific rule governing its interpretation, which reads as follows:

> "The rules of this Agreement shall be interpreted in accordance with the provisions of the General Taxation Law as regards the interpretation of tax legislation."

Accordingly, we need to refer to the General Taxation Law, Article 23 of which reads as follows:

> "1. Tax regulations shall be interpreted in accordance with the criteria accepted by law.
>
> 2. Where the terms used in tax legislation are not defined therein, they shall be interpreted according to their legal, technical or customary meaning, as appropriate."

Accordingly, the rule on interpretation established in the law governing the Agreement contains a reference to the criteria accepted by law, i.e. the aforementioned interpretation criteria established on a general basis in the Civil Code.

In order to fully understand the regulatory powers vested in the competent institutions of the Historical Territories by the Economic Agreement with the Basque Autonomous Community (EABAC), they need to be examined from various standpoints.

In accordance with the basic principles of legal interpretation, the historical and legislative precedents should be examined along with the various political and social motivations, and a comparative analysis should be made of other systems of political and financial decentralization in other Western countries.

This will give an indication of the actual regulatory powers assigned under the Economic Agreement with the Basque Country and their true scope, which will enable the various harmonization rules analyzed later to be fully understood.

3. THE INSTITUTIONAL AND HISTORICAL SETTING

3.1 INSTITUTIONAL FRAMEWORK

3.1.1 A unique system

It is important to note that, because of a number of factors, the system created by the EABAC is a *unique system*.

It is a model of decentralization of both revenues and expenses, with a feature which various authors have highlighted, i.e. it is a system of *"unilateral risk"*, since the State does not share in the tax revenues collected in the Basque Country. Nor, however, is it responsible for covering the public-sector expenses, rather it is the Basque Country which (through the quota) contributes to defraying the general expenses of the State. Hence, the consequences of good or poor management of the EABAC fall exclusively on the Basque Country, and the Basque Country's contribution to the State's general expenses for the powers which have not been devolved is not based on tax revenues but on variables which are exogenous to the Basque Country, namely the expenses in the General State Budget for those powers.[1]

As explained in section 3.4.1, the expense contained in the General State Budget is corrected by a coefficient based on the ratio between the Basque Country's income and the income of the State as a whole.

The system of tax federalism created by the EABAC is genuinely unique in that it differs considerably from traditional decentralization schemes:

- Practically the entire tax system of the State is devolved, thus amply exceeding the principle of vertical equilibrium.
- Regulatory powers over much of the tax system (specifically, the main general taxes such as personal income tax and corporation tax) are devolved to the sub-central government.
- The sub-central government does not receive transfers or subsidies from the State; rather, it finances the latter's general expenses through a contribution.
- The contribution to the State general expenses is made under a criterion of unilateral risk, based on the volume of those expenses at any given time.

These features are not to be found among the most decentralized countries in the world and, hence, the Basque system is quite unique.

3.1.2 Comparative analysis

In order to appreciate how unique the system provided by the EABAC really is, we present below a comparative analysis of the various solutions adopted in other countries for decentralized systems.

3.1.2a) Models of federalism

In principle, we will refer to States where the system responds to the idea of tax federalism, involving multiple levels of government, each with a degree of financial autonomy and decision-making power, even though the States themselves are not constitutionally federal.[2]

i) Canada

The Canadian system, backed by court rulings which are favourable to the development of tax actions by the provinces, involves the devolution to the provinces of powers over:

- *Direct taxes*

  Note that the Federal Government also has direct taxes. Therefore, although the provinces have a complete set of powers as regards direct taxes, they have imposed "voluntary limits" on their own powers, basically by delegating to the Federal Government the collection and management of part of the direct taxes corresponding to the provinces, i.e. the provinces have waived a tax belonging to them and merely collect a surcharge on the federal tax.

- *Taxes on the retail sale of various goods*

  The Federal Government imposes a tax (similar to VAT) on goods and services, and the tax on retail sales is reserved for the provinces, since it has been interpreted by the courts as a direct tax. Nevertheless, provinces such as Quebec have accepted the Federal Government's proposal to use the base of the federal tax, due to the management problems posed by the system.

- *Taxes on the capital of companies with a permanent establishment in the province*

  Some provinces have established this tax for all companies, others apply it only to trusts and banks, and others do not have it at all.

As regards direct taxation, certain provinces have not adopted the system described above regarding a surcharge on the federal tax; the most paradigmatic case is Quebec which, as well as maintaining its own income tax (on both persons and companies) in addition to the federal regulation, includes a single mechanism for co-ordination between the federal and provincial taxes which involves a tax credit for Quebec residents against the Federal tax; this is due more to the Quebec government's refusal to participate in certain federal expenditure programs than to true co-ordination in tax matters.

Note that the Federal Government retains the regulation and exaction of many taxes (see above as regards direct taxes and the principal indirect tax, and other sundry taxes such as customs duties).

This distribution of powers is summarized in the share-out of tax revenues at the various levels of government: on average, 50.69% is collected at federal level, 39.88% at provincial level and 9.43% at local level.[3]

Logically, since Canada is a decentralized federal State, the provinces need greater financial capacity to meet the expenditure they have assumed, which is achieved through "payment of the necessary compensation to provide the provincial institutions with sufficient revenues to place them in a position to provide reasonably comparable levels of public services at reasonably comparable levels of tax burden," and qualification for subsidies depends on whether the individual province's tax capacity is lower than the average of certain reference provinces.

ii) Germany

Tax powers are split between the Federal State and the Länder based on the principle of concurrent legislation (the Länder have regulatory powers over all cases which do not meet the conditions for the Federal State to legislate, or where the latter does not use its powers), but the Länder have legislative powers (albeit devolved to lower-order territorial entities) over local taxes on consumption and luxury, whereas the Federal State has exclusive powers over customs duties and financial monopolies.

However, the concurrent legislative powers do not exist in practice since the Federal State makes full use of its tax powers, leaving the Länder with minimal legislative scope in this connection. Thus, in view of the Länders' lack of legislative powers in tax matters, the decentralized system is actually a system of distributing the tax revenues collected.

This distribution is based on the following parameters: the revenues from the various indirect taxes existing in Germany are allocated, as appropriate, to the treasury of the Federal State or the Länder, and the latter collect the wealth tax and inheritance tax. However, the bulk of Germany's tax burden corresponds to personal income tax, corporation tax and VAT. These major revenue items are shared on the basis of the following average percentages:

Table 2:
Revenue sharing in Germany

	Federal Government	Länder	Local entities
Personal income tax	42.5	42.5	15
Corporation tax	50	50	-
VAT	56	44	-

Source: "Tributos propios de las Comunidades Autónomas". ADAME MARTINEZ.

Nevertheless, in order to attain financial equilibrium (since Germany is a federal state), transfers of funds are made both from the Federal State to the Länder (vertical equilibrium) and between the Länder, depending on their relative financial capacity (horizontal equilibrium) in order to achieve each Länder's objectives. It is estimated that, as a result of the foregoing, 71.36% of total tax revenues go to the Federal State and 21.24% to the Länder, the remainder going to local entities.[4]

iii) USA

In principle, both the Federal Government and the States have taxation powers and, consequently, the same taxable event may be subject to both federal and state tax; however, the state's powers are not unlimited, since any state law is null and void if it contravenes the US Constitution or a law of the US Congress (federal).

Tax revenues in the USA are distributed as follows:

- The Federal Government is entitled to the following main taxes: personal income tax, corporation tax, excise taxes, inheritance and gift tax.
- The states' main taxes are on sales, although most states also collect personal income tax and corporation tax, basically on the same taxable events as are taxed by the Federal Government.

There is no specific design for a system of compensation to the states by the Federal Government to enable the former to defray their expenses; rather there is a general system of subsidies decided by the Federal Government. As a result, approximately 66.06% of tax revenues go to the Federal Government, 20.58% to the states and the remainder to local government.[5]

iv) Switzerland

The Swiss model can be analyzed from three standpoints:

- From the regulatory standpoint as regards taxes, there are two spheres of power: the Confederation and the cantons.
  - The Confederation has sole powers over value added tax, customs duties, stamp tax, taxes on account and certain indirect taxes on specific consumptions.
  - There is an overlap of powers over the main direct taxes, since both the Confederation and the cantons have powers in this area.
  - The cantons have exclusive powers over personal wealth tax and certain indirect taxes.
- Collection and management of federal taxes is generally delegated by the Confederation to the cantons, with the Confederation retaining powers of oversight. The cantons remit 70% of these tax revenues to the Confederation.
- Since the cantons' tax resources are not sufficient to cover the powers which they have, there is a system of financial compensation in the form of federal subsidies plus the aforementioned portion of tax revenues collected for the Confederation, and a system of redistribution whereby that percentage is distributed among the cantons.

Tax revenues are ultimately distributed as follows: 62.00% to the Confederation, 21.82% to the cantons and the remainder to local entities.

3.1.2.b) The Italian system

Having analyzed the paradigms of tax federalism, before drawing a conclusion as to the nature of the EABAC, it may be useful to refer briefly to the *Italian regional model* which, according to authoritative sources, was the inspiration for the construction of the territorial organization of the State in the Spanish Constitution.

Under the Italian system, the regions finance themselves using a few taxes (mainly levies) plus a share in the State's tax revenues (plus certain special contributions by the State); the region with the greatest financial autonomy is Sicily, which we describe briefly below because of its special features.

The current finance system in Sicily reserves revenues from the tax on tobacco products and monopolies and on lotteries for the Central State, in addition to customs duties. The region, which has taxation powers, keeps all other taxes collected in its territory; additionally, it has regulatory powers which are subsidiary to those of the State and apply not only to regional and local taxes but also to State taxes not expressly excepted.

3.1.3 Conclusions of a comparative analysis and an analysis of the current system in Spain

A comparison with the system provided by the EABAC only highlights the special nature of the latter, since only Canada and Switzerland devolve such a range of powers over the main taxes ("devolved taxes" under the EABAC definition), but both of those countries have an overlap of devolved and central powers with the result that in certain cases (most of Canada's provinces), the devolution is more nominal than real.

Although tax-raising powers are devolved more often, (apart from the Swiss cantons and Sicily) the regional authority does not normally take over all direct taxes and VAT, as it does in the case of the Basque Country. To illustrate this statement, it is sufficient to compare the figures given above for the various countries with those for the Basque Country, where 86.5% of tax revenues in 1992 were "devolved taxes" (therefore collected by the Basque Country itself).[6]

Financial equilibrium is normally achieved through subsidies; the EABAC does not involve subsidies but, on the contrary, its Quota system implies a flow of funds from the region to the central administration. The only comparable system is that of the Swiss cantons, but the amount they pay into the central treasury is based on their tax revenues, unlike the Quota system, which is based on a much more complex system involving a unilateral risk.

As a result of the aforementioned structures, those decentralized States do not need to arrange systems of tax harmonization like those discussed here since the only case where the regional and central systems need to take account of each other is in Quebec, and this is not really a question of harmonization but, rather, a problem with accepting federal expenses.

Nevertheless, although it follows that the system under the EABAC is unique, it should be borne in mind that if all the Autonomous Communities comprising the Spanish State enjoyed a similar system, the Central State (as a Federal or Confederal State) would be left with minimal taxation regulation and collection powers to an extent without parallel in any other country today.

Accordingly, it is appropriate to describe here the system prevailing both for the Navarra Autonomous Community and for the Common Territory of the Spain State.

Commencing with the Common Territory, the system designed by the Organic Law for Financing the Autonomous Communities (LOFCA) simply determines that the Autonomous Communities keep the revenues from their own taxes (basically those relating to services devolved to the Autonomous Communities, since the latter have barely created any taxes *ex novo*) plus those devolved by the State, which are of secondary importance in terms of amounts (inheritance and gift tax, wealth tax, transfer tax and stamp duty, and

gaming taxes), plus a part of the personal income tax debt and the regulatory capacity to determine its amount, which involves the largest part of the Autonomous Communities' financing. The difference required for the Autonomous Communities to discharge their obligations is made up by subsidies.

The system in Navarra, whose historical background is very similar to that of the EABAC, involves a system of "Economic Conventions" which resemble to those between the State and the Basque Country and is structured on two levels: taxation (Navarra has regulatory, management, inspection and revision powers over taxes) and finance (based on an overall contribution to the State to defray its general expenses).

Prevailing systems of fiscal federalism propound the centralization of the redistributive and stabilization functions, and assign the determination of the public costs associated with public services to all levels of government. Accordingly, the EABAC clashes with the currently fashionable economic theories, again highlighting its unique nature and importance.

In fact, the courts have established a significant precedent in this respect: the Spanish Supreme Court ruling dated 19 July 1991 (Bench 3, Section 2) states that the Basque Country should retain a peculiar tax system based on the EABAC "since, otherwise, the tax legislator would merely be an amanuensis (as stated in the contested ruling) – nay, a mere transcriber, we would say – and the proclaimed autonomy would cease to exist."

We will end with a conclusive quote from Medina Guerrero, who defines the system as "a financial regime without parallel in any other federal state of our time, only comparable, mutatis mutandis, with now-defunct quasi-federal systems where the central administration, which had scant taxation powers, only obtained the revenues required to discharge its duties in the form of subsidies from the member states."[7]

3.1.4 The importance of the EABAC as regards the level of self-government in the Basque Country

To complete the description of the institutional framework surrounding the EABAC, having described its uniqueness in comparison with other systems, it is worth noting the importance which the most authoritative authors attribute to the EABAC for the autonomous self-government of the Basque Country.

In fact, there was a noteworthy contribution to the parliamentary debate on the Law by the Socialist member of parliament (subsequently Minister of

Economy for several years), Mr. Solchaga Catalan, who stated his "conviction that the Economic Agreements are not only an important, substantial part of the implementation of the Basque Country's Statute of Autonomy but, moreover, they are the basic financial substance whereby autonomy is established and operates in the Basque Country."[8]

The reader will by now have been persuaded of the importance and uniqueness of the system being analyzed here.

3.2 ORIGIN OF THE ECONOMIC AGREEMENT. HISTORICAL DEVELOPMENT

This section will conduct a brief analysis of the most outstanding historical events relating to the background, creation and subsequent development of the various Economic Agreements.

3.2.1 The "Fueros"

Before discussing the origin of the Economic Agreement, it is necessary to briefly mention the "foral" system, a set of institutional relations and consuetudinary rules existing in the Basque territories.

This system is much broader than the mere regulation of tax relations between the Territories and the State, although only that aspect of the "fueros" will be discussed here.

The "fueros" are a compilation of uses and customs expressing the peculiar status of a people through time and they materialize, in regulations, a unique form of political organization. Thus, "the fuero did not arise suddenly, as do constitutions; it was built up progressively ... rising from the very nature of the human community. But that nature is a historical nature."[9]

Note, moreover, that attempts have occasionally been made to equate "fuero" with "privilege" out of the mistaken interpretation of them as something granted graciously by some authority which is particularly beneficial for its recipients.

This interpretation is rebutted by a Basque author, who stated that "the origin of the fueros of the Basque provinces has nothing in common with the gracious acts of a prepotent authority; rather, they arise from the repeated patterns of action of a community. In order for a community to develop fueros, it must be autonomous, i.e. it must be able to give itself a legal system which is sufficient to cover all its activities. Therefore, the fueros should be classified not as a "gratia" but as a "ius."[10]

In fact, after the Basque territories joined the Kingdom of Castile, for

many years the Castilian monarchs continued to respect the uses and customs established by the Basque peoples.

Accordingly, the "foral" system was a veritable limit on royal authority, and the competent institutions of the Basque provinces even had the power, through the institution of the *Pase Foral* ("foral approval"), to grant or deny the validity of laws as regards their application in those territories.

In the tax sphere, the fueros implied that "the king lacked the powers to impose levies on these territories, with the result that their participation in defraying the monarchy's expenses was confined to granting sporadic 'donations', approved by the Provincial Governments of the Basque territories at the request of the king, which expressly stated the voluntary nature of the delivery"[11] however, the frequency of these donations varied considerably over time.

3.2.2 Crisis of the Foral system

The foral system went through various phases, involving a progressive reduction in its content to provide greater centralism and unity of the Crown, and various attacks were directed at the fueros themselves or at fundamental components of them in an attempt to place the Basque provinces on an equal footing with the rest of the State.

It was in this way that the concept of "fueros" became distorted to make them equivalent to concessions granted by the monarchs; that is, from being something which arose from the Basque peoples, they came to be viewed as a "gracious concession" of the King.

Additionally, despite the consuetudinary nature of the Fueros, since the end of the 18th century they began to evidence a certain conservativeness (maintenance of a protectionism system at all costs) which clashed with the incipient liberal tendencies of certain sectors of society.

3.2.3 Origin of the Economic Agreement

During the 19th century, two civil wars (the Carlist wars) changed the course of the "fueros" (although the latter were not directly related to the origin of the wars), since the Basque provinces found themselves on the losing side.

The first of the wars ended in 1839 with an Agreement between the two sides which contained a commitment to propose that Parliament grant or modify the fueros, in a very broad sense but, at all events, *without prejudice to the constitutional unity of the Monarchy.*

Thus commenced a process of abolition of the fueros which culminated

in 1876 after the conclusion of the second Carlist war.

The *"constitutional unity"* referred to in 1839 was again used as an instrument to abolish what was, at the time, the basic manifestation of the "fueros", namely exemption from conscription and taxes, and to extend the interpretation of "fuero" as "privilege".

On 21 July 1876, a law was passed which, though not expressly mentioning the abolition of the Foral Institutions, in practice rendered them void by suppressing their principal powers, and is considered by authorities to be the origin of the Economic Agreement which was set out in the Royal Decree dated 28 February 1878.

The first article of that Decree stated as follows: "the duties ... to provide military service when the law requires and to contribute in proportion to their wealth to the expenses of the State are extended to the inhabitants of the provinces of Vizcaya, Guipúzcoa and Alava in the same way as to the other (inhabitants) of the Nation."

According to Lámbarri and Larrea, "the Royal Decree dated 28 February 1878 is the first place where the expression 'Economic Agreement' was coined, in the preamble, albeit with a different meaning: 'it only remains for them (the Basque provinces) to enter into the Economic Agreement'."[12] We refer, in this case, to section 3.3.6.b) iii) below.

Thus it was established that the inhabitants of the Basque provinces must contribute to financing the common expenses of the State, albeit with their own system based on the powers of the Provincial Governments to regulate levies and taxes and on the payment to the State of certain pre-set total amounts, which enabled the provinces to retain much of the fiscal autonomy which they had previously enjoyed and, in particular "the (Basque) provincial governments are permitted to adjust the collection of the required quota ... to the circumstances of the country, and to propose to the Government the method of collecting it."[13]

In short, although the historical "fueros" were dealt a deadly blow by the elimination of the tax exemption, central government taxes were introduced into the Basque provinces gradually and they were collected not by the State tax apparatus but through overall quotas.

It should be noted than many Basques see the Economic Agreements as a prolongation (albeit attenuated) of their ancient Fueros. In the words of Castells, "the Agreements were more than just agreements between the Government and the Basque Provincial Governments regarding the quotas to be paid each year. They involved the provinces' ability, through the Provincial Governments, to administer themselves in certain areas, with the power to attend to a number of services ..."[14]

Accordingly, in the words of one writer, the Economic Agreement could be defined as "the way in which the Government adopts an agreement with the

Basque Provincial Governments to comply with the constitutional duty, imposed on the Provinces by the Law of 21 July 1876, to pay, in the corresponding proportion, the levies, duties and taxes indicated in the General State Budget. The Provincial Governments are obliged to pay a quota for the devolved taxes, and are responsible for paying it into the Treasury, and they reserve the right to use the means they deem most appropriate to collect the quota."[15]

3.2.4 The Economic Agreements

There have been various Economic Agreements between the first one, which arose from the Royal Decree dated 28 February 1878, and the one currently in force, which was approved by the Law of 13 May 1981. However, the previous Economic Agreements were negotiated between the individual provinces and the State but were expressed in a single document which, nevertheless, established a specific quota for each province. Accordingly, the 1981 Economic Agreement (currently in force) is the first one to refer to the Basque Country as a unit.

There were seven further Economic Agreements after that of 1878, and their fates varied considerably; the Economic Agreement was in fact derogated by the provinces of Vizcaya and Guipúzcoa in 1937 during the Spanish Civil War.

The Economic Agreements concluded after the first one with each of the Basque provinces were as follows:

- Second Agreement: article 14 of the Budget Law dated 29 June 1887.
- Third Agreement: Royal Decree dated 1 February 1894.
- Fourth Agreement: Royal Decree dated 13 December 1906.
- Fifth Agreement: Royal Decrees dated 9 June 1925 and 24 December 1926.

The Fifth Agreement explicitly stated that the Provincial Governments were empowered to establish the tax system which they saw fit. The only limitations involved the prohibition against adopting measures which might clash with the international agreements signed by Spain or which involved levies, duties or taxes reserved for the State.

To the aforementioned list of Agreements, it would also be necessary to add the two arranged solely with the province of Alava and the current one, arranged with the Basque Country as a whole, all of which will be discussed later.

3.2.5 The 1931 Constitution

The 1931 Constitution of the Spanish Republic established a decentralized State, thus making it necessary to design, albeit in general terms, the main guidelines for financing the Autonomous Communities; however, it was decided to give the Autonomous Communities almost total freedom to regulate this matter in their Statutes of Autonomy.

With regard to the "foral" system, after intense debates it was finally decided to preserve the peculiar tax systems of the foral territories, but this was done by excluding all mention of the matter from the Constitution, thus leaving it open for subsequent express recognition and development in the Statute of Autonomy.

Consequently, the 1936 Statute dealt with the matter and recognized clearly the Basque Territories' taxation powers, leaving the territories the broadest possible scope for regulating tax matters.

Article 12 of that Statute stated as follows:

> "The Basque Country may adopt the tax system which it deems to be fair and fit ..."

Additionally, the system of Economic Agreements was expressly recognized in the following article, although this whole process was truncated suddenly by the outbreak of the Civil War.

3.2.6 Suppression of the Agreements with Vizcaya and Guipúzcoa in 1937

A civil war broke out in Spain in 1936 which led to the abolition of the democratic institutions, including the Statute of Autonomy and the Constitution, and the establishment of a strongly centralist State. This dictatorship came to an end in 1975 with the death of General Francisco Franco, and a new democratic Constitution was promulgated in 1978 which remains in force today.

In 1937, the provinces of Vizcaya and Guipúzcoa were occupied by the winning side and, as a result, Decree Law dated 23 June 1937 was issued which abolished the Agreements system for these two provinces, which were described as "traitors", while it was maintained in force for Alava; the Decree Law contained an evident contradiction, by describing the Economic Agreement

system as a "notorious privilege" which involved "discrimination against the other provinces", yet maintaining it in force in the province of Alava for political reasons.

Consequently, the Agreement system remained in force for Alava, and two further agreements were arranged exclusively with that province:

- Sixth Economic Agreement with Alava: Decree dated 29 February 1952.
- Seventh Economic Agreement with Alava: Royal Decree dated 26 November 1976.

The last Agreement above is particularly noteworthy since it was arranged at a historic moment when the State was involved in a profound process of political change with its sights set on drafting a Constitution.

Thus, "its insertion in the new constitutional political context eliminated the controversy which had surrounded the system and ... served as a model for the Parliament when drafting the clause which protects and respects the historical rights of the 'foral' territories".[16]

The Statute of Autonomy of the Basque Country itself, which was approved by Organic Law 3/1979, dated 18 December, established that the Agreement with Alava would serve as a model on which to base future Economic Agreements (Eighth Additional Provision):

> "The first Economic Agreement to be arranged after the approval of this Statute will be inspired by the material content of the Economic Agreement currently in force with the province of Alava, without this implying any detriment to the province ...".

3.2.7 Particular reference to harmonization rules

At this point of the book, it is appropriate to include a brief description of the harmonization rules contained in previous Agreements. In fact, there is not a long history of harmonization rules (as they are understood here) in the Economic Agreements. The first one to appear was the *respect for the international pacts signed by Spain with foreign nations*, which was contained in the fourth Economic Agreement, approved by the Royal Decree dated 13 December 1906 and was repeated in subsequent Agreements down to the present day.

There were no other harmonization rules[17] until the Economic Agreement arranged with Alava (under Royal Decree 2.948/1976, dated 26 November), which, in addition to reiterating the respect for international pacts, referred to the powers of the *high inspection of the State Administration as regards compliance with the goals of the Agreement* and to the *application in Alava*

of the exceptional or temporary tax rules which the State decides to apply in the Common Territory.

Finally, though not a harmonization rule per se, it should be noted that the need for harmonization was taken into account in the implementation and execution of all the Agreements. For example, the Decree dated 18 May 1931 stated that any disputes arising between the Government and the Basque Provincial Governments out of the interpretation and application of the Economic Agreement would always be resolved by mutual agreement between the Ministry of Finance and the Provincial Governments.

3.3 CONSTITUTIONAL FRAMEWORK

3.3.1 The current legal and political framework

The new legal and political framework created by the 1978 Constitution established a new model of State based essentially around the recognition of the peculiarities of the individual territories. This principle is set out in article 2 of the Constitution itself:

> "The Constitution is based on the indissoluble unity of the Spanish Nation, which is the common and indivisible fatherland of all Spaniards, and it recognizes and guarantees the *right to autonomy* of the nationalities and regions comprising it and the solidarity among them."

Additionally, Title VII of the Constitution, entitled "The territorial organization of the State" begins with the following precept (article 137):

> "The State is organized territorially into municipalities, into provinces and into the Autonomous Communities which may be created. All these entities enjoy autonomy in the management of their respective interests."

3.3.2 Autonomous Community financing in the Spanish Constitution

3.3.2.a) General principle: financial autonomy

The Spanish Constitution establishes a system for financing the Autonomous Communities based on the general principle of autonomy, as specified in article 156.1:

"The Autonomous Communities shall enjoy *financial autonomy* to develop and execute their powers subject to the principles of *co-ordination* with the State Treasury and of *solidarity* among all Spaniards."

The Basque Country's unique position was recognized constitutionally in the First Additional Provision of the Constitution:

"The Constitution protects and respects the historical rights of the foral territories.

Any general updating of that 'foral' system will take place in the framework of the Constitution and the Statutes of Autonomy."

3.3.2.b) Limitations on the exercise of financial autonomy

The Spanish Constitution itself establishes various lines of action which the Autonomous Communities must follow in developing the powers of financing which they are acknowledged to have.

The first such guideline is in the references contained in article 156:

- *co-ordination* with the State Treasury, and
- *solidarity* among all Spaniards.

Additionally, throughout the Constitution there are numerous references to principles to be observed by the Autonomous Communities in developing their financial autonomy:

- Solidarity. Articles 2, 138, 156 and 158. (See 5.3.3).
- Tax justice. Article 31: "All shall contribute to sustaining the public expenditure in accordance with their economic means through a fair tax system inspired in the principles of equality and progressiveness which shall not, in any event, be confiscatory."
- Equal rights and obligations. Article 139.1: "All Spaniards shall have the same rights and obligations in any part of the territory of the State."
- Freedom of movement and establishment. Article 139.2: "No authority may adopt measures which directly or indirectly hinder the freedom of movement and establishment of persons and the free circulation of goods throughout Spanish territory."
- National economic policy. Article 148.1: "The Autonomous Communities may take on powers in the following areas: ... 13. Fostering the economic development of the Autonomous Community within the objectives established by national economic policy."
- International relations. Article 149.1: "The State has exclusive powers over the following matters: ... 3. International relations."
- Customs. Article 149.1: "The State has exclusive powers over the

following matters: ...10. Customs and excise."

- Monetary system. Article 149.1: "The State has exclusive powers over the following matters: ...11. Monetary system: currency, exchange and convertibility; regulation of credit, banking and insurance."
- General planning of economic activity: Article 149.1: "The State has exclusive powers over the following matters: ...13. Bases and co-ordination of general planning of economic activity."
- Statistics for State uses: Article 149.1: "The State has exclusive powers over the following matters: ...31. Statistics for State uses."
- Mercantile and criminal legislation: Article 149.1:"The State has exclusive powers over the following matters: ...31. Mercantile and criminal legislation."

3.3.2.c) Co-existence of two systems of financing

The Spanish Constitution laid the general foundations for the new system of financing the Autonomous Communities and placed the "foral" question on a constitutional plane.

An analysis of article 156 of the Constitution leads to the conclusion that the financial autonomy refers only to expenses but not to revenues, since it is established "for the development and execution of their powers." However, this should be qualified by the comments in sub-section d) below.

At all events, the Basque and Navarra autonomies followed different routes in attaining autonomy beyond mere expenditure to embrace revenues also, and the item quoted above from the First Additional Provision of the Constitution is particularly relevant in this connection.

In conclusion, it could be said that there are two co-existing systems for financing the Autonomous Communities:

- The system of Agreements and Conventions, applicable to the "Foral" System Autonomous Communities, namely the Basque Country and Navarra.
- The financing system referred to as the "common system", which is applicable to the other Autonomous Communities.

3.3.2.d) The common regime

The system of financing designed to structure the financial and tax relations between the Autonomous Communities and the State is expressed in the content of the various Statutes of Autonomy which have been approved and in the Organic Law for Financing the Autonomous Communities (LOFCA), article 1 of which again proclaimed the principle of financial autonomy.

The latter system, referred to as the "common system", will be discussed briefly in this section with a view to highlighting the uniqueness of the system of Economic Agreements, which is the purpose of this book.

The Autonomous Communities' sources of revenues are set out in article 157 of the Spanish Constitution and in article 4 of the LOFCA, and they consist basically of a share in the State's revenues, transfers from an Interterritorial Compensation Fund and own taxes (which are residual in nature).

Nevertheless, Organic Law 3/1996, dated 27 December, partially amended the LOFCA by introducing several new features, including most notably, for the present purposes, the granting of regulatory powers to the Autonomous Communities with respect to the taxes whose collection has been devolved to them, this being done to further the process of *fiscal co-responsibility* between the various levels of government.

It should be noted that, to date, the assignments of taxes from central level to the Autonomous Communities in the common regime had only been for the purposes of collection.

The preamble to the Law stated that "in order to materialize that principle of effective fiscal co-responsibility ..." it had been decided to "... transfer certain regulatory powers to the Autonomous Communities in connection with the devolved taxes ..."

It should be noted that the term "fiscal co-responsibility" is not at all clear, at least in the wording of the Law. To clarify its meaning it is necessary to resort to the English term "accountability",[18] which relates to a system where the party which is responsible for *spending* decisions is also responsible for decisions which imply a greater or lesser *tax burden* on its citizens. This concept is used in the Ministry of Economy and Finance's July 1990 Report on the Reform of Personal Income Tax and Wealth Tax, which proposes increasing the tax accountability of the Autonomous Communities, thus taking the first steps along the path which is furthered in the aforementioned Law.

In this connection, the Basque territories are subject to the system expressed in the Economic Agreements and, therefore, in principle, the system established by the LOFCA is not applicable to them, unless partially and supplementary, based on the content of the LOFCA's First Additional Provision, which reads as follows:

> "The traditional 'foral' system of Economic Agreements shall apply in the Basque Autonomous Community in accordance with the provisions of the corresponding Statute of Autonomy."

It is interesting, in any case, to note how the principle of accountability ("co-responsibility" in the Spanish wording) is raised to prominence in an attempt to make the Autonomous Communities responsible for part of the system. In fact, the financial and tax system established by the Economic

Agreement with the Basque Country (EABAC) is not only in line with this principle but is actually much more advanced since the Basque Country is fully responsible for tax collection in its territory and fully assumes the related risks.

Moreover, the common system designed by the LOFCA clearly evidences the direct relationship between regulatory powers and responsibility at Autonomous Community level with respect to the results of the tax and financial system. It could be concluded therefore that the EABAC, which places full responsibility on the Basque Autonomous Community under what we call the principle of unilateral risk (see 3.4) must necessarily be accompanied by devolution of the fullest regulatory powers.

Lastly, it should be noted that, under the new common regime designed by the LOFCA, the Autonomous Communities which are subject to that regime are still guaranteed that their financial needs will be fully covered by transfers from the State, if they are not covered by devolved taxes; this is another difference with respect to the EABAC system.

3.3.3 The "distinguishing features": the historical rights of the "foral" territories

As stated above, the Historical Territories of the Basque Country have a specific, unique system of financing whose roots, growth and development have already been described.

It is now necessary to analyze how these unique features, as expressed in the Economic Agreement, fit in with the current legal and political framework, and the scope and meaning of the First Additional Provision of the Spanish Constitution, cited in 3.3.2.a).

Numerous studies have raised the question of the "historical rights" protected by the Constitution, although it would apparently be pacific to state that "the expression Historical rights refers to rights which have existed in the past, which predate the Constitution itself, and which, though not deriving their validity from the Constitution, do obtain a guarantee as regards their exercise."[19]

However, this matter is complex and has been the subject of much debate, "particularly when the foral regulations as a whole have never been fixed or immutable; moreover, the historical rights of the foral territories were never totally abolished."[20]

The fact that the historical rights are reflected in the Constitution gives them constitutional standing and it is only fair to note that they achieve recognition of the fact that the pre-date the Constitution itself and not merely as a historical reference but as something which is alive and under development,

the only limits being the framework of the Constitution itself and the statutes of autonomy.

Due to the complexity and controversial nature of these matters, the drafters of the Constitution opted not to include any further detail of the financial decentralization of the State, and the Constitution could be said to be open on this point, although the absence of greater specificity does not prevent the systems of the Economic Agreements from fitting perfectly into the framework of the Constitution.

Thus, the Constitutional Court ruling 76/1988 establishes that "the constitutional guarantee means that the content of the foral system should preserve, in both its organization features and its sphere of power, the recognizable image of the traditional foral regime ... The constitutional guarantee does not assure a specific content or a scope of powers which is established once and for all but, rather, the preservation of an institution in terms which are recognizable from the standpoint of society's image of that system at each time and place." Specifically, the Ruling identifies the Economic Agreement as a part of that guaranteed "foral" core, by saying that "the system of agreements ... is part of the minimum content of the constitutional guarantee for that regime, since their total disappearance would imply the disappearance of an essential factor in the recognition of the persistence of the foral system."

Therefore, the idea of interpreting the Agreement as being equivalent to a privilege does not fit the *"respect"* afforded by the Constitution and, subsequently, the Statutes, which is a faithful reflection of the legal validity of this institution (which has been accorded recognition at the highest level) in the present day.

That constitutional precept is transferred into the sphere of financial autonomy of the Basque Autonomous Community through the revival of the concept of Economic Agreement, which had only disappeared temporarily, and not from the entire Basque Country and Navarra, due to the War.

The aforementioned Court has also stated, in Ruling 191/1988 among others, that "the exception of the unique agreement systems with the Basque Country and Navarra (is) supported by the Constitution."

It is interesting to highlight the words of the Minister of Finance, Mr. Garcia Añoveros, during the parliamentary debate of the Law on the Economic Agreement with the Basque Country: "(this Law) is not an attempt to project an archaic and outdated institution on the current reality of Spain; on the contrary, it implies the revitalization, in the provinces of Vizcaya and Guipúzcoa, of an institution with deep historical roots which, moreover, has remained in force down to this day since its abolition in Vizcaya and Guipúzcoa by the 1937 Decree did not eliminate the institution, which remained alive in Alava, and it was clearly an act of war."

The Minister continued by saying that "The EABAC is, therefore, a Historical Right which is fully current. The First Additional Provision of the 1978 Constitution enshrines the respect for the historical rights of the foral territories, guarantees support for them and provides for them to be brought up to date, which means not restoration but adaptation of a traditional, foral regime to a new political and legal reality which has arisen from the Constitution itself and in which it should take place."[21]

3.3.4 The Framework of the Statutes

Title III of the EABAC regulates the bases for the financial and tax system of the Basque Autonomous Community. It is here that the generic content of the First Additional Provision to the Constitution is first updated.

Thus, article 41 enshrines the Agreement system:

> "1. Tax relations between the State and the Basque Country shall be regulated by the *traditional foral system of Economic Agreement and Conventions*."

As regards purely financial relations between the parties, the EABAC then states, in the same article, that they will be instrumented through the formula of the Quota to be paid to the State for burdens not assumed by the Autonomous Community.

3.3.5 The Economic Agreement

As an implementation of the provisions of article 41 of the Basque Country Statute of Autonomy, referred to above, the EABAC was approved by Law 12/1981, dated 13 May, as provided in the Statute of Autonomy. This Law had a single article, which provided that:

> "The Economic Agreement with the Basque Autonomous Community referred to in article forty-one of Organic Law three/nineteen hundred and seventy-nine, dated eighteen December, governing the Statute of Autonomy for the Basque Country, is hereby approved."

Thus, by referring to the specific articles of the Basque Country Statute of Autonomy, the aim was to refer to the precepts, not of Law 12/1981 (which has only one), but of the text incorporated into it by reference.

Accordingly, connecting with the content of the First Additional Provision

of the Spanish Constitution and of article 41 of the Basque Country Statute of Autonomy, it can be stated that the EABAC is the result of updating a traditional "foral" system within the framework of the Spanish Constitution and as an implementation of the Basque Country Statute of Autonomy.

In conclusion, the system arises from the constitutional recognition (First Additional Provision) of the historical rights of the foral territories. Subsequently, the Basque Country's Statute of Autonomy (specifically, article 41) specifies the scope of those rights in relation to finance by establishing that tax relations between the State and the Basque Country will be regulated by the traditional system of Economic Agreements. Finally, Law 12/1981, dated 13 May, approved the Economic Agreement with the Basque Autonomous Community and established the first Quota.

3.3.6. Nature of the EABAC

The EABAC can be considered from various perspectives which provide complementary (not radically different) views of the agreement and aid in locating it in the complex reality which it represents. The Economic Agreement can be viewed from at least three standpoints: material, formal and political.

i) Material view

From this standpoint, the EABAC is a method of financing applicable to the Basque Autonomous Community.

The definition of what the EABAC represents, as regards content, is contained in the aforementioned article 41 of the Basque Country Statute of Autonomy, which views it as a system aimed at regulating tax relations between the State and the Basque Country.

The inclusion of these provisions in the Basque Country Statute of Autonomy when defining the framework of agreements is of particular interest considering that the Statutes of Autonomy form part of what the Constitutional Court itself has termed the "constitutional block", i.e. the set of rules to be considered by the Court when determining the constitutionality of a law, provision or act with the force of a law of the State or of the Autonomous Communities.

ii) Formal view

Formally, the EABAC is a Law approved by the Parliament which was drafted and processed in a very special way, and this should be borne in mind when assessing it fairly as regards its political content; most noteworthy was the creation of a Joint Commission for the purpose, comprising representatives of the State Administration and the Basque Autonomous Community.

The text which was agreed upon in the Commission was signed on 29 December 1980 and approved by the Cabinet on the following day. It was subsequently approved by Parliament, by the Provincial Governments of the three Historical Territories and by the Basque Government.

Additionally, the Law was processed through Parliament by the urgent procedure, as an act with a single article. Accordingly, only total amendments could be proposed; that is, Parliament could merely accept or reject the EABAC.

iii) Political view

An analysis of the EABAC would be totally lopsided if it did not take account of the fact that it is a *pact*.

The EABAC is a sort of pact between the Basque Country and the State which establishes the ground rules governing tax relations and the system of self-financing for the Autonomous Community, whereby certain historical rights expressed (as the State itself repeated recognizes) in the historical "fueros", are "protected and respected".

There is no shortage of arguments for describing the EABAC as a pact, or of authors who support this assertion, but it will suffice to quote article 1 of the EABAC itself, which states that it is the result of an agreement between two wills, that of the State and that of the Basque Country:

> "This Economic Agreement *agreed* between the State and the Basque Country, as provided in the Statute of Autonomy ..."

Note also that the State authorities have consistently recognized the EABAC expressly to be a pact. For example, the Royal Decree dated 6 March 1919 defined the Agreement as an *agreement inserted in a Law, and established that neither of the parties by interpret the contract on its sole authority ...*

As regards its peculiar drafting and processing, we refer to the section on the formal view of the EABAC, since it is intimately related thereto.

In fact, this question came out in the debate on the Report in a joint session of the Constitutional Commission of Congress and the Delegation of the Basque Parliamentarians, and a ember of parliament, Mr. Guerra, requested a clarification as to "whether this law is a law which only ratifies or whether it can be amended or, at all events, whether the Agreement is specifically something to be negotiated between the competent institutions and the State ..." Two members of parliament, Messrs. Fernandez Ordoñez and Bandres, responded by pointing out that the EABAC was a pact: the former said that "Agreement refers to a prior agreement which is later laid before Parliament", and the latter stated that "the word Concierto (Agreement) ... is

the pacted will, the agreed will, the agreement, in short, between the two powers."[22]

Additionally, various statements made subsequently during the EABAC Law's passage through Parliament highlight that it was intended to take the form of a pact, as expressed by the then Minister of Finance, Garcia Añoveros, and by the members of the various parliamentary groups.

Accordingly, "what is fundamental of the Basque people, is the negotiation between the political power in the Basque Country and the political power on a general level, between the Central Administration and the Basque administration. This negotiation, if translated into parliamentary terms, would involve the majority, in theory, of this Congress and the majority of the Basque Parliament. This is what gives it the greatest strength and connects it with the negotiation and with the 'foral' concept of Economic Agreements ..."[23]

Thus, the expression "Economic Agreement" which, curiously, was first used in the sense described in 3.2.3 above, perfectly matches the fact that it was a pact from the very beginning down to the present day.

Moreover, after noting that the Agreement is a pact, it should be pointed out that it is futile to equate this with a privilege since a privilege implies something that it is granted or conceded through the unilateral will of the party in a position to do so, which is not compatible with something which is arranged by mutual agreement between two negotiating parties.

Additionally, the methods envisaged for future amendments to the EABAC (i.e. the same one as used to promulgate it), for adapting it to material changes in tax matters (i.e. by agreement between the two Administrations) and for processing the detailed rules to implement it all evidence the fact that the EABAC is a pact.

Lastly, the fact that the EABAC is a pact is backed by the Constitutional Court, which expressly recognized this fact in its Ruling 76/1988, in which it stated that "historically, the contributions by the 'foral' treasuries to the State treasury were determined by the system of agreements, which implies an *agreed or pacted* element in the core of the 'foral' system (almost exclusively so since the Law of 21 July 1876) and which constitutes, therefore, part of the minimum content of the constitutional guarantee for that regime, since their total disappearance would imply the disappearance of an essential factor in the recognition of the persistence of the foral system."

3.4 ECONOMIC IMPLICATIONS OF THE AGREEMENT SYSTEM. WITH SPECIAL REFERENCE TO THE QUOTA

As explained in previous sections, the content of the various Economic Agreements has always revolved around two major questions: regulatory

powers and tax-raising capacity, on the one hand, and the Quota (i.e. the financial relations between the Basque Country and the State), on the other.

The central idea of the Quota is that it is the contribution by the Basque Autonomous Community to defraying the general expenses of the State relating to powers not transferred for self-government by the Basque Country. This means that, since it is generally the Autonomous Community which collects the taxes and, since it must contribute to financing certain expenses of the State, the idea is to create a financial flow which, in principle, is favourable to the State and gives rise to an amount payable to the State (referred to as the Quota).

The Quota is a contribution by the Basque Country to assist in financing the powers borne by the State in the Basque Autonomous Community. In consequence, the taxes not devolved under the Agreement which are collected in the Basque Country by the State (i.e. the central taxes) are deducted from the Quota.

Method for determining the Quota

Article 48 of the Economic Agreement states that the methodology for determining the Quota will be set every five years by a law passed by the Spanish Parliament after agreement in the Joint Commission on the Quota.

In simple terms, under the methodology established in the current Economic Agreement, the Quota is calculated as follows:

$$Q = i \cdot (PNA - TRND)$$

where:

- i — is the imputation index
- PNA — is the value of the Powers Not Assumed by the Basque Country (e.g. defence and foreign relations)
- TRND — is the Total Revenues Not Devolved under the Economic Agreement which the State collects in the Basque Country.

The imputation index represents the Basque Country's relative ability to contribute in comparison with the State as a whole, which is determined in practice on the basis of income, in accordance with article 53 of the Economic Agreement.

The determination of income-based indices for use in calculating a territory's contribution is normally a complex matter due to the evidently

opposing interests of the parties involved. Consequently, it is not easy to establish a specific indicator to measure income (Gross Domestic Product, Gross National Product, Family Disposable Income, Gross Added Value, etc., and the question of whether to measure at factor costs or market prices), or even to agree on a source from which to obtain the statistical data for the period in question.

The Economic Agreement itself determined that index for 1981 and established that the five-yearly Quota Laws would determine it for each period. It follows from the Seventh Transitory Provision of the Economic Agreement that the imputation index for the Basque Country for 1981 was 6.24%, and this percentage remained unchanged in the subsequent five-year periods (1982-1986, 1987-1991, 1992-1996).

It is worth considering whether maintaining the 6.24% rate over 16 years has been beneficial or detrimental to the Basque Country in comparison with the relative actual trends in its economy, its income and, in short, its capacity to contribute.

The methodology for valuing the Powers not Devolved to the Basque Country consists of classifying each budgeted item of State expenditure as "devolved" or "not devolved" at any given time. One of the key points in determining the Quota each year is the quantitative delimitation of the charges borne by the Basque Country and, consequently, the powers not devolved to the latter. According to certain authors, whereas some areas lend themselves readily to classification as powers devolved or not devolved to the Autonomous Community, there are others where it is difficult to delimit the assumption of powers, areas where functions and services are borne by the competent institutions of the Basque Country but without a decree explicitly transferring them, and areas where there is a duplication of functions.

In order to avoid the need to define the value of the Powers not devolved each year, the mechanism for annually updating the Quota during each five-year period was defined, based on an index which does not depend on those charges.

Finally, there is the method for determining the Revenues which are Not Devolved.

In practice, the State retains intact its powers to collect taxes nation-wide from three sources:

- Taxes not devolved to the Basque Country (TND), namely customs duties, taxes collected through fiscal monopolies and the tax on alcohol.
- Non-tax revenues (NTR), such as financial revenues, revenues from assets, and incoming transfers and subsidies.
- The public deficit (PD) , if any, presented by the State General Budget; in practice, there is a structural deficit. This is an aggregate which, in practice, coincides with the gross public sector borrowing requirement in the year.

As part of the method for determining the Quota, in the first year of application of each five-year Quota Law, a "base Quota" is obtained by valuing the Devolved Powers and the Devolved taxes in the General State Budget for that first year. This "base Quota" is updated in subsequent years using the R coefficient, which is found as follows:

$$R = R_t / R_0$$

where:

R_t is the amount of Devolved Taxes collected in year t

R_0 is the amount of Devolved Taxes collected in year 0

Accordingly, the Quota in year t (Q_t), apart from specific treatment of the powers of the National Institute of Health Services, the National Institute of Social Services and the financing for the Autonomous Community Police Force, is calculated as:

$$Q_t = i\, R_t\, Q_0$$

Table 3 illustrates the amount of the Net Quota in relation to the absolute and relative volumes of devolved taxes collected in the Basque Country in the period 1981-1994 (in millions of pesetas).

According to table 3, the Quota has declined rapidly as a proportion of devolved taxes collected, from 37% in 1982 to 5% in 1995. This is explained by the fact that the Basque Country has gradually taken on further powers which have a particular effect on the financing, via the Quota, such as the National Institute of Health Services, the National Institute of Social Services and the financing for the Basque Autonomous Community Police Force.

Table 3:
The quota as a percentage of devolved taxes

Year	Devolved Taxes Collected	Net Quota	Net Quota/ Devolved taxes
1981	N/A	37,53	N/A
1982	145,06	53,91	37.16%
1983	171,30	65,05	37.98%
1984	216,60	74,78	34.53%
1985	244,67	87,89	35.92%
1986	303,69	97,42	32.08%
1987	377,33	110,83	29.37%
1988	438,28	101,12	23.07%
1989	503,00	75,14	14.94%
1990	561,17	70,56	12.57%
1991	625,86	76,30	12.19%
1992	672,00	48,97	7.29%
1993	686,40	34,12	4.97%
1994	685,71	34,94	5.10%

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4. THE ECONOMICS OF TAX HARMONIZATION

4.1 OBJECTIVES AND GUIDELINES FOR TAX HARMONIZATION

The theory of international tax harmonization and coordination is one of the most complicated areas of international public finance. Tax harmonization can be defined as the process of removing tax disparities to the point where they no longer distort the allocation of resources.[1] One can distinguish two approaches to tax harmonization in economic unions and two approaches to methods of implementation of tax harmonization.[2] As far as the approaches are concerned, a distinction can be made between the equalization approach and the differentials or fiscal diversity approach. In the former, a standardization, i.e., uniformity of tax base and equalization of tax rates among members of the union is advocated. The standardization could occur with or without the unification of the tax system under the umbrella of a single fiscal authority. The equalization approach implicitly assumes that there can be conflicts of interest between the goals of the union and those of the individual member states and it gives precedence to the common goals of the union over those of the individual members. The fiscal diversity approach is based on the principle that the tax system of a country is an instrument of that country's economic policy. Countries should in principle be free to pursue their own economic policy while at the same time minimizing the externalities of the tax system. Therefore, it could be desirable that members of an economic union cooperate with each other and implement a minimum degree of harmonization, particularly in the administration of taxes. The fiscal diversity approach implicitly argues that welfare of the individual member of the union coincides with the welfare of the union as a whole and that an individual member is best equipped to select the tax system that maximizes its own and therefore at the same time also the union's welfare.

As far as the implementation of tax harmonization is concerned, there are two possible methods. The first is that harmonization is imposed on the members of the union administratively. An alternative to administrative implementation is implementation through market forces, i.e. tax competition. Tax competition is based on the fact that members of unions differ from each other in several respects. Members could, for instance, have different preferences

for different taxes. Member states could also have different opinions as to the role of taxation in their economies. Moreover, some taxes are simply not acceptable in certain members of the union. Finally, members usually differ from each other with respect to their preferences for the size of the public sector. As a result of these differences, it is argued, taxes should be based on residence. If it that is the case, it is likely that governments will compete for scarce and mobile resources as well as tax revenues. This will tend to restrain governments in their tendency to set too high taxes or spend too much money and will at the same time create an efficient provision of public goods, as well as a convergence of tax systems in the union.

In this chapter we shall outline the economic principles that underlie international taxation. Economic theory has predominantly been occupied with the efficient allocation of resources and therefore requires that international tax rules are based on economic neutrality of decisions with respect to relative effective tax burdens at home and abroad. Apart from efficiency criteria, international tax harmonization has also been analyzed with the criteria of distribution and macroeconomic stabilization. Although issues of vertical and horizontal equity, as well as macroeconomic stabilization have been important in tax harmonization debates, the discussion in the literature has so far no doubt been dominated by the criterion of an efficient allocation of resources.

In international economic analyses of taxes, tax harmonization is usually advocated with the purpose of *avoiding distortions*. Two types of distortions are usually distinguished, viz. general and specific distortions. General distortions are those which have an identical impact on all decisions regarding consumption, production, factor use or factor ownership. They imply, for instance, an equal tax on consumption of goods and services or an equal tax on income. Specific distortions on the other hand exert their influence only on specific products or specific factors of production. A tariff on imported products may serve as a good case in point. As a rule, taxes always cause both type of distortions. However, the economic theory of international taxation is particularly concerned with the ways in which specific distortions can be avoided. The reason for this is that general distortions leave the international pattern of production, consumption and other decisions unaffected and therefore result in neutrality of the tax systems with respect to these decisions. In other words, when tax systems are neutral it does not matter whether one country has a higher overall tax rate than another, as neutrality implies a situation in which decisions by economic individuals are unaffected as if there were no international differences in taxes. Specific distortions, on the other hand, result in artificial adjustments to the naturally given comparative advantages of countries and can, therefore, result in countries that specialize according to their comparative disadvantage.

Even if specific distortions did exist, it does not follow automatically that they should be eliminated. This depends, first of all, on the question how important they are, i.e. on the question whether or not they seriously distort the functioning of the internal market. Secondly, some distortions are a deliberately choice of governmental policy and are imposed on an economic system for other reasons than economic policy (e.g. equity considerations with respect to the income distribution, or policy *vis-à-vis* merit and demerit goods). Thus, what appears to the economic theorist to be a distortion of competition, may well represent the outcome of government decision-making in which economic efficiency has to be balanced against socially desired objectives, and which simply reflects the need for collecting government revenues in the most expedient manner. Fourthly and finally, the desirability of eliminating specific distortions also depends on the level of economic integration that is strived for by the integrating countries. If integration is supposed to be limited to free trade areas, then it can be argued that this does in itself and of itself not require an extensive harmonization of policies. If integration is supposed to go beyond this stage as to also encompass free movements of labour and capital, then tax burdens can easily be shifted and there might be better case for a certain degree of harmonization of some policies.

Thus, even if specific distortions are present it can still be possible to benefit from the international specialization which is implied by free trade. However, this raises the question to what extent these benefits could be increased by modification of government policies that result in economic inefficiencies.

The efficiency or neutrality criterion works out differently for indirect taxes on the one hand and direct taxes on the other. For both types of taxes, neutrality requires that pre- and post-tax decisions are the same, i.e. the tax has no influence on the decisions that are taken by individuals or firms. Below, we shall discuss the implications of neutrality for both type of taxes.

4.2 HARMONIZATION OF INDIRECT TAXES

4.2.1 The economic theory of harmonization

Let us first apply the requirement for allocative efficiency to indirect taxes. As is well known, indirect taxes can be levied on the basis of the destination principle or on the basis of the origin principle. Under the *destination* principle, taxes are levied in the country of destination, i.e. where consumption takes place. International differences in tax rates are usually dealt with through border tax adjustments by imposing domestic indirect taxes on imports and

by rebating indirect taxes in the case of exportation. As a result of this system all goods of identical types will be taxed with identical rates, irrespective of the country of production. Therefore, there is no discrimination between the consumption of domestically and foreign produced goods, i.e. destination taxes are non-discriminatory taxes on consumption. Things would be different in the case the tax would be based on an *origin* system, i.e. the country of production levies a domestic tax on commodities, irrespective of whether they are sold at home or abroad. Since origin taxes are domestic production taxes, border tax adjustments are unnecessary.

The requirement of neutrality of indirect taxes is based on a well known result from international trade theory that countries will maximize their benefits by specializing according to their comparative advantage and by refraining from imposing any border taxes. This optimality of free trade means that when countries specialize according to their comparative advantage they both obtain a higher level of real income than compared to the situation where they do not have free trade.

In determining the (in)efficiency of destination and origin taxes, the key factor is how a tax affects relative prices of home-produced and imported goods.[3] In the event these prices would change as a result of a particular tax, consumers will substitute foreign produced goods for domestically produced goods or vice versa and the tax will not be neutral, since the location of production will change.

Which principle, origin or destination, should be preferred on the basis of efficiency grounds? The argument is most easily developed if we start the exposition with the assumption of flexible exchange rates and uniform tax rates that are levied on all goods that are produced or traded in a country. Let us start with the case where country A has a comparative advantage in the production of good X, whereas country B has a comparative advantage in the production of good Y. Assume next, that country A levies an indirect tax of 50% on both goods X and Y and that country B applies a tax rate of 20 %.

In the case the tax would be levied on the basis of the destination principle, all exports would be exempted from taxation. As country A could potentially export both goods X and Y, the imposition of a 50% tax would not affect A's comparative advantage. Also note that goods that enter country A as imports would be taxed equally as domestically produced goods, and therefore the relative price of imported and home produced goods would remain unaffected. Hence, indirect taxes that are uniformly applied have no impact on trade nor on exchange rates.

In the case the tax would be levied on the basis of the origin principle, all goods produced domestically, including those that are destined for exports, would be taxed. Thus, both goods X and Y will be subjected to the same tax and comparative costs are unaffected as before. However, the tax will have an

impact on the export price of these goods relative to the price of foreign goods. Since A has a comparative advantage for the production of good X, the price of that good relative to the price of good X in country B will increase. As a result A's exports will decline. At the same time, A's import goods (Y) will increase in price vis-à-vis these Y goods that are produced by country B. As a result, A's imports are likely to rise. Both the decrease in exports and the increase in imports will have an unfavourable effect on A's balance of payments, and given the foreign tax rate of 20% and the domestic tax rate of 50%, A's currency will depreciate with a factor of 1.2 - 1.5, so as to offset the unfavourable trade effects.

The above example makes clear that origin and destination taxes are economically equivalent. Thus, whatever system is chosen, equivalence ensures that the volume and the structure of foreign trade is not affected. This conclusion holds even if the uniform tax rates are different internationally. In other words, assuming flexible exchange rates, and uniform internal taxes, indirect taxes need not interfere with the specialization according to comparative advantage and would enable both countries to enjoy the benefits of free trade.

The equivalence result also implies that a change from one system to another will not have any long-run trade effects. The reason for this is that we move from one neutral system to another. Thus, if policy makers would decide to move from a destination system to an origin system, this change should, at least in the long run, not lead to a deterioration of that country's trade balance. This is not to say, however, that there are no trade effects to be expected in the short run. There are, for instance, some significant short-term benefits and costs to be expected from a move from destination to origin systems. Exporters could, for instance, be forced to charge higher prices and therefore be confronted with declining profits. Similar remarks hold for importers. However, in the long run these changes would be neutralized and relative prices would be restored and return to their free trade equilibrium levels.

The question arises to what extent the equivalence result depends on the assumptions made. First of all, consider what happens if the countries would levy non-uniform VAT rates. In this case, the tax system will no longer be neutral, i.e. it will no longer be possible to optimize both production and trade. Therefore, a choice must be made between the achievement of efficiency in production on the one hand and efficiency in exchange on the other. In this respect, the destination principle is consistent with the objective of achieving productive efficiency, whereas the origin principle is consistent with the objective of efficiency in exchange.

To see why this is so, consider the case where country A would differentiate its VAT rates internally such that X goods would be taxed 50% and Y goods would be taxed 30%. Like we saw before, the tax would leave net-of-tax producer prices unaffected if the tax would be levied on the basis

of the destination principle. This would be the case for both X and Y producers in country A and country B. Producers would therefore equate their production prices with their marginal costs of production and the latter would be identical for all producers in the union, so the system would achieve productive efficiency. However, the differential tax rates will affect the behaviour of consumers. As the relative price of Y goods decreases, consumers in country A will consume more Y and fewer X goods. Since relative prices that consumers in both countries are facing are different, the destination system will not result in exchange efficiency and trade between A and B will be distorted.

That would not be the case under the origin principle. Since arbitrage and competition will equalize prices in countries A and B, net-of-tax producer prices will be affected in a non-proportionate way. Thus, equality of relative consumer prices ensures the occurrence of exchange efficiency, whereas productive efficiency will not be achieved in this system.

Obviously, the neutrality result depends on the uniformity of the tax rate. Furthermore, it shall be clear that, once non-uniform tax rates are introduced, the exchange rate can no longer be depended on to restore neutrality, since that would require two exchange rates for the same currency. There are other reasons why the exchange rate may not be able to guarantee equivalence. In this respect it should be noted that we implicitly assumed above that exchange rates are dependent on trade. However, they are also dependent on capital flows and we should therefore know how tax differentials influence these capital flows. Also, it is well known that exchange rates are nowadays primarily influenced by asses trades rather than by trade flows. This means that the change in the expectations of currency traders after or in anticipation of a change in taxes will influence exchange rates more heavily than the changes in currency demand resulting from exports and imports.

Another departure from the standard assumptions concerns the possibility that the exchange rate is fixed rather than flexible. When the assumption of flexible exchange rates is removed, balance of payments considerations become important. By imposing a higher origin tax, country A will find that its balance of payments deteriorates and will develop a payments deficit. Note that this effect on the balance of payments is not the same as would have occurred with a tariff: in case of the latter, the balance of payments would have improved. As a result of the origin tax, A's export products will rise in country B and A will therefore export less. Conversely, since A's domestic prices rise relative to imported goods, A's imports will increase. Therefore, A develops a balance of payments deficit. Thus, the balance of payments effects of a general origin tax are the same as the effects of an appreciation of A's currency.[4] The negative effects of this origin tax on productive efficiency and the balance of payments could be avoided if country A would introduce an

export rebate and a compensating import duty. Alternatively, the negative effects could also be compensated for by declining factor prices, which would produce the same effects as flexible exchange rates. Interestingly, under fixed exchange rates, destination taxes could remain neutral, as they still don't affect producer prices.

Another negative aspect of origin taxation under fixed exchange rates is that it encourages producers to manipulate prices so as to benefit from tax differentials. For instance, exporting firms that are located in high tax countries could decide to underinvoice exports and to overinvoice imports. These types of administrative distortions do no exist under the destination system as the valuation of imports and exports does not affect the tax liability. Under this system, it will be remembered, exports are exempt from taxation and the lower import tax which is due to undervaluation of the imports will be compensated by a lower tax credit that the importing firm could claim.[5]

Non-uniformity of tax rates within countries can cause a breakdown of the equivalence result for various reasons as well. Non-uniformity can imply different tax rates for different goods and can also mean that certain goods are exempted from taxation. Virtually every country with a VAT exempts a variety of "necessary" goods or applies lower rates to these goods. OECD countries furthermore use numerous exclusions in addition to common necessities. Normally, financial services, life insurance, education and health services or religious organizations are all VAT exempt.Preferential tax treatment typically applies to a large number of non-traded goods. As a result, one expect that the system of exemptions produces trade effects. The reason for this can be easily understood. Consider the case where non-tradeables are zero-rated. If a VAT applies to traded goods and not to non-traded goods, the relative prices of exportables to non-tradeables and of importables to non-tradeables would increase. Thus, a tax wedge is introduced between the different classes of goods. Either the cost to consumers of importables and/or exportables relative to non-tradeables will increase and/or the return to businesses of exportables/importables to non-tradeables would decrease. In both cases the consumption of tradeables relative to non-tradeables is discouraged and/or the amount of investment in the tradeables relative to the non-tradeables sector will decrease. Hence, exemption which primarily falls on non-tradeables will tend to discourage the production of tradeables.

The problem of exempted goods is further complicated when they consist of tradeables (foods). If exempted goods belong to the category of tradeables, then it is in principle possible that the exemption will cause them to be exported.

Preferential rates (exemptions) are frequently applies as a remedy for the regressivity of the VAT systems. However, they have been criticized on a number of grounds. First of all, preferential rates are an extremely inefficient

and costly way to redress regressivity. It is much more efficient to seek remedies outside the VAT system, for instance, by giving tax credits or direct income transfers. Secondly, preferential rates cause inefficiencies by distorting consumer and producer choices. Thirdly, they can significantly narrow the VAT tax base and could even in the long-run cause negative trade effects as a result of the fact that the lower tax revenues must be compensated by other taxes, for instance, corporate taxes.

The neutrality result, though intellectually appealing, is very fragile indeed, as the above analysis goes to prove. Thus, as a guide for policy it is of limited value. How then, are policy makers to choose between either origin or destination taxes? No matter what system is chosen, distortions will always arise, be they distortions of productive or exchange efficiency. According to a powerful result which was derived by Diamond and Mirrlees,[6] an optimal tax system preserves productive efficiency, i.e. a destination system would be preferable to an origin system.

Having said that, however, the application of the destination principle can still lead to several undesirable distortions. These are primarily administration and compliance distortions, which are frequently the result of the exemptions and differential rates within and across countries. Consider again, for instance, exemptions. These usually apply to sectors like small businesses, financial institutions, public and non-profit institutions, and household and informal production. Exemptions have two main consequences. *First*, since the exempted firms are not entitled to claim tax credits, it is likely that they will pass on the effect of higher costs to their consumers, which results in higher prices for their services and creates consumption distortions. *Secondly*, exempted firms may also give rise to production distortions, as the higher prices that they charge for their products increases the costs for producers who use the exempted product as an input. Consequently, some cascading may arise. Furthermore, firms that are exempted from paying VAT will be encouraged to produce certain services themselves (hospital laundries) rather than buy these services from other firms. Thus their input decisions are distorted as well. Finally, apart from this production distortion, exemption of firms can also lead to trade distortions, as exempt firms cannot claim a VAT credit upon exportation of their products.

Some authors have argued, that origin systems are to be preferred as they tend to result in considerably smaller administrative and compliance distortions. In addition to that, even under a destination system, some distortions are likely to arise, since consumers will be tempted to go cross-border shopping. As a matter of fact, many authors have suggested that in situations where border controls have been eliminated (e.g. internal markets) the possibility of cross-border shopping constitutes a powerful argument for the imposition of origin

taxes.

An alternative system that could be used in the absence of border controls is the system of the restricted origin principle in which the origin system would be applied to all internal union trade, whereas the destination principle is applied to extra-union trade. This system would require border tax adjustment at the external borders of the union. Although an interesting option, taxation on the basis of the restricted origin principle will introduce its own type of complications. One problem with a system that taxes extra-customs unions imports on the destination of the country that imports and that subsequently treats intra-customs union movements of the product on an origin basis is that it will cause all imports in the customs union to enter the union through the member state with the lowest tax rates. These imports can then be sold anywhere in the customs union without any additional taxes being imposed upon them. This problem, which is known as trade deflection, will imply that the lowest tax rate will be the effective tax rate for imports and will also have as a consequence that the lowest-tax member of the customs union will collect all the tax revenues.

The problem of trade deflection could in principle be solved in two ways. Firstly, it could be decided, that imports shall be taxed according to their ultimate destination. However, this option will be difficult to administer and will be discriminating and therefore create distortions. Secondly, a common external tax could be imposed on imports. Needless to say, this option would also create distortions in the case imports would be taxed differently from domestic production.

Georgakopoulos and Hitiris[7] have suggested a reason why a restricted origin system might be efficient. They argue that the trade deflection which will be inherent in such a system may be able to compensate for other sources of distortion, in particular distortions caused by high tariffs or inefficient differential taxation of goods and services. Assume, for instance, that tariffs are high and that, as a result there are large inefficiencies in the customs union. The application of the restricted origin system with the accompanying trade deflection will reduce the price of importables and thus give rise to efficiency gains.

Summarizing this section and considering all the arguments their is a presumption that destination taxes offer better guarantees to safeguard productive efficiency. The consumption losses which are inherent in this system do not lead to major distortions of competition between the union members. The potential productive inefficiencies which are created by an origin tax are likely to be larger than the consumption distortions that are introduced by a destination tax. Furthermore, the consumption distortions introduced by a destination tax are likely to be borne by the country that

imposes the tax, whereas the productive inefficiencies that are introduced by an origin tax are likely to be shared by all member states of the union.

4.2.2 Indirect tax harmonization in the EU: VAT

At the start of the integration process in Europe, there were marked differences between the tax systems of the six founding fathers of the Community. First of all, sales taxes varied considerably: some countries applied VAT, others applied cumulative turnover taxes and yet others had taxes on gross value. In addition to that, excise systems differed widely, both as far as tax rates and tax bases were concerned. Furthermore, there were widely different systems of income tax and corporate taxation.

The Rome Treaty contained a separate chapter on tax provisions, which dealt with indirect taxes only. The Treaty stipulated in Art. 99 that "the harmonization of legislation concerning turnover taxes, excise duties and other forms of indirect taxation" would be a principal objective of the Community. Furthermore, for income and corporate taxes, Art. 100 permitted Community action only for measures necessary for a proper functioning of the common market. In effect, this means that Commission authority is restricted in this area to eliminating double taxation of firms working in cross-frontier activities and removing taxes that restrict capital movements rather than attempting to harmonize or narrow the rates levied by the various states. This limited tax competence for EC action is in contrast to the right of the US federal government to levy taxes on corporations and individuals.

The countries of the EC had widely different indirect tax systems at the time the Community was created. Apart from excise taxes, there were two types of general sales tax in use. These were:[8]

(1) single stage taxes, which themselves could be found in 3 varieties:
   - manufacturer sales taxes (levied on sales from manufacturers to wholesalers);
   - wholesale taxes (levied on sales from wholesalers to retailers);
   - retail sales taxes (levied on sales from retailers to consumers).

(2) multi-stage taxes which are levied each time goods or their components are sold and which could be found in 2 varieties:
   - VAT taxes, in which case deductions are made for taxes paid at earlier stages of production;
   - cascade taxes, in which these deductions are usually not permitted and in which every stage of production is subjected to the tax.

All original members of the EC had cascade taxes, except for France, that operated a hybrid type of VAT system. Most EC countries introduced VAT after 1967.

The Neumark Report,[9] which was published in 1962, recommended the introduction of a common VAT system in the Community. The reason for this recommendation was that, although cascade systems are in principle easy to administer, they have some defects in comparison to VAT taxes. First of all, cascade taxes are not taxes on final goods but are basically taxes on business inputs. Secondly, cascade taxes give an advantage to vertically integrated firms over relatively unintegrated firms. Thirdly, the calculation of export rebates and import surcharges is almost, if not entirely, impossible under a cascade system.

In 1967 two directives were adopted by the Council which harmonized sales taxes on the value added model. All the Member States came under an obligation to adopt the VAT system no later than January 1st, 1970 (Italy and Belgium were granted extensions). New Members were also under an obligation to introduce VAT type taxation. Later directives in the 1970s laid down the base (i.e. collection of goods and services) upon which the tax was to be levied. This included the important Sixth Directive of 1977. Since then, intra-Community trade has been taxed on the basis of the destination principle. Border tax adjustments ensure that exports leave the country of production tax-free and are subsequently taxed in the country of destination. A long-standing objective of the Commission, however, is to switch taxation on intra-Community trade from the destination to the origin principle so as to remove fiscal barriers and frontier controls. Since the start of the internal market programme (1985), the European Commission has submitted several proposals on VAT harmonization.

The issue of VAT harmonization has been high on the agenda since then. However, it proved too controversial to produce a comprehensive and simple arrangement.

Currently, a transitional arrangement is in force, pending the a definitive arrangement which is based on the system of taxation in the country of origin. Under the present regime, the distinction between exports and imports in intra-Community trade is abolished and intra-Community movements do not give rise to a tax obligation. VAT is being charged in the country of destination10 and there is a relief from VAT in the country of origin. Member States tax authorities co-operate through a computerized network for the exchange of information. Furthermore, the internal market programme has produced a certain harmonization of VAT rates, in that the standard rate shall not be lower than 15% and the reduced rate shall not be lower than 5%. In addition, some goods may be exempted from taxation.

The present transitional system, which was to be phased out in1997, has been criticized for being unduely complex. For instance, there are 25 rules determining the place at which a transaction should be taxed.[11] The complexity of the system implies that business have to indicate their part of their turnover going to different Member States, and this basically segments the internal market. Member States are also reported to apply the common system differently among each other, implying that businesses should be familiar with 15 different legal arrangements.

Proposals put forward by Commissioner Monti in July 1996 seek to eliminate this deficiencies among others by introducing the principle that a single place of taxation should be established. In practice this would mean that taxation and deduction should be the responsibility of one and the same tax authority. Taxation in a single place would, according to the Commission, imply a substantial amount of VAT rate harmonization, preferably a single standard rate. The proposals also introduced the principle that the final arrangement should not result in a decrease of tax revenues in the Member States. Reductions in tax revenues should be avoided by the adoptation of mechanism reallocating tax revenues between Member States.

4.2.3 Indirect tax harmonization in the EU: excise duties

The EC has made several efforts to harmonize excises, as these duties are considered to be a danger to a proper functioning of the common market. However, the progress in this harmonization process has been even slower than that of the VAT harmonization. Excises can be levied on a variety of goods. A Commission proposal in 1972 suggested that the excises on manufactured tobacco, alcoholic beverage and hydrocarbon oils should be retained and harmonized. In practice EC member states levy excises on many other goods as well, such as non-alcoholic beverages, coffee, tea, sugar, electricity, and even cars.

Early efforts at excise tax harmonization began by defining the taxable products. Not only were the commodities mentioned to which taxation should be limited, but there was also work in the direction of agreeing to common definitions of tobacco products and establishing a range of relationships between the specific and ad valorem components of excises. In early attempts, the discrimination that used to exist between foreign and domestic products in the field of indirect taxation was also abolished. In this connection, France and Italy used to employ substantially higher excise duties on foreign distillates and tobaccos. This form of discrimination on the basis of nationality was ended by the Court of Justice.

Among the more recent efforts at excise harmonization, two areas are

worth mentioning: the administrative side of excise duty taxation and the tax rates themselves. As far as the administrative side is concerned, the removal of border controls in the internal market necessitates certain changes in this field. The administrative side of the tax relates to the way the duty is collected. In most countries of the Community the tax payment is enforced through a system of tax stamps or "banderoles". This means that goods whose duty has been paid will be stamped, so that they can easily be distinguished from goods that have not paid their duties. The alternative system for paying the duty is the system of bonded warehouses, whereby goods are stored in a bonded warehouse without payment of the duty and whereby the duty is only paid when the goods leave the bonded warehouse.

The Commission[2] has proposed the system of linked bonded warehouses to control the movement of dutiable goods between member states. In this system goods could be transferred to and from warehouses without paying the duty. However, once the goods leave the warehouse for final sale, duties would become payable, and once the duties would be paid, goods would go in free circulation in the entire Community. That could in principle mean that goods would only be distributed from the country with the lowest duties.

As far as the harmonization of rates is concerned, the Commission's 1987 proposals argued that all excise duties should be completely unified. This was supposed to be necessary for the proper functioning of the internal market. There are good reasons why excise duties should be harmonized rather than VAT rates. First of all the differences between excise duty rates are usually much bigger than those for VAT rates. In addition, VAT rates are usually levied over the duty-inclusive price, thus exaggerbating price differences between Member States. Secondly, excises are single-stage taxes, which do not result in refunds. This gives a powerful incentive to buy the goods under consideration in the country with the lowest taxes. Thirdly, contrary to the case of VAT taxation, excisable goods that enter into the production process will distort the cost structure, precisely because the excise duties are non-refundable.

In 1989 the Commission changed its original proposals by suggesting that the EC should adopt minimum rates and target rates (i.e. rates to which excise duties would have to converge in the future) in the case of duties on alcoholic beverages and tobacco. The Council accepted this proposal in 1993, and set minimum rates for excise duties which are to be reviewed every two years.

4.3 HARMONIZATION OF DIRECT TAXES: THE CASE OF CAPITAL INCOME

4.3.1 The economic theory of harmonization of taxes on capital income

Efficiency considerations are also at the heart of policy discussion relating to the international taxation of capital income. For efficiency to exist in international investments, two conditions must be met.[12] First of all, the investment should be located in the area where production costs are the lowest. Secondly, investments must be done by the company that could produce at minimum costs, i.e. by the company that is the lowest-cost producer. The first condition relates to the "where" of investments, the second to the "who" of investments. In the literature of international taxation of capital income, these two conditions have been translated into two different concepts of tax neutrality, viz. capital export neutrality (CEN) and capital import neutrality (CIN).

CEN is said to exist when an investor is faced with the same effective tax rate irrespective of the location of the investment. In other words, if tax rates between countries differ and companies are investing in a low-tax country, even if production costs in that country are higher than in the high-tax country, there is no capital export neutrality. CEN, therefore, relates to the decision of *where* to invest and for CEN to obtain, a company must face the same effective tax rate everywhere. The following example illustrates the absence of CEN:

Country	A	B
Production costs	1000	1500
Price	2000	2000
Profit	1000	500
Profit tax	800(80%)	100(20%)
After-tax profit	200	400

In the absence of a tax, the company that produces the product from our example would choose to produce in country A. However, due to the existence of a differential profit tax, the company will instead choose to invest in country B, where it can achieve a higher after-tax profit. Thus, CEN is absent and the existence of corporate tax differences diverts investments from country A to

country B. From the perspective of productive efficiency, this investment implies a waste of productive resources and therefore reduces the overall level of welfare in the community of countries A and B. CEN could be established if both countries would have the same effective tax rates.

By contrast, CIN relates to the issue of *who* invests. One could also say that CEN concerns the international allocation of investments, whereas CIN relates to the international allocation of savings. CIN is said to exist when all operations in one particular jurisdiction face the same effective tax rate. Thus, CIN primarily produces efficiency in exchange. An example may illustrate the meaning of CIN.

Firms from country:	**A**	**B**
Price without tax	100	110
Price with tax	120(10%)	110 (0%)

In the example it is assumed that firms from countries A and B supply a particular product to the market of country C. In the absence of a corporate tax, firms from country A would be the cheapest producers. However, as a result of the tax, firms from country A may decide to charge higher prices, as they will have to be able to make sufficient profit in order to provide their shareholders with an acceptable return. As the less efficient firm from country B is not subjected to the tax (or to a lower tax) it will get most of the market of country C. This would be different in the case the tax rates were harmonized, as the artificial advantage for companies from country B would be eliminated.Thus, for CIN to obtain, all companies must be having the same effective tax rate irrespective of their nationality and location, so that taxation does not affect the relative competitive positions of the companies. Clearly, this harmonization would produce positive welfare effects in a tax union of A and B.

The above example makes it clear that the benefits of tax harmonization can only be reaped if there are differences in productive efficiency and when the most efficient firm is facing the highest tax rates. In the case both firms would be equally efficient and firms from country B would be faced with lower tax rates, or in case the most efficient firms would face the lowest tax rates, harmonization would not produce the above mentioned welfare effects for the union *as a whole*. Of course, when all countries are equally efficient, a higher tax in one country might result in a loss of production in that country and all production might subsequently take place in the other country, but this

would not lead to a waste of resources. At the same time, when all investment locations are equally efficient, the fact that taxes in country B are lower than in A, does not matter to anyone except the citizens of country A. Thus, if no country or location is more efficient than another, there can be no welfare loss for the union as a whole if taxes encourage firms to favour one firm location or investment location over another.

CEN and CIN can be obtained by appropriate choice of jurisdictional principles. Two alternative jurisdictional principles are at the disposal of the tax authorities as a basis for income taxes. The first principle is the residence or world-wide principle, according to which taxation is applied to the total income of residents irrespective of the place where the income was earned. This means that companies or groups of companies are taxed on their world-wide incomes. The second principle is the source or territorial principle, according to which the tax is applied to all incomes earned within the taxing jurisdiction, whether or not this income is enjoyed by residents or non-residents. As a general rule, CEN obtains if the residence principle were applied uniformly. CIN obtains in the case of uniform source taxation.

When governments tax at source in the capital importing country, CEN can be approached when governments would operate a "*credit*" system when taxing foreign source income. This implies that the resident country deducts all foreign-paid taxes which are levied on foreign incomes and that the (positive) difference must be paid to the government of the resident country. Thus, companies would have no incentive to try to take advantage of the lax tax regime abroad. However, even under a tax credit system, some distortions to CEN are still possible. Think, for instance, of a situation where the tax rate in the resident country is lower than abroad. When the tax authority does not refund the excess tax which has been paid abroad, CEN will not apply as companies have an incentive to invest in low-tax jurisdictions. CEN may also not obtain in the case companies delay the repatriation of profits. Finally, CEN may be hard to achieve in the case of portfolio investments, as it is extremely difficult to ensure that foreign-source income is declared to the tax authorities of the capital exporting country. Usually, only source taxes are paid when this declaration does not take place.

CIN is in principle obtainable when taxation takes place at the source, i.e. when taxes are levied on national profits. It can be approached when resident countries *exempt* all foreign source income which is earned from capital exports. CIN may also not be approached for some reasons. Firstly, there could be withholding taxes on dividends. Secondly, as is well known (see furtheron), there is a bias against equity financing and in favour of debt financing in most tax regimes as interest payments are usually tax deductible. Companies that do not have an existing flow of profits in a foreign country are therefore usually obliged to take recourse to equity financing, and, as a result,

should earn higher pre-tax rates of return, which prevents CIN from being obtained.

Achieving CIN and CEN at the same time is normally only possible if all countries would face the same effective tax rate or would have a common tax regime (with common rates, tax bases, allowances etc.), of which intercountry compensation of losses is a feature. That normally not being the case, however, a choice must be made between CIN and CEN as countries cannot at the same time operate a credit system and an exemption system. In case the imposition of a common tax regime is impossible, which, CIN or CEN, would be preferable?

The starting point to this question could again be the Diamond and Mirrlees result that an optimal tax structure preserves productive efficiency. That would lend support to the argument that CEN is to be preferred. In addition to that, deviations from CEN are usually considered to be more costly than deviations from CIN. Under the not unreasonable assumption that companies are more responsive to differences in the tax burdens when making decisions as to their investments than households are when making their decisions to save, variations in effective tax rates between countries can do more harm than do variations in effective tax rates within countries. That would be another argument in support of achieving CEN.

However, there are also costs involved in deviating from CIN. This is, for instance, the case if competition is imperfect and tax advantages enable high cost producers to drive out low cost competitors. That would result in a loss of productive efficiency, which could be an argument to doubt the residence principle. Also, applying the residence principle may be very difficult in practice, as it would require consolidated corporate accounts. Furthermore, if parents were taxed according to residence, then a foreign subsidiary might have a different value to different parents, i.e. parents in low-tax residence countries might have an inventive to own subsidiaries in high-tax countries. That could lead to an undesirable amount of concentration of business.

Considerations of fairness or equity also would push in the direction of source-based taxation. In this connection, equity can be understood to have two dimensions. Firstly, there is intercountry equity, which implies an equitable distribution of tax revenues between capital exporting and capital importing countries. It could be argued, that source taxation is simply a compensation for the public services offered by the government of the capital importing country and that this country should be entitled to at least a part of the profits made by foreign business on its territory. Secondly, tax payer equity could imply that it is not fair that companies are taxed differently solely because they reside in different tax jurisdictions. Moreover, as foreign capital owners have better opportunities to conceal their foreign earned income from their own tax authorities, application of residence taxation could result in an

erosion of the corporate tax base with the consequence that the burden of taxation would be shifted towards less mobile factors, such as labour, land, real estate and consumers. Needless to say, this could result in less equitable personal income tax regimes.

Thus, although it seems that there are strong arguments in achieving CEN, a clear-cut case cannot be made as to its desirability in comparison to CIN. That is, however, not as disappointing as it might look at first sight. The reason for that is that many tax reform proposals can increase both CIN and CEN. This is, for instance, true for the abolition of withholding taxes on dividends. Other examples include the abolition or reduction of de facto tax incentives given to foreign direct investors.

Apart form the purely economic distortions caused by differences in corporate tax regimes, there are a number of other distortions which are worth mentioning.[13] The most important of these distortions are administrative, organizational and financial distortions. *Administrative distortions* arise because tax planning, tax collection and tax avoidance have produced a large tax administration industry, both within government, and within companies. Multinational companies nowadays employ huge tax departments whose job it is to minimize the tax bill and to sort out how the company can deal with different international corporate tax provisions. In addition to that, large government tax bureaucracies have been set up in order to repair the loopholes that are created by differences in corporate tax regimes between countries and in order to make sure that companies comply with their tax obligations. From a strictly economic point of view, the activities of the tax administration industry, should be considered as a waste of resources and as socially useless forms of activity.

Organizational distortions arise because differences in international tax regimes change the way in which transnational firms organize themselves. Different governments usually give different tax incentives in order to encourage certain types of activity in jurisdictions. Thus, it may happen that companies locate their R&D department in a certain country, their accounting department in another country and a holding company in yet another country. If there are no sound commercial reasons to locate these various different department in different countries, then responding to international differences in tax incentives implies that the organizational efficiency is reduced.

Financial distortions arise because international corporate differentials could change the financial structure of international firms. In this respect it should be noted that most tax systems favour debt financing over profit retention or the issuing of new equity. The reason why this is so is that interest payments are usually tax deductible whereas dividend payments are usually not. In the context of international business and transnational investments, we

also see that the tax systems usually favours debt finance over equity finance. In many cases interest payments abroad attract a lower withholding tax than dividend payment abroad. As a result of this transnational companies are stimulated to use debt finance rather than equity finance. This problem is aggravated by the possibility of tax arbitrage between countries. Tax arbitrage occurs when allowances are given from low tax countries to high tax ones. Companies operating in a country with high statutory tax rates may have an incentive to maximize the amount of interest of payments, particularly if these interest payments flow abroad to countries with low statutory tax rates. Thus, tax arbitrage causes companies towards using even more debt. It should be obvious that the encouragement of heavy reliance on debt finance and the concentration on interest payments in certain countries are two undesirable distortions which results from international differences in corporate taxes.

4.3.2 Direct tax harmonization in the EU: the case of capital income taxation

Direct tax harmonization is not a direct objective of the EU. The legal basis for corporate tax harmonization is formed by Art. 100, which deals with the harmonization of laws in general. This general harmonization is obligatory only in so far as the establishment or functioning of the internal market is at stake. Thus, harmonization of laws *per se* is not a stated objective of the Treaties and clearly serves to safeguard the process of integration, i.e., the harmonization of corporate taxation serves to guarantee the four freedoms and to eliminate distortions of competition in the internal market. In practice harmonization of direct taxes has been minimal as it is limited by the objectives of the Community. In so far as national tax provisions do not discriminate on the basis of nationality or in so far as they do not form a threat for the internal market freedoms, the manouvering space for European Community action is much reduced. The Maastricht Treaty further complicated things with the introduction of the principle of subsidiarity. This principle implies that areas which do not fall under the exclusive competence of the Community (such as direct taxes), the Community can only act when the objectives of proposed measures are better achieved if Community action rather than Member State action is taken. Before Community action is taken, however, Member States are under an obligation to adjust national provisions that are at odds with the Treaty goals (Art. 5). This means that the Community only becomes active when Member States do not eliminate these provisions or do not wish to so. In addition to that, harmonization is only necessary in so far as non-harmonization would result in distortions to competition in the internal market.

It follows that the issue of harmonization of direct taxes is an extremely complicated one. Nevertheless some degree of tax harmonization is more and more felt as a necessary requirement for the proper function of the internal market. Even at this moment, after the completion of the internal market, Member States are reluctant to cooperate in a substantial harmonization as taxes are touching upon the heart of a Member State's sovereignty. Thus Member States are, to a large degree, free to set levy their own direct taxes and to independently determine the tax rates.

What then, if anything, has been achieved in the field of corporate tax harmonization? Early attempts at harmonization of corporate taxation devoted quite a bit of energy to the thorny issue of harmonizing the corporate tax systems. The system of taxation depends on the extent to which corporation income tax and shareholders' personal tax are integrated. Four systems of corporate taxation are found in the Community, notably:

- the classical system, which is characterized by a complete separation of corporate and personal income tax, i.e. under this system income is taxed to shareholders and to corporations as distinct tax payers. Taxable income earned by a corporation and then distributed to an individual shareholder as dividend is thus taxed twice, once to the corporation and once to the shareholder upon receipt of the dividend.
- the split-rate system, which uses two distinct tax rates for distributed and retained profits and in which the distributed profits are usually taxed at a lower rate than retained profits.
- the tax credit or partial imputation system, which is designed to partially avoid the double taxation which characterizes the classical system. Double taxation is partially avoided by imputing part of the corporate profit tax to the personal tax liability of the shareholder.
- the full integration of full imputation system, in which the corporation is seen as a partnership of shareholders and in which shareholders are taxed under the personal income tax. Thus, the corporation tax in fact does not exist, or corporation tax of profits is fully imputed to the income tax paid by the shareholders.

At this moment, most Member States operate a partial imputation system. Netherlands and Luxembourg operate a classical system, Germany a full imputation system, the remaining countries operate a partial imputation system.

The first proposals were drafted the Neumark Committee in 1963. The Neumark Committee suggested that the Community adopt the split rate system of taxation. A later report, the Van den Tempel report, suggested the adoption of a classical system in 1971. Finally the Commission proposed a directive in 1975 (OJ, C253 of 5.11.75) according to which the Community

would have to adopt a partial imputation system (most Member States had adopted the imputation system at that time).[3] Eventually, no preference for either one of the systems has been decided upon so far.

The directives that have been produced by the EU Commission have all been guided by the idea that firms should be able to be active in the entire Community, without locational decisions, as well as decisions as to the nature of an investment and its financing being influenced by national tax provisions. The long-run objective of these directives has been to abolish distortions to competition and to establish neutrality of taxes, particularly as far as cross-border income flows are concerned. Four main areas can be distinguished where the Commission has been active:

a) The removal of tax obstacles to co-operation between enterprises in different Member States.
b) The approximation of corporate tax systems.
c) The approximation of rules for the determination of taxable profits.
d) Tax measures in relation to the liberalization of capital movements.

The most successful area where the Commission has been operating is the first one. For long, cooperation between enterprises in different Member States was hampered by tax rules that discriminated in favour of cooperation between firms within one and the same Member State, and that made international cooperation between firms much more costly. The elimination of these obstacles has been an issue of the highest priority in the Commission's harmonization strategy. In this area three directives were adopted in 1990 that are worth mentioning:

(1) The parent/subsidiary directive (90/434/EEC), which was first proposed in 1969 and which deals with withholding taxes of dividend payments paid by subsidiaries located in one Member State to parent companies in another. These withholding taxes used to be a considerable barrier to cross-border capital flows within the Community. The directive eliminates double taxation of such dividend payments.
(2) The merger directive (90/435/EEC), which has also been on the table since 1969, and which not only deals with capital gains that are realized in case of cross-border mergers, but also with capital gains as a result of the disposition or transfer of assets, the contribution of assets or exchanges of shares between two companies located in different member states. The directive ensures that capital gains are no longer taxed at the time of a merger, but rather at the moment when the capital gains are collected. As such, the directive could contribute to the formation of European firms.
(3) The arbitration convention on transfer pricing (90/436/EEC), which aims for the elimination of double taxation in connection with the adjustment of profits of associated enterprises. Originally this arbitration convention

was filed as a proposal for a directive in 1976. It was designed to eliminate the double taxation that occurs when the tax authorities in one Member State increase the amount of an enterprise's profits and when such an increase is not accompanied by a corresponding adjustment in the Member State where the associated enterprise is located. Tax authorities in one Member State can increase the amount of an enterprise's profits by applying transfer pricing rules. When common rules in the field of transfer pricing do not exist and/or are not applied uniformly, such a practice would harm the operations of transnational corporations. Particularly small and medium-sized transnationals, who do not have enough resources to employ the necessary expertise to face these complex administrative and legal procedures would benefit from the establishment of the arbitration convention.

All the above-mentioned directives have now been transposed in the Member States. Since 1990, the Community has not adopted any new directive. The importance of these three measures should not be exaggerated, as the regime does not affect the national rules that apply to domestic operations. In addition to that, the measures apply to certain companies only, i.e. not all cross-border income flows are coming under their jurisdiction. This applies, for instance, to the removal of tax barriers to the cross-border distribution of profits, which is limited to parent companies that have a minimum holding in a subsidiary from another member state of at least 25%. Furthermore, a number of Commission proposals are still pending, such as the compensation of foreign losses directive, or have recently been withdrawn, such as the proposed interest and royalties directive. Finally, to remove all distortions and create a real level playing field, initiatives like the European company statute and initiatives on the taxation of savings are highly recommendable.

In the past, several attempts have been undertaken to *harmonize the corporate tax system* in the Community. In the report of the Neumark Committee of 1963, it was suggested that the Member States adopt the split-rate system of taxation. However, the Member States did not agree with this proposal and so it was not implemented. A later report, the Van den Tempel report of 1971, suggested the adoptation of the classical system. This system was also rejected by a majority of Member States. Finally, in 1975 the Commission in a proposed directive suggested the adoptation of a partial imputation system (see furtheron). Furthermore, the directive would imply a far reaching harmonization of systems of company taxation and of withholding taxes on dividends. Among others it suggested:

- each Member State would have to apply a single rate of corporate tax to

profits, whether distributed or not;

- the single rate would be in the range of 45-55%.
- distributed dividends would confer a right to a tax credit on any recipient resident in a Member State;
- each Member State would also have to fix a single rate of tax credit attached to dividends distributed by its resident companies;
- the rate of tax credit could not be lower than 45 per cent or higher than 55 per cent of the amount of corporation tax on a sum representing the distributed dividend increased by the tax;
- each Member State would have to impose a withholding tax of 25 per cent on the dividends distributed by its companies, unless the name of the recipient would be known to the tax authorities.

The Commission proposals of 1975 were made at a time in which "Eurosclerosis" made difficult decisions as those on corporate tax regimes impossible and in which the economies of the Community were going through a deep recession. Some Member States feared they would have to increase their corporate tax rates and they were for reasons of competitiveness not in agreement with the Commission proposals. Furthermore, the 1975 proposals dealt with the tax system and the rates only, but left the tax base untouched. The European Parliament at that time argued that harmonization of the corporate tax base should be given preference. The discussions on the proposals therefore continued for many years, and has so far not given rise to a lot of Community action.

Harmonizing tax rates without touching upon the important differences in *tax bases and tax incentives* makes little sense. The tax base relates to the rules that govern the determination of taxable profits. Tax incentives are frequently given through the tax base. Harmonization of the tax base would basically make it inappropriate for Member States to grant tax incentives through the tax base and would only make tax incentives through tax credits or direct subsidies possible.

Efforts to arrive at a comprehensive harmonized set of rules governing the determination of taxable profits in the Community have been fairly disappointing. Ideally such harmonized rules would have to deal with the treatment of depreciations, capital gains, stocks, provisions, value adjustments, overheads etc. and they would also apply to all enterprises regardless of their legal form. The Commission has never produced a comprehensive proposal but instead limited itself to presenting proposals to harmonise parts of the tax base definitions. In 1984, for instance, the Commission proposed a directive on the cross-border compensation of losses.

A final area in which the Commission has been active concerns *tax measures in connection with the liberalisation of capital movements* within the framework of the internal market programme. The liberalisation of capital movements has created greater possibilities for tax avoidance. This is not only true for individual taxpayers who might be able to conceal a part of their taxable income for the tax authorities in the Member State where they are resident, but also for transnational corporations who are able to manipulate transfer prices between subsidiaries resident in different Member States. In the past problems of tax avoidance were usually dealt with through bilateral treaties between the Member States. In 1977 the Council adopted a directive on mutual assistance by the tax authorities of the Member States according to which Member States could exchange information in the field of direct taxation.

The liberalization of capital movements in the internal market has also made it much easier for savers to transfer their savings and income beyond the borders of their resident Member State and to avoid declaration of the interest income to the tax authorities of the resident state. As some Member States do not at all or only levy very low withholding taxes on interest income paid to non-residents, savings could be misallocated as a result of tax-avoiding capital movements. To correct that, the Commission proposed a directive on the introduction of a minimum common withholding tax at a rate of 15 per cent on interest received by Community residents. Alternatively, the receipt of interest payments could, according to the proposal, be notified to the tax authorities of the country of residence.

At the end of 1990, the Commission appointed a Committee of independent experts on company taxation (the Ruding Committee) who were asked to investigate the role of taxation in business decisions with respect to the location of investment and the international allocation of profits between enterprises.[14] Did differences in corporate taxation and corporate tax burdens create major distortions to the functioning of the internal market? The Committee's report was published in 1992. The report found that differences in corporate tax regimes between the member states produced significant distortions of investment and location deci sions and suggested a number of policy recommendations for action at the Community level. In the spirit of the internal market, the Committee argued that Community harmonization should be limited to the minimum necessary to remove discrimination on the basis of nationality and the most important distortions to competition in the internal market. Minimum and not maximum harmonization was deemed appropriate for various reasons, among other, the subsidiarity principle, the requirement that Member States want to retain as much flexibility as possible in their tax systems, the fact that corporate tax harmonization, due to its links with personal taxation, cannot take place in isolation, and the fact that other

federations also have not gone so far as to fully harmonize all taxation in their constituent states.

The recommendations of the Committee (Ruding Committee, pp. 203-219.) were divided into three categories. Firstly, there were measures which related to the elimination of double taxation of cross-border income flows. Secondly, there were recommendations relating to three aspects of the corporation tax, i.e. tax rates, the tax base and the tax system applied. Thirdly and finally there was a recommendation on the use of local corporation taxes on a mixed-basis. To be more specific, the details of the proposed measures included the following:

(1) Measures aimed at the elimination of double taxation on cross-border income flows
   - to broaden the scope of the parent/subsidiary directive. As the scope of this directive varies from one Member State to another, the Committee recommended that the directive be extended to cover all enterprises which are subject to income tax, irrespective of their legal form.
   - a substantial reduction in the participation thresholds prescribed in the parent/subsidiary directive. The directive allowed for elimination of withholding taxes on dividends only when the parent's participation in the subsidiary would exceed 25%. This percentage should be lowered.
   - for shareholders other than parent companies, the Committee recommended a uniform withholding tax of 30% levied at the source on dividends distributed by EC-resident firms.
   - elimination of withholding taxes levied by source countries on interest and royalty payments between enterprises in different member states: the Committee recommended the speedy adoptation of this directive (which was later withdrawn by the Commission).
   - in order to avoid double taxation problems in cases of transfer pricing the Committee recommended that all Member States would ratify as soon as possible the Arbitration Convention.
   - cross-border compensation of profits: the Committee recommended parent companies should have the possibility of offsetting losses which are incurred by subsidiaries in another Member State. For this purpose, Member States are urged to adopt the directive on cross-border loss compensation. In addition to that, the Committee recommended that the scope of this directive be extended, such as to also create the possibility of horizontal cross-border loss compensation, i.e. loss compensation from subsidiaries in one Member State to subsidiaries in another, as well as Community-wide loss-offsetting with groups of enterprises.

(2) Measures relating to tax rates, base and systems of corporation tax. These measures related to the core of Member States sovereignty to set taxes.
- with regard to statutory corporation tax rates, the Committee recommended that a minimum rate of 30% should be set for all Member States, regardless of whether profits are retained or distributed as dividends. In the longer run, the Community could also adopt a maximum rate of 40%. Preferably, this range of 30-40% for corporation taxes should include local corporation taxes, such that the total tax burden on companies does not fall outside the prescribed range. Establishing minimum rates would have as an important advantage that it would reduce the danger of excessive tax competition.
- corporation tax base: the Committee argued that differences in rules which determine the level of taxable profits create distortions which are incompatible with a good functioning internal market. In addition, the Committee maintained that harmonization of tax rates does not make any sense unless at the same time some degree of harmonization of the corporate tax base is achieved. Furthermore, the Committee noted that Member States are increasingly trying to attract businesses through the granting of tax incentives, particularly through the tax base. Therefore, there seems to be an urgent need for some approximation of the rules determining the tax base. This is not to say that the Ruding Committee favoured a complete harmonization, but rather a partial harmonization of those elements of the tax base for which harmonization through market forces will not be effective. In these cases the Committee suggested that the Commission would set some minimum rules or standards. The Committee advocated a piecemeal approach towards the harmonization of the tax base. This implies that separate directives would deal with various aspects of the tax base (e.g., the definition of taxable profits, depreciation rules, tax treatment of intangibles, the tax treatment of leasing, stock valuation, deductibility of occupational pensions, the allocation of headquarters costs, etc.).
- tax incentives: the Ruding Committee noted that Member States are increasingly competing with each other in order to attract new businesses by granting tax incentives, especially through the tax base. Tax incentives that operate through the tax base are usually not very transparent. The Committee expressed a clear preference for using direct and transparent incentives such as direct subsidies rather than using tax incentives through the tax base or tax credits. Furthermore, it was of the opinion that the use of tax incentives should remain limited and should always be accompanied by the use of appropriate "sunset" provisions. However, the Committee at the

same time recognized that tax incentives might be useful and necessary in certain circumstances, particularly when cohesion in the Community would be at stake or whenever the acceleration of economic development in certain regions would require their use.

(3) Local taxes with a composite base: in some Member States (F, D, L, E) some local taxes are levied on a mixed base. Since there is no economic rationale for these mixed bases, the Committee recommends their abolition and suggested that all local business taxes are replaced by an on-profit tax which is levied on the same basis as central government corporation tax.

The Commission welcomed the Ruding Committee's proposals with a substantial amount of reservation and self-containment. The Commission quoted the subsidiarity principle in deciding against some of the recommendations made by the Ruding Committee. In fact none of the Committee's recommendations has been implemented. and it could be argued that the harmonization of corporation tax is in a state of a deadlock. At this moment, 18 proposals relating to direct tax harmonization are still on the Council's table waiting to be adopted, whereas as much as 30 proposals have been withdrawn by the Commission.

4.3.3 Other direct taxes

Above we discussed the harmonization efforts in the fields of indirect taxation (primarily VAT taxes) and corporate income taxation. The EC has been most active in these fields. Apart from import duties, other taxes have not been subject to a large amount of harmonization. This is most notable for payroll and income taxes, where no explicit harmonization efforts have been undertaken. Part of the reason why harmonization has been scarce in this field is that the Rome Treaty provisions for approximation of laws (art. 100) require unanimity. For the other part, the declining share of revenue from taxes on mobile production factors (capital) has forced Member States to try to make up for lost revenue by raising taxes on immobile factors such as labour and land.

However, the payroll and income taxes are subject to the general Rome Treaty rules on prohibition of discrimination on the basis of nationality. This implies that harmonization efforts have primarily been directed at eliminating technical and administrative hindrances to the movement of people within the Community and at avoiding double taxation of citizens.

4.4 THE SCOPE OF TAX HARMONIZATION: ALTERNATIVES

In a federal or multilevel system of government there are several layers of public authority, for instance, regional, state and central or federal governments. Each one of them usually has its own expenditures which are usually financed by central, regional and local taxes. The theory of fiscal federalism deals with the best assignment of governmental functions over the different layers of government. Which fiscal functions should be transferred to the central authority and which ones should stay in the hands of the lower governments? Furthermore, what criterion should be applied to the transfer of responsibilities to different levels of government?

In recent years there has been a renewed interest in this question in several countries (Canada, USA, Belgium, etc.). In many cases the debate has been on the merits of decentralization of government, which is supposed to result in a better and more responsive government, which could contribute to a more effective economic restructuring of the economy by delivering better quality government services. The theory of fiscal federalism tries to provide an economic rationale for decentralizing the fiscal responsibilities among different layers of government. Normally, this theory assumes that the macroeconomic and distributional responsibilities of government are best assigned to the central government. However, that need not be the case with allocational policies.

A well-known paper on the case for decentralization is Oates (1972).[15] According to that author, a basic drawback of a centralized system of government is that the government is insensitive to differences in preferences between local communities. Central provision of public goods is based on a compromise and may therefore result in a too large provision of public goods in some communities and a too small provision in others. Local provision of public goods might remedy this problem of suboptimal provision of public goods. Furthermore, there exists a variety of public goods. For instance, one could distinguish global public goods, regional and local public goods, whose benefits have spatial boundaries, i.e., for local public goods local consumers form an optimal consumption group. If this is the case and if each layer of government would be able to impose benefit taxes on its own citizens, then it would be possible to produce an optimal amount of public goods for each region.

The prescription that the central government should provide only services whose benefits are felt by the entire nation, and that regional services should be provided regionally and that local services should be accounted for locally, may be a difficult criterion to operationalize. The example of street lightning is very illuminating in this respect: its benefits are felt locally, but any stranger who travels in the town will benefit from it. Moreover, it could be argued that,

if a central government would be able to obtain information on preferences for local public goods, it could provide different quantities to different localities and, in principle, achieve an efficient allocation of public goods. Thus, in the real world, regions cannot be delineated precisely for two reasons. First of all, for each regional good there may be spillovers, which means that neighbouring regions will benefit (or be hurt) from activities in other regions. This would call for cooperation among regional governments and could also be a reason to provide financial compensation for benefit spillovers. In principle such compensation could take place without a central government. Secondly, tax payers' preferences in different constituencies usually differ. When individual preferences of tax payers differ and tax payers are not happy with the local supply of public goods, they can "vote with their feet" and are free to move to other constituencies in order to maximize their own as well as social welfare. This is the essence of the Tiebout[16] model. According to this model, people an efficient allocation is achieved if people with similar preferences live in the same jurisdiction. Thus, some jurisdictions will have a larger public sector than others. Therefore if people have different preferences an efficient allocation is more likely to be achieved if public finances are decentralized in a multilevel system. Consequently, too much centralization of public finance would be less efficient than some degree of multilevel finance. The theory of fiscal federalism therefore seems to imply that the larger the geographical distribution of the benefits of goods, the more centralized should its provision be. Higher levels are particularly relevant as public service providers when local levels of governments cannot provide services efficiently themselves (subsidiarity).

The theory of fiscal federalism typically addresses the allocational responsibilities of governments. In fact it assumes, perhaps implicitly, that the distributive and macroeconomic stabilization roles of government are best assigned to the central government. Although the focus on the efficiency of the assignment of fiscal responsibilities to different layers of government has allowed the theory to draw some fairly strong conclusions, ignoring the distributional and stabilization aspects of governmental functions renders these conclusions of smaller value. Nevertheless, the theory clearly limits the scope for centralization of government functions to cases where:[17]

- voters/consumers have homogeneous preferences for public goods among regions. As we saw above, this argument in itself is not enough to defend centralization. Even if preferences are homogeneous, it can still make sense to provide public goods through lower tiers of government if this is more cost effective than centralized provision.
- the existence of regional spillovers. This is by far the most important argument for central provision of public goods. In principle the mutual gains from regional benefit spillovers could be internalized by coordination

and cooperation, and the central government could play an active role by supporting this, for instance through the setting of minimum standards, as well as by determining the legal and institutional framework for such a coordination.

- regional competition for factors of production might cause social disruptions and unrest, for instance through large scale migrations and therefore implies the existence of political costs. A central government could be needed to avoid these social disruptions, for instance by setting minimum standards for the provision of certain public goods. Decentralized coordination of the provision of public goods is usually expensive and could involve high transaction costs. Central decision-making could therefore reduce transaction costs.
- the possibility exists that (a) certain region(s) are have much more influence than others and where powerful regions are able to impose costs on other regions. In that case a central government could be useful to set minimum standards for public goods and engage in redistributive activities on behalf of the weaker regions.
- the lower transaction costs through economies of scale in the provision and financing of public goods.
- lower forms of governments are more likely to respond to political pressure from lobbying groups as they are usually closer to their communities.

The above arguments show that most of the discussion relating to the centralization of government deals with the expenditure aspects of government policy and not with revenue aspects. We should now ask ourselves how centralization of government can be defended from a revenue point of view. In this connection it might use useful to start with Musgrave's (1983).[18] According to this author, the mobility of the various tax bases plays a very important role. In practice this would, first of all, suggest that taxes with highly progressive rates, because of the perverse incentives they might provide for migration between regions, should be levied at the central level. Secondly, taxes on highly mobile tax bases (portfolio capital) should also be levied by the central government because of the possibility of distortions of regional economic activities. Thirdly, tax bases that are distributed in a highly unequal way between regions (e.g. natural resources) should also be levied by the central government, because regional taxation would lead to inequities and could even entail allocative distortions.

In Musgrave's view, regional governments should primarily focus on those taxes whose base cannot be moved. In this case one could think of property taxes and taxes relating to specific regional benefits (user taxes and fees).

Musgrave's views have not gone uncontested. One could, for instance, argue that precisely because some factors of production are mobile, governments are limited in the extent to which they are able to generate redistribution. Tax competition is therefore an effective way to constrain government's taxing and spending behaviour. Furthermore, it is hard to see why regional governments, who should tax immobile tax bases, should not be able to tax natural resources. It is also not immediately clear shy taxing natural resources should lead to allocative inefficiencies and inequities.

In the literature on public finance, several other arguments have been mentioned for (de)centralized tax assignment:

- there is the argument of benefit pricing, which means that each level of government should tax according to the regional distribution of benefits derived from public services. Economic theory maintains that a link between a taxpayer's bill and the provision of public goods is the best way to guarantee efficiency and constrain the size of the public sector.
- there is the Musgravian argument that redistribution is best allocated to the central government.
- according to the tax competition argument, tax bases have become increasingly mobile and the difficulty of imposing local taxes on certain tax bases (portfolio capital) calls for centralization of taxation. Tax competition could in principle be avoided by uniform taxation rates and bases. However, an alternative to that would be tax coordination between regions. This would allow the regions to maintain a certain amount of decentralized tax legislation.
- the regional arbitrariness argument states that some taxes are arbitrarily distributed between regions. This is, for instance, the case with customs duties. Regions that have specialized more than others in foreign trade will usually get most of these duties, irrespective of the final use of the imported commodity. The same is true for agricultural levies and VAT taxes. Regional governments could collect these taxes even though the consumption of the taxed goods takes place outside their jurisdictions. Because the regional apportioning of these taxes is highly unequal, it has been argued that they should be collected by central government.
- the economies-of-scale-in-collecting-taxes argument. There can be significant economies of scale in the collection and administration of taxes. Decentralized tax collection frequently results in higher transaction costs. However, that being the case, central tax administration and collection does not necessarily mean that the proceeds from taxation should be assigned to the central government. In other words, the right to tax and the right to absorb the proceeds of taxation are in principle fully separable.

The conclusion of our discussion so far is that the ideal system of public finance would be some mix of local and central finance and that this mix is to be preferred to either a purely local or a purely central system. This mix would result in better community choice and better services than either a purely local or a purely central system. However, on a priori grounds we cannot answer the quantitative question of how much finance should come from each source. That depends, as we saw above on a host of factors. The mix of local and central finance means that some kind of financial relationship between localities and central government must be established. This relationship can take several forms. First of all, there can be rigid separation of central and local revenue sources. From the administrative point of view this is the simplest system, and would give a maximum of freedom to all levels of authority. A draw back of this system is that it lacks flexibility to meet changes in expenditure and revenue needs over time. In this respect it should be noted that the expenditure needs of one level of government could increase more rapidly than the tax base, which could cause a distortion in the tax mix or might lead to a reduction of expenditures. Also, in case most of the taxes are for local use, unacceptable differences in the spread of tax bases could result. A second type of financial arrangement that is possible between central government and localities is tax sharing. There could be a single tax collecting administration that would levy taxes (for instance, income taxes) that would be set by both the central and the local government and in which the local government could vary its own rates. The local income tax could draw on the same base as the central income tax and the central government would act as a tax collecting agent for the local government.

If local areas are given the freedom to vary their own rates, which are then combined with those of the central government and collected by the appropriate authority, then a "tax jungle" might be created in which the tax base is progressively eroded. This would be particularly problematic if citizens have residence in various areas, or when citizens work in one area and reside in another, or if companies operate in different areas. Thus a machinery for coordination is needed.The tax jungle could either be the result of localities outcompeting each other for giving tax concessions to firms or by not imposing certain taxes because they fear the companies or people move out of their areas.

Apart from the arrangement in which local authorities are free to set tax rates, tax sharing could also be implemented by splitting the tax revenues according to some pre-agreed formula or by employing a system of tax credits. Tax sharing is usually difficult to implement because it needs a substantial degree of consensus between the central government and the localities. Also there is the danger that it destroys the link between taxation and the provision of public goods. However, it should also be said that the economists argument

that a neat vertical distribution of tasks between various levels of government is the most efficient allocation of governmental functions is nothing more than a theoretical construct that could be hard to operationalize.

In addition to arranging the vertical relationships between various levels of government, multilevel systems also have to make arrangements for horizontal distribution of taxes. In the theory of fiscal federalism that problem does not arise as this theory is primarily occupied with allocation issues and therefore favours independent tax policies within different regions. States may be free to vary tax rates and tax bases and are free to give tax concessions to citizens. Taxes are therefore primarily seen as prices for government services. However, in practice taxes are not only used for allocational issues, but also for redistribution. Under horizontal aspects, assigning taxes to regions may have some undesirable effects, as poorer regions have a lower tax base can therefore not supply a sufficient level of public services. This could in turn preserve existing regional disparities and could be considered unfair by the poorer regions. A solution for this problem could be the provision of horizontal grants which could equalize the fiscal position of regions. Grants can be conditional and unconditional, selective or general purpose. General purpose grants are available for spending by the recipient government without any restriction on the destiny. Specific purpose grants are only available for certain types of programmes designated by the granting government.

The above discussion has made clear that the literature on fiscal federalism does not offer anything like a blueprint on the principles of or assigning taxes and on the design of grant systems in multilevel government systems. In stead, the literature on fiscal federalism provides us with relatively simple models, in which considerations of factor mobility, political stability and fairness necessitate horizontal coordination and grants at the regional level, as well as establish the requirement of vertical interaction between various levels of government. As a result, it is impossible to provide a clearcut, neat and tidy allocation of government functions to different levels of authority. Much seems to depend on the particular institutional, political, historical and even cultural setting in a particular federation.

4.5 DISTORTIONS TO BE RECTIFIED BY MEANS OF TAX HARMONIZATION

The European Commission's view is that approximation of taxes is a precondition for the successful functioning of the internal market. In the Commission's view, a single market with the free flow of goods, services and factors of production requires the abolition of fiscal frontiers between the

Member States. The implication of this for indirect taxation is that the destination principle, which requires border tax adjustments and which therefore seem to imply border controls, should be replaced by a system that does not require these controls. This could be achieved by shifting towards a system of restricted origin taxation or a system of origin taxation proper. In addition, since equivalence of origin and destination systems is unlikely to hold in reality because of the rather restrictive conditions under which this result applies, the origin system should be complemented with "approximate" uniformity of rates.

As far as capital income taxation is concerned, the Community's achievements have primarily focused on those elements of Member States' tax legislation that impede intra-Community flows of factors of production, especially those that discriminate on the basis of nationality. The most important impediments in this respect relate to double taxation of cross border income flows between companies and the manner in which corporate and personal incme taxes are integrated (i.e. the tax system).

The Commission has usually expressed desires to go much further in the harmonization of taxes. However, the Commission's views on harmonization/ approximation have not gone unchallenged in the sense that several authors have questioned the need for harmonization, or even approximation. Some of these authors have gone as far as to maintain that the only approximation which would make sense is to have a unified system that allows for differential tax rates. In other words, they believe that unified rates are neither necessary nor desirable. Cnossen,[19] for instance, defends the case of diversity rather than uniformity of tax rates. In his opinion, "far reaching tax harmonization is neither necessary nor desirable" for several reasons. First of all, Cnossen argues that it is not the process of harmonization itself that is significant, but that it is the objective that it tries to achieve that counts. If this objective cannot be defined clearly, it is useless to harmonize taxes. Secondly, Cnossen argues that legal uniformity does not necessarily imply that the actual application of the system is identical. In this respect he quotes the Danish and Italian VAT systems, which are "identical on paper" but which differ greatly in practice. Therefore, even if legal systems are identical, there can be differences in enforcement policies, and uniformity implies that effective enforcement and the method of tax administration are identical as well. Only when the latter two conditions are fulfilled will a guarantee exist that citizens from different Member States pay the same effective tax rates. Thirdly, Cnossen argues that looking at the distortionary effects of individual taxes may be too much of a partial approach to the problem of tax harmonization. In stead it is better to concentrate on the overall effects of taxes and public expenditures (fiscal neutrality of the entire system). In this respect it should be noted that there may be a difference between first-best arguments for tax harmonization and

second-best arguments. In a second-best analysis, a distorting tax differential might very well offset the effects of public subsidies, for instance, to domestic industries or infrastructure expenditures. Similarly, in a second-best analysis one could argue that the harmonization of taxes has gone far enough and that further harmonization of taxes might even create distortions of its own in case not attention is paid to harmonization of direct taxes, particularly corporate tax differences. Fourthly, Cnossen argues that EMU will imply the loss of sovereignty in the macroeconomic policy-making of countries and monetary unification might therefore provide good arguments in favour of fiscal diversity. In addition, this fiscal diversity might also encourage the Member States to proceed more rapidly towards the monetary union. Fifthly, the empirical evidence in existing federations does not seem to indicate that uniformity is absolutely necessary. Many existing federal states maintain diversity in their tax systems. In this respect one could point at the example of the USA or Switzerland. Finally, Cnossen argues that uniformity ignores the fact that countries can have different preferences for particular types of taxes. This is most importantly true for the balance between direct and indirect taxes. In this respect it is well-known that some states have bigger preferences for indirect taxes than others, who wish rely more heavily on direct taxation. In addition to that Member States have different revenue requirements. For instance, the tax burden ratios in some Member States are as low as 30 per cent of GDP, whereas in others they are close to 50 per cent of GDP. EC tax policy harmonization efforts should respect these different revenue requirements, whilst at the same time trying to minimize the distortionary effects of these differences.

Thus a certain amount of tax diversity seems to desirable. However, different tax systems and different tax rates could also result in tax competition between Member States, which could lead to a downward spiral of tax rates and hence of potential revenue. The process of tax competition could make the enforcement of residence based taxes on mobile factors (capital and portfolio investments) impossible, as this would require a substantial exchange of information between the tax authorities of the member states. When the tax competition would be fierce, this would imply that only source-based taxation can be maintained, unless a substantial degree of international harmonization can be accomplished.

Tax competition is usually implemented through tax incentives that are given to firms for new investments. This could result in a drop in tax revenues, at least in the short run. An interesting question is whether these tax incentives work, i.e. do they generate enough new investments? The empirical evidence quoted in the Ruding Report (p. 43) indicates that reductions in statutory tax rates are less effective in generating new investment than accelerated depreciation allowances and investment tax credit. However, even in the case

of accelerated depreciation allowances and in the case of investment tax credits, the empirical evidence seems to indicate that the tax revenue forgone generally exceeds the amount of new investment attributed to the tax incentives.

However, this is not to say that there are no arguments at all in favour of tax competition (see Ruding Committee, p. 151). First of all, tax competition can increase the efficiency in the provision of public goods. In this respect it is argued that when governments compete with each other for attracting resources, residents and trade, lower taxes will improve the performance of firms and therefore attract new businesses. However, this mechanism only works well in case taxes that are paid by the individual taxpayer are benefit taxes, i.e. the price for public services which are provided to them. In other words, this would preclude the use of taxes for income redistribution purposes. Furthermore, it has to be noted that a high provision with good quality public services must be paid by higher taxes. Secondly, tax competition could curtail the influence of special interest groups on government (bureaucrats, farmers, etc.) Thus, it eliminates situations where the government has grown to suboptimal (=too large) sizes.

The above discussion makes clear that a complete unification of domestic tax rates and bases is neither feasible, nor desirable from an efficiency point of view and that efforts aimed at harmonization are best directed at the taxation of international flows of goods, services and factors of production.

As far as the movements of goods and services are concerned, we have concluded that taxation should not interfere with the direction of trade, i.e. it should not result in a distortion of comparative advantage. Both origin and destination taxes could be neutral in this respect and rates need not be identical across regions, although it would be preferable to have a large degree of harmonization as to the system of indirect taxation and the products which are covered under various rates and exemptions.

As far as the taxation of factors of production is concerned, attention should primarily be focused on the more mobile factors of production, in particular capital. For these factors of production, some degree of harmonization of tax rates and bases seems preferable, although strict uniformity does not seem to be a prerequisite for CIN or CEN to obtain, as long as cost differentials between regions exist. What is important though, is that the tax systems avoid double taxation of capital and biases in the direction of particular kinds of sources of finance. As long as differences in national rules do not discourage the movement of individuals and companies from moving from jurisdiction to another, a certain diversity of tax systems and rates seems tolerable. In order to avoid tax wars, governments could decide to set minimum and maximum rates for certain types of taxes, esp. corporation tax.

With this in mind, it seems that the lack of progress in European tax harmonization is something which should not be regretted too much. The experience of the EC has shown that every movement in the direction of tax harmonization which does not respect the diversity of tax systems, is doomed to fail. The need for tax harmonization does, to a large extent, depend on the objectives of integration and harmonization must normally be justified on a case-by-case basis while applying the subsidiarity principle. More specific rules on the extent to which harmonization should be achieved cannot be given by economic theory and will probably vary per country or federation. Many tax harmonization developments in existing federations stem from historical evolution and the institutional peculiarities of every country have produced different degrees of harmonization.

4.6 CONCLUSIONS

This chapter has dealt with the difficult question of how much tax harmonization is necessary on the basis of economic theory and on the basis of experiences of soem existing federations and countries. In summary, once could argue that we have arrived at the following conclusions:

a) that complete harmonization of taxes is impossible.
b) that some diversity in tax systems is good.
c) that some harmonization is good as well.
d) and, finally, that it is impossible to provide exact quantitative measures as to the optimal degree of diversity or harmonization.

Complete harmonization of taxes is *impossible* for a variety of reasons. First of all, complete tax harmonization, at least in the European Community has proven impossible for the very practical reason that tax question require unanimity in the decision making process. As compeletely uniform taxes erode the sovereignty of states and regions, they are very reluctant to completely harmonize their entire systems of taxation. Secondly, the choice of the tax regime in each region/state is determined by different views on the role of taxation in raising revenue and serving as an instrument of economic and social policy (see Ruding Committee, p. 45). In addition to that, different regions/states usually tend to have different ideas as to economic efficiency, fairness, feasibility and acceptance of various taxes and tax measures. Thirdly, harmonizing taxes completety deprives countries of an important instrument of economic policy. In a monetary union this would be unacceptable, as countries have already given up an important instrument of their economic policy, viz. the exchange rate. Fourthly, the empirical evidence on tax policy in existing federations clearly indicates that, even in highly centralized

countries, it is usually impossible to achieve a full-fledged unification of tax systems and rates.

Our analysis has shown furthermore that in order to have tax harmonization it is crucial that one has a concrete idea as to the objective to be achieved. Even if the objective is to have a free flow of goods, services, capital and labour among several regions, than it is still not necessary to completely harmonize taxes. The literature on tax harmonization that we have discussed above suggests that there are two fundamental tax coordination criteria (see Cnossen[13], who calls this Musgrave's fundamental tax coordination criteria). The first criterion is that of fiscal neutrality, which requires that taxes do not distort the relative prices of domestically produced and foreign produced goods and factors of production, and hence that ensure that the free flow of trade and factors is not distorted. In other words, taxes that reverse the flow of trade and factors are considered distortionary and constitute examples of taxes that should be harmonized. The second criterion is that of tax base entitlement, which requires that property rights in the tax bases are clearly established. These property rights should be based either on the residence or the source principle. Both tax coordination criteria do not require a complete harmonization of the tax systems and rates. That is also true of the fairness criterion, which would require a fair distribution of the tax revenues. Fairness coulb probably not be achieved in case of identical tax systems and rates, as it usually demands that stronger shoulders carry heavier tax burdens. Finally, we have argued that different tax rates usually reflect local differences in preferences for public goods between regions. An efficient tax system would allow for these differences in tax rates.

On the other hand, there are also some arguments which require a certain degree of tax harmonization between regions and countries. These arguments, among others, include administrative aspects of taxation, such as differences the enforcement regimes. Tax authorities usually find it difficult to enforce their taxes on activities that are undertaken in other jurisdictions. Hence, a general movement in the direction of source-based taxes would considerably ease the enforcement of tax policies and reduce the cost of such enforcement. Other arguments that were encountered in favour of a certain degree of tax harmonization included the phenomenon of spill-overs, i.e. the situation in which taxes cause externalities in neighbouring states. This is, for instance, the case in the example of cross-border shopping, but also companies decide to alter their location decisions as a result of differences in taxation (i.e. when CEN/CIN does not obtain). There can also be substantial economies of scale in the collection of taxes, which is another argument for centralization.

NOTES

1. T. Westaway, "The fiscal dimension of 1992", in: Dennis Swann (ed.), *The European Single Market and Beyond*, Routledge, London, 1992, p. 82.
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5. MEASURING THE TAX BURDEN: THE LEGAL ISSUES

5.1 INTRODUCTION

5.1.1 Harmonization rules

As described in Chapter 2, the competent institutions in the Historical Territories are empowered to maintain, establish and regulate the tax regime in their territory.

Before going into detail regarding the individual regulations which might be classified as harmonization rules in the EABAC, it should be noted that all these limitations arise in order to delimit the initial freedom of action of the Historical Territories in tax matters. Consequently, the limiting or modulating principles presuppose the existence of powers to which they must be applied.

In short, the general freedom of the Historical Territories to regulate all tax matters is constrained by various regulations aimed at making it feasible for the Basque tax system to work correctly within the general framework of the State.

5.1.2 Harmonization rules and "fiscal competition"

Here is it necessary to undertake what we feel to be an essential reflection before approaching an in-depth study of each harmonization rule. It is beyond doubt that the harmonization rules and the tax regulations in the EABAC have legal standing and seek to regulate relations between the two Administrations in a purely juridical sphere regarding the distribution of powers based on historical and political motives.

However, when analyzing the rules it is necessary to bear in mind that harmonization *per se* is not merely a technical-legal need aimed at making two systems compatible but that it also has a range of implications for the various administrations involved, both directly through tax collection and indirectly through the wealth generated in each territory by the subjects of the taxes.

This background of economic implications must be viewed in the light of the relations between the State and the Basque Country, which are based on

the "unilateral risk" enshrined in the system, as explained above, in the sense that the Basque Administration bears, fully and unilaterally, the risk involved in managing a fully empowered tax and finance administration in its territory.

Accordingly, it is logical that there should be fiscal competition between various regional treasuries since each one will seek to "create wealth" in its territory and increase its tax revenues. European countries have various types of incentivation measures which, apart from being technically correct, are of undoubted interest, e.g. for the installation of business projects. In fact, the European Union has tried by various means to achieve harmonization between direct taxes in its member states, with little success precisely because of each State's interest in maintaining its own peculiarities and, fundamentally, because of the aforementioned economic motives.

Consequently, the fact that the competent authorities in the Historical Territories have regulatory powers raises the possibility of fiscal competition between them and the State Administration, as mentioned above. Hence, the harmonization rules are not only aimed at achieving results which are harmonious on a technical and political plane of making the taxes of both systems compatible; from the State's standpoint there is also the power to establish a distinct "foral" tax regime as a way of entering into fiscal competition.

Accordingly, as we will see in detail, the wording of the harmonization rules betrays the intention to prevent fiscal competition from arising through the powers in the hands of the Basque Country institutions so as to avoid diverting investments, taxpayers, wealth and, in short, tax revenues.

It should also be emphasized that, in addition to the fiscal competition which arises among States, the case of competition between the Spanish State and the Historical Territories of the Basque Country also involves cultural factors which facilitate such diversion.

Thus, in analyzing the various harmonization rules, we will reach the foregoing conclusion, although in principle we could indicate several harmonization rules from article 4 of the EABAC which reflect unilateralness on the part of the State, e.g. rule 12 indicates that the application of the EABAC may not lead to the overall effective tax burden in the Basque Country being *"lower"* than that in the Common Territory (i.e. the limitation is only imposed on the Basque Country), and rule 11 does not allow the regulations of the Historical Territories to "reduce the possibilities for business competition .."; it would appear that the State *would* be permitted to do so. Moreover, the second rule orders the tax system not to adopt measures which discriminate against investments on the basis of their place of origin.

One can practice a *reduction ad absurdum* of the meaning of the harmonization rules which relate to the diversion of investments as a result of the Basque Country's tax regulations. Let us take the following case:

- Identical corporation tax in the Common Territory and in the Basque Country.
- The State finances a port in Bilbao (Basque Country) and not in another city outside the Basque Country.
- An analysis of investment decisions reveals that a number of businesses have invested in the Basque Country solely because of the proximity of a port.

In this case, investment decisions have been affected by expenditure made by the State itself, and no one objects, nor does it contravene any regulation. That is to say, the scope for the Basque Country institutions to affect investment location using their own powers is limited, but there is no limit on the possibility of doing so using the expenditure of the State.

Similarly, this type of idea in the harmonization rules can also be taken to the absurd in connection with the unilateral risk:

- If the Basque Country reduces its taxes and collects less in revenues, because of its financial autonomy it will have less to spend. If this lower expenditure means less infrastructure, then the investment decision will be affected, on the one hand, by lower taxes and, on the other, by poorer infrastructure. Accordingly, the net effect on the decisions should balance out, since the impact of lower taxation would theoretically be offset by other countervailing factors.
- The opposite case would be where, as above, we are dealing with investment decisions based exclusively on the existence of a port in Bilbao, and corporation tax is the same in the Common Territory as in the Basque Country, or is even higher in the latter, and the competent institutions of the Basque Country are the ones financing the port in Bilbao.

  That is, the Basque Country would be allowed to affect business location decisions by higher expenditure, but not by lower revenues; this is, in principle, surprising, to say the least.

  Although the LOFCA contains similar rules to avoid situations of fiscal competition on the basis of the regulatory powers devolved to the Autonomous Communities, we consider that the foregoing comments regarding the Basque Country are not applicable in that case since the system of financing these Autonomous Communities does not involve the characteristic of "unilateral risk", which is the key factor in the foral economic system.

  Note, however, that the impact of any measure of this type must be viewed in the long term, since the immediate effect is not significant.

Despite the aforementioned cautionary measure adopted by the Central Administration in recognizing the taxation powers of the Basque Country institutions, we will try to seek practical applications for the various harmonization rules analyzed here since they are the positive law which are the object of this book. However, the foregoing reflection should be borne in mind when interpreting the harmonization rules.

5.1.3 Classification of the harmonization rules

The harmonization rules will be classified on the basis of their general or specific scope, distinguishing between two major groups:
- Harmonization rules which relate to the tax system as a whole *(general harmonization rules).*
- Harmonization rules relating to specific taxes or components of the tax system *(specific harmonization rules).*

5.1.4 Approach to the analysis of the harmonization rules

In analyzing the harmonization rules, out of the various interpretations which can be given to the rules, only those which give content to the EABAC as a whole and to each individual rule in particular, and which allow a "fair solution"[1] in each case, will be considered valid, since otherwise the EABAC would be meaningless.

Note also that an in-depth analysis of the harmonization rules contained in the EABAC is, if anything, even more complex due to the fact that the Agreement has not been expanded in detailed regulations.

In this respect, as well as conducting a detailed analysis of the rules contained in the aforementioned chapter 4, which are defined explicitly as harmonization rules, this chapter will also examine other provisions of the EABAC which we consider to have a similar goal.

5.2 SPECIFIC RULES

5.2.1 The General Taxation Law and the regulations implementing it shall be applied as a means of co-ordination, as regards systematics, terminology and concepts, wherever it does not clash with the specific provisions of this Law (art. 4.1)

The wording of the regulation leads to the conclusion that the existence of the General Taxation Law ("Ley General Tributaria – LGT") should not imply that the Basque Country Institutions do not have the power to issue their own Basque General Taxation Regulations.

The conclusion as to the scope affected by this rule is as follows:

- The application of the General Taxation Law does not imply any limitation on the contents of each General Foral Taxation Regulation or of those aspects of the General Taxation Law which are not systematics, terminology or concepts.
- These aspects bind not only the content of any future Basque General Taxation Regulation but also of the whole body of regulations issued by the Institutions of the Historical Territories under their sovereign powers in tax matters.

This conclusion, with respect to the first point cited above, is backed by the Basque High Court of Justice Ruling dated 21 October 1993, which states as follows:

> "... and, therefore, *the legislator of the Foral Treasury is fully empowered to establish his own*, as the Vizcaya Foral Treasury has done in this case, and this Court finds that does not in any way contravene article 4.1 of the Agreement Law since the latter refers to the application of the General Taxation Law as a means of co-ordination as regards systematics, terminology and concepts whereas, in the case at hand to which this ruling refers, the aforementioned regulation of the system of payment has no connection with the co-ordination of the concepts, terms and systematics of the General Taxation Law."

Therefore, the regulations issued by the Basque Country do not have to adhere to the General Taxation Law as a whole but only as regards the structure of the various taxes, the terms and their meaning, in line with the definitions in the General Taxation Law itself.

It should be borne in mind, in any event, that this harmonization rule is practically observed at all times, since the systems and terms used in all European countries are very similar.

However, the importance of this principle should not be underestimated in that it implies the use of the same "language" in the Common Territory (defined in the General Taxation Law) and in the Basque Country (which must respect the "language" of the General Taxation Law).

5.2.2 The same withholding tax rates shall be required for personal income tax and corporation tax as in the common territory

Firstly it is necessary to define the term *withholding*. In Spanish tax law, withholding is a concept included under the heading of tax prepayments, and this heading comprises withholdings per se, payments on account and fractionated payments.

It could be said that a literal interpretation of article 4.3 of the EABAC would lead to the conclusion that, although it is not possible to apply different withholding rates, it would be possible for an entity with tax sovereignty to subject certain income to withholding and exempt other income without breaching the aforementioned rule.

This purely grammatical interpretation could be refuted from a logical and systematic analysis of the precept. That is to say, if the idea is to harmonize, it does not appear logical to limit the rates to be applied to a particular event (withholdings, in this case) but not to limit when that event, or other events or elements which might affect the resulting tax debt (e.g. rebates), should exist.

Accordingly, the Basque High Court of Justice ruling dated 21 October 1993 stated that the set of regulations on withholdings should be the same in the Common Territory and in the Historical Territories, and annulled the Eight Additional Provision of Basque Regulation 11/1990, which extended the exemption from withholding provided in article 8.1 of Basque Regulation 7/1985 (which governed the Tax Regime of certain Financial Assets) to the financial assets regulated by Foral Decree 109/1990, dated 25 September (the so-called "Basque bonds").

The Court stated literally that "in this connection, article 4.3 of Law 12/1981 governing the Economic Agreement is tremendously clear, 'the same withholding tax rates shall be required for personal income tax and corporation tax as in the common territory', whereas article 8 of Law 14/1985, governing Financial Assets, establishes the cases of non-withholding, which do not include the Foral Bonds, which means that the Foral Territories cannot by themselves establish a (non) withholding on Foral Bonds, thus exempting from withholding a case not envisaged in the *common legislation which, under art. 4.3 of the Agreement, must be equal to the Foral* (legislation)."

Finally, we come to the following question: what is the underlying reason

whereby in principle, based on the generally established harmonization rules, it is possible to establish different rates for final taxation under personal income tax and corporation tax, but it is not possible to establish different withholding rates?

The explanation must be sought in the meaning of withholdings as a payment on account of the final tax settlement. Since a withholding is a tax payment on account of the final tax of the subject from whom the tax is withheld, it is logical to apply the regulations (foral or common) which cover the taxable subject, regardless of the identity of the payer. It is also necessary to take account of the various handles applicable to the payment of the withholding by the withholder.

Finally, it should be considered that withholding tax and similar are accessory to personal income tax and corporation tax and it would be logical, beyond the provisions of positive law, for regulatory powers over the tax to extend also to the withholdings on account of same.

Nevertheless, if the Historical Territories were given total powers to regulate withholdings, this could create extraordinary technical complications. If the handle were taken to be the payer's place of residence, additional precautions would have to be taken to prevent companies from establishing fictitious domiciles in the Basque Country if the withholding rate there were lowerthan in the Common Territory; if the handle were taken as the recipient's domicile, there would be many complications arising from the payer's having to ascertain the domicile of each of the recipients.

5.2.3 Under property tax, the same definition shall be adopted for the taxable event and the same criteria shall be used to value rural and urban property as are established in the common territory

For these purposes, the Provincial Governments shall designate representatives in any commissions created in the Ministry of Economy and Finance to establish the aforementioned criteria (art. 4.4.1)

5.2.3.a) Powers of the Historical Territories

This harmonization rule refers to a tax which is covered by a specific provision of the EABAC, namely article 41:

> "The property tax shall be regulated by the rules dictated by the competent authorities of the Historical Territories and shall be levied on urban and rural properties located in their respective Historical Territory."

Considering the two provisions (articles 4.4.1 and 41 of the EABAC) it is possible to state that the general principle is one of vesting full powers over this tax in the competent institutions of the Historical Territories, apart from what is expressly provided in the aforementioned harmonization rule, namely the taxable event and the valuation methods.

5.2.3.b) Ultimate meaning of the rule

The competent institutions of the Historical Territories could, while adopting an identical definition of the taxable event and maintaining the same valuation methods, exempt any particular case or tax it more heavily than in the Common Territory.

Accordingly, we need to seek a different justification for this harmonization rule, outside the sphere of property tax itself. The idea would be to find the impact on other taxes of the taxable event under property tax and of the related valuation methods.

5.2.3.c) Correction of the ultimate meaning of the rule

This tax is governed by Local Finance Law 39/1988, which defines the taxable event and takes the taxable base to be the cadastral value of the property.

That is to say, the *cadastral value* of the property is taken as the basis for valuation, which is obtained using the *criteria* established generally in the Common Territory.

Thus it is necessary to trace the link between the taxable event under property tax and the related valuation methods with other taxes which may be of major importance, in terms of revenues, in the tax system as a whole, so as to find some justification for the harmonization rule at hand.

The cadastral value of property has an impact on other taxes which are much more important in the tax system, namely wealth tax and, most importantly, personal income tax, which could justify the existence of a harmonization rule like the one in article 4.4.1 of the EABAC.

5.2.4 For tax purposes, the same classification of business activities as in the Common Territory shall be used, without prejudice to their being broken down into greater detail by the competent institutions of the Historical Territories (art. 4.4.2)

It is clear what this rule seeks to harmonize: the classification of business activities. This is the name given to the regulation approved by Royal Decree 1.560/1992 which has no counterpart in the Basque Country, since it is a statistical regulation, an area in which article 149.1.31 of the Spanish Constitution grants exclusive powers to the State ("statistics for State

purposes").

Nevertheless, since the harmonization rule qualifies this by saying "for tax purposes", the meaning of this rule might arise from the fact that, although the Basque Country does not have powers in the area of statistics, insofar as a tax regulation (specifically, the tax on business activities) might modify the use of this classification for tax purposes (given the Basque Country's sovereignty in tax matters), the EABAC seeks to preserve intact the State's exclusive domain in statistical matters, ensuring that a classification is used from which the State can obtain data which are comparable with those obtained for the Common Territory.

Hence, this rule must be linked to the tax on business activities, albeit not to the substance of this tax, since article 42 of the EABAC establishes that:

> "1. The tax on business activities shall be regulated by the rules issued by the competent institutions of the Historical Territories."

Therefore, the meaning of the rule would be that, although the Basque Country has taxation powers to establish the regulations governing this tax, it does not have the power to establish the classification on the base of which the tax is assessed, which is also used for statistical purposes, and this facilitates the compilation of data for these purposes by the Central Administration, thereby respecting its exclusive competence in this area.

Additionally, it should be noted that the rate established in this tax has an impact on other taxes, mainly personal income tax and value added tax, which would reinforce the need for this harmonization rule; however, those taxes could cease to refer to the rates of the tax on business activities.

5.2.5 The acts of incorporation, increase and reduction of capital, transformation or dissolution of companies shall be subject to the same taxation as in the common territory (art. 4.6)

To begin with, we will abbreviate the excessively wordy list of events covered by this rule to the term "corporate transactions".

Delimitation of the "acts"

The fact that this rule focuses on the taxation of certain acts clearly limits the precept to the indirect taxation of same.

The contrary would involve a breach of the letter and the purpose of the rule, since the latter would appear to be related to the State's exclusive powers in the area of mercantile legislation (article 149.1.6 of the Spanish Constitution), and it does not appear to be particularly meaningful to separate the revenues

generated by this type of transactions entirely from the Autonomous Community legislation (e.g. corporation tax), since this would imply that the powers of the Historical Territories in this area, which are expressly recognized in the EABAC, would be meaningless in practice.

The idea behind having these corporate transactions taxed in the same way in the Common Territory and the Basque Country may arise from the possibility of shifts, i.e. that, for tax reasons, they might not take place in what would otherwise be their natural location.

Nevertheless, if the applicable regulation is determined using the same handle as is contained currently in the EABAC regarding collection (articles 30.5 and 30.6 relate to the corporate domicile and fiscal domicile as handles), then the effect would not be a fictitious "shifting" of the locus of these corporate transactions (since that locus would not affect the applicable legislation) but, rather, a fictitious shifting of corporate domiciles to the Basque Country or to the Common Territory.

The requirement that these acts be taxed identically is, as stated before, "harmonizing", whereas any attempt to ensure that the indirect taxation arising as a result of the performance of these acts were equal would be "unifying", as well as a breach of the letter of the rule.

5.2.6 The tax regularizations or asset revaluations which the Historical Territories may decide upon shall not imply the incorporation of hidden assets or the elimination of fictitious liabilities (art. 4.9)

5.2.6.a) Accounting outlook on the harmonization rule

Article 38 of the Civil Code establishes that, apart from exceptional cases "fixed and current asset items shall be accounted for at acquisition price or production cost."

Since there is no monetary stability, the items comprising companies' balance sheets are recorded at different values depending on when they are entered, and this leads to tax consequences which imply greater taxation of companies than that resulting from their economic capacity.

Accordingly, to correct this type of imbalance, tax measures have been designed to avoid taxation on capital gains of a purely monetary nature; the most long-standing method is the revaluation, which consists of applying a coefficient, established for each year, to the cost and depreciation of the revalued assets; the aim is to reflect the effect of monetary depreciation over time, and a reserve (equity) is recorded for the difference between the net book values before and after the revaluation, which has full tax effects apart from the capital gain thus obtained, which is exempted.

5.2.6.b) Content: powers of and constraints on the Historical Territories

The literal wording of article 4.9 of the EABAC clearly establishes the powers of the competent institutions in the Historical Territories to issue asset revaluation rules, the only limitation being that they may not incorporate hidden assets nor eliminate fictitious liabilities. Section Four of Chapter One of the EABAC, which covers corporation tax, includes no additional limitation in this area.

Additionally, Section Two of Chapter One of the EABAC establishes with respect to personal income tax that "the competent institutions of the Historical Territories may maintain, establish and regulate, within their territory ..., the regularization or revaluation of the values of fixed assets associated with the conduct of business, professional or artistic activities" (article 7.5.a of the EABAC).

Nevertheless, unlike the case of corporation tax, revaluations for personal income tax purposes relate only to fixed assets and, therefore, cannot apparently include current assets.

In conclusion, the Historical Territories have powers in this area, subject to no specific limitations other than those contained in the harmonization rule in article 4.9 of the EABAC and that indicated in the preceding paragraph.

5.2.6.c) Practical implementation of the powers of the Historical Territories

In implementation of their powers as set out in the EABAC, the competent institutions of the three Historical Territories issued asset revaluation regulations in 1990, which were not matched by the State at the time.

Although these regulations did not imply the incorporation of hidden assets or the elimination of fictitious liabilities, the State Administration appealed against them in the courts on accounting grounds, claiming that the application of these tax regulations would lead to infringement of mercantile regulations.

The Basque Country High Court of Justice found for the Historical Territories. Below are described the content of the related court rulings, basically the Basque Country High Court of Justice ruling dated 21 October 1993 regarding the Vizcaya Historical Territory asset revaluation regulation dated 21 December 1990.

The State Administration based its appeal on the claim that the aforementioned Vizcaya regulation on asset revaluation breached certain accounting rules since it did not respect the general principle of valuing asset items at acquisition price or production cost. In this connection, in support of its claim the appeal cited the related articles of the Commercial Code, the newly consolidated Companies Law ("Texto Refundido de la Ley de Sociedades

Anónimas") and even the 4th Company Law Directive.

The articles cited by the State Administration in its appeal included article 38 of the Commercial Code, which establishes that "the valuation methods shall not vary from one year to the next" and, additionally, that "the fixed and current asset items shall be recorded ... at the acquisition price or production cost." The appeal also cited articles 195 and 196 of the Companies Law in this connection. This argument, plus the State's exclusive powers in mercantile legislation, formed the grounds for the appeal.

It is appropriate to transcribe the words of the High Court in this point of its Ruling to the effect that, whereas the literal wording of the legal texts cited above implies that "the valuation of companies' asset items must be made according to their acquisition price, or production cost, ... , it is no less true that all of the regulations cited are strictly mercantile in nature, which in no way impedes the tax legislation being appealed, all the more so considering that the (consolidated) Companies Law itself provides ... the possibility of a different valuation of assets items, for purely accounting purposes and for tax purposes, which difference must be reflected in the notes to the financial statements, according to the Law."

In any case, if the literal wording of the rule in article 4.9 of the EABAC states clearly that the competent institutions of the Historical Territories can issue asset revaluation regulations but this is deemed to be an encroachment of powers reserved exclusively for the State in mercantile matters, the conclusion is that the harmonization rule is empty in practice since it allows certain actions which, in practice, are impossible to take. This would doubly detract from the content of the EABAC: firstly, as regards the scope for action by the Historical Territories and, secondly, by establishing a harmonization rule which is meaningless, since it is useless to establish limitations on powers which do not exist.

In 1996, asset revaluation regulations were issued for companies under the State legislation and those under the Basque legislation. There are certain differences between the two regulations, most notably the inclusion by the State of a 3% charge on the credit balance of the revaluation reserve; the Foral Territories omitted this charge, and their regulation has been appealed by the State Administration.

5.3 GENERAL REGULATIONS

5.3.1 Attention to the State's general taxation structure (art. 3.1.2)

5.3.1.a) Historical approach

None of the previous Agreements contained a rule of this type. However, it can be deduced in all the Agreements (despite the recognition of the taxation powers of the Basque Country's Provincial Governments) that the system which they introduced would presumably be the same as in the common territory.

5.3.1.b) Significance of the rule beyond the constitutional system

The question arises as to what is meant by the phrase "general taxation structure". If it refers to the basic principles established by the Spanish Constitution, then the precept is meaningless since respect for the basic general constitutional principles is implicit in the system of the EABAC because of its origin, as has already been discussed.

Consequently, the harmonization rule must have some broader meaning. Intuitively it can be seen that attention to the general structure implies maintaining a direct tax on individuals, another direct tax on legal persons and a general indirect tax on consumption as the basic pillars of the system, although the foregoing should be qualified with the meaning of the two essential words in this rule:

- "Attention", which means having regard to or *taking into account*. That is to say, it does not mean that it must be "followed" or "respected", merely that it must be taken into account.
- "Structure" is defined as the distribution and order in which the parts of a whole are configured.

This, plus the location of the rule among those which must be respected by the Basque tax system, implies that this is something ethereal, particularly considering that the general tax structure and the tax culture have always been the same, and that this structure is imposed, to an extent, by the economic situation, which is an international situation in which everything is interrelated (note the similarity in tax structures in Spain's European neighbours). It could be concluded that it is practically impossible to breach this rule.

5.3.1.c) Original power to levy taxes by Law

It should be noted at all events that the question raised by this harmonization rule is non-trivial since, under article 133.1 of the Spanish Constitution, *the original power to establish taxes is vested exclusively in the State through law.*

Since the EABAC is a law issued by the State (the Parliament, as

expression of the people's sovereignty), regardless of whether or not it is a pact, and, since the EABAC itself (article 2) grants taxation powers to the competent institutions of the Historical Territories, it cannot be argued that these institutions cannot in any case establish taxes on grounds that the regulations they issue are Basque Territory regulations, which do not have the status of a law.

There is another route for interpretation, namely that the system of sources established in the Spanish Constitution is not applicable to the Basque Country's tax system. The proponent of this theory justifies it on two grounds. Firstly, on the basis of the First Additional Provision of the Spanish Constitution, which supports and respects the historical rights, of which the Agreement system is one; accordingly, the Constitution itself respects the Basque Country's system of sources of tax law. the second argument is that *the question is not to apply the system of sources of law from an organic and formal standpoint but, rather, to interpret that system from a material perspective, i.e. considering the areas which the Constitution itself reserves to the law, regardless of the fact that, in the case of the Historical Territories, it is not approved by Parliament in an organic sense nor through a law in a formal sense.*

Here lies the importance of this harmonization rule, in that it can be inferred that the Institutions of the Basque Country's Historical Territories have the power to create taxes. This qualification with respect to the State's tax structure is essential in that, in addition to that capacity to establish taxes without limits which was cited at the beginning of the commentary on this rule, it is recognizing the possibility for the Institutions of the Basque Country to establish taxes *ex novo* (contrary to the theory that the Institutions of the Historical Territories cannot establish taxes since the regulations they issue do not have the rank of laws), for which reason proponent of this theory considers it advisable to establish a harmonization rule in this connection to limit the aforementioned.

Lastly, recall in this respect that the Autonomous Communities have the power to establish their own taxes, as recognized in article 157.1.b of the Spanish Constitution and reiterated in article 4.1.b) of the LOFCA.

Having determined the existence of the power to establish taxes, it should be examined whether the opposite power, namely the power to eliminate taxes which exist in the State legislation, should also be included in the normative powers of the competent Institutions of the Historical Territories, which will also be affected by the duty of submission to the State's general tax structure.

5.3.2 Submission to the International Treaties or Conventions signed and ratified by the Spanish State or to which the latter adheres (art. 3.5)

5.3.2.a) Definition of International Treaty

The definition contained in article 2.1.a) of the Vienna Convention reads as follows: "an international agreement entered into in writing between States and governed by International Law, whether it be in a single instrument or in two or more common instruments and regardless of their particular denomination."

5.3.2.b) Its nature within domestic legislation

Regard should be had to article 96 of the Spanish Constitution, which establishes that "validly arranged International Treaties, once published officially in Spain, *shall form part of domestic legislation*. Their provisions may only be derogated, modified or suspended as provided in the Treaties themselves or in accordance with the general rules of International Law.

That is to say that, once they are published, International Treaties become obligatory in Spain since they become part of internal legislation. But, what rank do they have? Since they cannot be rendered inapplicable by a modification of their content through a domestic regulation, even if the latter is a law, the only option is to resort to the principle of competence: what is regulated in an international treaty becomes part of the latter's scope and is not open to modification by domestic legislation.

Accordingly, the conclusion is that this rule in the EABAC merely reiterates the fact that the regulations issued by the Basque institutions are subjugated to international treaties insofar as the latter are a source of legislation which is obligatorily applicable in Spain. In principle, it does not appear necessary to include this text in the EABAC, since it has been established on a constitutional plane that the EABAC is fully subject to the Spanish Constitution, which is the origin of the entire system.

5.3.2.c) How EU Directives are binding on the Basque Country's institutions

The question arises (to which we do not seek to provide a hard-and-fast solution, but which we feel needs to be raised) as to how the content of Directives binds the institutions of the Basque Country.

Firstly, we should note that the Constitutional Court has repeatedly stated that the execution of Community law is the responsibility of the party materially holding power under internal law, since there is no specific power of executing Community law.[2] This reasoning is based on the fact that the execution of international treaties and conventions, where they relate to items

under the power of the Autonomous Communities, does not imply the attribution of new powers over and above those held under other precepts.[3]

Additionally, the State cannot make use of its exclusive powers in the area of international relations to extend its powers to all activities comprising an implementation, execution or application of international treaties and conventions and, in particular, European community law.[4]

Accordingly, it is the competent institutions of the Historical Territories which are responsible for complying with Directives with respect to devolved taxes, and they need not execute Community law in the same way as in the Common Territory since, as they are dealing with taxes subject to Autonomous Community legislation, the power to execute these "international obligations" in the area of the Basque Country lies with the institutions of the Historical Territories, and they may use methods which differ from those used in the Common Territory provided that they achieve the result sought by the Directive. This was accepted by the Basque Country High Court of Justice in a ruling dated 11 May 1994 regarding a case where a Directive of the Council provided the possibility of establishing a system of exemption or imputation in order to achieve the stated purpose.

However, if the institutions of the Basque Country maintain their taxation powers even in the case of transposition to internal law of the contents of Community Directives, then the Central Administration will be the sole interlocutor of the Community authorities as regards the effective compliance with Community stipulations, and the latter is hard to measure as regards its practical consequences, since it may be satisfied through various formulae or methods, and not necessarily by attributing competence in compliance with Community law to the State Administration.[5]

It follows, therefore, if the Basque Country would be obliged to adopt the necessary measures to execute a given Directive (even though the party directly responsible before the European institutions would be the Spanish State), and if it transposed Community legislation incorrectly, it would be obliged to do so correctly, since the primacy of Directives over internal legislation refers not only to cases of failure to transpose their content into the internal legislation but also to cases of transposition not in accordance with the Directive, as the European Court of Justice has found.

Nevertheless, the Spanish Supreme Court[6] has stated that it can only control the legality of internal legislation issued in implementation of a Directive which is below the rank of a law since, otherwise (i.e. if it has the rank of a law), its conformity to the Directive cannot be controlled. Although expert opinion finds the Court's justification of this position somewhat strange, since article 1 of the Law on the Administrative Appeals Jurisdiction (which is what prevents laws from being controlled by judicial bodies) should be interpreted in accordance with the Directives (this refers not only to the

regulations subsequent to the community *acceuil* but also to those which predate the latter), the Court's position stands.

Additionally, the Constitutional Court[7] has stated that an alleged contradiction between treaties and subsequent laws or other provisions is not a matter affecting the constitutionality of the latter to be resolved by the Constitutional Court; rather, it is purely a question of selecting the legislation applicable to the particular case, which must be resolved by the courts with jurisdiction in that matter.

Therefore, although it may be difficult to control the conformity of the State laws to Directives, this is not the case with regulations issued by the institutions of the Historical Territories of the Basque Country since, as they do not have the category of laws, their effective compliance with the provisions of the EU Directives can be controlled in any case by the courts.

5.3.3 Respect for solidarity in the terms provided in the Constitution and in the Statute of Autonomy (art. 3.1.1)

5.3.3.a) The principle of solidarity in the Spanish Constitution

Various articles throughout the Spanish Constitution make reference to this principle, indicating thereby the particular value which it receives in what is Spain's highest legal precept.

The vagueness of the term solidarity, which would qualify as what expert opinion and court precedents have described as an "indeterminate juridical concept", does not in any way mean that it is not obligatory, but it would need to be defined positively in line with the circumstances of the time when it is to be applied.

The articles of the Constitution which refer to the solidarity principle are as follows:

Article 2

> "The Constitution is based on the indissoluble unity of the Spanish Nation, the common and indivisible fatherland of all Spaniards, and it recognizes and guarantees the right to autonomy of the nationalities and regions comprising it and the *solidarity* among them."

The fact that the concept of solidarity is introduced immediately after recognizing the right to autonomy highlights the fact that the two are indissolubly linked. It would not be possible to conceive of the right to autonomy for the various nationalities and regions without considering the need for solidarity in order for the system to work and for the interterritorial

imbalances to be corrected.

Nevertheless, although the principle of solidarity is mentioned in a situation of apparent equality with that of autonomy, it is autonomy which is the fundamental principle being recognized, and solidarity is a necessary corollary of the latter in order for the system to develop harmoniously.

We consider that the two principles are fundamental and that the exercise of the right to autonomy would not be feasible if there were nothing to introduce elements of solidarity into the system, without forgetting that these elements would be introduced to permit the appropriate exercise of a right which is acknowledged and guaranteed.

Article 138

> "1. The State guarantees the effective realization of the principle of *solidarity* enshrined in article 2 of the Constitution, fostering the establishment of an appropriate and fair economic balance between the various part of Spanish territory."

In this case, the reference to the principle of solidarity is contained in Title VIII of the Constitution, entitled "*The Territorial Organization of the State.*"

Article 156

> "1. The Autonomous Communities shall enjoy financial autonomy to develop and execute their powers subject to the principles of co-ordination with the State Treasury and of *solidarity* among all Spaniards."

This precept, which was discussed in the context of autonomous community financing in general (section II.3) enshrines the principle of financial autonomy for the Autonomous Communities and then lays down the principles which the Autonomous Communities must adhere to in developing the powers deriving from this general principle.

Article 158

> "2. In order to correct interterritorial economic imbalances and to make the principle of *solidarity* effective, a Compensation Fund shall be established for investment expenditure, whose funds shall be distributed by the Parliament among the Autonomous Communities and provinces, as appropriate."

Like the foregoing article 156, this article is part of Title VIII, which relates to the Territorial Organization of the State, and it provides a mechanism which seeks to make the principle of solidarity effective.

5.3.3.b) The principle of solidarity in the Basque Country's Statute of Autonomy

Here we cite the reference to the principle of solidarity in the Basque Country's Statute of Autonomy (article 41.2.f):

> "The Agreement system shall be applied in accordance with the principle of solidarity referred to in articles 138 and 156 of the Constitution."

5.3.3.c) The principle of solidarity in the LOFCA

The principle of solidarity referred to in the foregoing articles of the Spanish Constitution, the Basque Country's Statute of Autonomy and the EABAC is also contained in article 2 of the LOFCA (Organic Law for Financing the Autonomous Communities), which indicates the principles which must govern the exercise of financial autonomy by the Autonomous Communities.

> "1. The financial activity of the Autonomous Communities shall be exercised, ..., subject to the following principles:
>
> c) The *solidarity* among the various nationalities and regions which is enshrined in articles 2, 138.1 and 138.2 of the Constitution."

Regarding the scope which the LOFCA seeks to give to the principle of solidarity, it could be considered to relate both to the redistribution mechanism (which takes the form of the Interterritorial Compensation Fund) and to the guarantee of a minimum level of fundamental services in the various Autonomous Communities. Both aspects, which are envisaged in the Spanish Constitution, are implemented in articles 15 and 16 of the LOFCA.

In principle, the application of the LOFCA to the Basque Autonomous Community is greatly limited. For example, the First Additional Provision of the LOFCA reiterates that the Basque Communities shall be governed by their own regimes, specifically the Economic Agreement in the case of the Basque Country.

Nevertheless, certain provisions of the LOFCA might be applicable to the Basque Country to the extent that they do not clash with the provisions of the EABAC, i.e. on a subsidiary basis. Accordingly, the principle of solidarity is one of those which are generally applicable to all the Autonomous Communities in the State, particularly considering that it is enshrined in the Constitution, and that the LOFCA refers directly to the related articles of the Constitution.

5.3.3.d) Content of the solidarity principle

The basic idea of the solidarity principle is to correct interterritorial imbalances between the wealthier Autonomous Communities and those which are less fortunate, and to ensure that they all develop in the most harmonious possible way.

Continuing with the scheme proposed by Castells[8] which, in our opinion, links with the provisions of the LOFCA, we consider that solidarity will be effectively implemented through:

- The system which guarantees a minimum level of basic public services in all the Autonomous Communities.
- The Interterritorial Compensation Fund, which finances investment in the less-developed territories.

i) The minimum level of basic services

Considering the first meaning of the principle of solidarity, as set out above, article 15 of the LOFCA states as follows:

> "1. The State shall guarantee the minimum level of basic public services under its control throughout Spanish territory.
>
> 2. When an Autonomous Community ... cannot ensure a minimum level of provision of the set of basic public services which it has assumed, a supplementary assignment shall be made in the General State Budget, specifying its destination, whose purpose shall be to guarantee the level of these services in the terms of article 158.1 of the Constitution."

This reference to the minimum level of services is a faithful reproduction of the contents of article 158.1 of the Spanish Constitution.

> "1. The General State Budget may establish an assignment to the Autonomous Communities depending on the volume of State services and activities which they have assumed and on the guarantee of a minimum level of basic public services under its control throughout Spanish territory."

Although this meaning of the principle of solidarity is enshrined in the Constitution and implemented, to an extent, in the LOFCA, it is extremely complicated to define its true scope and significance and the possible mechanisms for putting it into effect.

To date no agreement has been reached which allows this mechanism for balancing public services to be implemented in practice. Although the matter has been discussed at great length and working groups have even been formed

to report on the matter, there are still no satisfactory solutions for putting it into practice.

In fact, it is even questionable whether this levelling mechanism is not merely the Autonomous Communities' participation in the State's revenues, but we are inclined to think that this is not the case, although, to a degree, the guarantee of sufficient funds is implemented through the distribution of the State's revenues to the various Autonomous Communities in general.

Accordingly, the provisions of article 158.1. of the Spanish Constitution and of article 15 of the LOFCA probably refer to an exceptional mechanism solely for application in cases of substantial failure of what might be termed the ordinary systems of financing. The aforementioned working group, which was formed at the proposal of the Council for Fiscal and Finance Policy, went so far as to say that: "if the normal financing is reasonably designed, it is impossible for circumstances to arise in which article 15 would come into effect."[9]

On the basis of the foregoing, if it is assumed that those provisions of the LOFCA (which are backed by the Constitution) are applicable to the Basque Country, they might be applicable only in the event of a major breakdown in the financing system under the EABAC, and no such case has arisen to date.

ii) The Interterritorial Compensation Fund

Under the second meaning of the solidarity principle, the idea is to establish redistribution mechanisms, which include most notably the Interterritorial Compensation Fund, whose purpose is to finance investment in the less wealthy Autonomous Communities.

In fact, the principle of solidarity was one of the major items discussed in the debates about the Economic Agreement.

Article 50.3 of the EABAC establishes that the contribution to that Fund shall be treated as a "powers not devolved" for the purposes of calculating the Quota payable by the Basque Country to the State, the amounts contributed to the Fund being established in the General State Budget; accordingly, the Basque Country contributes to that Fund through the Quota. According to SIMON ACOSTA,[10] in this connection the principle of solidarity is expressed in the "full currency of the principle of contributive capacity."

Article 50.3 of the EABAC states as follows:

> "The following, among others, shall be deemed to be powers not devolved to the Autonomous Community:
>
> a) The amounts assigned in the General State Budget to the Interterritorial Compensation Fund referred to in article 158.2 of the Constitution. The contribution to this charge shall be made by the procedure to be determined

in the Quota Law referred to in article 41.2.e) of the Basque Country Statute of Autonomy."

Accordingly, it is possible to identify two basic objectives to be attained through the solidarity principle:

- Firstly, ensure that the Basque is not left out of the mechanism for redistributing wealth on which the Interterritorial Compensation Fund is based. As stated above, the Basque Country does contribute to the ICF through the Quota payable to the State (see II.4).
- Secondly, regarding the impediment that the tax burden borne by the Basque Country is significantly lower than in the rest of the State, we refer to chapter V.

It could even be stated that the Basque Autonomous Community's contribution to the ICF, through which the solidarity principle is effectively implemented, takes place (formally, at least) by a more direct route because, since the provisions to that Fund are articulated through amounts allocated in the General State Budget, the other Autonomous Communities do not directly contribute anything to the Fund.

Therefore, "one cannot properly speak, at least "immediately", of inter-regional solidarity since the regions do not contribute anything directly to the Fund. Only indirectly (since the State clearly must obtain its funds from the regions and, in the final instance, from the citizens) can one speak of inter-regional solidarity. Nevertheless, we believe that there is an exception to this general situation. This is the case of the nationalities with an agreement or convention, which must contribute proportionally to the solidarity fund as part of their quotas, and this is not only a logical consequence of their usufruct of the State's taxes and of a harmonious interpretation of articles 41.2.d) and 41.2.f) of the Basque Statute, but also as a consequence of the precision arising from the fact that the Senate added the term 'general' before the aforementioned burden of the State."[11]

5.3.3.e) Practical implementation of the principle in the Economic Agreement

This section analyzes the possibilities and limitations involved in the Autonomous Community's regulatory powers as recognized in the Economic Agreement, and the effects which may arise, from an economic and dynamic standpoint, in connection with the principle of solidarity between Spain's Autonomous Communities.

As stated above, the practical implementation of the principle of solidarity in the Economic Agreement is determined by the Quota (the contribution to defraying the State's general expenses), without forgetting the existence of the

unilateral risk (explained in II.4) but whose effects have yet to be determined.

The simplified formula for calculating the Quota is as follows:

Quota = Imputation index (State powers not devolved to the Autonomous Community – Compensations)*

We will now analyze each of the components of the formula from an economic standpoint.

i) Imputation index

According to article 53 of the Economic Agreement, the expression "imputation index" must be determined on the basis of income levels in the Historical Territories. The index can be conceived as the Basque Country's relative ability to contribute to financing the State's general expenses.

The Economic Agreement does not establish what indicator of income should be used to determine the imputation index, and there is a variety of appropriate indicators, e.g. Gross Domestic Product, National and Regional Income, Gross Added Value, Family Disposal Income, etc.

These indicators are determined and published by various sources, both public and private, and their results do not coincide due to the different methods of processing the figures. The study which follows uses these indicators of income:

- Gross Domestic Product at market prices, published by the National Statistics Institute (INE).
- Gross Domestic Product at market prices in the Basque Autonomous Community, published by the Basque Statistics Institute (EUSTAT).
- Gross Added Value at market prices, obtained from the aforementioned public agencies.
- Gross Added Value measured at factor costs, published by the National Statistics Institute for both the Basque Country and the State as a whole.
- Gross Added Value measured at factor costs, published by the Research Service of Banco Bilbao Vizcaya.

As explained above, the imputation index has remained constant at 6.24% during the 16 years of the current Economic Agreement, regardless of the actual relative development of the regional and national economies.

This means that, *a priori*, depending on how the respective incomes have developed, the actual Quota may have been over or under the figure required by the spirit of the Agreement and, consequently, there may have been excessive or insufficient compliance with the principle of solidarity.

Table 4:
Income levels and the quota

Real ratio between State and regional incomes	Effect on the Quota
Over 6.24%	Calculated at below the true level. Undercompliance with the principle of solidarity
Under 6.24%	Paid in excess. Excessive transfer of funds and overcompliance with the principle of solidarity.

According to certain authors,[12] the figure of 6.24% was determined by considering the results from various alternative indicators of income obtained from various sources, and its maintenance over time has been justified on the grounds that the imputation index should not be understood as a real, precise indicator of the Basque Country's ability to contribute at any given time, but rather as an objective indicator, which would imply that any excess or shortfall which might arise from deviations with respect to the actual evolution would be absorbed as a supplementary or compensatory side-effect of the principle of unilateral risk.

Others[13] consider that the 6.24% figure is most likely the result of a political agreement, based on certain indicators of the relative importance of the Basque Autonomous Community's economy in the State as a whole. Those authors claim that the value of the index could be considered correct for 1981, insofar as it is half-way between a progressive imputation index (i.e. one that measures differences in per capita wealth) and a regressive one (i.e. which measures other factors not related to income, such as population). Accordingly, as those authors state, the fact that the index has not been revised during the validity of the Economic Agreement has been detrimental to the Basque Country since its position relative to the State as a whole has deteriorated considerably in terms of both population and (principally) relative wealth.

However, those authors consider that article 53 of the Economic Agreement seeks to determine the imputation index on the basis progressive indicators, specifically income, although they admit that it does not establish which indicator to use to quantify this magnitude. In this connection, those authors reveal that:

- Most indices suggest that the Basque Autonomous Community's share in the economy is greater than 6.24%.
- The most appropriate income indicator for these purposes would be Gross Added Value at factor costs, on the grounds that it is the one used in the Agreement with Navarra.

It could be argued here that the Economic Agreement itself could have established which income indicator to use, particularly considering that the Agreement was amended at around the same time as the Agreement with Navarra; accordingly, the fact that gross added value at factor costs was not included may have been deliberate omission. In any event, the 1990 Agreement with Navarra does not expressly say so, although this would appear to be the indicator which was used to establish the imputation index.

Based on the proposed income indicator, the aforementioned authors conclude that: firstly, the actual development of the indicator has brought the real imputation index closer to the agreed one (6.24); secondly that the net Quota paid by the Autonomous Community is approximately 100,000 million pesetas lower than would have been obtained by applying the resulting imputation index, although this amount is offset, to an extent, by the transfers from the State to the Basque Autonomous Community for items (social security and VAT adjustment) which are determined on the basis of the imputation index and, consequently, are understated.

Given the diversity of opinions on this matter, in order to establish the actual situation in each year, below we calculate the actual ratio between regional and State income.

These magnitudes are compared using the aforementioned income indicators, since there are differences in the measurements of the two parameters. The results obtained vary between 5.5% and 7.2%, depending on the year and source.

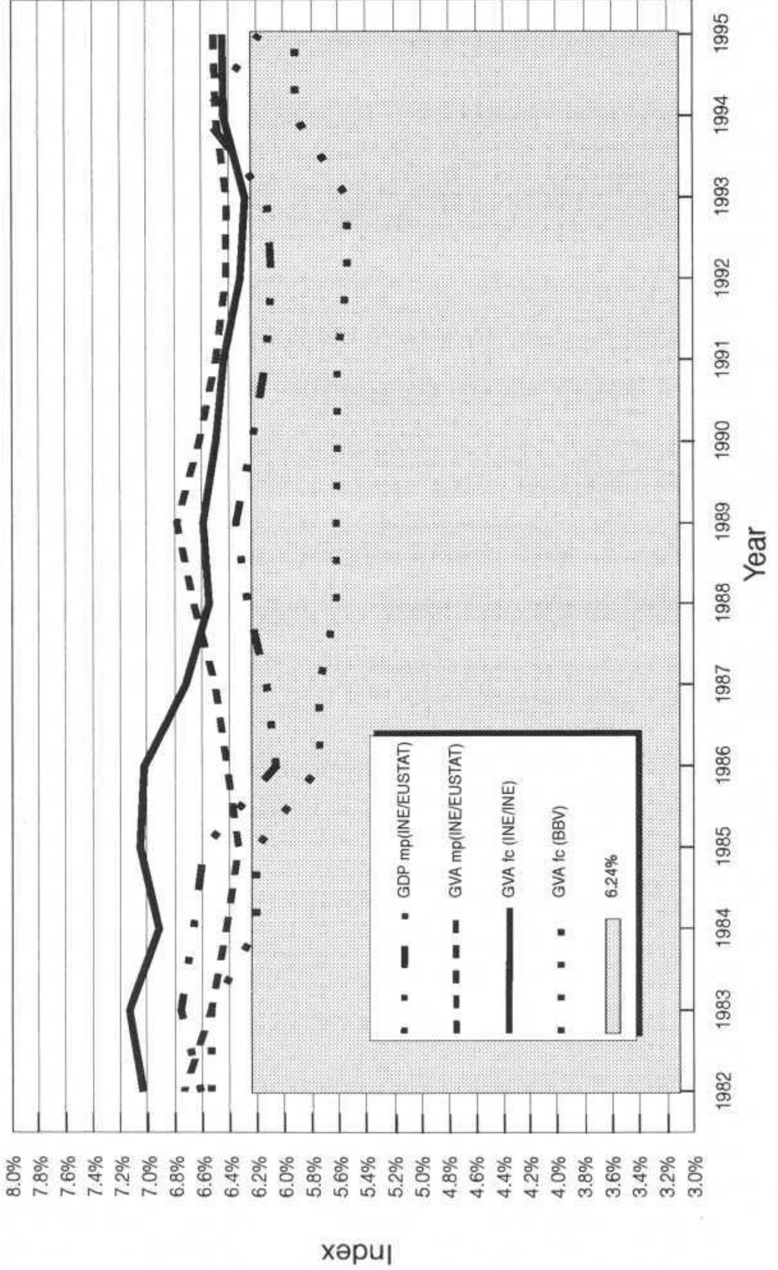
Using the Gross Value Added (GVA) at factor costs published by the National Statistics Institute, as proposed by the authors cited above, the result ranges from 7.4% down to 5.8%. However, if the figures published by Banco Bilbao Vizcaya for the same indicator are used, the range is from 6.6% to 5.5%.

These data are plotted for each year and source in figure 6.

The following comments can be made on this graph:

- The results vary considerably depending on the income indicator used and on the source of the data. The highest levels of participation are obtained using the Gross Value Added at factor costs figure from the National Statistics Institute, according to which the Basque Country's income was over 6.24% throughout the period analyzed here. The lowest level of participation is obtained using the GVA at factor costs figure from the

Figure 6:
Imputation Index
Several income indicators



Banco Bilbao Vizcaya (BBV), according to which the Basque Country only exceeded the 6.24% level in 1983 and 1984, and was below it in the rest of the period analyzed.

- Table 5 gives the Basque Country's average share in the national economy in the period 1982-1995 according to the various indicators.

Table 5:
Basque Country's share in the national economy

	Average
GDP mp (INE/EUSTAT)	6.34%
GVA mp (INE/EUSTAT)	6.53%
GVA fc (INE/INE)	6.67%
GVA fc (BBV)	5.88%
Average of indicators	6.35%

Table 5 shows that, according to the income indicators (with the exception of the one determined by the BBV), the Basque Country's share in the Spanish State's income was higher than the 6.24% imputation index. The average of indicators used gives a figure 0.11 percentage points higher than the 6.24% index.

- All of the indicators reveal that the Basque Country's share of the national income has been declining, apart from a slight upswing in 1983 according to the figures from EUSTAT, and a relatively large surge in 1994 (according to certain indicators), which persisted into 1995.

Moreover, as an additional comment, it should be borne in mind that although the indicators quantified in market prices are in the same currency and arise from economic processes in the same market unit, surveys of internal price levels reveal that they are not homogenous and, consequently, between 1982 and 1995, prices in the Basque Country were slightly higher than the average for the State. This would tend to distort the result by overstating the nominal value of Basque income with respect to its actual value.

One final aspect to be considered with regard to the imputation index is the Basque authorities' ability to influence it using the regulatory powers granted to them under the Economic Agreement. This will be analyzed in detail in the dynamic model at the end of this section, but we will make the

following comments:

- The use of fiscal powers might imply the creation of an environment which encourages or discourages the economic subjects with regard to performing certain activities in the scope of the tax powers, but it does not imply that they will actually be performed, or that the final results of the induced actions will have the desired effect or attain a sufficient amount.
- Additionally, since it is a relative index, it also depends on the degree of dynamism of the economic players in the rest of the national territory (the common territory), whether or not it is induced by the applicable tax regulations.

Consequently, the real future impact on the imputation index of any tax measure cannot be known when such a measure is issued and its side effects are difficult to quantify, even if the regulations issued under the Autonomous Community powers had the intended economic success; accordingly, it would appear that the effect (as regards the principle of solidarity) of tax measures issued under the powers granted by the Economic Agreement is imprecise and probably impossible to measure. Moreover, this does would imply that the other territory would ignore such new tax measures and fail to react by issuing measures with similar effects during the period when the former were in force or producing their effects.

ii) Powers of the State not devolved to the Basque Autonomous Community
The State's powers which are not devolved to the Basque Autonomous Community are determined as a function of:

- Total expenditure according to the General State Budget.
- less: the portion of that expenditure relating to powers devolved to the Basque Autonomous Community, and
- less: the powers developed by the Basque Autonomous Community relating to powers not devolved but which are financed through the Quota. To date, this item only includes the cost of the Basque Autonomous Community Police Force.

The contributions to the Interterritorial Compensation Fund are included as part of the State's expenses and, therefore, the Basque Country contributes to financing and sustaining them indirectly through the Quota. Additionally, interest payments and principal repayments of the government debt are computed as part of the powers not devolved.

The amounts thus calculated are approved by the Joint Commission on the Quota and, once agreement has been reached, they are included in a Law which must be passed by the Spanish Parliament.

However, since 1987 this procedure has only been carried out once every

five years; in intervening years the figures agreed upon in the first year are corrected by agreed indices (which may or may not reflect the real evolution of the various magnitudes), unless new powers are devolved during the period, in which case their cost is introduced into the calculation. The update index is calculated on the basis of tax revenues collected in the State each year (Chapters I and II of the General State Budget) with respect to the baseline year. Moreover, this automatic mechanism excludes the cost of the Basque Police Force, which is included at the actual cost each year, and the same procedure is followed for the costs of the National Institute of Health Services and the National Institute of Social Services.

The value of the powers which are devolved is calculated in the year of devolution by calculating the amounts of public expenditure in the General State Budget which relate to those powers in that year. This process may include both the direct costs of a given function and the indirect costs (administration, co-ordination, etc.), which must often be estimated using criteria of reasonableness and proportionality, given the complexity of determining them exactly.

However, in the opinion of some authors,[14] in order for the value of the powers not devolved to the Autonomous Community to quantify the extent to which the residents of the Basque Autonomous Community benefit from public expenditure by the State Administration, those powers should be valued on the basis of the effective cost of those expenses, which could best be approximated by imputation index systems in some cases, using different indices for different services, and by the actual cost of provision, in other cases. Those authors believe that, given the lack of information, the proposed system is unviable in practice.

Consequently, in the opinion of those authors, although the option adopted by the Economic Agreement of assigning a single imputation index to all charges may simplify the system considerably, it can distort valuations and affect the Quota and, consequently, the amount of same may be too high or too low, depending on the case. These comments are equally applicable to the valuation of the compensations considered in calculating the Quota (which will be discussed later).

There would appear to be a contradiction between the claims of the aforementioned authors that the 6.24% Quota is understated (see above) and their statements that the costs of powers not devolved to the Autonomous Community should be determined by individual imputation indexes for each power, because it would be necessary to compare the 6.24% index with the one found for each power not devolved and thus assess whether or not the transfers in the Quota correspond to reality.

Note, however, that the component of the Quota relating to powers not devolved to the Basque Autonomous Community is not at all affected by the

Basque Country's revenue-raising ability nor by the size or destination of the latter's public expenditure, regardless of the valuation method used. This is one of the most important manifestations of the principle of unilateral risk on which the Economic Agreement is based. The volume of public expenditure decided upon by the Spanish Parliament when approving the General State Budget has a fundamental effect on the amount of the Quota to be paid and, therefore, on the solidarity demanded of the Basque Autonomous Community as a result of the budget.

Table 6 shows the State Budget and the total amount of powers not devolved to the Basque Country (in millions of pesetas and percentages, respectively), expressed only for the baseline years of the five-year Quota Laws (1988 and 1992) since these are the only ones for which information is available, but considering that they are, in any case, significant for the other years in each five-year period.

The following comments can be made on the table:

- The powers not devolved account for a high proportion of total expenditure in the General State Budget, although the proportion is declining due, basically, to the greater powers devolved to the Basque Country.
- The powers not devolved represent an average of 55% of total State Budget expenditure; therefore, because of the imputation index, the Basque Country finances approximately 3.5% of the total expenditure in the State Budget through the Quota.
- Budgeted expenditure has risen much faster than the level of powers not devolved (73%, compared with 35%, respectively). As mentioned above, this means that the Basque Autonomous Community has taken on more functions.

Table 6:
The State budget and non-devolved powers

Year	State Budget	Powers not devolved to the Basque Autonomous Community	Powers not devolved (% of budget)	6.24% of powers not devolved	% of State Budget financed by the Basque Autonomous Community
1988	8,939,237	5,589,162	62.52%	348,76	3.90%
1992	15,461,894	7,510,492	48.57%	468,66	3.03%

Source: Calculation of the Quota for those years.

iii) Compensations

The compensations, which are items deducted from the powers not devolved to the Basque Autonomous Community, include the following:

- The State's revenues from taxes not devolved under the Economic Agreement.
- Other non-tax revenues of the State.
- The imputable part of the State Budget deficit.
- The share of certain direct taxes which accrue in the Basque Country but are collected by the State on the basis of the handles established in the Economic Agreement (direct taxes and withholdings from the State-owned banks and from companies holding concessions to State monopolies, and direct taxation of foreign companies). Additionally, by agreement of the Joint Commission on the Quota, this section includes withholdings from salaries of State employees working in the Basque Country and withholdings from yields on government debt securities.

Since the powers of regulation, collection and inspection lie with the State Tax Administration, the amount by which these compensations can be reduced for powers not devolved cannot be controlled by the Basque Country tax authorities under the powers granted to them by the Economic Agreement.

We believe that the treatment as compensation of the imputable part of the State Budget deficit is coherent with not demanding that the Autonomous Community pay, out of its current revenues, certain outlays by the State whose financing is to be deferred using debt. Otherwise, the citizens of the Basque Country would be required to make an additional tax effort to maintain the spending power of their public agencies or to substantially reduce the real spending power of those agencies.

Table 7 shows the trend in these amounts (in millions of pesetas) for the baseline years of the five-year Quota Laws (taken as 6.24% of the respective totals).

Table 7:
The compensations

Year	Taxes not devolved	Non-tax revenues	Budget deficit	Devolved direct taxes	Total
1988	97,01	35,19	98,37	17,07	247,65
1992	118,04	68,08	180,96	29,23	396,29

Source: Calculation of the Quota for those years

The following main comments can be made concerning the table:

- The level of compensations has risen considerably, due mainly to the spectacular rise in the public deficit (84%) and to the State's non-tax revenues. The latter effect might be due, to a great extent, to the issuance of considerable amounts of government debt securities, i.e. to the public deficit in the final instance.
- The compensations in the baseline years for the Quota rose by 60%.
- The central taxes (i.e. those not devolved to the Basque Country) include most notably excise taxes and customs duties. It is noteworthy that these taxes are compensated for on a proportional basis, in terms of the imputation index, rather than by considering where those taxes actually accrued. This may have a significant impact on the Quota as can be inferred from table 8.

Table 8:
The real tax ratio and its effect on the quota

Real ratio between tax accruals at State and regional level	**Effect on the Quota**
Over 6.24%	The Basque Autonomous Community is penalized economically. Excess funds are transferred and the solidarity principle is exceeded.
Under 6.24%	The Basque Autonomous Community benefits. Underlying solidarity deficit.

The Basque Country has more industry than the average for the State as a whole. According to statistics published by the Fundación para la Investigación Económica y Social (FIES), the gross added value of the Basque Country's industrial sector accounted for 10.34% in 1985, 9.85% in 1987 and 8.98% in 1991 (compared with an imputation index of 6.24%), so the excise taxes and customs duties accruing from the Basque Country's industrial activity may be higher than the average derived from the imputation index. However, there is not enough hard evidence to back this hypothesis and quantify the effect.

Moreover, the State has non-tax revenues, such as the charge for certain

costs included in electricity bills and paid by all electricity users, which are not included in calculating the compensations (e.g. in 1994 that figure involved a transfer of funds by Basque Country consumers which we estimate at 14,000 million pesetas).

The degree to which the compensation payments cover the powers not devolved to the Basque Autonomous Community, expressed for the baseline years for determining the Quota are shown in table 9 (in millions of pesetas).

Table 9:
Compensation payments and non-devolved powers

Year	Powers not devolved	Compen-sations	Net difference	Compensation / powers not devolved
1988	348,76	247,65	101,12	29.0%
1992	468,66	396,294	72,36	15.4%

The main comments which can be made on these figures are as follows:

- The trend in the difference reveals the twin effect of the devolution of powers to the Basque Country and the degree to which the Economic Agreement absorbs, on an agreed basis, both the development of tax regulations and the amounts of revenues from central taxes.
- Since the decisions on both magnitudes lie almost exclusively with the State, the Basque authorities have no control over them and the amount of the Quota can very considerably depending on decisions taken by the State.
- The Quota would only be negative if the powers not devolved were lower than the devolved taxes. For this to arise, the level of devolved powers would have to be very high and there would also have to be a considerable mismatch between the taxation powers expressed in the Economic Agreement and the taxes in force throughout the Spanish territory.

The latter scenario (i.e. a negative Quota) would not involve a breach of the principle of solidarity since a negative figure would be due to the scant own tax-raising powers provided by the Economic Agreement due to a mismatch between them and new taxes promulgated by the Spanish State in comparison with a high level of devolved powers.

Moreover, if the Quota proved to be negative, this would be independent of the Basque Country qualifying for funds from the Interterritorial

Compensation Fund due to poorer performance by the Basque economy in relation to that of the State as a whole.

5.3.3.f) Conclusion

The principal conclusions of the foregoing discussion are as follows:

- The financial relations which the Economic Agreement establishes between the State and the Basque Autonomous Community are based on the principle of unilateral risk for the Basque Country and, consequently, the amount of the Quota payable does not depend on tax decisions by the Autonomous Community authorities, whereas their spending power depends on their own tax-raising capacity.
- The Basque tax authorities have some ability to influence the imputation index, although that influence is minimal and impossible to determine because of the fundamental impact of exogenous factors on their decision-making capacity and because of the effect caused by the dynamism of the economic players which operate in the Common Territory at any given time.
- Additionally, the Economic Agreement does not grant any powers to act directly on the elements involved in determining the powers not devolved or the compensations.
- Certain authors consider that the magnitudes of the Basque Autonomous Community's model of financing arise more from political and historical reasons than from economic realities. They conclude that, from an economic standpoint, the methodology used to determine the Quota does not comply with the latter's stated aim, and the amount of the Quota has historically been lower than would have been obtained using strictly economic criteria. Nevertheless, the difficulty of measuring all the simultaneous economic effects involved makes it difficult to prove this assertion since it is impossible to quantify the result with accuracy.

As a corollary, it could be stated that the compliance with the principle of solidarity, expressed basically in the contribution to the State through the Quota, is determined basically by decisions and variables which fall outside the regulatory and tax-raising powers granted by the Economic Agreement to the Basque tax authorities, and this is regardless of the question as to whether the amount of the Quota has been historically higher or lower than that which would have been appropriate given the function for which it was established.

5.3.3.g) Dynamic economic model derived from the potential use of the Autonomous Community's tax regulatory powers, and impacts on inter-regional solidarity

The analysis summarized in the preceding section reveals that the Basque tax authorities' room for manoeuvre with respect to the solidarity principle is very limited. Nevertheless, this is not the complete picture since we have not yet analyzed the dynamic effects which can arise from the exercise of the Basque Country's regulatory powers.

The main measures adopted to date have focused on corporation tax and consisted basically of fostering business investment by introducing incentives which lead to a reduction in the effective tax rates levied on business profits over limited periods of time. These measures have been influenced by the principles of economic policy at State level and in the Basque Country, which are essentially the same except that the latter have a greater regional component (unemployment, regional decline, excessive concentration of business in sectors with weak demand growth, etc.).

The basic objective of the abovementioned measures is to boost economic activity by making a fiscal sacrifice in the short term with a view to maintaining or raising direct and indirect tax revenues in the medium and long term.

The short-term reduction of tax revenues in the Basque Country has no effect on determining the immediate amount of the Quota, as discussed above.

This policy of incentives can have contradictory effects on the trend in the region's Gross Domestic Product for the following reasons:

- It reduces the public sector's ability to raise finance and its spending power, which has an immediate negative effect on the Gross Domestic Product.
- On the other hand, it boosts the private sector's financial capacity, and this finance may be used for consumption or investment, both of which have a positive effect (albeit more difficult to measure) on the Gross Domestic Product (depending on how and on what it is spent, and on the success or otherwise of the investments) or it may be saved (i.e. capacity to finance private investment and/or to absorb greater public-sector debt).
- Over time, if the private sector absorbs the negative effects on the Gross Domestic Product of the public sector's measures on expenditure, an expansive fiscal policy can actually boost regional income in the medium and long term and also increase tax revenues, thus boosting the public sector's expenditure capacity.

Therefore, a reduction in nominal taxation in the Basque Country can have a positive impact directly on the Quota and (indirectly) on the State, for the following reasons:

- If the incentives policy is successful in the medium and long term and, consequently, the regional income increases to a greater extent than income at State-level, this will enable the imputation index and, consequently, the Quota to be increased (while maintaining the other values of powers not devolved and compensations at the same level).
- Additionally, if the increase in individuals' personal disposable income leads to an increase in their private consumption, this might lead to an increase in tax revenues (both for the Basque Autonomous Community and for the State), which would not affect the Quota but would involve a transfer to the Common Territory of income generated in the Basque Country.
- Moreover, the additional personal disposable income might be allocated to increasing individuals' savings, in which case, as well as allowing for greater tax revenues, it might boost the State's net revenues if the savings are invested in government securities, since the withholding tax on the revenues from those securities is collected directly by the State and only 6.24% of it is contributed to the Basque Autonomous Community.

The Basque Country has one of the most open economies of any of Spain's regions. Taking 1992 as an example and using the input-output tables published by the Basque Statistics Institute (which have been published since 1990), the absolute and relative economic flows were as follows (amounts in millions of pesetas).

Table 10:
Imports and exports in Basque country

	Amount	**% of total funds and uses**
Imports		
From the rest of the State	1,669,326	17.9%
From other countries, including EU	673,090	7.2%
Subtotal: imports	2,342,417	25.1%
Exports		
To the rest of the State	1,571,099	16.8%
To other countries, including EU	713,830	7.6%
Subtotal: exports	2,284,931	24.4%

Source: EUSTAT, 1992.

Note that there was a severe economic crisis in 1992 which affected the Basque Country with particular severity. As a result, its net external balance was negative.

Therefore, the effects of any measure to activate the regional economy can favour the other regional economies of the State, from which approximately 17.9% of the Basque Country's total resources come and to which it sends approximately 16.8% of same (1992 figures).

Unfortunately, we do not have statistics indicating the trends in these figures between 1981 and 1995.

5.3.3.h) Published estimates regarding the solidarity principle

The Fundación Fondo para la Investigación Económica y Social (FIES) has attempted to quantify the relative effect of solidarity between Autonomous Communities based on an estimate of transfers of family disposable income. The results published for 1985 and 1991, measured as percentages of GDP and Regional Income, are given in table 11.

Table 11:
Transfers of disposable income between autonomous communities

	1985		1991	
Communities Transferring Funds	**As % of GDP**	**As % of Regional Income**	**As % of GDP**	**As % of Regional Income**
Basque Country	-10.35	-9.49	-9.94	-11.33
Madrid	-7.94	-11.56	-12.24	-17.18
Balearic Islands	-8.23	-0.75	-12.93	-0.07
Catalonia	-3.63	-3.95	-2.66	-4.30
Navarra	-5.71	-4.63	-7.15	-5.12
Aragon	-4.11	-2.35	-3.23	-0.45

5.3.4 No tax measures shall be adopted to encourage investment which discriminate on the basis of the place of origin of the goods or equipment in which the investment is materialized (art. 4.2)

5.3.4.a) Scope of this rule

The Spanish tax system (and particularly the Basque system) has traditionally sought to encourage business investment by providing incentives (credits and rebates) under corporation tax and personal income tax for investment in new fixed assets; accordingly the discussion will focus on possible discrimination caused by incentives of this type provided by the Basque Provincial Governments.

In assessing the true scope of this rule, we find it contains two key words, namely "goods" and "origin" which are extremely difficult to define.

The reference to "goods" could be taken to mean all types of goods. However, there is then a reference to "goods or equipment". The use of the disjunctive preposition "or" is very interesting since it could perfectly well have been omitted, leaving just the word "goods".

It is not clear what conclusion to draw, since it could be understood that only goods which are, at the same time, equipment fall under the scope of the rule, and since the word "equipment" refers to tangible fixed assets, only the latter would be covered; it would appear that the rule seeks to clarify the matter further and not leave any possibility open, by including both financial investments and intangible assets within its scope.

Additionally, the word "origin" is extremely difficult to define since it could refer to the place where the good was manufactured, or where it was placed at the buyer's disposal, or where the materials comprising it come from, etc.; in fact, most goods do not have one single "origin". Lastly, property and intangible assets (assuming they are covered by the rule) would merit separate treatment.

5.3.4.b) Ultimate meaning

It could be concluded that the State's representatives in drafting the EABAC were particularly interested in drafting a rule to cover this area, despite its vagueness in both legal and practical terms. The idea may have been to prevent the Basque Country (an industrial region which is particularly strong in the machine tool sector) from issuing a rule favouring machinery acquired from suppliers located within its territory (thus eliminating the possibility of an "industrial autarchy"), which would later be developed in detailed regulations (which has not happened).

The Spanish legislator repeated this idea in the Law partially amending the LOFCA, article 19 of which establishes, as regards the regulatory powers of

the Autonomous Communities, that they "shall not adopt measures which discriminate on the basis of the location of goods, origin of income, performance of expenditure, provision of services or performance of business, acts or events."

It should be noted that to date there have been no disputes between the State Administration and the Basque Country in this connection.

5.3.5 The same tax regulations as those of the State shall be applied to banking and money market transactions and to the other means of financing companies (art. 4.5)

5.3.5.a) Introduction

Firstly, note that the rule refers to three dissimilar items and we must seek some common ground from which to analyze the meaning of the rule in a coherent way.

Breaking down the rule, it refers to the need to apply the same tax rules to:

- banking transactions,
- money market transactions, and
- other means of financing companies.

5.3.5.b) Approach to the analysis

Although the foregoing three items need to be analyzed separately, the fact that they are taken together in the same harmonization rule, and the literal wording of the rule itself, mean that we must bear in mind that there is necessarily a connection between them.

We consider that the aforementioned harmonization rule does not deal with three separate events but, rather, it is actually a general reference to*means of financing companies* and, additionally, points out two specific cases, namely *banking transactions and money market transactions*; this argument arises from the literal wording of the rule, which reads "... and to the other means of financing companies"

5.3.5.c) General case: means of financing companies

i) General delimitation

The phrase "means of financing companies" could cover a multitude of items, particularly if the rule is analyzed from a dynamic perspective and not as relating to a specific act.

The High Court of Justice of the Basque Country, in a Ruling dated 18 May 1994, expressed itself in these terms regarding a case where the State

Administration invoked this rule to annul certain regulations governing the tax regime for securities investment companies and funds and the provision of a double taxation tax credit in this connection, and stated that "while admitting that the credit established is indirectly a possible means of financing a company, it is not a juridical or economic act with a financial purpose, it has no impact on the financial market and, accordingly, the rule in 4.5. is not applicable ...."

Accordingly, the scope of the rule is limited to means of financing as "acts", i.e. from a static, formal standpoint, and requires that such acts have a direct impact on the financial markets.

ii) Analysis of the various tax regulations which are applicable

Below we examine which tax regulations apply to the transactions and means of financing referred to above.

1. Direct taxes

Neither the Spanish State nor the Basque Country has direct taxation on this type of transaction and financial media which are levied on the act itself, although a broader interpretation of the harmonization rule could extend it to other cases of effects induced by taxes on other events and could even include corporation tax, since it is levied on company profits and, consequently, affects self-financing.

It follows, therefore, that if this harmonization rule, which literally states that "the same tax regulations ... shall be applied" to the events described in the rule, were interpreted in the broadest possible sense, this would leave the tax authorities of the Historical Territories totally bereft of decision-making power with regard to the taxation of companies.

Additionally, note that the High Court of Justice of the Basque Country, in the ruling cited above, explicitly stated that, for article 4.5 of the EABAC to apply, there must be a direct relationship between the item in question and means of finance.

There is also the question of the effect on the prices of financial products and services produced by the difference between the effective tax rate borne by finance entities subject to Basque corporation tax and those subject to that tax in the Common Territory; various sources consider that the effect would be negligible.

2. Indirect taxes

Capital increases are subject to tax (transfer tax, in this case) and certain banking services are subject to value added tax (VAT).

Note that there is a specific harmonization rule (discussed in 5.2.5 above) regarding operations to capitalize companies (in the strict sense of the term)

and the consequent taxation of those acts (referred to as "corporate transactions"); therefore, it can be presumed that article 4.5 is not seeking merely to repeat the content of the aforementioned rule.

Moreover, the application of this rule to VAT meets with two clear objections. Firstly, when this harmonization rule was introduced, no such tax existed in the Spanish tax system. Secondly, VAT is a tax under European Community regulations and, consequently, the Historical Territories can have no influence in this area.

In short, by eliminating cases to which this harmonization rule might apply, we conclude that it refers not to self-financing but only to financing from sources outside the company, excluding subsidies, in order to be coherent with the other two cases covered by the rule (banking and money market transactions) which are interest-bearing transactions involving third-party finance.

5.3.5.d) Means of financing: specific cases

Here we analyze the two transaction types which are cited as specific cases of the general concept of means of financing companies.

1. Banking transactions

In the first place, it is necessary to ascertain the scope of the term "banking transactions." For coherence with the general provisions of the harmonization rule, which refers to "other means of financing companies", we should only consider banking transactions which are means of financing companies.

This point could also focus on the impact on the banks, as subjects of the various taxes, so as to prevent them from being taxed differently in the Basque Country and the Common Territory, although this approach is questionable in two fundamental aspects.

In order to attempt to establish identical taxation for all banks, it is necessary first to determine basically the taxes which affect these entities, namely the following:

- Corporation tax, a direct tax on the earnings of legal persons, and
- value added tax, an indirect tax which, though falling on the end customer in principle, is particularly burdensome for banks since most of their transactions are exempt from this tax and, consequently, because of the workings of the tax itself, they cannot deduct the VAT from these transactions against the VAT borne on their inputs.

To argue that this harmonization rule is applicable to VAT is inappropriate on the basis of the objections given above in connection with means of finance in general.

As regards attempting to avoid different taxation under corporation tax;

regardless of the possible lack of justification, in our opinion, the appropriate place would have been section 4 of the EABAC, which refers to that tax. In fact, point 18.3 of that section establishes that "even when they operate in the Basque Country, the following shall pay tax only to the State Administration: the State-owned banks, ..." Therefore, considering that the entities which pay tax only to the State are subject to the State's legislation, if the drafters of the EABAC had wished to include the entire banking system under a single system of taxation, article 18.3 would not have confined itself to the State-owned banks (a much more limited concept).

Therefore, it could be concluded that modifications in the taxation of banks cannot materially distort company financing transactions and, consequently, it is extremely unlikely that the application of the Economic Agreement with the Basque Country could seriously affect the principle expressed in the harmonization rule analyzed here.

2. Money markets

If the scope of this precept extended to any type of transaction related to the money markets, the consequences would be severely limiting for the institutions of the Historical Territories since it would be necessary to tax any of the assets traded on those markets in exactly the same way, which would be meaningless and, consequently, the powers of the Historical Territories would become void of content through a harmonization rule which, in principle, refers to "means of financing companies."

It could be postulated that the reference in this harmonization rule to money markets must bear some relation to means of financing companies, i.e. that it might refer to the need to provide companies access to those markets, under the same conditions, to obtain finance through the issuance of commercial paper, for example.

In short, it would appear that, by coherence with the rest of the article, this part of the precept must refer only to tax regulations governing companies' access to the money markets to finance themselves, and not to any investment they might make in the money markets.

5.3.6 No tax amnesties, whatever their denomination, shall be granted unless they have first been established on a general basis by a Law passed by the Spanish Parliament (art. 4.7)

5.3.6.a) Conceptual delimitation

The Spanish Constitution makes no mention of amnesties, and the positive law on the subject is in article 10 of the General Taxation Law, which states as follows:

"The following shall be regulated by Law in all cases:

f) The granting of pardons, condonations, rebates, *amnesties* or moratoria."

Accordingly, the concept of a tax amnesty appears here in connection with the forgiveness of a tax debt, but it is not distinguished from the other items which are various forms of forgiveness. Note also that the harmonization rule refers only to amnesties, and not to the other concepts.

Accordingly, after consulting the amnesty laws which have been issued in Spain, interpretations by the Prosecutor's Office of the Supreme Court and even the dictionary, we note that the characteristic feature of an amnesty is that all persons benefit from it, thus distinguishing it from items which involve forgiveness as an individual pardon.

The matter is clarified by the Supreme Court Ruling dated 19 December 1995, from which we take the following extract:

"... the listing of the operations required to benefit from a tax amnesty reveals that, to obtain this benefit, there must be a modification of the accounting entries or, rather, a complement to the existing entries either by "incorporating" assets or by eliminating liabilities ... Article 31 of the Law of 14 November 1977 cannot be wielded to obtain a tax benefit in a case not envisaged in the law granting the benefit ..."

Therefore, if the Supreme Court describes article 31 of the Law of 14 November 1977 as granting a "tax amnesty", let us examine what it says:

"Subject to the limitations on valuation and the justification established in ..., companies subject to corporation tax ... may, with exemption from any tax, levy and liability of any type with respect to the Administration, and in the period between the publication of this Law and 30 June 1978:

...

The *exemption* to which this article refers shall comprise all direct and indirect taxes owing to the Treasury by the company regularizing its balance sheet up to the date of the first balance sheet closed after the entry into force of this Law, in which balance sheet the regularization transactions permitted by this Law shall be carried out."

It can be concluded that a generalized exemption from the payment of taxes, in this case due to the inclusion of concealed assets and the elimination of fictitious liabilities, is treated by the Supreme Court as a "tax amnesty", and this is the basis on which we should interpret the concept which the present rule seeks to harmonize. That is to say, we will assume "tax amnesties" to be

a synonym of *generalized tax exemption.*

However, we should not take the similarity with the case at hand to be absolute since another of the harmonization rules, discussed in 5.2.6. above, states that revaluation rules cannot allow the incorporation of concealed assets or the elimination of fictitious liabilities.

As regards the phrase in the rule stating that it refers to tax amnesties, "whatever their denomination", we feel that the meaning is self-evident. If the competent institutions seek to introduce anything which coincides with what has been stated above, no matter what name is given to it, the harmonization rule will apply. This precept will always be applied with a purposeful interpretation.

5.3.6.b) Powers of the Historical Territories

Having determined, as far as possible, what is meant by tax amnesty, the content of this harmonization rule becomes simpler since it merely indicates that the institutions of the Historical Territories of the Basque Country do not have the power to grant such an amnesty, and that amnesties may only be granted by the State by means of a law approved by the Parliament.

This being the case, how then to interpret article 10.f) of the Vizcaya General Tax Regulation, which states that the "granting of general pardons, condonations, rebates, *amnesties* or moratoria" must be regulated in all cases by a Vizcaya Provincial Regulation?

The other concepts can be regulated by a Basque Provincial Regulation, since the system created by the EABAC (a State law) legitimates a Basque tax system based on Provincial Regulations and their implementing rules. However, this is not the case with amnesties since, under the Economic Agreement, they can only be granted by a Law approved by the Spanish Parliament. The conclusion is that the provision of the aforementioned article as regards amnesties clashes with the EABAC.

5.3.6.c) Criminal law and Basque tax law

Under article 149.1.6 of the Spanish Constitution, criminal law is reserved exclusively for the State.

In principle, if the Basque Tax Inspectorate detected a tax crime (on the basis of wilful fraud of sufficient amount) by a taxable subject, it would send the case to the appropriate court, in accordance with the State criminal legislation.

However, the problem arises in that, at least under current criminal law, tax crime relates to the act of defrauding the Public Treasury in cases of major importance, i.e. which exceed a specific amount of tax defrauded (currently 15 million pesetas in tax debt). Accordingly, for a tax crime to take place, more than 15 million pesetas must have been defrauded.

No matter how much the regulations issued by the Basque Country Institutions differ from those of the State, they cannot undermine the definition of tax crime directly, since it is based on the tax payable and not on technical factors whose regulation might be different in the Basque Country (e.g. failure to file particular returns, ...). Nevertheless, if the treatment of a particular taxable event in the Basque Country implied lower taxation of that event than under the State regulations (even if the other taxes were much higher), this might mean that the tax payable under that particular heading might be less than 15 million in the Basque Country whereas the same case would have given a tax debt of over 15 million pesetas (and, consequently, involved a tax crime) under the State regulations.

Nevertheless, we consider that the foregoing reasoning should not be applicable since this would strip the very EABAC of meaning, and we cannot follow a reduction ad absurdum involving unification instead of harmonization when the very existence of the EABAC in itself implies there is a difference.

However, note that administrative penalties are paid into the corresponding Basque Provincial Treasury, whereas criminal fines are paid to the State Treasury. It might be advisable to harmonize these two cases.

5.3.7 No direct or indirect tax privileges shall be granted, nor shall subsidies which imply the repayment of taxes be granted (art. 4.8)

5.3.7.a) Scope of the privileges

Firstly, note that the meaning of privilege in this rule is not related to the idea that the EABAC itself could be considered a privilege. We feel that this question has already been clarified sufficiently. Hence it could even be argued that no "normal" implementation of the EABAC could ever imply a breach of this harmonization rule.

Consequently, we will assume that the term "privilege" used in this harmonization rule cannot coincide with the meaning of the term in article 138.2 of the Spanish Constitution, which establishes that:

> "The differences between the Statutes of the Autonomous Communities may not imply, in any event, economic or social privileges."

It should even be borne in mind that article 41.2.f) of the Basque Statute of Autonomy orders that the EABAC be applied in accordance with the principle of solidarity referred to in article 138 of the Spanish Constitution. Since article 138 of the Constitution includes both the principle of solidarity and the paragraph transcribed above, and thereby links solidarity with the non-

granting of privileges in the Statutes, and since we have defined above that the EABAC system intrinsically complies with the solidarity principle, that system cannot in case imply a privilege.

Accordingly, the case at hand would appear to be a form of pardon (in the broad sense used above in connection with amnesties), but applied on an *individual* basis in this case.

As regards the juridical meaning of the term, authoritative opinion has it that privileges are provisions dictated to regulate not an abstract relation but a given specific relation, and are not applicable to any other. That definition highlights that a privilege refers particularly to its recipient but ignores that it involves special treatment, feature which should not be forgotten since we are dealing with a tax regulation. In any case, we feel that it would be very difficult to grant a privilege since the combined application of the other harmonization rules would prevent most measures of this type.

Moreover, such a privilege could never arise in the Basque Country because of the inclusion of the EABAC in the framework of the Spanish Constitution. Note the wording of article 31.1 of the Constitution:

> "*All shall contribute* to sustaining the public expenditure *in accordance with their economic means* through a fair tax system inspired in the principles of *equality* and progressiveness which shall not, in any event, be confiscatory."

Hence it can be deduced that the prohibition on the creation of privileges does not come directly from this harmonization rule but stems from the Constitution, which is equally applicable to the legislation in the common territory.

The ruling dated 18 May 1994 by the High Court of Justice of the Basque Country coincides with this analysis:

> "One cannot therefore speak of tax privileges because this case does not involve an individualized rule which breaches the principle of equality, which would moreover be prohibited or forbidden to the State on the grounds of unconstitutionality, but simply of an Autonomous Community regulation implemented within the scope of the powers of the Vizcaya Historical Territory."

The reason for this redundancy can be found in the motives of the State's representatives in drafting the EABAC, i.e. to prevent the passage of any measure whereby the Basque tax legislation might prove especially attractive for residents of the common territory and lead them to change their domicile, thereby further emphasizing the rule which obliges the Basque tax system not

to impede the free circulation of goods and persons in Spanish territory.

Nevertheless, de la Hucha Celador[15] understands the reference to "privilege" in the context of comparisons between the regulations of the Historical Territories and those of the State, and not merely as a problem of internal comparison between subjects of the Basque regulations. We clearly do not agree with this interpretation, as can be deduced from the foregoing discussion.

5.3.7.b) Relationship between subsidies and taxes

The second part of the rule prohibits the granting of subsidies which involve a tax refund. Again, this is difficult to explain unless we consider the oft-quoted intentions of the State.

However, note first that there is a rule about subsidies in article 4 of the EABAC, which comes in Chapter I of the Agreement, relating to the tax system. The method of granting subsidies is not connected to the tax system and, consequently, the presence of this rule is somewhat surprising. It is also unusual within the general workings of the Territorial Public Administrations in Spain, since no such rule is established for any tax administration other than the Basque one, not even in the LOFCA. The inclusion of this proviso is difficult to understand unless it implies a recognition of the unique nature of the Basque tax system, there is also the aforementioned interests of the State's representatives in drafting the EABAC.

As regards the content of the rule itself, how can it be determined whether a subsidy involves a tax refund? In fact, any official subsidy is a transfer of funds from a public power to a subject which meets certain pre-set conditions, and it is financed out of public funds, including those obtained through taxes. Therefore, in principle, since all subsidies would imply the refund of taxes, the Basque Country institutions would not be able to grant any subsidies, which is absurd.

The rule might refer to cases where the granting of the subsidy is made conditional on the payment of certain taxes (although the rule uses the word "imply" which would lead to something more abstract and less direct). It can be inferred, therefore, that the State's side in negotiating the EABAC wished to prevent subsidies which implied the refund of taxes whose regulation in the Basque Country is the same as in the Common Territory, by order of the EABAC.

The case might arise where a subsidy were made conditional upon or quantified on the basis of the taxes collected in the future from a given taxable subject. Would this therefore be an advance refund of taxes to be paid in subsequent years? The truth is that, if it is difficult to define how a subsidy could be a tax refund, it is even more difficult when considering the future projection of the amount to be paid, as distinguished from the amount received in the present, and the applicability of the rule would be arguable.

5.3.8 The rules issued by the competent institutions of the Historical Territories may not reduce the possibilities of business competition or distort the free allocation of resources and the free movement of capital and labour (art. 4.11, paragraph one)

5.3.8.a) Analysis of the rule

The rule clearly places two limits on the Basque regulations, since they may not:

- limit business competition,
- or distort the allocation of resources and the free movement of capital and labour.

Following the methodology referred to in section 2.2, we should conduct an exhaustive analysis of each of the terms of the rule. However, we feel that this is not so important in the case at hand and, for clarity, it is advisable to conduct a preliminary general analysis, recognizing that this rule is the transposition into the EABAC of the "market unity principle" enshrined in articles 139.2 and 157.2 of the Spanish Constitution, which provide for the free circulation and establishment of persons and goods in Spanish territory. This concept has been very well expressed in several Constitutional Court rulings[16] relating to matters not connected to the Basque tax system.

This rule could also be viewed as the inclusion in the EABAC of articles 2 and 3 of the Treaty of Rome, as regards the establishment of a "common market" and a gradual homogenization of economic policies by the establishment of the following principles, among others:

- The elimination, between Member States, of obstacles to the free movement of persons, services and capital.
- The establishment of a regime which guarantees that competition will not be distorted in the "common market".

Note that the limiting concepts used in the text of the rule are purely economic, are not clearly defined in our positive law, and are combined in an attempt to cover a vague target, namely "market unity" in the broadest sense of the term.

On an intuitive level, and taking the strict wording of the rule, it is clear that any tax regulation which is applicable to only some of the players in a market alters (albeit very slightly) the conditions in which the players complete and, therefore, affects the unity of the market. In the absence of graduations in the text ("... may not reduce ... or distort ..."), it could be concluded that, despite the regulatory autonomy which the Basque basic legislation enjoys in some areas, it must always be identical to that of the State

in order not to breach this harmonization rule.

However, this conclusion, which would make the Historical Territories' regulatory powers meaningless, is automatically invalidated by even the most superficial exercise in systematic interpretation since, if this were the case, an ordinary law (the EABAC) would be clashing with the provisions of the Basque Statute of Autonomy, which provides the competent institutions of the Historical Territories with the power to maintain, establish and regulate the tax system. As explained above, this interpretation would breach the First Additional Provision of the Spanish Constitution since it affects what is possibly the foundation of the foral system, namely tax autonomy.

In short, this rule cannot be used to reduce the Basque tax legislator to a mere amanuensis or transcriber, as repeated court rulings have stated.[17]

A further reflection on the absurdity of a literal interpretation of this rule is that it states that the Basque regulations may not "limit competition" but it says nothing about regulations issued by the State to amend other State regulations already adopted by the Basque institutions; this is clearly a sign of unilateralness. If the Basque institutions confined themselves to not adopting amendments made by the State, the legislations in the two territories could become very different, effectively altering the market position of the parties subject to those legislations without breaching the letter of the rule.

5.3.8.b) Meaning of the harmonization rule

However, the foregoing analysis cannot lead us to consider the rule as void, since there is evidently a voluntas legislatoris which cannot be ignored despite the unfortunate wording adopted. Consider that this rule is the most explicit expression of the idea underlying the entire EABAC, namely to avoid fiscal competition between the Common Territory and the Basque Country (as described extensively in 5.1).

We have already mentioned the concept of market unity as being essential to this rule. Taking what we consider most relevant from the rule itself and from the aforementioned constitutional law, we can identify the following characteristics which delimit the scope of this harmonization rule.

- Market unity does not mean uniformity, since the political diversity implied by the division of the State into Autonomous Communities must have some meaning.
- To breach this harmonization rule, the Autonomous Community must act outside its powers, which, in the case at hand, leads us to examine the full content of the Basque Country Statute of Autonomy and the EABAC in order to apply the rule.
- From this perspective, the objective sought by the regulations issued by the Basque Country institutions must be legitimate, i.e. their explicit purpose must be justified.

- There are other constitutional principles relating to this question, namely article 139.2 and (more explicitly) article 157.2, which forbid the adoption of tax measures on goods located outside the territory or tax measures which involve an obstacle to the free movement of goods and services. We will refer to this particular point later.
- There must not be a quantitative mismatch between the goal pursued and the effects of the regulation in question.

5.3.8.c) Particular reference to article 157.2 of the Spanish Constitution

We feel it is enlightening at this juncture to consider the item in article 157.2 of the Spanish Constitution which makes it impossible for the Basque institutions to adopt tax measures on goods located outside the territory of the Basque Country.

There are specific cases where the current handles regarding applicable regulations of the EABAC do make Basque tax regulations applicable to goods located outside the Basque Country.[18]

We must therefore understand that the constitutional precept does not prohibit personal tax handles (i.e. as regards applying legislation depending on the tax domicile of the owner of the goods and where they are located); rather, it prohibits the establishment of extraterritorial tax sovereignty detached from other factors. In fact, there is no record of disputes in this area.

Regarding the concept of impeding the free movement of goods and services, note that any difference between the regulations of two territories implies a relative alteration of the situation of individuals in the market, but in order to classify such alteration as an obstacle it is necessary to ascertain its magnitude, since a minimal difference has no effects for practical purposes. It would also be necessary to consider the effects of the applicable legislation as a whole, since the two systems might balance out.

5.3.8.d) Market

The concept of competition is clearly linked to the concept of the market. Therefore, we consider it necessary to analyze the possibilities for competition in each market.

From a geographical standpoint, the market can be classified as local, national or international. Accordingly, the impact of a tax measure on competition will vary depending on the market under discussion.

For example, a tax rule is unlikely to affect competition in a local market where only companies affected by the rule have access, since all players will be affected to the same degree.

In a broader market, we need to distinguish the following:

- The imbalance existing between the tax rule in question and the tax rules

applicable to other agents competing in the market which reside in other territories.
- The potential in the market of those players which are affected by the rule.
- Other distinguishing features as regards structure, organization and costs of inputs.

Considering the Basque Country, it appears excessive to imagine that a local rule could limit the scope for competition in, for example, the international market.

However, in principle there are grounds for believing that there might be an effect on competition in the national market; the greater the extent to which the other influencing factors coincide and the greater the inter-relations between the players in the market, the greater will be the possibilities of such an effect.

5.3.8.e) Possible impact of taxation on free competition

The effect of tax regulations varies depending on whether they relate to:
- Taxes directly affecting end customer prices (indirect taxes).
- Taxes levied directly on company profits (direct taxes).

The effect of a regulation in the first case above is clear. Lower taxes mean lower prices which, in the short term at least, will make the product more attractive in the marketplace.

The effects in the case of direct taxes are more complex and difficult to determine. However, an indirect tax is just another cost for companies and, consequently, lower taxation could produce an effect similar to the one indicated in the preceding paragraph.

However, this effect need not be linear, since a reduction in business costs does not necessarily lead to a reduction in prices, since this depends ultimately on the individual company's competitive strategy and on its efficiency and the costs of the various factors of production.

Business competition is affected by various factors, the first of which is what might be termed "barriers to entry".

It is arguable whether a general tax regulation can constitute a barrier to market entry, although certain non-general rules would have an effect, e.g. a tax on the production of a particular good or levied on companies in a particular sector which is considered to be strategic.

Apart from the preceding example, if a given tax rule is applied to any subject in a given territory and, therefore, to any subject which so wishes, and there are no barriers to the free movement of persons or capital, then we consider that the rule cannot reduce the possibilities of business competition. Evidently, the foregoing statement also depends on the costs of transferring

a production unit into the territory whose taxation is different. However, it is certainly valid for newly-created companies or new investment by existing companies.

Accordingly, we believe that exogenous barriers to market entry cannot, by themselves, reduce business competition unless they are linked to "personal" aspects, i.e. the concession of privileges or the establishment of prohibitions (whether explicit or implicit) to access. These additional aspects are forbidden by other harmonization rules.

5.3.8.f) Free allocation of resources. The search for competitiveness

The harmonization rule also refers to the free allocation of resources.

As described in Chapter III from a purely economic standpoint, since resources are scarce, they must be located and used in the tasks for which they are most efficient which, from a business standpoint, means that an efficient combination of the degree of intensity of resources (i.e. a balanced costs policy) leads to an optimum amount of goods and services. In other words, the goal is to achieve the highest degree of business competitiveness.

Competitiveness, understood as improving a company's position for market access in comparison with its competitors, depends on a number of factors (some of which have already been discussed) including:

- the price, which is the result of cost efficiency, among other factors,
- the available technology (know-how),
- differentiation,
- the quality, experience, availability and costs of labour,
- economic infrastructures,
- customer service,
- the quality of the product and of the production processes,
- other less relevant factors.

The competitiveness factor which is most sensitive in the marketplace is probably price, since modifications to the price can, in the short term, trigger variations in the relative positions of companies in the market (the degree of variation will depend on the extent of the price change).

However, in the long term, a price change is not always a significant indicator of improvement in a company's competitiveness because, if it is not accompanied by improvements in the other factors listed above, the market's perception of the product may be neutralized by shortcomings in the other factors. Moreover, individual companies can have different cost structures depending on their individual competitiveness strategies, their inputs and their relative size in the market. Additionally, a slight modification in prices by smaller firms can have a greater effect given the rigidity of their unit costs.

Comparative analyses in this context need to be qualified to a considerable

extent since it is very difficult to find two companies in the market with comparable overall competitiveness factors, leading to the conclusion that competitiveness is a factor which is measurable within a company (i.e. in terms of improvement or disimprovement) but that it is not possible to make comparisons between companies whose organization, human and technological resources, etc. are different.

The foregoing list of cost-generating factors could have included business taxation, since this is evidently a component of companies' cost structure. However, the analysis of this factor should focus on determining to what extent it affects the free allocation of resources, in line with the literal wording of the harmonization rule under consideration.

5.3.8.g) Possible impact of taxation on the free allocation of resources

It should be admitted that taxation does have some impact (albeit minimal) since, taking the example of tax on business profits, the existence of tax credits for investment and job creation and of different nominal and effective tax rates will impact the allocation of resources and the decision as to where to invest.

All other business competitiveness factors being equal, a reduction in effective taxation obtained through tax credits and the earlier recoupment of investments due to the higher after-tax profits will not be neutral.

However, reality is much more complex than the foregoing theoretical model, and the degree of influence declines as further factors are introduced into the model. Chapter V includes several examples of how a modification in tax regulations can impact various economic magnitudes.

In short, it should be construed that the harmonization rule does not seek to be rigorous in this sense since there will always be some form of distortion where the tax regulations differ. This matter has been discussed extensively in Chapter III.

Also, as mentioned above, the effect on the price may not be sustainable in the long term. Moreover, a reduction in business costs due to a reduction in taxation does not necessarily boost competitiveness since a company's logical reaction may be to redistribute the effect to other costs in order to improve the other factors set out above and, ultimately, obtain an improvement in competitiveness in overall terms.

Even then, business competitiveness (measured as a company's closeness to the market in comparison with its competitors) would not be affected since, as stated above, the competitiveness factors are closely linked to the concept of each company viewed in isolation, and a company may improve its competitive position without this impacting its competitors' strategy.

We also believe that it is essential to analyze the practical effects of the harmonization rule since, if it were proved beyond a shadow of doubt that taxation actually influences business decisions as regards resource allocation,

there should be some corrective effect offsetting the distortions caused by the tax regulation.

However, it should be borne in mind that any such distortion can only be observed after the fact, i.e.:

- after the tax regulation allegedly producing the distortion has actually come into force, and
- once it has been observed that, based on the regulation, businesses have taken decisions which distort the free allocation of resources.

Therefore, if it were found that a tax regulation had given rise to distortion, the solution might be to annul the regulation which breaches the harmonization rule, in which case the question would arise as to what to do with the parties which had benefited from the regulation:

- Annul the regulation retroactively, and have the beneficiaries "repay" the quantified amount of the tax advantage obtained through the revoked regulation, which would raise problems with pre-existing tax situation which had become definitive either through expiration of the statute of limitations or through approval in a tax audit. This would be a severe breach of the constitutional principle of legal security.
- Cancel the regulation from the moment when it is deemed to be in breach of the harmonization rule.

5.3.9 When issuing their tax regulations, the competent institutions of the Historical Territories shall attend to the principles of general economic policy (art. 4.11, 2nd paragraph)

5.3.9.a) Legislative position

This precept needs to be analyzed in the context of higher-ranking legislation on the subject.

The Spanish Constitution includes, under exclusive powers of the State, the "bases and co-ordination of general planning of economic activity" (article 149.1.13). The Constitutional Court has made a direct interpretation of this precept, stating that:[19] "What the Constitution is pursuing in granting the general organs of the State the exclusive power to establish the bases for regulating a given area is that those bases should have a uniform regulatory structure which is valid throughout the nation, thus assuring, for the sake of general interests which transcend those of individual Autonomous Communities, that there is a basic common regulation from which each Autonomous Community, in defence of its own general interests, can establish the peculiarities which it wishes within the framework of the powers which the Spanish Constitution and its Statute grant it in that area."

The Constitution also grants Autonomous Communities the possibility of taking on powers regarding "Fostering the economic development of the Autonomous Community within the objectives established by national economic policy." These powers are held at all times by the Common Institutions of the Autonomous Community and cannot be expressly delegated to the Provincial Governments.

Article 10.25 of the Basque Country Statute of Autonomy provides that the Autonomous Community shall have exclusive powers over "promotion, economic development and planning of the economic activity of the Basque Country, in conformity with the general regulation of the economy."

An examination of the foregoing precepts reveals, in the first place, a diversity as regards the terminology which is used (general economic policy, general planning of economic activity, general regulation of the economy, ...) which make it difficult to obtain a practical interpretation.

On an intuitive level, it can be concluded that these precepts reserve general policy for the State, with application in a more specific and subordinate sense (planning, development, etc.) being under the control of the Autonomous Communities; however, the distinction is so blurred in practice that little of substance can be derived from it apart from the vague primacy of the State. This matter will not be explored further here since it is felt to involve more a constitutional analysis of the Basque Country Statute of Autonomy which is outside the scope of this work. Note however that none of the terms are defined in Spanish positive law or in public finance case law.

However, the application of these concepts is coloured by the fundamental distinguishing feature of the Quota finance system, namely that the Basque Country's contribution to the State treasury does not depend on the tax receipts in the Historical Territories (the unilateral risk). Consequently, (and this is not the occasion for specific examples) the principles of the State's general economic policy which must be followed by the Basque Country will not include those expressed in tax regulations which relate merely to tax collection.

5.3.9.b) Analysis of the harmonization rule

The harmonization rule can become much easier to interpret if it is broken down into its component terms.

- It relates exclusively to "foral" regulations. To clarify this statement, consider that articles 10.26 and 45.2 of the Basque Country Statute of Autonomy specifically regulate monetary and credit policy.
- The rule refers directly to the Foral Institutions as being competent to issue this type of regulation.
- As regards the "intensity" of the rule, it uses the term "attend", meaning "take account of". We feel that this lack of imperativeness arises not only

from the intention of the legislators but also (necessarily) from the vagueness of the obligation to be complied with, i.e. "general economic policy", which would make it meaningless to use an expression such as "shall apply".

- The use of the term "principles" of general economic policy places the rule on an even higher plane of vagueness than the term "policy", which is already quite diffuse. The term "principles" can lead to different specific policies and, conversely, a given measure may be supported by various principles. Consequently, the relationship between principles of general economic policy and tax regulations is extremely remote and, therefore, difficult to apply apart from evident generalizations.
- Although it is the Historical Territories which are obliged to attend to these principles, the principles may be influenced, as we have seen, at least by the State and the Common Institutions of the Basque Country. Although, given the interpretation of the constitutional text, there should be no major discrepancies between the two administrations, it is interesting to consider that if the Basque Common Institutions, under the unilateral risk *vis-à-vis* the State as regards the financing of their powers, decided to undertake a very different economic policy, it would not be logical for them to be prevented from using taxation (as opposed to monetary policy which, moreover, is mostly beyond their powers) on the grounds of a direct link between the Historical Territories and the State through this harmonization rule.

In a situation, which deals with an undefined concept (general economic policy) over which various administrations (State and Autonomous Community) have powers and to which the foral institutions are only required to attend, it is clear that, although the rule is not void of content, it would certainly be very difficult to apply in practice. The High Court of Justice of the Basque Country pronounced itself on this matter[20] but did no more than refer to the necessary balance between the principle of the economic unity of the nation and the diversity of State and Autonomous Communities, considering also that the equality of all Spaniards always applies.

Determining, at the date of promulgation, whether a given tax measure clashes with the principles of general economic policy may be more difficult than might be imagined, unless the regulation is in open breach of such principles (e.g. a regulation penalizing job creation when there are economic policy measures seeking to reduce unemployment).

In this regard, it is clear that the more a tax regulation contributes to achieving the goals pursued by a specific economic policy, the greater the extent to which a measure will "attend" to such policy; this is something which is very difficult to assess reliably when a regulation is issued.

The provisions issued by the Basque authorities regarding Corporation tax apparently have the same objectives as set out repeatedly in successive State General Budget Laws. However, according to recent experience, the different incentives offered by the Basque legislation have caused the principal disputes between the Common Territory Administration and the Basque Provincial Governments, which relate to the scope of the regulatory powers granted to those Provincial Governments under the Economic Agreement. However, we understand that these disputes arise not through failure to attend to the principles of general economic policy.

5.3.9.c) Main tax measures adopted by the Basque authorities

To guide the subsequent economic analysis, we feel it is advisable to identify the main tax provisions which have been issued in exercise of the powers conferred by the Economic Agreement. Consider that the normative autonomy attributed by the Economic Agreement to the competent institutions of the Historical Territories has confined itself to Company Tax in the period considered here.

An analysis of the regulations issued by the aforementioned institutions reveals that they involved stimuli for investment, saving and employment. There follows a list (which does not seek to be exhaustive) of the main tax stimuli established by the various Basque tax regulations issued by the competent institutions of the Historical Territories:

- Special tax incentives for reconstruction of the damage caused by the floods in August 1983.
- Incentive regulations of 1988, relating to investment and employment.
- Asset revaluation, 1990.
- Incentives of 1993 relating to investment, employment, which provided "limited" tax holidays for newly-created companies that met certain requirements as regards investment and job creation.
- Incentive regulations of 1995, similar to their predecessors, although without tax holidays.
- Tax stimuli for investment and employment contained in the new corporation tax regulation in force from 1 January 1996.

In short, the regulations issued by the Competent Institutions of the Historical Territories has been extensive with regard to incentives for business investment and employment, possibly because the economic crisis was particularly harsh in their jurisdiction due to the high concentration of declining industries and because of a target of economic growth to reduce the high levels of unemployment.

5.3.10 The pertinent agreements shall be adopted in order to apply in the Historical Territories the exceptional and temporary tax measures which the State decides to apply to the common territory, and the same validity periods as for the latter shall be established (art. 4.10)

5.3.10.a) Context of the precept

The text of this rule is a copy of the provisions of article 41.2.c) of the Basque Country Statute of Autonomy, and this should be borne in mind since we are dealing not only with a harmonization rule but also with a higher concept which is a fundamental block in the system's structure.

The content of this rule needs to be linked to the "attention" to the principles of general economic policy established in article 4.11 of the EABAC, discussed above. It is clear that if such exceptional measures are issued, it will be because they are part of the general economic policy established by the Spanish government and, therefore, in this case the EABAC is being somewhat repetitive.

The rule literally seeks to establish an exception to the Basque Country's own tax system, namely the case of exceptional and temporary measures, an area where the foral legislator, despite being able, in principle, to establish the tax system he sees fit (while respecting the harmonization rule), must confine himself to being a mere "transcriber" of State legislation.

Considering the connection with the principles of general economic policy (which must also be reflected in the permanent and structural measures), we understand that the adoption of exceptional measures should be a priority, since they are the immediate reaction to an actual situation. That is to say, if tax regulations of this type are issued, the Basque Country must adopt them, whereas the structural legislation can be different as long as the same underlying principles are attended to.

5.3.10.b) Delimitation of the concept

A case of this importance, in that it involves a gap in the Basque tax sovereignty, needs to be appropriately delimited. To do this, it is necessary to define what is meant by "exceptional and temporary measures", since an abusive use of the term could render the EABAC meaningless.

Firstly, it should be made clear that these two terms ("exceptional" and "temporary") are indeterminate legal concepts and, as has been indicated above, must be defined when applied. Accordingly, the question as to whether such circumstances apply cannot be decided by the State: the courts have the final word.

As regards meaning, we can establish (since exceptionally is more difficult to establish beforehand) that such rules should, in principle, have a

limited period of validity, as suggested by the wording of the rule itself.

It is also important to note that tax regulations of this type which are issued by the State may be foreign to the system established by the Basque Country. For example, if the State issued an exceptional regulation to promote employment to combat a particularly serious situation of unemployment, with a validity period of one year, the adoption of this measure by the Basque Country might be meaningless if the latter permanently maintained other schemes to promote employment which are similar to the one adopted exceptionally by the State. In this case, the "foral" regulations need not be identical to those of the State, nor should the Basque legislature abandon its regulation in order to copy the exceptional regulations issued by the State.

To take an example where this rule might be applicable, if the Basque Country did not have any schemes to incentivate employment, it is much clearer that the Basque Institutions would be obliged to adapt their legislation to the State regulations.

5.3.10.c) Practical impact

The most important comment here is that the rule does not make such exceptional and temporary measures immediately applicable in the Basque Country but, rather, provides that the institutions of the Historical Territories adopt the pertinent resolutions to transpose the content of such measures into foral legislation. This is, once more, a recognition of the Basque Country's underlying power to establish its own tax system.

It should also be noted that this rule is not only to be observed, from the State's standpoint, as obliging the Basque Country to adapt its legislation, but also from the standpoint of the latter it is a safeguard for the Basque tax system against attempts by the State to impose "exceptional" and "temporary" measures on it, since such measures apply not immediately but only when they are issued by the competent Basque authorities.

Additionally, although not directly germane, note that this rule does not prevent the competent institutions of the Basque Country from issuing such exceptional and temporary measures as they see fit within the framework of the EABAC.

5.3.10.d) Summary

This principle must be observed as a corollary of the need for the competent institutions of the Basque Country to follow the principles of general economic policy, although (importantly) the rule means that the principles of economic policy do not apply directly to the Historical Territories but must be adopted by the Basque tax system, thus recognizing the tax regulatory powers of the Historical Territories.

NOTES

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6. Ruling dated 8 October 1992.
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14. Zubiri and Vallejo, ibid.
15. F. De la Hucha Celador, *Introducción al régimen jurídico de las Haciendas Forales*, Estudios de Derecho Financiero y Tributario, La Caixa, Civitas, Madrid, 1995.
16. Rulings dated 16/11/81, 28/1/82, 30/11/82, 28/4/83 and 1/7/86.
17. Supreme Court 18/7/91 and matching rulings.
18. Example: The fixed assets of a company subject to the Basque company tax regulations are depreciated and give rise to the same tax deduction regardless of the territory in which they are located.
19. Ruling dated 28/1/82, among others
20. Ruling dated 11/5/94.
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6. THE MEASUREMENT OF TAX BURDENS: THE ECONOMIC ISSUES[1]

6.1 INTRODUCTION

Harmonization rule no. 12 of the Economic Agreement, article 4, establishes, that "this Agreement shall not imply an effective overall tax burden lower than that existing in the common territory." However:

- This concept is unusual within Spain's internal legislation, apart from the wording of the new Organic Law for Financing the Autonomous Communities referred to above.
- The Agreement does not define the method for determining the effective tax burden in the two tax territories.
- No official public agency publishes an annual indicator of the effective tax burden.

The concept of the tax burden has been studied from a theoretical perspective and it is also calculated annually by the OECD to compare the tax burdens between countries and observe their evolution.

Linking this concept with the comments in Chapter 5 regarding the idea underlying the various harmonization rules which try to avoid tax competition between the Basque Country and the Common Territory, the Supreme Court Ruling dated 19 July 1991 described it as the blanket clause among harmonization rules, regardless of the fact that its unfortunate wording makes it difficult to apply in practice, as will be described later.

A first approach can be made to the concept of tax burden by distinguishing between the two basic meanings which can be given to the term, namely legal tax burden and effective tax burden. Although these two terms will be examined in detailed below, it could be stated that the essential difference between them is that the legal tax burden would be a quantification of the level of tax receipts potentially arising from the current regulations, whereas the effective tax burden would be the actual tax collected; therefore, due to factors which will be discussed later, it is normal for these two indicators to differ or for the relation between them to be indirect and imprecise.

This quantitative assessment will deal with the effective tax burden because harmonization rule no. 12, article 4 refers expressly to this concept.

We will begin with a theoretical study of the effective tax burden, broken down into the following headings:

- An overview of the concept of tax burden.
- Measurements of the tax burden. Specific, widely-accepted indicators of the tax burden: the classical index and the Frank index.
- In-depth analysis of the legal tax burden versus the effective tax burden.
- Description and analysis of the "fiscal balance", as opposed to the tax burden.
- Following the theoretical study of the effective tax burden, the specific scope and significance of the 12th harmonization rule in the Economic Agreement will be analyzed, including a discussion of the indicator to use and the quantitative and temporal scope of the rule, among others.

6.2 THE TAX BURDEN – INITIAL OVERVIEW

6.2.1 Definition of the tax burden

Surveys of the tax burden seek to measure the effect of taxation on the distribution of revenues and wealth in a society, and seek to ascertain who pays the taxes. This question can be answered by examining the tax laws, i.e. the various tax rates and the parties legally liable for paying them. It is well known that the legal impact of a tax need not, and probably does not, coincide with its economic impact. This mismatch is due to the fact that persons adjust their behaviour on the basis of their tax liability. Consequently, a person who is not legally liable for a tax may actually be paying it due to a process of "tax shifting", which clearly shows that the economic impact of a tax may differ from its legal impact. Accordingly, from a political standpoint, the effective tax burden is probably more relevant than the legal tax burden.

Economic theory has produced a number of instruments for measuring the tax burden, and many analytical and computation methods have been used to estimate this concept. These surveys normally identify the impact of a tax on the various groups in society. Atkinson & Stiglitz[2] identified the following spheres where tax incidence studies have been conducted:

- Producers, consumers and suppliers of production factors; in the case of tax on goods, the effects are analyzed with respect to profits and the revenues of the factors of production and of the consumers. If the price of the product rises, we say that there is a tax incidence, whereas if the tax affects the revenues of the production factors and intermediate factors, we say that the tax has been absorbed by the taxable subject.
- The functional distribution of revenues; in this case, the focus is on the distribution of revenues between labour and capital. This makes it

necessary to analyze a tax as regards its effect on the supply and demand of labour and capital and, consequently, on the prices of those factors.

- The distribution of income among individuals; the effects of state taxes and public expenditure can be analyzed for individuals which are classified according to group or income level. Which groups or income brackets pay most of the taxes and which ones benefit most from public expenditure?
- The regional impact of a tax; the effect of a program of taxation and/or public expenditure may vary from region to region.
- Inter-generational effect; taxes imposed on the present generation may produce benefits for the next generation, or vice versa.

This chapter will analyze basically the first, second and fourth types of impact, commencing with a definition of the tax burden and tax shifting.

6.2.2 Definition of tax incidence and tax shifting

We will commence our analysis with a textbook illustration of tax incidence.

The standard examination of tax incidence begins with a model of partial equilibrium in a competitive market. We will use a basic example of supply and demand for a particular good, say apples.

Figure 7:
Tax incidence: the basic model

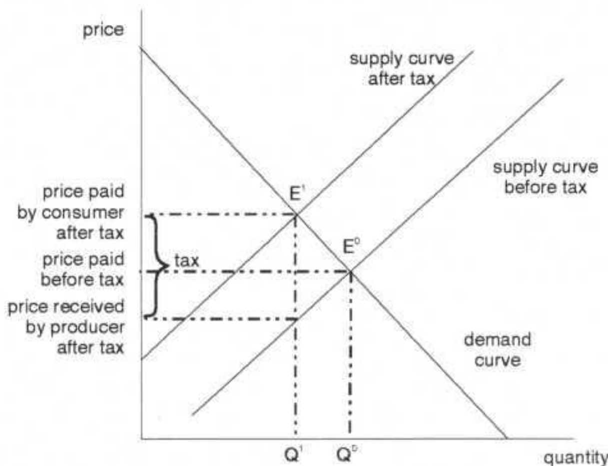


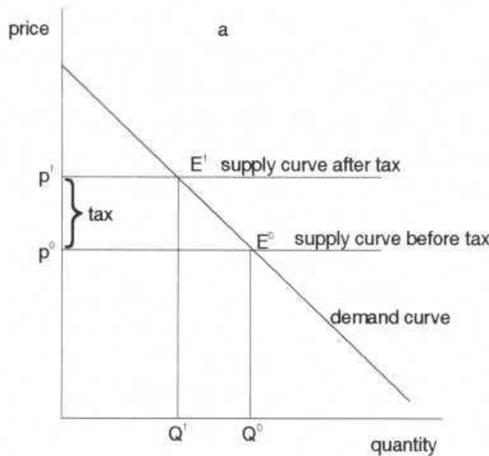
Figure 7 can be used to summarize the effect of a tax on amounts and prices. Before the tax, the equilibrium in the market is at point E. Assume that

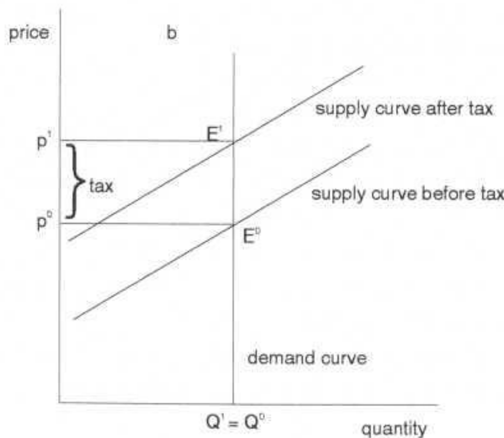
the government imposes a tax of t on apple producers, which must pay the tax to the government. The effect of this tax is to shift the supply curve up to the extent that apple producers are no longer prepared to supply the same number of apples at the same price: now they want the old price plus the tax.

As shown in the figure, the upward shift of the *supply* curve raises the equilibrium price. Nevertheless, the price rise is lower than the amount of the tax. Consequently, although the tax is levied on producers, consumers are actually paying a part of it in the form of higher prices. Thus, the tax burden is apparently shared between consumers and producers.

The amount by which prices rise due to the tax depends on the slope of the supply and demand curves. Various limiting cases can be distinguished.

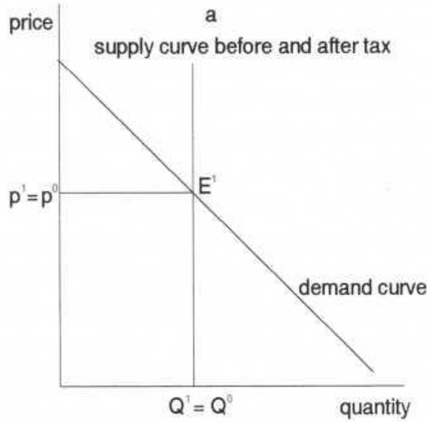
Figure 8:
Tax incidence: special cases

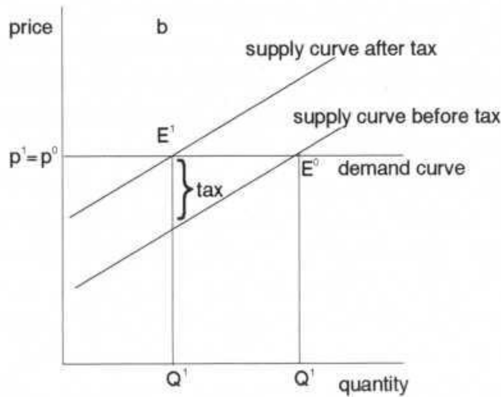




First consider Figure 8(a), where the supply curves are perfectly elastic. In this case, the price will rise by the total amount of the tax; i.e. the tax is passed on completely and the entire tax burden is actually borne by the consumer. The other limiting case is where demand is perfectly inelastic. In this case, the price also increases by the total amount of the tax.

Figure 9:
Tax incidence: special cases





In figure 9 it is assumed that:

- the supply curve is perfectly inelastic, and
- the demand curve is perfectly elastic.

With a perfectly inelastic *supply* curve (diagram 9-a), the market price is not affected by the taxation and the producers bear the entire tax burden. The same result is obtained if demand is perfectly elastic.

The above analysis shows that the slopes of the demand and supply curves determine the extent to which the tax is passed on to the consumer or borne by the producer. The slopes of the demand and supply curves can be measured by their respective elasticities. The more elastic the demand curve and the less elastic the supply curve, the greater will be the amount of tax borne by the producer and the lower the tax burden on the consumer. Moreover, the less elastic the demand curve and the more elastic the supply curve, the lower the amount of tax which will be borne by the producer and the greater the tax burden on the consumer. This conclusion is known as Dalton's Law and it expounds a basic principle on the incidence of a tax: a tax is borne entirely by inelastic demand or supply.

This analysis can also be used to show that it does not matter who the government collects the tax from, whether producers or consumers. Consider, for example, if the government collects the taxes from the consumers instead of the producers. In this case, the tax will shift the demand curve upwards, and the effect on prices will again depend on the elasticities of supply and demand.

The principles governing the impact of taxes on goods can be readily extended to other markets. Consider, for example, a tax on labour. Once again, the conclusion is that it does not matter who the government collects the tax from (i.e. workers or employers); what matters is the elasticity of supply and demand in the labour market. Imagine that the labour supply is perfectly inelastic. In this case, the workers will bear the entire tax burden, i.e. the effect will be to maintain the gross wages the same and to reduce the net amount paid to the workers.[2] Conversely, if the labour supply were very elastic, employers would have to bear most of the tax burden.

Discussing the labour market enables us to illustrate another factor relating to the transfer of the tax burden. Returning to the example of the product market, let us assume that neither the supply nor the demand curve are totally elastic. As we know, this means that the producers and consumers share the tax burden. Nevertheless, the implicit assumption in drawing this conclusion is that producers produce apples using labour whose supply is perfectly elastic, i.e. it is assumed that the workers would have the option to work for a given wage anywhere else outside the apple industry. Another implicit assumption is that the producer has zero supply elasticity. Evidently, these assumptions need not hold. Assume, for example, that the apples are produced using a perfectly inelastic labour supply and a perfectly elastic capital supply. Many empirical studies suggest that labour is quite inelastic with respect to wage rates (i.e. the assumption of a fixed labour supply is a

good working hypothesis for the market as a whole). Additionally, the assumption of a fixed capital stock is quite unlikely since savers can readily turn to consuming, and investors may be reluctant to invest if taxed. In these circumstances, a tax on basic products would depress wages. The application of Dalton's Law leads to the conclusion that taxation can have an impact on areas where no such impact would have been expected, in principle.

This is clear if we consider, for example, the effects of property taxes. These are usually established at local rather than national level and they tend to vary between different local jurisdictions. In the short term, a high local property tax will probably produce a high tax burden on property owners, since investment in property can be viewed as immobile in the short term. The property tax will only be borne by existing owners of real estate.[3] To see this, consider the case of property yielding an annual return of 10%, so that an asset yielding $100 is worth $1,000. If the local government imposes a tax of $50 per $1,000 of property value, this is equivalent to a 50% tax on the yield. If the existing owners only had to pay $50 and the value of the property were $500, assuming that more taxes were not levied elsewhere, it would still be possible to obtain a net yield of 10%. It is evident that subsequent owners will not be willing to pay more than $500 for the property since they can obtain a 10% yield elsewhere.

The impact of property tax in the long term may be different. Property owners who cannot or do not wish to move elsewhere face the same tax loss in the short term. However, the capital can be used firstly to improve the quality of the property (construction of sewers, roads, etc.). This would provide the possibility of passing the tax cost on to the new owners of the improved property. The same result would be obtained if the capital could leave the tax jurisdiction. In this case, capital in the high-tax jurisdiction would be reduced, and the opposite effect would occur in low-tax jurisdictions. As a result, the return on investment would rise in the high-tax jurisdiction and it would fall in the low-tax jurisdiction. This process would halt when the yields were the same in all jurisdictions. If the high-tax jurisdiction were very small in comparison with the low-tax jurisdictions, the effect would be insignificant. However, if this is not the case, the overall result in this free economy would be for the yield on investment to decline. There could also be certain side effects. Consider, for example, the smaller number of houses which would be available if capital fled the high-tax jurisdiction. As a result, rents would rise in order for the capital invested to earn the same return as in the low-tax jurisdictions. Another effect is that, as a result of the export of capital, labour has less capital to work with and, consequently, faces lower wages.

Local property taxes can also illustrate the phenomenon of "tax exports". Assume, for example, that all the property in the jurisdiction with property tax

is owned by non-residents. They will be ones bearing the tax in the short term, whereas the welfare of local residents will not be affected. Nevertheless, in the long term, when the capital can be exported, local residents will face higher rents and lower wages. Consequently, if there is capital flight, the local residents are the ones who ultimately bear the tax burden.

The impact of corporation tax has also been analyzed using this model. The burden of this tax must ultimately be borne by someone, and not necessarily the company. Once again, there are many possibilities. The most evident one is that shareholders bear the tax burden in the form of lower dividends. Corporation tax can also be passed on to consumers in the form of higher prices, or to the workers in the form of lower wages. Another possibility is that investors respond to the individual tax on companies by investing less in companies and more in non-corporate entities, until the rate of return on the two classes of investment is the same. The result of this process of equilibrium is that all the owners of capital (corporations, non-corporate entities and residents) bear the burden of corporation tax because the after-tax yield is lower as a result of the tax. Another possibility is that the burden of the corporation tax system has already been discounted in the form of lower share prices than would prevail in the absence of the tax. According to this hypothesis, investors in equities suffer no loss due to the law.

All the foregoing examples are analyses of partial equilibria. The drawback of this type of analysis is that it ignores all manner of side effects in sectors other than the one being considered. This may not be a problem if a direct tax is levied on an activity which is insignificant with respect to the economy as a whole, but it evidently becomes more problematic in the case of general taxes. For example, a reduction in total wages will particularly benefit labour-intensive industries; it can also be argued, with regard to supply, that a shift in the apple supply will impact the demand for products in other sectors and the demand for factors in those sectors.

To summarize, we have identified two basic principles of tax incidence, namely that it does not matter on which side of the market the tax is collected, and that taxes are borne by demanders or suppliers according to their elasticity, since those with an elastic curve can pass on the bulk of the tax burden.

6.2.3 Other preliminary comments

The tax burden can have varying scopes and meanings depending on the standpoint from which it is defined and analyzed, the principal ones being legal, economic, doctrinal and academic. The following paragraphs contain a preliminary analysis of this concept.

To facilitate comprehension of what follows, we will set out the simplest and most widely-used formula for determining the tax burden, namely *Tax receipts/Income* (used by the OECD, among others), although this formula will later be subjected to a critical analysis.

Therefore, from a generic standpoint, we first need to analyze Receipts and Income.

"Receipts" need to be defined in the light of the definition of Impositions. Under the General Taxation Law, Impositions, which are used to cover the State's general expenses, are classified in three major groups: Taxes, Levies and Special Contributions. The most important group, both quantitatively and qualitatively, is Taxes.

Taxes can be defined as a removal of funds from the private sector of the economy by the public sector which are not strictly a consideration. However, the other categories of imposition are, in some sense, a consideration basically for services provided by the public sector, whether such services are demanded by the subjects or not borne by the private sector.

The other magnitude, "Income", is estimated each year by public and private sector entities on the basis of its composition (origin) and destination. However, the estimates differ and become particularly less efficient when they address regional income within the State.

Impositions need not account for all public-sector revenues which involve an immediate effort on the part of the citizens (e.g. issuance of government debt securities), nor need all public-sector revenues create the tax burden (e.g. rent from property).

Calculating tax burdens is a tremendously difficult task. Consequently, indicators of the tax burden provide only "indicative" information. Tax burden indicators are incomplete for a various reasons.

Firstly, perhaps we should consider not just imposition collection but also *other types of coercive revenues* obtained by the public authorities, public agencies (e.g. social security) or private entities under public concession (e.g. toll motorways, water bills, etc.) and even compulsory personal services (e.g. military conscription, alternative social service, etc.) which would form part of a broad interpretation of tax collection but are not susceptible to precise quantification in terms of the economic effort demanded of citizens. There is also a quantitatively important effect, namely the financial gain obtained by the Administration on tax refunds (viewed as unremunerated deposits) which is built into in the Spanish tax system.

Secondly, we need to consider the *time scale over which to measure collection.* It is generally accepted, for evident practical reasons, that it should be measured on an annual basis, generally coinciding with the calendar year, but it cannot be ignored that collection accounts follow basically a cash criterion rather than a strict accrual criterion. Consequently, effects arising

from timing of tax payments, from granting tax deferrals, from incentives involving tax deferrals or even temporary exemptions from certain taxes, together with the speed with which excess taxes are refunded and the speed with which tax fraud is detected and settled and with which court rulings on tax (either favourable or contrary to the interests of the Treasury) are settled, leading to considerable atypical revenues or one-off payments, mean that the *annual tax receipts* are very much an approximate economic magnitude but are not indicative of the economic effort demanded of the citizens of a given territory in a given *year*. Moreover, most taxes accrue as a result of certain economic events or facts, which may or may not occur in a given year due to a variety of factors (economic cycle, one-off activities, changes in consumption patterns or mere chance).

Thirdly, the tax burden does not have a precise operational meaning, taken as an absolute parameter, since the arithmetic result will not indicate whether a level of taxation is high or low because:

- Both the level of demand for public services, and their cost, and the real needs which need to be attended to, can vary substantially between countries at a given time, or within a country at different times, or between different zones of the same country.
- Additionally, the national social organization can establish different means of financing what are considered priority social needs which can be attended to by contributions from citizens, and these may or may not be included in the calculation.

Therefore, we consider that the concept should be evaluated in relative terms in comparison with other economies.

We now come to the question of*comparability*, i.e. whether an appropriate indicator of the tax burden could show whether the citizens of a particular territory are subject to more or less burden from the public powers, at a given time, than the citizens of another territory. Comparability, which is apparently a simple idea, actually involves both conceptual and practical problems, which are due fundamentally to the following:

- The difficulty in defining homogeneous magnitudes in terms of the effort involved, because of the various factors affecting the latter (i.e. relative wealth of the country and its distribution among the citizens and companies, price levels, effects of currency conversion, etc.).
- The procedures for distributing the burden among the various taxes and among the citizens, particularly in progressive taxes, and the different formulas for saving or investment (which may not be included in the taxable base of certain taxes), and their dynamic effects in the long term.
- In particular, although this underlies the foregoing comments, since the goal is to measure the effort expended by citizens, the decreasing effects

of marginal utility must also be considered, since persons with higher nominal income may have to make a lower economic effort than citizens at relatively lower income levels.

- Additionally, the comparative effective tax burden may prove to be very similar or very different, whether the tax regulations are different or even similar, since the result is due both to the nominal tax burden from the legislation governing each country's tax system and from the way the tax is managed, and from the actions of the citizens themselves, not to mention the economic circumstances of the moment.

6.3 MEASURING THE TAX BURDEN

6.3.1 Modern methodology in tax burden studies

Empirical studies have been conducted to calculate the tax burden using various approaches. Atrosic and Nunns[4] distinguished between:

- studies on representative samples of taxpayers
- studies of aggregate data
- studies of microdata
- microsimulation studies
- applied general equilibrium models

Studies of representative samples of taxpayers normally calculate the tax burden for certain groups of taxpayers. These groups may be general (e.g. single men with no dependants, men with dependants, or with an average number of children, etc.) or specific (e.g. focusing on the group which will benefit most or suffer most from a particular tax). The tax rates, taxes effectively paid and taxes as a percentage of income are usually compared within each group. These surveys can vary as regard the range of taxes covered, from focusing on a single tax to covering all taxes levied at all levels of government. This type of study cannot reach any conclusion about the tax burden or expenditure without making certain assumptions about the impact of the various taxes.

For example, it is assumed that personal income tax is borne by wage-earners, that company taxes are normally borne by the shareholders and owners, etc. Certain taxes, such as property tax, capital gains tax, motor vehicle tax, etc. are normally borne by the consumers or by taxpayers and consumers. The resulting tax burden is calculated, for example, for four-member families in various income groups. These calculations indicate whether a tax system is progressive or regressive.

Surveys of representative samples of taxpayers are the oldest method for

calculating the tax burden. These surveys have been used on many occasions to evaluate the effect of changes in tax regulations. This type of survey is subject to certain apparent limitations, one of the more important ones being that they cannot address questions of horizontal equity, i.e. it is not certain that all taxpayers within a single revenue group will be affected in more or less the same way by tax policy. To reach this conclusion, substantially more information would be required on each taxpayer category (e.g. income sources, consumption patterns, etc.). There is no guarantee that the taxpayers in a given category bear the same tax burden.

Studies of aggregate data are similar to studies of representative samples, the essential difference being that they introduce the distribution of income and relate income to the distribution of the tax burden. This makes it possible, for example, to compare the revenues obtained by each revenue group with the percentage of total public expenditure which they receive. Using the Lorenz curves and Gini coefficients, the researcher can draw conclusions about the equity of the tax system. Moreover, comparing the taxes paid by each revenue group enables this type of study to draw conclusions about the progression or regression of the tax system.

Both studies of representative samples of taxpayers and studies of aggregate data estimate the tax burden by making certain assumptions about the impact of various taxes. The table below details the standard assumptions made by many of these studies.[5] Once an assumption has been made about the impact, the tax payment can be imputed to individuals with the aid of statistics on revenue distribution or according to consumer expenditure, etc. The effective tax rate for each income bracket is determined by calculating the tax imputation to the average revenues in each bracket.

As in the case of studies of representative groups of taxpayers, studies of aggregated data are not appropriate for addressing the question of horizontal equity.

This is not the case with studies of microdata, which have the advantage of being able to model differences in the tax burden between persons in the same income bracket. The information collected in these studies, which can cover hundreds of thousands of taxpayers, relate to variables such as access to various sources of income, consumption patterns, savings, demographic characteristics of individual taxpayers, non-tax economic characteristics, etc. The advantage of this procedure is that it can address questions of horizontal equity and can define the tax burden on the basis of demographic or similar characteristics. The availability of information in individual tax records enables the tax burden to be calculated individually instead of by income brackets, and makes it possible to analyze the effects of differences in the source of income. Microsimulation studies estimate and evaluate the effects of individual taxes on variables such as individual income, income distribution, tax receipts and economic efficiency.

Table 12:
Standard assumptions in studies of tax incidence

Taxes	Assumptions regarding impact	Imputation according to:
Personal income tax	Unchanged	Taxes paid
Corporation tax	1/2 on consumption 1/2 on income from capital	Consumption Income from capital
Excise and sales taxes	Consumption	Type of consumption
Property taxes:		
home	Owner	Ownership
rented home	Lessor	Rent
business	1/2 of income from capital	Income from capital
Payroll taxes:		
employer	Consumers	Consumption
employee	Employee	Earnings

Applied general equilibrium models (also referred to as computable equilibrium models) for analyzing the impact of taxes have become very popular in the last twenty years. With microsimulation tools, they are the most widely used methods for evaluating the effects of certain tax measures. Applied general equilibrium models are numerical specifications of complete equilibrium models, i.e. in principle they describe all sectors of the economy (family units, behaviour of companies, the public sector, the foreign sector, etc.). These models are used to evaluate a range of policies (e.g. tax and trade-related policies). Although the first applied general equilibrium models were designed at a high level of aggregation, much more disaggregated versions have recently become available. Their advantage is that they do not have the limitations of the partial equilibrium models and they can capture all types of interactions between sectors which the partial equilibrium models do not see. They also provide an exact framework for studying the interaction between the various taxes and public expenditure and their effect on such areas as resource allocation, distribution of income and economic growth.

Applied general equilibrium models have contributed substantially to measuring the tax burden and elaborating tax policies. These models normally allow a number of assumptions regarding the incidence of all taxes and provide the possibility of analyzing the effects on income of various tax proposals and of screening these effects from the distortion of economic

efficiency caused by taxes. Nevertheless, because of the enormous data processing load involved in these models, they are confined to academic research.

6.3.2 Tax coefficients

The tax burden is often measured in summarized form using tax coefficients and tax structure coefficients. These statistics have been used in many empirical analyses and have provided the support for many theoretical developments in measuring the tax burden (as described in the preceding sub-section), and they have been applied mainly in comparing different tax efforts between countries and regions. Many of these measurements have several drawbacks. Firstly, two countries can have the same tax indicator in terms of GDP but have different tax structures, different methods of determining taxable bases, different exemptions and tax credits, or simply different procedures for complying with tax law. Secondly, relating tax to GDP does not give any indication of the distortions (e.g. efficiency losses in the various tax structures). Regions may have identical coefficients but the effect distorting the tax effect may have a greater influence in one region than in another. Thirdly, tax coefficients do not reflect the integration of different categories of taxes e.g. between Personal income tax and corporation tax. Consequently, tax coefficients give scarcely any information about tax shifting.

Three types of statistic are normally defined for measuring tax effort and tax structure in different territories,[6] namely:

- the total tax burden coefficient is defined as:
  $TB_j = TB_j/Y$ i.e. Tax Receipts/Income

- specific tax burden coefficient:
  $TB_{ij} = R_{ij}/Y_j$

  Specific tax burden coefficients are normally calculated for personal income tax, corporation tax, employee social security taxes, employer social security taxes, general consumption tax (VAT) and excise taxes.

- measures of reliability in specific categories of taxes:
  $R_{rij} = R_{ij}/TR_j$

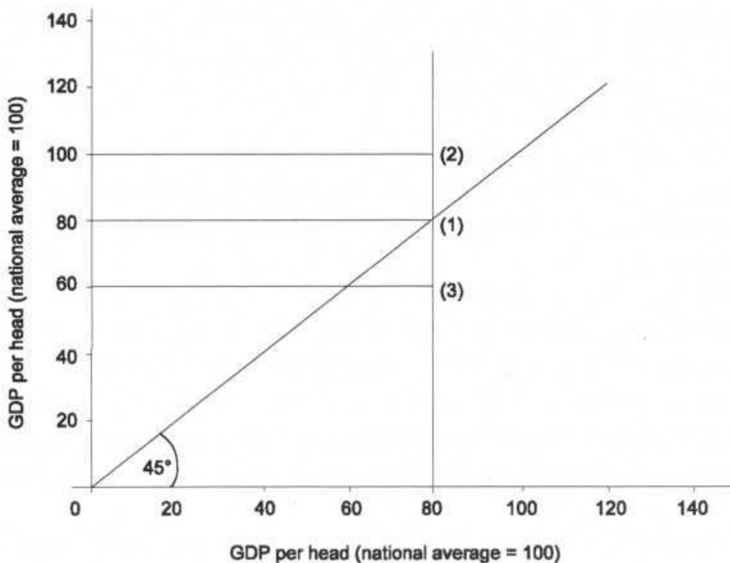
  which is an instrument for measuring the relative receipts under a tax, where R_{ij} = the yield from tax category i in country j and TR_j is the total amount of tax revenues.
  This sort of measure is an indication of the composition of tax revenues. In many countries, personal income tax and the related withholding tax

account for a major part (normally over 75%) of total tax revenues. Additionally, international comparisons have shown that, in the last two decades, many countries have become increasingly dependent on personal income tax and on withholdings from salary income, and that tax structures are giving less importance to taxes on consumption (which normally account for a constant percentage of tax revenues).

- Inter-regional comparisons of the tax burden also include measurements of the tax effort or "relative effort measurements," as they are usually termed. These are calculated by dividing the total tax burden in a region j by the national average.

Local tax efforts can be corrected to eliminate differences between the economic capacity of the residents of the various territories, e.g. for differences in per capita income. This can be used to evaluate whether certain citizens are being taxed at above or below the national average. Figure 10 shows the information which this adjustment can provide.

Figure 10:
Local and national taxation



In this graph, the abscissa is the average per capita taxation (base 100) and the proportion between local income and the national average. The ordinate reflects the effective tax receipts per capita, taking the national average to be 100. The distance to a line at 45° indicates whether the local community's per capita tax effort is above or below the national average. Assume, for example, that a region occupies position A and its average income per capita is 80% of the national average. If Area A is in position (1), where the tax receipts are also 80% of the national average per capita, then it can be concluded that the region's tax effort is average. If it is in position (2), then its tax effort is above average; in position (3), its per capita tax effort is below the national average. Comparisons between regions' tax efforts need to be analyzed with care, since a region's tax effort may be above or below the national average for a variety of reasons. It might be that the region is very poor and that very high tax rates are required to cover the basic services. There might also be cultural differences, i.e. citizens of a particular region may prefer to pay higher taxes in exchange for more public services. Conversely, a low tax effort may reflect an average level of services with a favourable tax base (e.g. a large number of wealthier individuals).

Figure 11 shows the results for 1982-1995 of the ratio between the per capita tax receipts in the Basque Country and the total for Spanish State as a whole. The trend in the graph suggests that, in per capita terms, the residents of the Basque Country suffer a greater tax burden than the residents of the Spanish State as a whole.

Summarized statistics like these are normally used by international organizations such as the OECD to indicate differences between tax policies and tax efforts between countries. As noted above, these coefficients need to be interpreted with caution since they cannot give a comprehensive picture of the level of government intervention in the economy or of the level of obligatory transfers from the private to the public sector.[7] This is due to several factors:

- In addition to taxes, governments have other non-tax means of collecting revenues, such as tolls for the use of highways, distribution of the earnings of State-owned companies, indebtedness, and monetary financing of public expenditure.
- Many governments use "fiscal expenses", i.e. subsidy programs implemented through the tax system whose effect is to reduce tax revenues. If other governments use direct expenses, the countries using "fiscal expenses" will have lower coefficients even if they have the same level of government intervention in the economy. Moreover, in certain cases it is difficult to distinguish between direct and fiscal expenses (e.g. certain head-of-household tax credits).
- Governments often provide guarantees for loans, with the effect of

Figure 11:
Per capita taxation on the average
Basque Country vs Spain

reducing the cost of debt.

- In many countries the government pays a sizeable portion of taxes to itself; i.e. lower levels of government can pay higher levels, or the vice versa.
- Tax coefficients usually depend on the form of government or constitutional system. Federal countries, such as the USA and Switzerland, usually have lower coefficients than centralized countries. However, considering that in federal countries, lower levels of government are normally entitled to charge personal income tax and Corporation tax, the information provided by the tax coefficient in a federal country is probably distorted by the fact that many taxes are local.
- Many tax coefficients depend on factors such as inflation and economic growth. For example, the coefficients for personal income tax tend to increase during periods of inflation and growth due to the progressive nature of the tax scale. This would not be the case with social security tax, which is normally subject to ceilings, with the result that the percentage of social security tax is lower during inflationary periods. Percentages of VAT normally rise with economic growth, but they are not seriously affected by inflation, which is in both the numerator and the denominator of the coefficient.
- Tax coefficients do not provide any information about the impact of the tax, which is problematic if the coefficients are used for comparisons of the tax burden between countries or regions, because it is well known that certain taxes can be transferred from one tax jurisdiction to another (tax exports). According to the international economic literature, this occurs when a big country imposes tariffs (because of the terms of trade effect). However, taxes can also be "exported" between regions, particularly in the case of production taxes when the region where the taxable event arises has a monopoly (e.g. taxes on tobacco in the southern states of the USA).
- The measures do not accurately reflect the taxable base, i.e. they assume implicitly that the taxes are levied on the GDP as taxable base. Given the differences in tax structures and in tax management systems, measurements such as those given above have no information on actual taxable bases.
- Tax coefficients mentioned earlier do not reveal whether public expenditure is effective and/or efficient. A low tax burden to finance government programmes which are ineffective or inefficient may be more harmful to economic growth and social welfare than a high tax burden to finance effective and efficient programmes.
- Lastly tax coefficients (and coefficients of public expenditure) are not a full measure of the funds relocated or redistributed by government. Government can also make use of credit policy, fiscal expenses policy and regulatory policy to finance, subsidize or create certain activities.

6.3.3 Classical index and the Frank Index

6.3.3.a) Classical index for measuring the tax burden

The classical indicator of the tax burden, described above, is the ratio between the resources detracted in a year and the total national income in the same period.

The critique of this index is that it is of little value since it does not appropriately consider per capita income and its distribution among the citizens.

6.3.3.b) The Frank Index

The Frank Index seeks to correct the effect described above by determining the tax effort on per capita bases.

The Frank Index is obtained from the above index, divided by per capita income; i.e. the classical index is now weighted by the inverse of per capita income. This index is expressed mathematically as follows: *(Receipts * Population) / National Income squared.*

The critique of this index arises basically from the great importance attributed by the formula to Income (which is squared). Consequently, countries with relatively higher income tend to have lower tax efforts according to this indicator. In other words, in order to obtain similar levels of tax effort with different levels of income, the tax burden in one territory must be greater than in the other in the same proportion as its income per capita is lower. This is explained simply in the following table.

Table 13:
Income levels, tax burdens and the Frank index

	Territory A	Territory B
Per capita income	100,00	400,00
Tax burden	25%	100%
Frank index	0.25	0.25

This means that if one country's per capita income is four times that of another whose Frank Index is 25%, it must confiscate all income in order to attain the same level of tax burden, according to this index. In mathematical terms, this implies that the ratio between tax receipts must be the square of the ratio between per capita incomes. In the example, the taxes in country B must

be 16 times the level in country A.

This index can also be criticized for ignoring the dispersion of per capita income; additionally, comparisons are affected when different currencies need to be standardized between countries with different price levels.

Despite the foregoing criticisms, we believe that this index can be used for similar economies, provided that the results are analyzed and interpreted appropriately. According to Eugene Domingo Solans,[8] out of all the indices and models of tax effort (Frank, Bird, Lotz and Moos, Tanzi, etc.), the most practical one is the Frank index, which relates the tax burden to a country's per capita income. However, he also states that the results obtained with this index need to be analyzed with care due to the excessive importance which the Frank index attributes to income. Specifically, Domingo Solans states that "since, if instead of income or Gross Domestic Product, the index used disposable income, i.e. income after paying taxes, as in the Bird index, the results would be more balanced and the (perhaps) excessive weight given by the Frank index to income would be corrected."

For every percentage point by which the per capita income of one territory exceeds that of another, its tax burden must rise by one-hundredth of the percentage of the tax burden in the country with lower per capita income.

Table 14 illustrates, for reasonable differences in per capita income, the increase in taxation which would make the Frank index equal, based on a 25% tax burden in the lower-income country.

6.3.4 Essential factors which impact the level of tax receipts

The foregoing paragraphs focused on certain factors which can impact the tax burden, as part of a general overview of the subject. However, certain circumstances which can affect the level of tax receipts merit specific theoretical analysis, in particular the following:

- Tax fraud.
- The economic structure.
- Progressiveness.
- Exceptional tax measures in the face of exceptional circumstances.

Tax fraud responds to a complex number of causes, some of which are inter-related. The principal causes are as follows:

- The complexity of the legislation and the methods of management and control which are applied.
- Culture: if the taxpayer feels subjectively that there is no relationship between his contribution and the public benefits which he subjectively perceives, particularly if society tolerates or even accepts and abets fraud.

Table 14:
Per capita income differences and the Frank index

Percentage Difference between Per Capita Income	Increase in the tax burden to attain the same Frank index (to be added arithmetically to the current tax burden)
1%	0.25%
2%	0.50%
3%	0.75%
4%	1.00%
5%	1.25%
6%	1.50%
7%	1.75%
8%	2.00%
9%	2.25%
20%	5.00%
25%	6.25%
50%	**12.50%**

- Economic organization and structure, since complex societies with a high level of inter-relations make tax fraud more difficult.
- Types of activities: i.e. agriculture, tourism and certain industrial activities which can be performed partially in the home find it easier to evade taxes; there are also small shops and business and professional activities over which it is more difficult to exercise control.

Business profitability: since low or very high levels of profitability may encourage tax fraud due to the need for a high marginal utility on revenues or because of the greater ease with which revenues can be concealed.

The economic structure can have a direct positive effect on the volume of tax receipts. Certain writers have studied this matter and concluded that a larger volume of economic activity and of trade boosts tax receipts by more than it boosts income.

A progressive tax structure can have various, opposing effects on tax receipts, depending on how income is distributed and on whether tax is levied

on families or on individuals.

Finally, certain exceptional circumstances (e.g. natural disasters, major industrial restructuring, etc.) can significantly cut tax receipts in the immediate aftermath and make it necessary to provide generous tax incentives in order to return quickly to the pre-existing situation. The smaller the territory in which these circumstances arise, the greater is the effect due to the possibility that the event will affect a larger proportion of that territory's taxpayers.

All these circumstances can mean that identical tax regulations and tax management systems can lead to very different levels of tax burden, even when the nominal tax burden is similar.

6.4 VARIOUS POSSIBLE CONCEPTS OF TAX BURDEN: EFFECTIVE BURDEN VS. NOMINAL BURDEN

Regardless of how it is measured, the tax burden can be considered from several standpoints, the main ones being as follows:

- Legal tax burden
- Effective tax burden

6.4.1 Legal tax burden

This can be considered as the potential economic effort arising for the taxpayers from the tax legislation in force. The legislation is the legal expression of the Treasury's policies at a given time in a particular territory and establishes what the public powers can require of the citizens under the law.

Therefore, the legal tax burden would be a synthesized indicator of the content of tax legislation in each of the items to be compared. This set of legislation normally changes with time and responds not only to the prevailing concept of the public powers as regards their degree of intervention in the economy, but also the intention to cover the trend in public expenditure needs at any given time, as the situation and economic circumstances permit, in order to obtain the necessary funds.

In practice, it can be difficult to make comparisons with other legislation in other territories due to the fact that the economic agents may be operating in different circumstances, and it may also be necessary to combine the economic effect of various taxes.

Nevertheless, after a probing analysis, it is possible to draw some conclusions (probably merely indicative) about the legislators' intentions regarding the burden arising for the taxpayers from the legislation applicable to them at any given time.

6.4.2 Effective tax burden

No matter how intensive the study, the difficulties involved in quantifying the tax burden by studying the regulations in force in various territories has led to the need to define other instruments for measuring it which are based more on mathematical methods and use the available statistical information and the actual tax receipts in each tax year.

The practical application of tax legislation to taxpayers' economic realities may lead to effects which would not be predicted from the laws themselves or from the projections of tax receipts based on those laws.

The fundamental difference between the legal tax burden and the effective tax burden arises, therefore, from the fact that the former measures the amount which it is wished to raise, whereas the latter measures the amount of tax actually raised. In particular:

- The establishment of a given regulation does not mean, per se, that taxpayers must necessarily perform the acts which are taxable events under that regulation. However, this possibility is probably insignificant except for taxes involving small monetary amounts levied on randomly chosen circumstances.
- Moreover, there are numerous real cases where a reduction of the legal tax burden did not have a symmetrical effect on the effective tax burden; on the contrary, the tax receipts can actually remain stable or even rise due to a complex interplay of causes and effects (ranging from a reduction in tax fraud or evasion to dynamic economic effects triggered by reduced taxation).

6.5 TAX BURDEN VS. TAX BALANCE

6.5.1 Benefit impact

So far we have only examined the problems of tax incidence and tax shifting from the tax side of the equation. It is possible to apply the same analysis from the standpoint of the State expenses budget. The expense burden can also be shifted; for example, a tax aimed as a subsidy to production may be shifted to consumers. It may be advisable to analyze the distribution of revenues arising from various public expenses. An appropriate approach to the tax incidence would take account not only of the tax burden on the revenue side but should also consider the expenses side of the national budget in order to evaluate the tax incidence of a number of variables. This is normally termed "benefit impact". A benefit impact analysis is a difficult undertaking since information is required on the assignment of public expenditure. Consequently, the benefit

part of the tax incidence has been relatively ignored in comparison with tax incidence itself. Many benefit impact studies confine themselves to the impact of the benefit at national level on various income brackets. However, little work has been done on the geographical impact of the benefits (e.g. on regions and local communities).

In estimating the benefits arising from the State's budget expenditure, a distinction could be made between:

- expenses relating to goods and services which can be assigned directly (e.g. education);
- transfers which are assigned by their very nature (e.g. Social Security); and
- expenses relating to goods and services which cannot be directly assigned (defence, police, general government administration).[11]

The benefits for certain categories of expense (education, health care, agriculture, social security benefits, etc.) can be assigned among family units on the basis of their related income bracket. In many societies, these benefits are reduced as income increases, reflecting the fact that many transfers consist primarily of retirement pensions and social welfare benefits.

Benefits which cannot be directly assigned to particular groups (e.g. defence) must be imputed, which can only be done using arbitrary assumptions. For example, it could be assumed that these benefits rise with income and that they should be imputed on the basis of the taxpayer's income. Another possibility would be to impute these benefits on the basis of the tax burden borne by the individual income brackets. It could also be argued the poor gain more from these benefits than the rich. The benefits assigned in this way can be broken down at various levels of government.

International and inter-regional comparisons of the impact of expenditure often use similar measures to those used in the analysis of international and inter-regional differences in the tax burden. The following coefficients are used to measure the expense effort in different jurisdictions:

- expenditure coefficient: $EC = PE/Y$

where PE = public expenditure

Expenditure coefficients are not the same as tax coefficients for two reasons. Firstly, governments often run a deficit and borrow to finance their current expenditure rather than raising the tax burden. Most countries run deficits, thus imposing "implicit taxes" on the economy by removing funds from the private sector for government use. Secondly, the tax coefficient does not take account of certain non-obligatory revenues collected by the government (e.g. fees for specific services).

- specific expenses coefficient: $EC_i = PE_i/Y$

where PE_i is a specific public expense

- measurements of dependency on specific government expenses (DPE): $DPE = PE_i/PE$

Measurements such as those defined above can indicate the relative importance of government expenses in the jurisdictions under examination and can provide indications of changes in the composition of public expenditure.

- relative ratios of expenditure are obtained by dividing the expense burden in region j by the national average.

As with tax coefficients, expense coefficients need to be interpreted with care, often for the same reasons as in the case of tax coefficients. Moreover, it should be borne in mind that expense coefficients do not measure the extent to which a government provides services (differences in the population involved), or the intensity with which they are supplied (level of supply compared with population involved) or the quality of the public services. They simply measure the effect of government expenses on the costs base and not in relation to welfare. Moreover, the geographical and regional study of services (social benefits), measured in terms of incidence using benefit coefficients, is complicated by the following phenomena:

- not all residents in a region have the same access to the public goods provided by the government in that region;
- the benefits can accrue to individuals outside the region bearing the tax burden, e.g. infrastructure financed with the public expenditure of a region can be used at no charge by residents of adjoining regions ("spillover").
- mobility of persons and capital.
- the composition of public expenditure can also affect the tax system, in terms of the total tax coefficient and the composition of tax revenues, due to the fact that many taxes are reserved for financing a specific type of public expenditure (e.g. social security).

6.5.2 Other factors

As mentioned before when discussing theoretical methods for determining the tax burden and as arose from the discussion of fiscal competition between territories, many writers consider that a study of the tax burden should

consider the effects of public expenditure, under two approaches:

- A maximalist approach, considering the entire public expenditure.
- A more restrictive approach, which seeks to link expenses with the taxes established specifically to finance them.

These concepts are based on two approaches:

- One, considering not only coercive revenues but also other revenues of the State which are required to meet its obligations.
- Two, deducting from the tax revenues the total amount of funds transfers from the public sector to the private sector which the private sector itself would otherwise have had to pay directly.

The philosophy underlying the term *fiscal balance* is probably the most appropriate one for measuring the net effort required of the citizenry by their public sector. However, in practice, it is extremely complex to measure what is "given back" to the private sector since it is often not sufficient merely to monetarily quantify the transfers without correcting for other more intangible factors, such as the efficiency in executing expenditure, attention to actual needs (arising generally from subjective or even ideological assessments), the real utility which this provides to the private sector and/or the redistributive effects which may arise.

The effects of the uncertainties described in the preceding paragraph may mean that, for the same level of classical tax burden in terms of State expenditure, and even with similar State expenditure in monetary terms, there may be different levels of tax burden as measured from the standpoint of the fiscal balance.

This problem remains theoretical in that no appropriate instruments have been developed to measure it in real economies.

This highlights, once again that, although what we know as "tax burden" is perceived intuitively to exist, it is objectively complex to translate it into reliable indicators in practice.

This philosophy could serve as an instrument for building consolidated long-term scenarios for defining and establishing tax policies, although such instruments should be used with caution.

In fact, it was Barrére[12] who said that "... In reality, the tax burden coefficient, like many of the coefficients used in modern reasoning (e.g. the equity coefficient) is merely an instrument of analysis.

Consequently, we consider that the essential significance of the coefficient is that it allows a comparative reasoning between magnitudes, recorded in the most diverse countries, which require an in-depth examination. It brings interpretative elements which demand a confrontation between the tax burden, the importance of per capita income, the range of satisfactions

provided by the public economy. Accordingly, it enables one to advance in the examination of certain phenomena; it is in the plane of economic analysis, not of financial analysis."

6.6 ANALYSIS OF THE HARMONIZATION RULE: INTRODUCTION

As stated above, the harmonization rule contained in article 4.12 of the Law of the Economic Agreement with the Basque Country literally states that "The application of this Agreement shall not imply an overall effective tax burden lower than that existing in the common territory."

The aim here is to delimit the intended scope of this harmonization rule by considering, inter alia, the foregoing theoretical analysis of the various meanings of the tax burden.

Firstly, note that the harmonization rule being analyzed here links the following terms or expressions:

- The concept of effective tax burden, which was discussed above and will be revisited.
- The expression "the application of this Agreement" i.e. the regulatory and management powers granted under the Economic Agreement to the Competent Institutions of the Historical Territories of the Basque Country.

That is, at first glance it could be inferred that the twelfth harmonization rule seeks to establish, quantify or, in the final instance, measure the impact on the overall effective tax burden of the use by the Basque tax authorities of the regulatory and management powers granted by the Economic Agreement.

The first comments arising from this reading, which will be expanded on later, are as follows:

- The fact that the rule speaks of *"effective burden"* should be understood as not limiting the powers of the Autonomous Community in that the Basque Country institutions may, within the scope of their powers, establish a different legal tax burden provided that it does not lead to a lower effective tax burden.
- Additionally, since the *"effective tax burden"* can only be measured some time after the fact, it might be construed that it is necessary to wait for a given period in order to be able to measure and evaluate the effects.
- The scope of the term *"overall"* should mean that the measurement should not be made on a tax-by-tax basis but on the set of taxes, which further reinforces what was said above regarding the actual ability to use the powers of the Autonomous Community regulations within the faculties granted for each tax. In fact, as can be inferred from the Supreme Court ruling dated 19 July 1991, the use of the term *"overall"* could also be

inferred as meaning that it should be extended to all taxes and even to other revenues (e.g. social security) regardless of what echelon exacts them.

- The term *"overall"* could also be interpreted as meaning the tax burden borne in a territory as a whole, as opposed to the individual tax burden, which could be taken as the tax burden borne by each inhabitant or, where appropriate, by each "standard inhabitant" of a given territory.
- The rule does not define accurately the formula and/or method for determining the overall effective tax burden.
- The wording *"lower than that existing in the common territory"* appears to suggest a static, timeless comparison, in contrast to the underlying dynamism of the concept of tax burden and to the period of time in which it should be measured.
- Following on from the previous comment, the Economic Agreement does not establish any specific period for measuring the tax burden for the purposes of compliance with this rule. In an extreme case, it might be sufficient for the tax burden on a particular day (if it could be measured) to be lower in order to breach the literal wording of the rule, which does not appear to be reasonable.

These initial reflections give rise to the first doubts regarding the interpretation of this harmonization rule and its intended or real scope. It is evident that the content of the rule is imprecise and that the specific definition required in order to apply it, without evident impairment of the jurisdictional criterion, will be extremely difficult due to the technical complexity of the matter and the number of variables to be considered.

6.6.1 Effective tax burden

As described in the preceding section, the concept of effective tax burden itself is not a pacific question in the area of public finance and there are many indicators of this variable which respond to different meanings or approaches to the concept of tax burden. It can be inferred from practically all the indicators that measurements of this variable are influenced by factors other than tax revenues, such as income levels (which can be measured in absolute or per capita terms) and the level of public expenditure ("fiscal balance" models) and others.

These indicators deal with the tax revenues actually collected in a given territory, which are affected not only by the regulations applicable in that territory but also by other variables and/or circumstances such as the structure of income and of the processes by which it is generated, the economic cycle,

the level of corporate efficiency, tax fraud and others.

Therefore, one might come to question the relationship underlying the Economic Agreement between tax and management regulations and their impact on the overall effective tax burden, since this relationship cannot be described as direct, unilateral, definite or, in some cases, quantifiable.

In fact, assuming that the same tax regulations and management system existed in the Historical Territories of the Basque Country and in the rest of the Spanish State, one might question whether the overall effective tax burden would be identical or, at least, similar. In fact, the question might arise as to whether the Autonomous Communities which are part of the common regime and are integrated into the State bear the same overall effective tax burden, despite having the same tax regulations and tax management system.

Accordingly, at this point of the analysis the following question arises: even assuming the existence of an indicator which reliably quantified the effective tax burden, and assuming that this indicator revealed that the effective tax burden was lower in the Basque Country than in the Common Territory, to what extent could that difference be attributed directly and unequivocally to the application of the Economic Agreement? In other words, under the foregoing assumptions, could it be stated categorically and unequivocally that a certain amount of the difference in the overall effective tax burden is due to different tax and management regulations?

The theoretical models of the tax burden analyzed above, and simple common sense, would suggest that the answer to these question is in the negative, and the relationship between tax regulations and the effective tax burden should therefore be treated with caution.

The sections below will attempt to analyze the actual situation.

6.6.2 Concepts of "overall" and comparability

Note that the preceding comments were based on two fundamental assumptions which can be deduced from the letter of the harmonization rule itself, namely:

- We understand that the term "overall" as relating to the effective tax burden should be construed as referring to all coercive revenues obtained by the public authorities.
- The rule appears to be seeking to compare the indicator of the overall effective tax burden obtained in the Basque Autonomous Community with that obtained in the Common Territory.

With regard to the first assumption above, note that coercive revenues obtained by the public sector in a given territory are not confined to taxes collected. As stated before, in the theoretical analysis of the tax burden, they

may be obtained by other means, the most significant one in Spain being social security contributions.

In this respect, note that:

- The powers granted by the Economic Agreement to the Historical Territories relate only to certain tax revenues, referred to as "devolved taxes", although these taxes evidently do not encompass all the coercive revenues exacted by all the public authorities in that Autonomous Community. That is to say, there are certain coercive revenues of a tax nature collected in the Basque Country (e.g. excise taxes) which should form part of the overall effective tax burden in the Basque Country but which are impossible to quantify.
- Additionally, in the scope of the devolved taxes, the existence of handles for application of legislation and/or for exaction by one administration or another may lead to distortions where it is difficult to determine the final taxpayer (and impossible to quantify the distortion), and this may lead to a shifting of the tax burden between territories, even in consecutive processes.
- Note also that the Economic Agreement attributes certain receipts to the Basque Country through adjustments both outside the Quota (mainly the VAT adjustment) and in the calculation of the Quota (adjustments in direct taxation and of central taxes, and even of effects arising from the budget deficit) which respond to pacted formulas and may differ from the related burden actually borne by the taxpayers in either territory.

In this connection, certain writers[13] state that: "... consequently, there is not a clearly defined relationship between the taxes paid in a region and what is collected by the treasury offices located in that region.

In the absence of adjustments, the tax receipts of the Basque Territories understate the true tax burden borne there. However, it is complicated to quantify this difference."

The second case further highlights the idea that the "effective tax burden" should be considered not in an absolute sense but, rather, in comparative terms with respect to other territories which, in the case of the twelfth harmonization rule, appear to refer to the Basque Autonomous Community and the rest of the State (Common Territory), although the Agreement does not expressly mention that Community.

As regards the question of comparability raised by the harmonization rule in article 4.12, the rule provides that the overall effective tax burden (of the Basque Country, we understand) must not be lower than in the Common Territory. That is to say, this rule establishes a mathematical inequality regarding the overall effective tax burden.

As described in the preceding section, which addressed the theoretical

aspects, quantitative indicators of the tax burden need to be handled with caution.

Therefore, it is not possible to draw reliable, real conclusions about the results of the foregoing mathematical relationship, which is expressed in terms of variables which cannot be quantified precisely. That is to say, although this aspect will be discussed in greater detail later, it can be said that the result obtained by comparing the overall effective tax burden in the Basque Autonomous Community and in the Common Territory might not be meaningful in practice given the lack of assurance that the indicators used are correct (in that they correctly and accurately quantify the overall effective tax burden) and that the comparison is homogeneous (in view of other distinguishing factors between the two territories, some of which are described later).

6.6.3 The indicator

Thirdly, the twelfth harmonization rule does not define the indicator to be used to measure the level of overall effective tax burden for the purposes of the comparison envisaged in the rule.

The section on theoretical aspects has referred, conceptually at least, to the numerous indicators established for this purpose by various authors. Those indicators included the "classical indicator", which links tax receipts to income, although it did not appear to be fully responsive to the concept of tax burden. Consequently, the possibility is raised of using other indicators (or a compendium or average of various pre-set indicators) to check, if possible, the degree of compliance with the twelfth harmonization rule.

That is to say, it could (and probably will) occur that the results will vary depending on the indicator used to quantify the overall effective tax burden, meaning that it would not be possible to conclude reliably whether the harmonization rule in question is complied with or not. For example, according to the "classical indicator" (tax receipts over income), the overall effective tax burden of the Basque Autonomous Community is slightly higher than in the Common Territory, yet the Frank index (analyzed above) shows that it is lower. Averaging the two indicators indicates that the effective tax burden is similar in the two territories. Is it possible, then, to draw a definitive conclusion as regards compliance with the twelfth harmonization rule?

The conclusion is, again, that the results obtained by comparing the overall effective tax burden must be treated with caution and analyzed in detail in order to be able to issue an opinion about compliance with the twelfth harmonization rule, and the results of the analysis would probably have to be considered on a relative basis, i.e. not viewed as conclusive.

Moreover, regardless of the indicator used for the effective tax burden, the result may vary for the same time period and territories depending on the sources of information. Recall that the analysis of the solidarity principle revealed that the income of the two territories (GDP or GVA) differed for a given year depending on the information source (see graph 401, regarding the imputation index). This is another reason why the results obtained should be considered to be approximate.

6.6.4 The meaning of "lower"

To date, the concept of "lower" has not been submitted to the courts for a pronouncement, so there is not sufficient legal or objective precision in this respect.

Since the measurement can be made with various formulas, or using the same formulas but with estimators taken from different sources, giving results which differ and whose accuracy cannot be relied upon, the concept of "lower" can only apply when the application of all the measurements give a lower coefficient. From a practical standpoint, it could also be said that the difference would have to be considerable in order for the rule to be considered to be breached.

It is noteworthy that, whereas the other harmonization rules seek to establish similar or proximate positions between the tax regulations applicable in the Basque Autonomous Community and the Common Territory, the twelfth rule only establishes a lower level, which may imply that a higher level would be an admission of discrimination. However, this comment needs to be viewed in the light of the fact that this clause seeks to eliminate the possibility of tax competition.

A more equanimous and balanced interpretation would be that this rule seeks to attain equivalent or similar levels of tax burden in the respective territories. This interpretation is backed by the Organic Law for Financing the Autonomous Communities, which states that "The Autonomous Communities ... *shall maintain* an overall effective tax burden which is 7 to that of the rest of the national territory."

If we take the concept of equivalence, it is necessary to establish when and above what degree of difference the levels would be deemed not equivalent. The aforementioned Law does not establish limitations and, therefore, it is objectively impossible for these writers to establish quantitative limits on what might be considered as *non-equivalence*. However, the interpretation can be made somewhat flexible, within reasonable limits.

The concept *shall maintain* suggests a more flexible position than the wording of the Economic Agreement (... *may not imply* ...) and one which is

probably more balanced with respect to the real capacity of the institutions with regulatory powers to influence the development of the items making up the overall tax burden. This more open wording may be used as an aid in interpreting the intentions of the legislators when drafting the twelfth harmonization rule.

6.6.5 Period of measurement

No period of measurement is defined in the harmonization rule. Nevertheless, the statistics institutes publish their information on an annual basis and, therefore, it would not be possible to determine the matter for shorter periods. Accordingly, the minimum period is the calendar year.

Given the underlying dynamism of the concept of tax burden and the range of factors which can affect a given year, it would also be logical in practice that, for the precept to be breached, the breach would have to be manifested in several consecutive years, and not just in one year.

Again, the Law uses the wording *"shall maintain"*, which is in line with the foregoing interpretation regarding measurement over a number of years.

Consequently, if the aforementioned analysis over a number of years revealed that the relative tax burdens were similar, it could be concluded that there was no manifest breach of the harmonization rule.

6.6.6 Analysis over time: annual vs. cumulative

The Economic Agreement does not establish time periods over which the overall effective tax burden in the Basque Autonomous Community and the Common Territory are to be measured for the purposes of determining compliance with the twelfth harmonization rule.

However, and possibly by the "imperative" of statistical publications and data, it appears to be generally accepted that the period to be used for making the appropriate measurements is the calendar year.

However, recall the problems which can arise, particularly as regard the tax receipts variable, from an annual measurement of the tax burden. It is clear that these problems are exacerbated when comparing levels of the tax burden borne or registered in different territories, since the policies established by the competent authorities in those territories may further distort the comparisons, precisely because of the differences in policy.

Therefore, although the tax burden in a given territory is normally determined on an annual basis, care should be taken in using the annual ratios obtained.

Without wishing to be repetitive, it is necessary to identify the main factors arising from the tax receipts variable which can distort the annual indicators of the tax burden:

- Different policies applied by the various administrations regarding tax refunds to their citizens. If one administration is relatively faster in repaying excess tax withheld, that administration's tax receipts will be understated with respect to those of the other administration.
- Tax receipts calculated on an annual basis are usually the result of the income (taxable base) generated in the preceding year. Therefore, for greater accuracy in the indicator of the tax burden (if the classical indicator is used) it would be necessary to compare the tax receipts of a given year with the income of the previous year. Even then, there would be no certainty that the ratio involved the income of a given year and the related tax receipts, and this without considering other distorting effects (tax shifting, basically).

It follows, therefore, that it might be more appropriate, at least for the purposes of comparison, to compare the tax burden indicators for the different territories based on periods longer than one year, although the annual ratios would also have to be obtained in order for the analysis to be minimally exhaustive. Although this would not eliminate all the distortions which may arise in the annual indicators, it would be reasonable to assume that such distortions would become less important over a longer time scale.

Various methods can be proposed to compare the tax burden registered in different territories over a given period (longer than one year), including the following:

- Simple average, for the period considered, of the annual tax burden indicators.
- Cumulative tax burden indicator, i.e. the ratio between total tax receipts in the period considered and the total income generated in that period. Evidently, in order to make the numerator and denominator uniform, they would have to be expressed in constant terms for a particular year.

6.6.7 Comments on the rule

The question could be raised as to what measures the Economic Agreement provides in the event that the effective tax burden in the Basque Country were found to be lower than in the Common Territory.

Note firstly that it would be very difficult to attribute a breach of this rule to a tax regulation and, even if this were possible, the effect would arise several years after the rule had come into force; consequently, by the time it

was found to have a negative effect on the tax burden, it might no longer be on the statute book and the taxpayers' actions in this connection might be statute-barred; consequently, the real impact of revoking one or more regulations would be zero, in this case.

Another hypothesis is that, in the event of a violation of the twelfth harmonization rule and in order to avoid further violations, the competent institutions of the Historical Territories might be obliged to establish tax regulations and management systems identical to those in the Common Territory or clearly less favourable than in the latter; this would evidently clash with the historical rights which the Economic Agreement seeks to reflect.

In any event, if the State Administration invoked the twelfth harmonization rule against the Basque tax legislation, the burden of proof would lie with the former, as has been established by the courts, and no convincing proof of this type has ever been laid before the Spanish courts.

The foregoing ideas that the twelfth harmonization rule must not be seen either as meaningless in practice or as seeking to suppress the regulatory powers granted by the Economic Agreement, appear to further the interpretation set out above that the rule was established as an "anti-abuse" clause.

NOTES

1. A large part of this chapter was written by Prof. Hans Maks of the Unversity of Maastricht, the Netherlands. The editors are much indebted for his contribution.
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3. See R.A. Musgrave and P.B. Musgrave, *The Theory of Public Finance*, McGraw-Hill, London, 1976
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5. Musgrave and Musgrave, Ibid.
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7. See o.a., Messere and Owens, ibid.
8. E. Domingo Solans, *La Presión Fiscal en España*, in *Papeles de Economía Española*, número 23.
9. Musgrave and Musgrave, ibid.
10. Alain Barrere, *Economía Financiera*, Editorial de Derecho Financiero, Madrid, 1969.
11. Zubiri and Vallejo, ibid.

7. THE OVERALL EFFECTIVE TAX BURDEN IN SPAIN AND THE BASQUE COUNTRY

7.1 INTRODUCTION

The preceding chapter examined the concept of tax burden and its possible meanings in the context of the twelfth harmonization rule contained in the Economic Agreement. In this Chapter we discuss the measurement of the *overall effective tax burden* in the period covered by the study, having regard both to the limitations on the measurement of the tax burden (a concept which is far from pacific) and the lack of precision in the twelfth harmonization rule itself, in that there is no mention of the indicator to be used, the time period for measurements or the variables and sources from which to draw them.

Before proceeding to measure this parameter, it would be advisable to refer to some of the peculiarities of the Basque Country's economic structure, which have already been discussed in the General Overview. This reference is necessary basically because these peculiarities, (i.e. the differences with respect to other neighbouring territories), will affect the evaluation of the results of the measurement. The aforementioned differential features are summarized below:

- The primary sector accounts for a lower proportion of GDP, and industry is relatively more important, although it is declining more rapidly; construction and services account for a lower proportion, although the latter is growing faster in the Basque Country.
- Lower consumption in terms of GDP, basically due to significantly lower public consumption.
- Greater openness to the outside (as regards both imports and exports), giving the Basque Country an "openness index" (imports plus exports/ GDP) on average 80 points higher than that of the Common Territory. As a result of this greater openness, the Basque Country is more sensitive to the economic cycle of neighbouring countries.
- Wages account for a higher proportion of GDP, and the net operating surplus is lower, despite a higher level of unemployment than in the State.

Considering the aspects which impact the measurement of the overall effective tax burden, the first point to note is that the indicator chosen is the

"classical" indicator (tax receipts/income), having regard to the limitations on its results while valuing its simplicity in comparison with other potential indicators.

The tax receipts variable is estimated by taking a broader view and including all taxes (devolved or otherwise) plus social security contributions. These receipts are then disaggregated, considering only taxes collected (i.e. excluding social security) so as to determine, finally, the tax burden ratio for the devolved taxes. The results of this entire process are analyzed, considering the various tax types and their impact on the results.

There are numerous ways to quantify the income variable (Gross Domestic Product, Gross Added Value, at factor costs, at market prices, etc.) which are published by various sources of statistics, both official (INE, EUSTAT) and private (BBV, FIES, etc.). The detailed annual study here addresses the GDP as determined by the INE for the Common Territory and by EUSTAT for the Basque Country. This calculation procedure introduces a bias into the results, since the figures are obtained from different sources. However, it is felt that the calculation must be performed in this way because it takes account of the figures published by the respective public institutes. There would also be the problems involved with a calculation of regional income by the National Statistics Institute (INE). Consequently, it is believed that the two institutes provide the best measurements for their respective territories.

Note that the income indicator adopted is the one which yields the lowest relative tax burden for the Basque Country, due to the fact that the income (GDP) measured by EUSTAT is higher than other similar measurements.

Measurements were also made using income indicators published by other sources. Although they will not be described in detail here, they were compared with the results of the aforementioned indicator using average data for the period analyzed.

Additionally, in order to avoid the distortions (see Chapter V) which can arise from the inter-territory comparison of ratios on an annual basis, although it would be more appropriate to compare indicators over longer periods, the "cumulative" tax burden was used; this consisted of the ratio of aggregate tax receipts in the periods described below to the aggregate income in the same periods, after converting both variables to constant 1995 terms.

The following periods were considered:

- From 1982 to 1995, both inclusive, since this is the entire period of validity of the Economic Agreement for which there are reliable statistics.
- Two sub-series, one running from 1982 to 1990, both inclusive, and the other from 1991 to 1995, both inclusive.

The reasons for splitting the total period of validity of the Economic Agreement into two sub-periods are as follows:

- The Economic Agreement approved originally in 1981 was in force from 1982 to 1990. The modified Economic Agreement promulgated in 1990 was in force from 1991 to 1995. The idea is to determine, as far as possible, the impact of this modification.
- It was mainly from 1991 onwards that the tax incentives introduced by the Basque tax authorities had the greatest impact, at least from a social standpoint (tax holidays), apart from the incentives to investment issued in 1988 which remained in force until 1993.

7.2 OVERALL EFFECTIVE TAX BURDEN

7.2.1 Overall effective tax burden, including all coercive revenues of the Public Administrations: taxes and social security contributions

In view of the overall nature of the figures discussed below, we will not comment exhaustively on the underlying aspects which affect their evolution, which will be discussed later as the various revenue items are analyzed.

However, it should be noted that there were two effects in 1989 which are important for the purposes of an initial comprehension of what happened in that year:

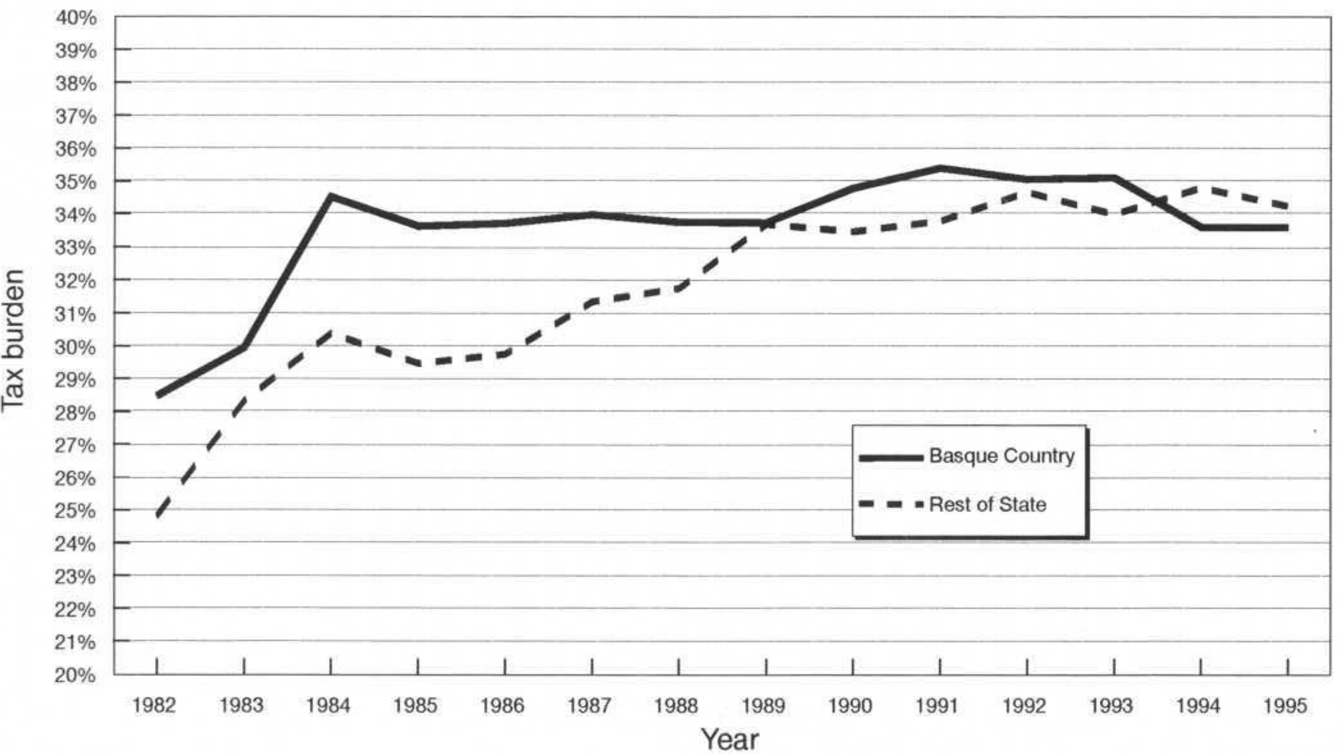
- In 1989, EUSTAT modified the baselines of its estimates, which boosted the income figures in that year and affect the denominator of the ratio.
- In 1989, the Constitutional Court issued a ruling recognizing the right to file personal income tax returns on an individual basis. Consequently, the filing deadline was extended from June to November in that year. The net balance of these returns is usually a rebate. This was the case in 1989, and the effect was heightened by the fact that families with more than one wage-earner could now split their income into separate returns. The Basque tax authorities refunded a greater proportion of this amount in 1989 than did the authorities of the Common Territory.

7.2.1.a) Tax burden calculated on the Gross Domestic Product

The results of this measurement are:

- The overall effective tax burden, including all taxes and social security contributions, was generally higher in the Basque Country in all the years analyzed here, apart from 1994 and 1995, when the gap narrowed, although the difference was as low as 0.5%-1% of GDP:
  - In 1989, there was the effect of the extended deadline for personal income tax returns, the differing lag in paying rebates in both territories and the change of baseline in EUSTAT's figures.

Figure 12:
All coercive revenues
On the GDP mp (INE/EUSTAT)



- There was another effect in 1994 which reduced the tax burden registered in the Basque Country with respect to that in the Common Territory, namely an increase in the Basque Country's relative level of income plus the different levels of rebates paid by the different administrations which, as will be discussed later with respect to specific taxes, distorts comparisons of tax receipts.

- The difference declined gradually up to 1988, and are not significant at the end of the period.
- According to this estimate, the overall effective tax burden in the Basque Country was apparently higher throughout the period analyzed here.
- The tax burden in the Common Territory is observed to have grown more quickly, from a lower starting point, which may be indicative of a progressive improvement in the management methods of its tax administration. The tax burden has also been rising in the Basque Country, although not so quickly, given that it started at a higher level.

Having obtained the tax burden ratio for each of the years, the results of the "cumulative" index, shown in the table below, will be analyzed.

Table 15:
"Cumulative" tax burden over GDP at market prices
Total coercive revenues

Tax burden	**1982-1995**	**1982-1990**	**1991-1995**
Basque Country	33.65	33.05	34.53
Rest of State	29.29	26.33	33.68
Difference	4.36	6.72	0.85
% variation	14.89	25.52	2.52

The preceding table appears to show that the overall effective tax burden in the Basque Country was higher than that of the State, particularly between 1982 and 1990, and that the difference was lower in the last of the periods analyzed.

Note that the proximity between the levels of tax burden in the period 1990-1995 is due principally to a sharp increase in the tax burden in the State (approximately 7 percentage points) compared with a more moderate increase in the tax burden in the Basque Country, which was starting from a higher level.

7.2.1.b) Effect of social security contributions

The volume of social security contributions in the Basque Country was substantially higher (in terms of GDP) than the average for the State, although the difference declined gradually and the levels were very similar in 1994 and 1995.

This difference was due to the aforementioned difference between the economic structure of the two territories, principally the higher proportion of wages in the Basque Country, which explains the higher relative volume of social security contributions with respect to GDP. However, note the following:

- Social security contributions are subject to ceilings, so they do not fully reflect differences in nominal wages.
- The adverse performance of unemployment in the Basque Country in comparison with the Common Territory may also have had an inverse effect on the tax burden.

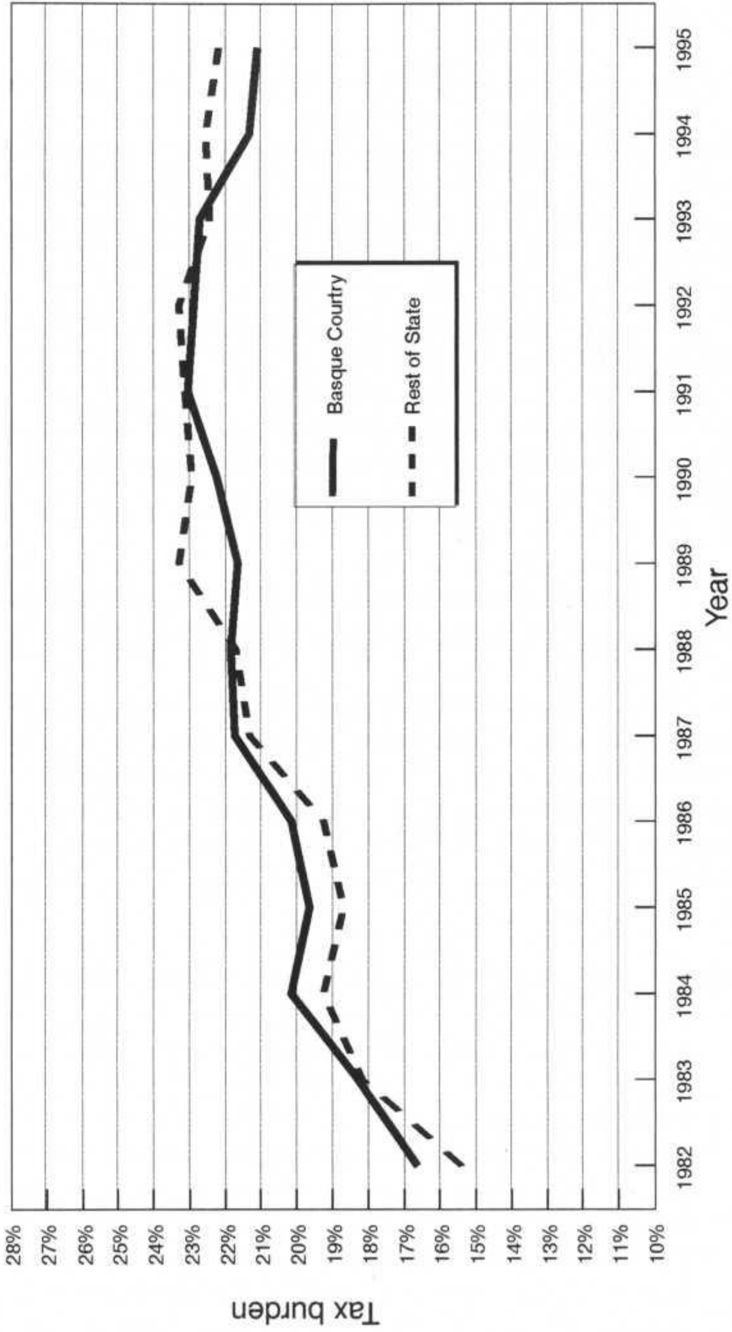
As will be shown below, the effect of social security contributions is the main source of the differences in the overall effective tax burden between the Basque Country and the Common Territory; segregating this item considerably reduces the differences.

It is not clear that the legislators intended for social security contributions, a clearly targeted coercive revenue, to be included in the concept of overall effective tax burden when the harmonization rule was drafted. Nevertheless, the OECD considers them in its published comparisons between countries, and it has been decided to include them for a more complete picture of the situation.

Since the twelfth harmonization rule refers expressly to the "overall effective tax burden", it could be considered necessary and appropriate to include social security contributions in calculating this indicator, for the following reasons:

- The term "overall", analyzed in Chapter 6, would appear to refer to all the coercive revenues obtained by the public authorities.
- It is clear that social security contributions are a form of coercive revenues obtained by the public authorities.
- Certain theoretical models of public finance consider that, in practice, social security contributions are a form of tax on the labour factor.
- Certain other European countries finance their social welfare systems out of other tax revenues (VAT and personal income tax).
- Merely because the twelfth harmonization rule states that the application of the Economic Agreement should not lead to a lower overall effective tax burden in the Basque Country does not necessarily mean that social security contributions and other taxes which are outside the regulatory or exaction powers of the Basque Country Historical Territories should not

Figure 13:
Social security contributions
On GDP mp (INE/EUSTAT)



be considered for calculating the aforementioned indicator, merely that the regulatory capacity of the Basque Country's Provincial Governments may not lead to a lower overall effective tax burden, regardless of the indicator used.

7.2.1.c) ***Final conclusion on the overall effective tax burden, including social security contributions***

According to the former information, it seems the overall effective tax burden in the referred period has been higher in the Basque Country than in the Common Territory. The substantial gap in the first years of that period has been progressively reduced. This reduction has made that at the end of the period, the tax burden levels have been very similar, although they are not so close if we analyze (for the period 1991 to 1995) the results obtained after calculating the cumulative tax burden index.

Moreover, it is necessary to consider the comments below regarding the taxes which have not been devolved and the effects of the unilateral risk on VAT, which are also analyzed below and have a negative effect on the overall effective tax burden in the Basque Country.

7.2.2 Overall effective tax burden, including all taxes collected by the Public Administration: devolved and not devolved

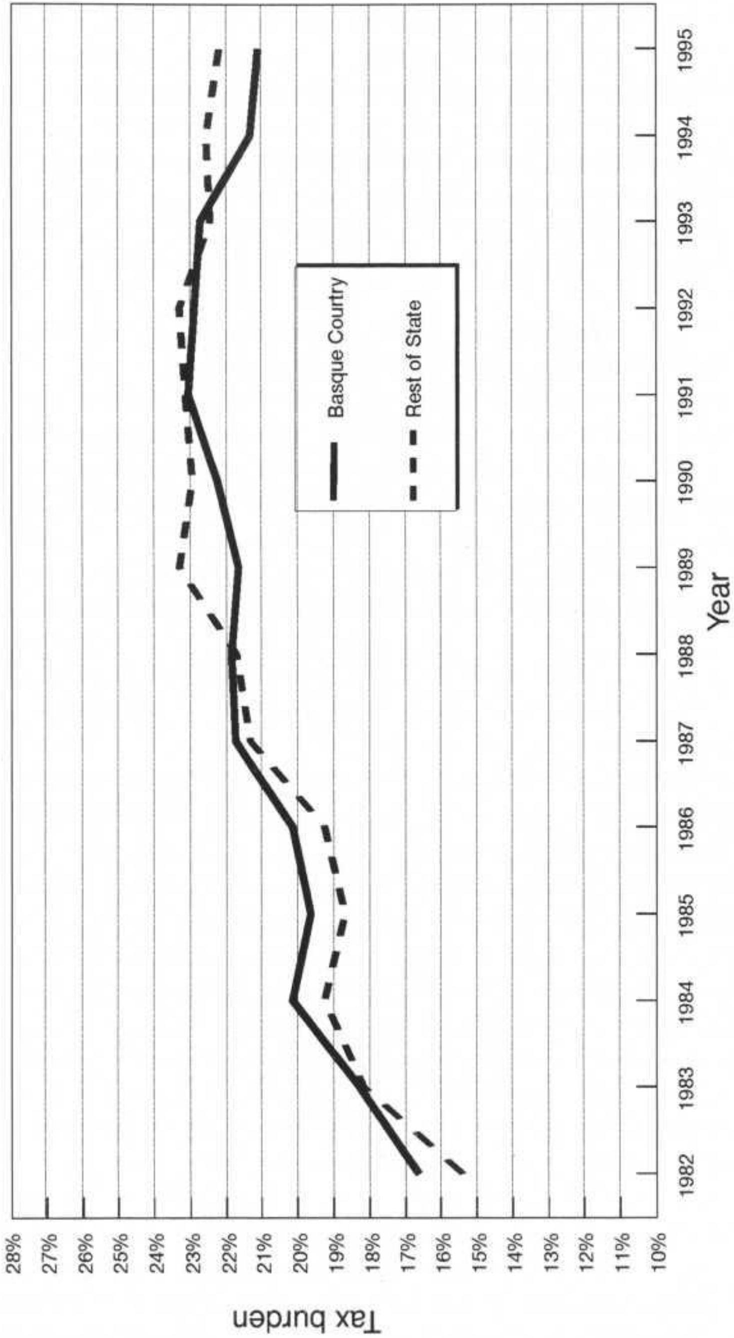
Before discussing the tax burden ratios obtained using total taxes, it should be noted that this classification includes certain levies and other revenues which, based on the sources of information used for tax receipts, do not fall under devolved or non-devolved taxes, but which are evidently tax revenues obtained by the public authorities. However, since the amount of these items is small, their quantitative impact on the conclusions will presumably be negligible.

7.2.2.a) ***Tax burden calculated on Gross Domestic Product***

According to the results of this measurement:

- The overall effective tax burden, including all devolved and non-devolved taxes, was higher in the Basque Country until 1988, when the two levels became equal. Between 1989 and 1990, the overall effective tax burden, considering all taxes, was slightly higher in the Common Territory, the greater difference arising in 1989 for the reasons described above. The overall effective tax burden equalized in 1990 (slightly higher in the Common Territory). In 1994, the Basque Country's ratio fell below that of the Common Territory due to the decline in tax receipts because of the slump of 1993, the unilateral risk as regards VAT (explained later), and

Figure 14:
All taxes
On GDP mp (INE?EUSTAT)



the increase in income due to the economic recovery. Additionally, the aforementioned factors must also be considered (see the detailed analysis of individual taxes).

- The economy performed particularly well between 1987 and 1991 and benefited the Basque Country to a greater extent; income (the numerator) rose by more than tax receipts (the denominator).

Calculating the tax burden for the longer periods defined above, the results are revealed in table 16.

Table 16:
"Cumulative" tax burden over GDP at market prices
Total impositions

Tax burden	1982-1995	1982-1990	1991-1995
Basque Country	21.12	20.39	22.19
Rest of State	19.43	17.32	22.56
Difference	1.69	3.07	-0.37
% variation	8.70	17.73	-1.64

It is noteworthy that, according to the preceding table, between 1991 and 1995 the tax burden in the Basque Country was slightly lower than in the Common Territory. Although this matter will be examined in detail later, this lower tax burden can be attributed to the effect of local taxes, since municipalities exercise a relatively high degree of tax autonomy through the imposition of surcharges. Apart from this period, when the tax burdens were practically the same, the Basque Country evidenced a significantly higher tax burden.

The figures in the table also show that the tax burden ratio in the Basque Country rose steadily, and was approximately two percentage points higher in the second period than in the first. In contrast, the ratio in the State behaved more erratically, starting with considerably lower ratios of tax burden and rising rapidly.

7.2.2.b) Comments on the overall effective tax burden considering all impositions, both devolved and non-devolved

This analysis reveals variations depending on the year; in some cases, the overall effective tax burden was higher in the State, in particular:

- In 1989, due to the indirect effects of the aforementioned Constitutional Court ruling and to the change in baseline by EUSTAT in that year.
- The positions were very similar after 1990, and the overall effective tax burden in the Basque Country varied erratically depending on the bases used for estimation.
- In 1993 there was an apparent decline in the overall effective tax burden in the Common Territory and, to a lesser extent, in the Basque Country, giving a higher overall effective tax burden in the latter territory (however, the figures for 1993 are still provisional).
- The tax burden in the Basque Country in 1994 and 1995 was slightly lower due to the combination of a fall in tax receipts and an increase in income.

Analyzing the results for periods longer than one year, the tax burden is found to have been considerably higher in the Basque Country for the periods 1982-1995 and 1982-1990, whereas it was practically the same in both territories in the period 1991-1995.

The following factors impact the calculation of this overall effective tax burden indicator:

- Non-devolved taxes, which are exclusively controlled by the State, which attributes then to the Basque Country on the basis of an index of 6.24%, as discussed below.
- The effects of the unilateral risk with respect to VAT, discussed below, which became evident in 1992 as a result of changes in trade flows.

Below we examine the effects over time on the tax burden arising from non-devolved taxes.

The non-devolved taxes are those for which regulation, collection, management and inspection powers lie exclusively with the competent institutions of the Common Territory. These are mainly excise taxes (hydrocarbons, alcohol, tobacco, etc.) and the taxation of non-residents.

Because of the procedures for calculating and settling the Quota, the Basque Country's share of the State's actual tax receipts under this heading is the imputation index, namely 6.24%.

Based on the total analysis of private and public consumption in both territories, the average ratio for the period is close to 6.40% (although there may be errors due mainly to the impossibility of assigning certain public consumption's to a particular territory), whereas the ratio is 6.7%, on average, in that period if we use only actual private consumption.

These comparison indices are determined on the basis of the indices of private and total consumption, both overall and relative, of both territories, but they do not expressly address the parts of that public and/or private consumption

really affected by those taxes, which varied in both nature and amount during the period in question.

Therefore, 6.40% and 6.70% are also alternative arbitrary percentages which might be indicative that the Basque Country is receiving slightly less than its fair share of non-devolved taxes (assuming that these alternative indices are the most appropriate).

Nevertheless, the lack of information means that the preceding statement is merely a hypothesis which cannot be proven, although it is probably indicative of a slight trend which is potentially unfavourable to the Basque Country, in the period analyzed, with regard to its share in non-devolved taxes. Compared with the size of the income variable, the effect of the non-devolved taxes is to slightly reduce the Basque Country's overall effective tax burden.

The main conclusion that can be drawn is that the actual effects of the non-devolved taxes (which are, therefore, exogenous to the Basque Country) on the overall effective tax burden in both territories are not known with certainty, but the effect is relatively higher in the Basque Country because of its smaller relative size. However, what analysis can be performed with the insufficient data available suggests that the overall effective tax burden in the Basque Country is declining slightly due to reasons not attributable to the tax system arising under the Economic Agreement.

7.2.3 Tax burden arising from the devolved taxes

7.2.3.a) Tax burden from the devolved taxes, calculated on the basis of Gross Domestic Product

The results of this measurement indicate that:

- The effective tax burden arising from the devolved taxes was higher in the Basque Country until 1988, when the two levels were practically equal. In 1989, for the reasons described above, the effective tax burden obtained using this estimator was higher in the Common Territory (considering the devolved taxes only). In 1990, the levels were practically the same and they remained so until 1994, when the tax burden was slightly lower in the Basque Country due to the reasons set out above.
- It should also be borne in mind that the economy performed particularly well between 1987 and 1991, and this effect was greater in the Basque Country due to its greater openness and sensitivity to the economic cycle; income (the denominator) rose faster than tax receipts (the numerator).

The results for the three chosen periods are revealed in table 17.

Figure 15:
Devolved taxes
On GDP mp (INE/EUATAT)

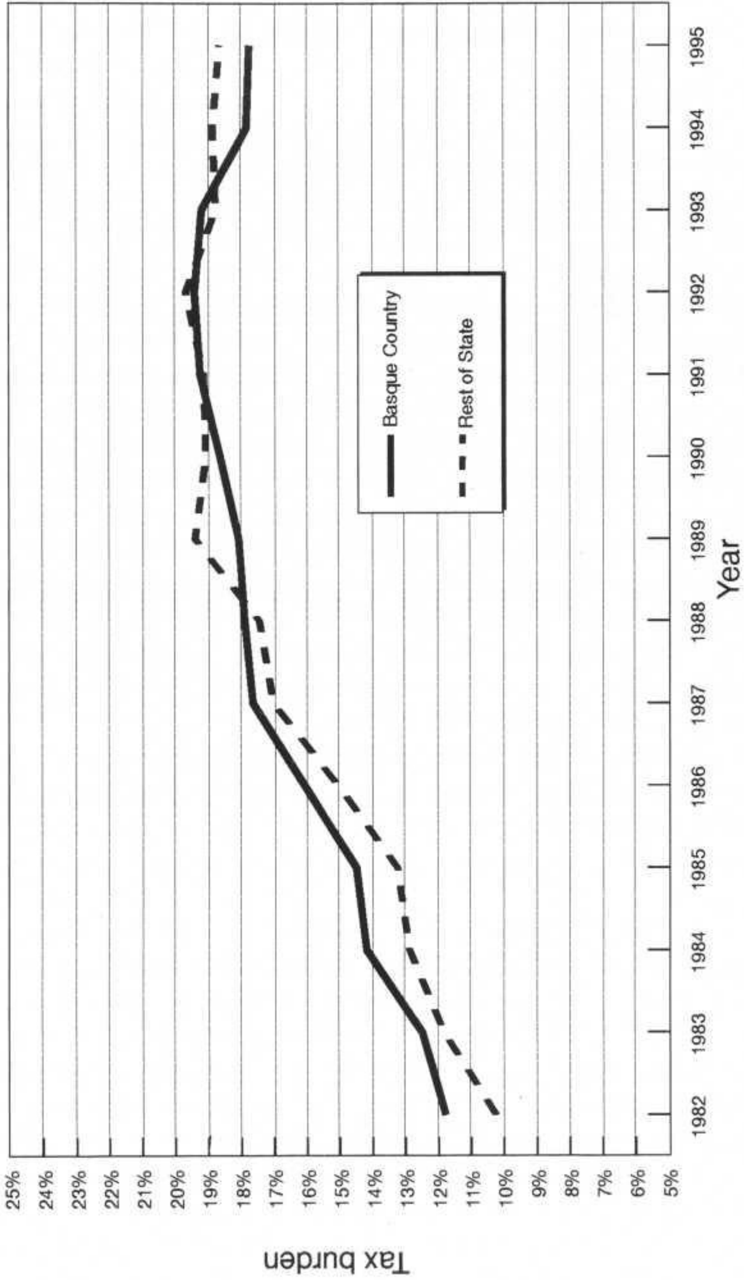


Table 17:
"Cumulative" tax burden over GDP at market prices
Devolved taxes

Tax burden	1982-1995	1982-1990	1991-1995
Basque Country	17.02	15.90	18.67
Rest of State	15.36	13.01	18.84
Difference	1.66	2.89	-0.17
% variation	10.81	22.21	-0.90

Accordingly, using this income indicator, the tax burden was notably higher in the Basque Country between 1982 and 1995 and between 1982 and 1990. The trend seems to have reversed after 1990, when the tax burden was higher in the Common Territory, although the gap was narrowing gradually.

However, the foregoing comments on the impact of municipal taxes need to considered. Using this income indicator, the tax burden deriving from these taxes was 0.39 percentage points lower in the Basque Country than in the Common Territory. Although this cannot be cross-checked sufficiently, it may be an indication that the Basque Country local authorities made less use of their power to impose surcharges on taxes; if this is the case, the question arises as to whether this difference (which is not significant) would be attributable to the Economic Agreement, despite the fact that municipal taxes are generally covered by the Agreement.

In order to eliminate the effect of municipal taxation, the table below shows the tax burden ratio found using only general taxes, i.e. all of devolved taxes except local taxes:

Table 18:
"Cumulative" tax burden over GDP at market prices
General taxes

Tax burden	1982-1995	1982-1990	1991-1995
Basque Country	16.04	15.01	17.54
Rest of State	14.03	11.81	17.32
Difference	2.01	3.20	0.22
% variation	14.33	27.10	1.27

The table shows that, if local taxes are excluded from the figure for devolved taxes, the tax burden in the Basque Country was higher in all the periods analyzed here although, as in the previous case, the figures suggest that the tax burden levels converged and were practically the same between 1991 and 1995 when, as stated above, the tax burden increased considerably in the Common Territory and more moderately in the Basque Country (which followed a smoother trend).

7.2.3.b) Comments on the tax burden due solely to the devolved taxes

There are no substantial differences in the period considered here with respect to the overall effective tax burden described in preceding sections, although it would appear to have been notably higher in the Basque Country throughout the period, and particularly so in the first sub-period (1982-1990), whereas the tax burden in the two territories tended to equalize between 1991 and 1995.

As an indication of future trends in the tax burden, the projected general tax receipts (devolved taxes excluding municipal taxes) for 1996 appear to show an increase in the tax burden in the Basque Country of approximately 0.7% of Gross Domestic Product with respect to 1995 (from 15.9% to 16.6%), whereas tax receipts are projected to remain at similar levels to 1995 in the Common Territory (17.1% of Gross Domestic Product).

Having analyzed the tax burden ratios, it is time to examine in detail the main devolved taxes in order to perform a more precise analysis of the results. This analysis should also help us to understand the effects arising from the handles and the adjustments to the distribution of tax receipts, both of which are impossible to quantify.

7.2.4.a) Accumulated percentage variation in the tax burden in terms of GDP at market prices

The differential between the tax burden in the Basque County and the Common Territory declined over time and turned negative in the period 1991-1995.

However, this was due mostly to temporary factor which, because of peculiarities of the Basque Country's economic structure, affected the Basque Country to a greater extent than the Common Territory. Once such factor was the particularly good economic cycle between 1987 and 1991.

This effect was heightened by once-off situations, principally the large increase in tax refunds by the Basque Country tax authorities in 1994 (discussed under the heading of the individual taxes).

The conclusion is that the narrowing of the tax burden differential is not due to the use by the Basque authorities of their taxation powers but, rather, to the leveling effect of the economic situation and to the large increase in the tax burden in the Common Territory from 1990 onwards.

7.2.4.b) Accumulated percentage variation in the tax burden in terms of the average of income indicators

Income can be measured by a variety of indicators:

- GDP at market prices, as measured by EUSTAT for the Basque Country and by INE for the Common Territory.
- GAV at market prices, again as measured by INE and EUSTAT.
- GAV at factor costs, with two alternatives: measurements by the INE for the Basque Country and the Common Territory, or by the BBV Research Service for both territories.

Although this is not the place for a complete analysis of each indicator, we can compare the tax burden ratios obtained from an average measurement of income with those obtained by measuring income using only GDP at market prices.

We observe that, apart from the period 1982-1990, the differential is greater than if only GDP at market prices is used, when the aforementioned narrowing is also observed, albeit more subdued.

This is due basically to the lower relative value of the BBV's figure for the Basque Country's GAV, reducing the denominator implies widening the difference between the different measures of the tax burden in comparison with the other measures of income, leading to a coherent increase in the average.

Table 19:
Accumulated percentage variation in the tax burden, between the Basque Country and the Rest of Spain, in terms of GDP at market prices (INE/EUSTAT)

% variation	Total coercive revenues	Total impositions	Devolved taxes	General taxes
1982-1995	14.89	8.70	10.81	14.33
1982-1990	25.52	17.73	22.21	27.10
1991-1995	2.52	-1.64	-0.90	1.27

Table 20:
Accumulated percentage variation in the tax burden, between the Basque Country and the Rest of Spain, in terms of the average of income indicators

% variation	Total coercive revenues	Total impositions	Devolved taxes
1982-1995	15.29	9.06	11.28
1982-1990	25.25	17.41	21.94
1991-1995	3.85	-0.38	0.35

7.3 DETAILED ANALYSIS OF THE TAX BURDEN TAX BY TAX

The tax burden arising from the devolved taxes appears to exceed the scope intended by the twelfth harmonization rule in the Economic Agreement. Nevertheless, as noted above, an analysis of this point may provide valuable additional information to aid in understanding the trends in the overall effective tax burden in both territories, particularly in the Basque Country.

7.3.1 Analysis of the tax burden arising from indirect taxes

It is advisable to analyze the tax burden from indirect taxes using the same income indicator as before, even though it is possible to make comparisons using more specific indicators which provide greater details of the effective revenue-raising capacity under these taxes (e.g. the residents' internal consumption). However, we will see that VAT is already adjusted in these terms; moreover, the tax burden needs to be evaluated on an overall basis and, in order to be able to fit the results for indirect taxes into the overall results, it is advisable to use the same income indicators as before.

The figures obtained in this way reveal that the tax burden from devolved indirect taxes is slightly higher in the Basque Country than in the Common Territory.

In both territories we see that the tax burden rose due to the introduction of Value Added Tax in 1986 in place of most of the pre-existing taxes (mainly the General Tax on Company Business and the subsidy in the form of a refund of this tax on exports – known as the Export Tax Credit), and remained stable thereafter, rising again in 1992 due to the increase in VAT rates. These taxes

account for approximately 6%-7% of GDP in both territories.

Because of its considerable relative impact and its complexity, Value Added Tax merits an individual analysis.

Value Added Tax

i) History

Value Added Tax was introduced into Spain in 1986 and was immediately included in the Economic Agreement, leaving no scope for any differences which might be of economic importance (under article 27.2 of the Economic Agreement, the Basque Country's powers are confined to: "the return and payment forms, which shall contain at least the same data as those of the Common Territory, and shall indicate the payment deadlines for each settlement period, which shall not differ substantially from those established by the State Administration").

Moreover, there was a change in 1993 as a result of the EC Directive which eliminated frontiers for tax purposes and created the concepts of acquisitions and deliveries which, inside the European Union, took the place of imports and exports, respectively. The result was that VAT on imports from the current European Union ceased to be collected by the State and become a national tax which was recognized and deducted in each taxpayer's return.

ii) Handles

The handles can be defined as the criteria contained in the Economic Agreement for determining which administration (Basque or State) is competent to exact the taxes on a given taxable event. That is to say, they determine which Administration the tax should be paid to.

The handles established for VAT, which are practically identical to those established for Corporation tax, are as follows:

- Taxpayers operating exclusively in a territory pay taxes to the competent authorities of that territory.
- Taxpayers whose volume of operations was less than 300 million pesetas in the previous year pay taxes to the competent administration corresponding to their tax domicile.
- Others pay taxes on the basis of the volume of operations in each territory, i.e. in proportion to the deliveries of goods and services in each territory. In order to decide where the various deliveries take place, the following rules are applied:
  - Deliveries of property take place in the territory where the property is located.
  - Deliveries of goods take place in the territory where they are placed at the buyer's disposal.

- Deliveries by generators of electricity take place where the generating plants are located.
- Deliveries of services take place in the territory where they are provided (apart from services provided with property, see above).
- Other deliveries of goods and services (related to the primary sector and transport) take place in the territory where the taxpayer has its tax domicile.

In short, the handles for internal operations in Spanish territory are attributed fundamentally on the basis of origin, and distortions can arise with respect to measuring the tax burden principally if the territory where the goods are finally consumed is different from that where the goods were produced or delivered.

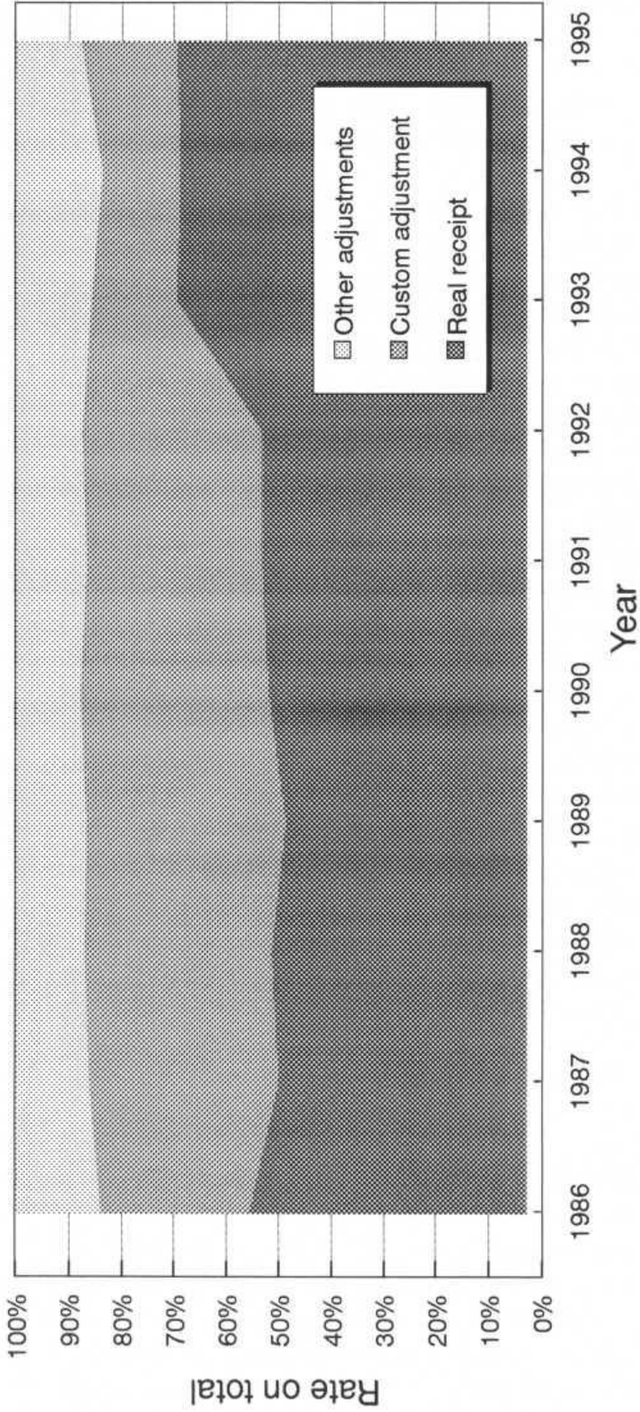
Consequently, the handles may not be appropriate in that their criteria for distributing and, therefore, determining the tax receipts on domestic transactions may not match those adopted to determine where the income is generated (regardless of how the latter is defined). For example, the following cases could arise:

- Manufacturing industry: since the handle is the territory where the manufacturing process is completed, this may lead to a shifting of the tax receipts with respect to the generation of income.
- Services sector: the fact that it is often impossible to determine where a service is provided, and the fact that it may be provided in various territories, means that tax receipts and income may not match.
- The difficulty in objectively establishing the handle in certain activities (e.g. transport) and the legislators' desire to exclude the indirect tax burden on taxpayers with a small administrative structure (individuals, and companies with turnover of less than 300 million pesetas) has led to the creation of what might be termed an "artificial handle", namely the tax domicile, which need not coincide with the place where the activity is carried out.

iii) Adjustments

The adjustments envisaged in the Economic Agreement, which involve the transfer of funds between administrations (from the Basque Country to the Common Territory and vice versa) are established in order to adapt the tax revenues of each territory to the taxes actually accruing there. Consequently, as a result of the handles and of the non-devolved taxes, the tax receipts of a given Administration do not match the taxes accrued in its territory. As a result, in order to bring tax receipts into line with tax accruals, the Economic Agreement establishes a number of adjustments which are mostly based on political agreements.

Figure 16:
VAT tax receipts
Real receipts plus indirect tax adjustment



These adjustments are particularly important in the area of VAT given the Basque economy's considerable degree of openness with respect both to the State and to other territories, by virtue of the Agreement itself. These adjustments are as follows:

- 6.875% of VAT collected by Customs.
- 1.232% of actual tax receipts in the Common Territory divided by 94.357% (i.e. 1.3056% of the State's tax receipts), or the Basque Country's immediate actual tax receipts divided by 5.643% (i.e. 21.8% of the Basque Country's tax receipts); the former or latter applies depending on whether the Basque Country's tax receipts amount to more or less than 5.643% of the State's tax receipts (excluding Customs).

The practical effect of the foregoing coefficients (including the alternatives) means that the Basque Country's total VAT receipts may be increased by up to 6.875% of the total.

The first adjustment was very important up to 1993 because, since then, it only affects imports from countries outside the European Union, which is Spain's main supplier. This adjustment amounted to 42,096 million pesetas in 1993 (down from 90,186 million in 1992).

The second adjustment has been of little economic importance (see graph 705). However, it is noteworthy, as shown in the graph, that these adjustments amount to about 50% of total VAT receipts (40% after 1993 due to the elimination of Customs within the EU). These magnitudes raise certain doubts about the reality of the computed receipts and, consequently, about the tax burden ratios obtained using those figures for tax receipts.

iv) Tax burden

The tax burden in both territories has followed similar trends, oscillating between 6% and 7% of GDP except for the first year, when the adjustments for the entry into force of the tax gave a tax burden approximately 1% lower in both territories than in the previous year.

The tax burden ratios for VAT were slightly higher in the Basque Country, particularly in 1994 due to an apparently larger decline in tax burden in the Common Territory.

Since the VAT regulations are practically identical in the two territories, the difference in tax burden ratios must be due to differences in economic structure and, in particular, in the intensity and direction of trade between the two territories, which represent:

- A relative decline in the penetration of Basque goods and services in the Common Territory, whereas the volume of imports from the Common Territory (in terms of GDP) declined more slowly, thus creating a slight trade surplus with the rest of the State up to 1990, and a slightly deficit

since then.

This implies a transfer of immediate VAT receipts from the Basque tax administration to the State tax administration, precisely in the years after the VAT rates increased (the standard rate went from 12% in 1992 to 16% in 1995).

- A relative rise in transactions with other countries, mainly in the European Union, particularly deliveries, which gave a net trade surplus from 1992 onwards. The implications are:
  - Zero net receipts, in most cases, when all the inputs were produced by suppliers which would have paid taxes in the Basque Country, because they were either internal or community transactions.
  - Negative net receipts when part of the inputs came from suppliers taxable in the Common Territory because, among other reasons, they were goods imported from outside the European Union.

Accordingly, since 1992 there seems to have been a new effect due to the unilateral risk, namely a relative decline in tax-raising capacity while the activity itself has had a positive effect on income, the overall effect being a reduction in the overall effective tax burden, while the Basque authorities have not taken any steps to reduce the tax burden (given that they cannot).

In 1994, the tax burden from VAT was higher in the Basque Country but it fell in relative terms since the comparisons between the tax receipts of the two administrations were affected by a fundamental factor, namely a 24% year-on-year increase in tax refunds in the Basque Country, compared with a 2.8% reduction in the Common Territory.

This factor, which greatly limits comparisons between the tax burden ratios in the two territories, contributed significantly (together with other direct tax effects) to reducing the overall effective tax burden in the Basque Country in 1994 with respect to that in the Common Territory.

7.3.2 Analysis of the tax burden from direct taxes

The tax burden from direct taxes developed as follows:

- Higher tax burden in the Basque Country until 1988, although the difference narrowed gradually.
- Substantial variation in 1989, for the reasons described before (Constitutional Court ruling and changes in EUSTAT's methods of estimation).
- Similar trends after 1990, with the tax burden slightly higher in the Common Territory; this difference accentuated in 1994 for reasons which are discussed below.

Because of their large relative impact and its complexity, Personal Income Tax and Corporation tax merit special attention.

7.3.2.a) Personal Income Tax

It should be noted firstly that the Basque Country's regulatory powers under the EABAC were very limited in the period considered here and only affected non-economic aspects, apart from certain tax credits and certain criteria for determining the taxable base for business, professional and artistic activities (of scant quantitative importance).

Therefore, since the regulations in the two territories are similar, differences in receipts and, consequently, in the effective tax burden from this tax must be due fundamentally to differences in economic structure, in the distribution of income and in the efficiency of the tax administrations in the two territories, and to other factors such as a higher cost of land in the Basque Country (resulting in higher incentives for house purchase).

i) Handles

The handles (defined above) are established for each source of income and are summarized as follows:

1. Final tax

The Personal Income Tax is claimed only by the tax authorities of the territory where the taxpayer resides.

For these purposes, a taxable subject (individual) is deemed to be resident in a territory if it spends more than 183 days in that territory in the calendar year.

2. Non-residents

Persons not resident in Spanish territory who obtain income are generally taxed only by the competent authorities of the Common Territory, regardless of whether the taxable income arose in the Basque Country. Tax withholdings from such income are also paid to the Common Territory.

3. Withholdings at source from salary income

Withholdings at source from salary income are established on the basis of the income. The handles established in this connection are as follows:

- The withholding from income for work or services is generally claimed by the competent administration in the territory where they are provided. Where the income arises from circumstantial work whose duration is less than six months, performed in Basque or Common Territory, the withholding is claimed by the Common or Basque Territory administration, respectively, provided that it is paid by companies or entities not

operating in the Basque/Common Territory.

- Amounts withheld from pensions and passive income paid by the Social Security, widows' and orphans benefit funds, mutual funds and other entities are paid to the administration in whose territory the income is paid.
- Withholdings from any form of compensation received by the members of the Boards of Directors of any form of company are claimed by one or other administration on the basis of the following handles:
  - In the case of companies subject to Corporation tax which operate exclusively in one territory, by the competent Administration for that territory.
  - In the case of companies subject to Corporation tax under both the Basque Administrations and the State, by both administrations on the basis of the volume of transactions performed in each territory, determined in accordance with the handles established for Corporation tax.
  - In the case of non-resident companies operating in Spain without a permanent establishment, only by the State Administration.
- Withholdings from income paid to functionaries and employees of the State in the Basque Country and functionaries and employees (under labour or administrative contracts) of State agencies or autonomous State bodies are paid to the State alone.

In short, the criterion followed by the Economic Agreement as regards payment of withholding taxes from salary income relates basically to the domicile of the recipient of the income, with the basic exception of State employees.

4. Withholdings from professional and artistic activities

Withholding tax from the income from professional or artistic activities is claimed by the competent administration of the tax territory of the party obliged to withhold, i.e. the party paying such income.

5. Withholdings at source from investment income

The handles established as regards payment of withholdings from investment income are as follows:

- Withholdings from dividends, shares in profits, interest and other consideration on bonds and similar securities are claimed according to the following rules:
  - When the payer is taxed exclusively in one territory, by the competent administration in that territory.
  - When the payer is subject to Corporation tax under both

administrations, the withholding tax is paid to both administrations on the basis of the volume of transactions performed in each territory, determined in accordance with the handles established for Corporation tax.

- Withholding tax from investment income paid by the State-owned banks, companies which are concessionaires of State monopolies and foreign companies is payable only to the State Administration.

- Withholdings from interest and other consideration for government debt securities and debentures will be payable to the Basque Country for securities issued by institutions in that territory and to the State in all other cases, regardless of where the interest, etc. is paid and of the status of the beneficiary. Withholdings from such income from foreign bonds and similar securities are payable to the State.
- Withholdings from interest and other consideration for deposit-taking transactions by banks, savings banks, tax-sheltered co-operatives and entities with similar status and those carried out in any other credit establishment or financial institution will be claimed by the Basque Country administration when the transactions are conducted in that territory and the income is paid by establishments located there.
- Withholdings from income from intellectual and industrial property and from the provision of technical assistance are claimed by the competent administration for the tax domicile of the payer.
- Withholdings from life and shorter-term annuities arising from capital deposits will be payable to the administration of the tax domicile of the beneficiary unless the payer is the State Administration, in which case the latter claims the withholding.
- Withholdings from leases of goods, businesses, mines and similar will be payable to the administration in whose territory they are located.
- Withholdings from interest on loans secured by a mortgage on property will be payable to the administration in whose territory the mortgaged property is located. If the property lies in both territories, the withholding will be paid in proportion to the value of the mortgaged goods in each territory.
- Amounts withheld from interest on loans secured by a mortgage on movable property or a pledge without delivery will be payable to the administration in whose territory the guarantee is registered.
- Withholdings from interest on ordinary loans, deferred prices on sales and, generally, any other income derived from the placement of capital will be paid to the administration of the territory where the party obliged to withhold has its tax domicile.

In short, the handles established for payment of withholdings from investment income are based (albeit with numerous exceptions) on the residence of the party obliged to withhold and on the administration which is competent to charge Corporation tax to it, and not on the administration to which the party receiving the income must ultimately pay its taxes.

Note finally that, regardless of the administration to which withholdings from certain income obtained by individuals are paid, the individual may deduct them in his/her tax return filed with a single administration. This means that a person can deduct before the Basque Country tax authorities withholdings from his/her income which were paid in to the Common Territory, and vice versa. This produces distortions between the tax receipts computed in a territory and the income generated there, but the effects are impossible to quantify in practice.

ii) Adjustments

The adjustments arise because of the handles for withholding tax, with the result that the Basque Country obtains a 6.24% (the imputation index) share of the following items collected by the State. Note again that these adjustments have a pacted component. In particular:

- Withholdings from salary income of functionaries of the State and State agencies. Note that we are unaware of the mechanism used to quantify this adjustment and, therefore, cannot know whether it corresponds to the taxes accruing in the Basque Country under this heading.
- Withholdings from interest on debt securities issued by the State and public institutions in the Common Territory.
- Withholdings from interest paid by the State-owned banks, companies which are concessionaires of State monopolies and foreign companies.
- Taxation of non-residents.

These adjustments are determined on the basis of the State's total receipts under these headings on the assumption that 6.24% of them comes from the Basque Country; there is no check to ascertain whether the related flow of funds to the Basque Country is excessive or insufficient.

Consequently, there may be distortions (which cannot be evaluated) if the actual percentage departs from 6.24%.

iii) Tax burden

In both territories Personal Income Tax receipts grew steadily between 1982 and 1991, and stagnated thereafter. These receipts amounted to approximately 5% of GDP in the early years, ultimately rising to close to 8%.

The tax burden was higher in the Basque Country (by 0.5%-1%) up to 1989, and the gap closed steadily thereafter with the exception of 1990,

although the Basque Country's tax burden continued higher (except in 1994 and 1995, when the opposite was the case).

The aforementioned difference in nominal wages, which comprise a major part of the base of this tax, probably made a significant contribution to creating a higher tax burden in the Basque Country over the entire period, whereas the increase in unemployment and the reduction in total wages during economic crises are the main reasons why the gap has narrowed. Other factors (see above) are more difficult to evaluate due to the lack of information.

Similarly, it has not been possible to prove the hypothesis regarding a different distribution of the concentration of income:

- With a mode which is slightly higher in the Basque Country than in the Common Territory, but
- with a greater relative concentration of income in the Basque Country.

Had such a distribution been available, it would have provided valuable information for a better understanding the impact of this tax's progressiveness.

As with VAT, comparisons between Personal Income Tax receipts in the two territories are not very significant due to the different refund policies; the difference peaked in 1994 when refunds rose 25% in the Basque Country (with respect to 1993) whereas they fell by 2% in the Common Territory.

This may be one of the fundamental reasons (together with the aforementioned VAT effect) why the overall effective tax burden for the Basque Country in 1994 was lower than in the Common Territory.

7.3.2.b) Corporation tax

The Corporation tax Law in the Common Territory was in force throughout the period considered here, and a new law came into force on 1 January 1996. However, the aforementioned law and its implementing regulations underwent major modifications during the period.

This is the tax where the Basque Country has made most use of its autonomous powers, and its incentives to investment and job creation are the main distinguishing features with respect to the Common Territory.

i) Handles

Before discussing the handles established in the Economic Agreement to determine which administration should collect from the taxpayers, it is advisable to note the cases where the regulations issued by the Basque tax authorities (which differ from those of the Common Territory) are applicable. These regulations are applicable to the following:

- Taxpayers which, pursuant to the established handles, pay tax only to the Basque authorities.
- Taxpayers which have their tax domicile in the Basque Country and

perform at least 25% of their total volume of operations in that territory. The handles will apply for the purposes of determining said volume.

The Economic Agreement contains an exception to these criteria, which are generally applicable. The exception relates to:

- Economic interest groupings, temporary joint ventures and concentrations of business which go beyond the scope of the Basque Country, and
- Groups taxed on a consolidated basis which comprise entities subject to tax in the Common Territory and in the Basque Country.

In both cases, the Corporation tax regulations of the Common Territory are applicable.

The competent administration(s) for collecting taxes are determined in article 18 of the Economic Agreement, as follows:

- Taxpayers whose volume of operations did not exceed 300 million pesetas in the previous year pay taxes to the competent authority of their tax domicile.
- Taxpayers which operate in only one territory will be taxed by the competent authorities for that territory, regardless of where their tax domicile is.
- Taxpayers which operate in the Common Territory and the Basque Country and whose volume of transactions exceeded 300 million pesetas in the preceding year pay taxes to both administrations in proportion to the volume of business conducted in each territory. The rules for determining the tax point of these transactions are basically the same as for VAT (see above).
- The official State-owned banks, concessionaires of State monopolies and foreign entities pay taxes only to the State Administration, regardless of their domicile and of the volume of operations (if any) performed in the Basque Country.

In short, apart from the exceptions regarding certain entities (banks, monopolies and non-residents), smaller companies are taxed by the administration of their tax domicile and other companies pay taxes in proportion to where their transactions were performed, which could coincide with the place where the income taxed under this tax was obtained.

In any case, we must remember in this section all the reflexions made when we talked about the handles related to Value Added Tax, referred to their aptitude to connect receipt and personal income.

ii) Adjustments

The main adjustments relate to the tax payments of companies which, in accordance with the Economic Agreement, may only be taxed by the State, namely the official State-owned banks, companies holdings concessions to State monopolies and non-residents (including their permanent establishments in the Basque Country).

These revenues are imputed to the Basque Country on the basis of the 6.24% imputation index, which may not match the profits actually obtained by those taxpayers in the Basque Country.

iii) Tax burden

The tax burden caused by Corporation tax is not very significant in either territory (1%-2% of GDP). These figures would appear to deflate the apparently excessive importance given to this tax and would indicate that the conflicts which have arisen between the tax authorities in the Historical Territories of the Basque Country and that of the Spanish State with respect to measures adopted by the former with respect to Corporation tax are somewhat disproportionate.

For example, even if the Basque authorities completely eliminated Corporation tax (which they cannot actually do), this would not have a substantial effect on the overall effective tax burden in the Basque Country since the resulting tax burden would differ from that in the Common Territory by at most two percentage points.

The tax burden in the Basque Country under Corporation tax is slightly lower than in the Common Territory, and tends to follow the same trend (although not so pronounced); the main differences arose in 1989 and 1991, the years of greatest economic growth in the period considered here, when the Basque companies were able to make greatest use of tax credits and tax loss carryforwards; moreover, in those years the Basque GDP grew faster, which heightened the effect of the relatively lower increase in the tax burden. It is noteworthy that, between 1989 and 1991, the tax burden in the Common Territory grew very rapidly in comparison with the preceding and subsequent years; consequently, it might be posited that the difference in the tax burden registered in the Basque Country in that period is due not so much to a reduction in the tax burden in the Basque Country (where it actually rose slightly) as to an extraordinary increase in the Common Territory which was not repeated.

Nevertheless, the main reason for the lower tax burden in the Basque Country appears to be due to lower business surpluses in that territory (amounting to around 4% of GDP) and this, by itself, might be sufficient to account for the relative difference in the tax burden.

As occurred in 1994 with Value Added Tax and Personal Income Tax

receipts, there were also substantial differences in Corporation tax as regards comparability of the tax receipts in the two territories, since the Corporation tax refunds by the Basque authorities rose by 114% in 1994 with respect to 1994, whereas refunds in the Common Territory rose by only 17%.

This factor also contributes (albeit to a lesser extent, due to the scant amount involved) to explaining the lower overall effective tax burden in the Basque Country in 1994.

7.4 ANALYSIS OF THE FRANK INDEX

7.4.1 Introduction

The theory underlying this indicator has already been discussed in the section on the tax burden.

Since this is an index which can be considered as measuring the fiscal effort, it merits an in-depth analysis to examine whether it is applicable to the twelfth harmonization rule of the Economic Agreement, which established that the overall effective tax burden in the Basque Country may not be lower than in the State.

To better understand this ratio, note the following:

- Per capita income in the Basque Country was higher than the average per capita income in the Common Territory throughout the period examined here.
- The Fundación BBV recently published a report on capitalization and growth in Spain and its regions for the period 1955-1995 ("Capitalización y crecimiento en España y sus regiones 1955-1995") which shows that the Basque Country's per capita income has outperformed GDP due to a moderate reduction in population.
- As shown below, this ratio decreased with time in both territories since both the Basque Country and the Common Territory experienced sustained growth in per capita income in nominal terms and the indicator's denominator is the square of income.

7.4.2 Results

7.4.2.a) Total coercive revenues of the State, including social security contributions

The Frank index was lower in the Basque Country throughout practically the entire period, starting from 1983.

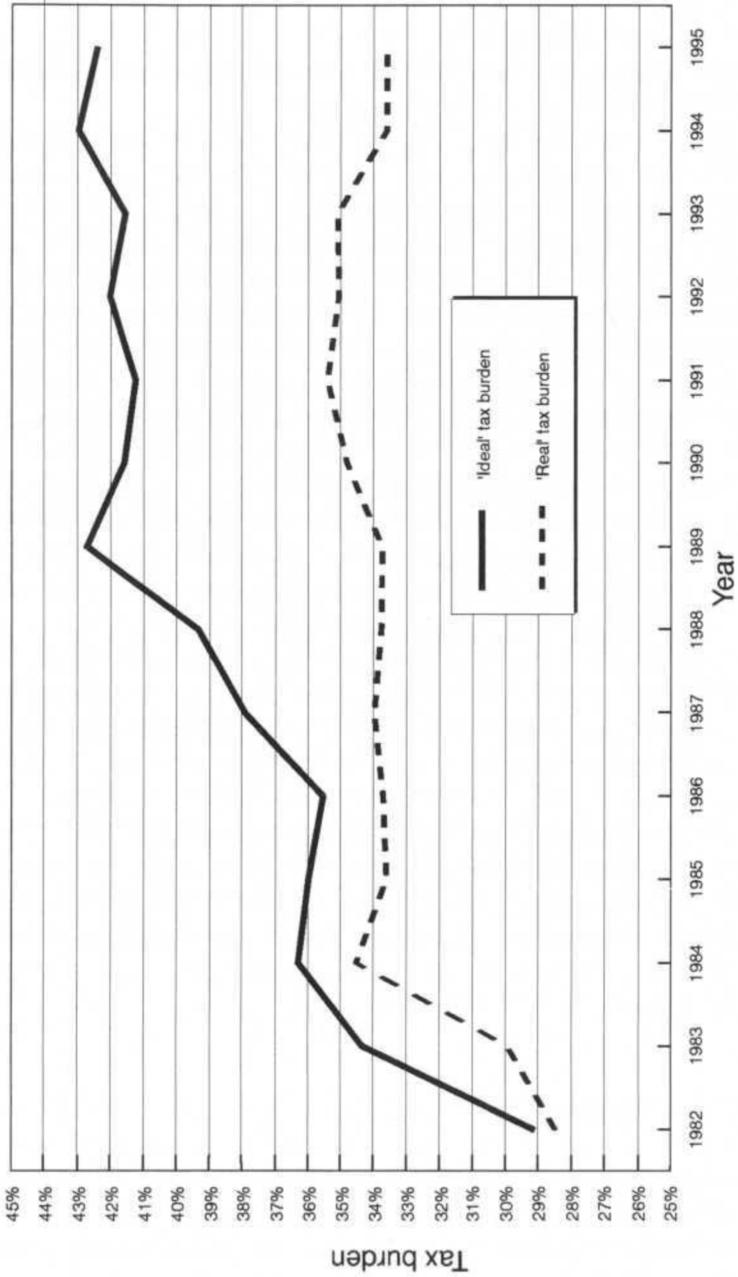


Figure 17:
'Ideal tax burden to match the Frank Index
On the GDP mp (INE/EUSTAT)

*7.4.2.b) **Total taxes: devolved taxes and non-devolved taxes***
The ratios were practically the same in 1982, and the ratio for the Basque Country was lower from 1983 onwards.

*7.4.2.c) **Devolved taxes***
The ratios were similar between 1982 and 1984, and the ratio for the Basque Country was lower from 1985 onwards.

*7.4.2.d) **Comments***
The apparent conclusion that can be drawn from these results is that the overall effective tax burden is lower in the Basque Country. Consequently, it is appropriate to calculate the additional tax effort to be made by the Basque Country to match the overall effective tax burden in the Common Territory in each of the years considered. The results are as follows:

- Figure 17 shows the *ideal* tax burden in the Basque Country in order to match the Frank Index of the actual overall effective tax burden in the Common Territory. Clearly, the overall effective tax burden would have to be around 8-10 point of GDP higher in the Basque Country.
- Since the foregoing calculation includes social security contributions and non-devolved taxes and indirect devolved taxes over which the Basque Country does not have regulatory powers of an economic nature, the question is: how much would the direct devolved taxes have to be raised to attain this equilibrium. The conclusion varies from year to year, but the mode is around 60%. This would imply that the Corporation tax rate would have to be raised to 56% and that individuals would have to pay 60% more tax than at present.

Raising taxes to the extent required to make the indices coincide would have resulted in confiscatory taxation, which is unconstitutional.

Moreover, the Basque Country's powers over direct taxes were not so broad during the period, and attaining such powers would have involved a total departure from the tax structure of the State, which would be a breach of the spirit of the Economic Agreement.

7.4.3 Conclusion

It is not coherent to argue that the legislators had in mind a measure of the tax burden like the Frank Index, since this would in practice lead to major differences between the tax regulations in the Basque Country and the Common Territory which would run counter to the apparent intent of the harmonization rule contained in the Economic Agreement.

The foregoing results are sufficiently sound evidence for concluding that this indicator is not adequate for calculating the overall effective tax burden in the terms intended in the Economic Agreement.

7.5 TAX BALANCE

We saw in Chapter 5, certain theories of public finance consider that the effective tax burden borne by the individuals in a given territory needs to be viewed not only in terms of the coercive revenues which the public sector exacts but also from the standpoint that those revenues must be offset with the public services received in return. This school of thought holds that individuals will be subject to burden from the public authorities for a "net amount", this being the amount paid by the citizenry which does not revert to them in the form of benefits.

Evidently, it is no mean task to quantify this "net amount", for a number of reasons which have been discussed before (efficiency and efficacy of expenditure, among others), but the main stumbling block is the lack of accurate data (basically for individual territories) on public expenditure.

Consequently, it is not possible to perform a minimally reliable empirical analysis of the results to be obtained from an appropriate indicator for the tax balance.

Nevertheless, considering data on public consumption, which is on average 4.5 percentage points of GDP higher in the Common Territory than in the Basque Country, it can be concluded that, assuming similar levels of tax burden in both territories (or even a higher tax burden in the Basque Country), the latter bears a higher "net burden" than the Common Territory.

The foregoing comment cannot be substantiated with reliable figures and must be considered merely as indicative. Moreover, public consumption accounts for only around 35% of total public expenditure, further highlighting the fact that the foregoing data are indicative at best.

7.6 FINAL COMMENTS

The analysis of the overall effective tax burden and of the tax burden arising from the main taxes individually, measured in terms of GDP, and considering the inherent limits of the system and of the information sources, tends to show that the Basque Country has a slightly higher overall effective tax burden, which has followed a more uniform trend over time, tending to converge on the figure for the Common Territory towards the end of the period

This convergence in recent years was particularly impacted by the

unilateral risk arising from the Economic Agreement, especially due to the major changes in trade flows and the resulting impact on VAT receipts.

Comparing the tax burden in each territory on a year-to-year basis may not be very appropriate due basically to the different tax management policies applied by the Basque Provincial Governments and the State Administration (which can shift large amounts of taxes from one year to the next). Therefore, for the purposes of comparison, it might be more appropriate to compare the tax burden figures obtained for periods of several years, since this would tend to reduce the distortions produced by the aforementioned policies.

So far, we have analyzed the figures as they were produced. The next chapter evaluates the estimated or potential effects and related uncertainties arising from the structural effects (which are, therefore, exogenous to the Economic Agreement) and other significant effects which may arise from the handles.

8. CONCLUSIONS

8.1 CONCLUSIONS ON MEASURING THE TAX BURDEN

8.1.1 Introduction

This chapter will present the various tax burden measurements discussed in chapter 7 with regard to the tax burden indicator adopted (tax receipts/income) comparing the Basque Country with the rest of the Spanish State in addition to considering the three taxation levels used in said chapter, which are as follows:

- Total coercive revenues (including social security contributions)
- Total taxation (devolved taxes, non-devolved taxes, levies and other revenues)
- Total devolved taxes

Although the previous chapter presented the results obtained from the tax burden ratios using the GDP income indicator at market prices (as determined by the National Statistics Institute and EUSTAT), other income indicators were mentioned, the average results of which will be presented. It is worth explaining that the above-mentioned results will be presented indicating the variation rate obtained from comparing the Basque tax burden ratio with that of the Common Territory; positive results indicate a greater tax burden in the Basque Country, whereas negative results indicate the opposite. The indicators mentioned above are as follows:

- GDP at market prices, using EUSTAT as a source for the Basque Country and the National Statistics Institute for the rest of the Spanish State.
- GAV at market prices using the same sources as mentioned above.
- GAV at factor costs using the National Statistics Institute as a source for both the Basque Country and the Spanish State.

The presentation of the results as an average over the period under consideration to a large extent mitigates the distortions arising from comparing them on an annual basis, among other reasons, due to the different refund policies of the Basque and Spanish competent authorities. In any case, for

1994 in particular, an attempt will be made to quantify the effect on the tax burden index of lower tax receipts in the Basque Country, as a result of exceptionally higher personal income tax, corporation tax and value added tax refunds to tax payers.

This section will also include a summary of the results obtained for the above-mentioned periods of the tax burden indicator used in chapter VI, which compares the total tax receipts obtained and income generated for these periods (in 1995 constant terms).

Section two of this chapter will subsequently attempt to quantify the hypothetical effect that the Basque Provincial Institution's Corporation tax incentives (asset revaluations, tax holidays, investment incentives, etc.) might have had on the Basque Country's tax burden index for the years 1991 to 1995.

The second section will also briefly consider the adjustments to indirect and direct tax receipts and the imputation criteria which have been used in the same way as the Quota methodology, to determine the collection of central taxes which correspond to the Basque Country. These considerations intend to diminish the importance of the quantitative results of the tax burden measurements discussed, inasmuch as they are based on tax collection data and certain adjustments which cannot accurately reflect the real tax burden of residents in the Basque Country and/or the Common Territory.

8.1.2 Average rates of variation in results

The average variation rates obtained with regard to the tax burden ratios from the income sources used are given in tables 19, 20 and 21.

Table 21:
Average Variation Rates (1982-1995)

	Total Revenues	**Total Taxation**	**Devolved taxes**
GDP at market prices (Eustat/INE)	5.61	-0.05	1.51
GAV at market prices (Eustat/INE)	6.86	1.13	2.63
GAV at factor costs (INE)	4.71	-0.79	1.01
Average of Indicators	**5.73**	**0.1**	**1.72**

Table 22:
Average Variation Rates
1982-1990

	Total Revenues	Total Taxation	Devolved taxes
GDP at market prices (Eustat/INE)	9.00	1.28	3.77
GAV at market prices (Eustat/INE)	10.00	2.52	4.89
GAV at factor costs (INE)	5.51	-1.52	1.1
Average of Indicators	**8.17**	**0.76**	**3.25**

Table 23:
Average Variation Rates
1991-1995

	Total Revenues	Total Taxation	Devolved taxes
GDP at market prices (Eustat/INE)	0.75	-2.28	-1.74
GAV at market prices (Eustat/ INE)	1.92	-0.74	-0.64
GAV at factor costs (INE)	3.39	0.28	0.78
Average of Indicators	**2.02**	**-0.91**	**-0.53**

The following comments can be made about the tables above:

- The average tax burden ratio obtained with the income indicators for the three "categories" of coercive revenues (total revenues, total taxation and total devolved taxes) for the first two periods under consideration is on average approximately 1.5% higher with respect to income in the Basque Country.
- The average of indicators was higher in the third period in the Common Territory, if the tax burden is quantified with regard to total taxation and total devolved taxes. In any event it is only slightly higher (less than half a point) and is probably due to the factors mentioned above, which include

significantly higher refunds to taxpayers.

- According to all the income indicators used, the tax burden determined on the basis of total coercive revenues exacted by the public sector is on average 2% higher with respect to income in the Basque country for all the periods under consideration.
- It is also worth noting that the ratios derived from total taxation more frequently show the tax burden to be higher in the Common Territory, as mentioned before. This could indicate that in the Basque Country the actual accrual of certain central taxes is undervalued.
- It is also worth pointing out that in all cases the GAV at factor costs income indicator, determined exclusively by the National Statistics Institute for both areas, shows the average tax burden to be higher in the Basque Country than in the Common Territory.
- Finally, it can be deduced from the ratios obtained in the different periods that, as disclosed in chapter 7, the tax burden in the Basque Country has increased gradually in a more or less uniform manner. However, the ratio for the rest of the State shows relatively low tax burden levels in the first few years of the period analyzed which increased sharply to make the ratio very similar, if not almost identical, to the levels recorded in the Basque Country.

8.1.3 Summary of the results regarding the "cumulative" tax burden

The following tables include, as indicated in section 1 above, a summary of the tax burden results obtained by the indicator which compares aggregate collection with aggregate income during the periods under consideration.

Table 24:
"Cumulative" tax burden
1982-1995

Tax Burden	Total Revenues	Total Taxation	Devolved taxes
Basque Country	35.28	22.14	17.85
Rest of State	30.6	20.3	16.04
Difference	4.68	1.84	1.81
% of variation	**15.29**	**9.06**	**11.28**

Table 25:
"Cumulative" tax burden
1982-1990

Tax Burden	**Total Revenues**	**Total Taxation**	**Devolved taxes**
Basque Country	34.33	21.18	16.51
Rest of State	27.41	18.04	13.54
Difference	6.92	3.14	2.97
% of variation	**25.25**	**17.41**	**21.94**

Table 26:
"Cumulative" tax burden
1991-1995

Tax Burden	**Total Revenues**	**Total Taxation**	**Devolved taxes**
Basque Country	36.7	23.58	19.84
Rest of State	35.34	23.67	19.77
Difference	1.36	-0.09	0.07
% of variation	**3.85**	**-0.38**	**0.35**

From the results above it seems that effective overall tax burden was higher in the Basque Country throughout the period analyzed, although more obviously so in the period 1982 to 1990. From 1991 to 1995 the tax burden levels tended to equal out, although they were still slightly higher in the Basque Country.

The tax burden appears higher in terms of both total revenues and total devolved taxes in the Basque Country for all the periods. The ratio to total taxes from 1991 to 1995 was slightly higher in the Common Territory, which could be a result, among other things, of the possibility that the central tax receipts were lower than the amount which actually accrued, as discussed above.

The tables above clearly indicate that, as discussed above, the tax burden ratio in the Common Territory increased significantly in the last years of the period and has almost reached the same level obtained in the Basque Country,

although it was evidently at a much lower level in the past. However, the tax burden ratio has developed more uniformly in the Basque Country, rising more slowly.

8.1.4 Other comments

As can be seen in the tables above, the overall effective tax burden calculated with regard to total coercive revenues obtained by public authorities is approximately 35% of income in each territory, although it is approximately 2% of income higher in the Basque Country than in the Common Territory.

The same indicator calculated with respect to total tax revenues (excluding social security contributions) is similar (20% higher than income) so that, as described in the paragraph above, the ratio for the Basque Country was slightly higher than in the Common Territory. Also, it should be noted that by comparing this ratio with the ratio for all coercive revenues, it can be inferred that social security contributions are relatively more significant in the Basque Country, probably as a result of the above-mentioned factors.

Finally, measurement of the tax burden with regard to devolved taxes is approximately 18% of the income indicator considered and is again slightly higher in the Basque Country.

It can be inferred from the quantitative data obtained in the above tables that in practice the harmonization rule of Article 4.12 of the Economic Agreement has not been infringed given that the overall effective tax burden in the Basque Country from 1982 to 1995 was on average slightly higher than in the Common Territory.

In any case, it is appropriate to note that this similarity (or, if anything, slight excess) cannot be attributed to the regulatory and management powers conferred on the Basque authorities by the Economic Agreement, in the same way that it would not have been possible to attribute a lower tax burden ratio to these powers.

Finally, it must be remembered that the overall effective tax burden was quantified using the *Tax receipts/Income ratio* which does not mean (as stated in Chapter 6) that it is the most appropriate indicator for this purpose, since the concept of tax burden is indeterminate and non-pacific, and has several meanings. This section of the study does not contain the results obtained from the quantification of the Frank index (nor other possible indicators which are difficult to determine) since it was not considered to be specifically included in the twelfth rule.

8.2 POSSIBLE ADJUSTMENTS AND THEIR QUANTIFICATION

8.2.1 Quantification of the effect of incentives on the tax burden

In view of their social impact, this section will quantify, in GDP terms, the effect on the tax burden of certain measures which were promulgated by the Basque tax authorities since 1990 (basically the 1993 asset revaluations and tax holidays as well as the 1988 incentive regulations which were in force until 1993). Nevertheless, taking into account the relatively low importance of Corporation tax receipts (approximately 2% of GDP) it is unlikely that the results of this quantification will be significant.

The procedure to be followed for this purpose is as follows:

- Firstly, the average percentage of the Basque Autonomous Community's Corporation tax receipts in comparison with the Spanish State's Corporation tax receipts will be determined from 1982 until 1990 inclusively. This period was chosen because the above-mentioned regulations had little or no effect during these years.
- Secondly, the average percentage obtained will be applied to the Spanish State's Corporation tax receipts from 1991 until 1995 (both inclusive) so as to obtain the maximum corporation tax receipts which would have been collected in the Basque country in the absence of the above-mentioned incentives.
- These "ideal" tax receipts will be compared with those which were actually collected from 1991 until 1995 and the differences will be obtained in absolute values and as a percentage of GDP.
- Then the average of the percentages of the differences obtained above will be calculated in GDP terms, i.e. in tax burden terms.

This analysis will be performed considering two different levels of Corporation tax receipts in the Basque Autonomous Community for 1994. Two levels will be used because, as described above, the tax refunds granted by the Basque Tax Administration in 1994 were considerably higher, in terms of interannual percentage increase, than the refunds granted by the State's Tax Administration (114% in comparison with 17%, respectively). Consequently, the tax receipts which would have been obtained if tax refunds had increased by the same percentage as State refunds will be considered as the differentiated level of tax receipts in the Basque Country.

Corporation tax receipts in the Basque Country from 1982 until 1990 averaged 4.78% of those obtained by the Spanish State. The table below shows the real corporation tax receipts obtained in the Basque Country from 1991 to 1995, the tax receipts which would have been obtained if the average above had been applied to the State's tax receipts, the difference between the

two figures in absolute terms and as a percentage of GDP (amounts in thousands of millions of pesetas).

Table 27:
The effect of Incentives on Tax Receipts

Year	Actual Tax Receipts	"Ideal" Tax Receipts	Difference	Difference as % of GDP
1991	62,844	69,182	-6,338	0.18%
1992	64,450	63,988	462	-0.01%
1993	54,899	57,549	-2,650	0.07%
1994	42,229	54,661	-12,432	0.29%
1995	58,105	64,220	-6,115	0.13%
Average			**-5,599.4**	**0.13%**

The possible effect of the corporation tax incentives promulgated by the Basque Authorities was very slight, both in average terms and in annual values, during the period considered.

The decrease in 1994 is particularly noteworthy, which basically seems to have arisen as a result of the increase in refunds discussed above. It does not seem reasonable to attribute this decrease to the tax holidays, among other incentives, in view of the fact that this does not hold in 1995 and it does not even remotely match the minimum maturation periods for potential new investment.

If the potential tax receipts of the Basque Tax Administrations are considered, disregarding the exceptionally high refunds (basically for standardization purposes) in order to compare Basque tax receipts with those of the Common Territory, the following table would be obtained:

Table 28:
The effect of incentives on "corrected" tax receipts 1994.

Year	Actual Tax Receipts	"Ideal" Tax Receipts	Difference	Difference as % of GDP
1991	62,844	69,182	-6,338	0.18%
1992	64,450	63,988	462	-0.01%
1993	54,899	57,549	-2,650	0.07%
1994	53,068	54,661	-1,593	0.04%
1995	58,105	64,220	-6,115	0.13%
Average			**-3246,80**	**0.08%**

As can be seen in the table above, the difference obtained previously, which was very small as a percentage of GDP is even smaller and almost negligible, if 1994 tax receipts in the Basque Autonomous Region are considered as those which would have arisen from a similar interannual percentage increase in refunds to that applied by the State's Tax Authorities.

In any case, considering the tables above, it seems that the effect of the Corporation tax measures promulgated by the Basque Tax Authorities, in terms of the tax burden, is clearly irrelevant.

8.2.2 Correction of the level of refunds in the 1994 tax receipts

As discussed in previous sections of this chapter and in chapter VI, in 1994 an exceptional event occurred which substantially affected the 1994 tax receipts of the Basque Autonomous Region. This event was the high level of tax refunds granted by the Basque tax authorities.

As a result, it was noted that comparisons with 1994 might not be meaningful, insofar as there was a sharp distortion which might occur, to a lesser extent, in the other years analyzed and, consequently, it seems more appropriate to make comparisons using averages which cover periods of several years.

This section seeks to quantify, as far as possible, the effect of the extraordinary volume of refunds on the tax burden in 1994.

The additional tax receipts, which would have been obtained in the Basque Autonomous Community if the refunds had varied at the same interannual rate as in the Common Territory will be measured, so as to

quantify that effect.

This analysis did not include all the circumstances which might have affected the level of refunds, such as a higher level of corporation tax losses or a hypothetical substantial increase in exports, amongst other factors, since these amounts were unknown. In any event, the possible effects of the above-mentioned circumstances do not seem to have been as great in 1994 in comparison with 1993, basically in personal income tax, exports or corporation tax loss carryforwards.

The following table shows the increases in tax refunds for all main taxes in 1994 in comparison with 1993 (in percentage terms) for the Basque Autonomous Community and the rest of the Spanish State.

Table 29:
Refunds in 1994

	% of variation in refunds in the Basque Autonomous Region	**% of variation in refunds in the Spanish State**
Personal Income Tax	24.5	-1.90
Corporation tax	114.6	17.10
VAT	23.8	-2.80

If the increase in the percentage of refunds of the Spanish State had been applied, the increase in tax receipts in the Basque Country would have been as follows (in thousands of millions of pesetas):

Table 30:
Increase in tax receipts in the Basque Country applying the same refund percentage

	Increase in Tax Receipts
Personal Income Tax	15,040
Corporation tax	10,839
VAT	10,967
Total Increase	**36,846**

The effects of said increase in tax receipts in percentage terms with regard to the various income indicators used in this study (i.e. in terms of the tax burden) are shown in the following table.

Table 31:
Effect of the increase in tax receipts on the tax burden indicator

	Effect on the Tax Burden
GDP at market price (INE/EUSTAT)	0.87
GAV at market price (INE /EUSTAT)	0.93
GAV at factor costs (INE/INE)	0.96
Average of Indicators	**0.92**

It can be deduced from the table above that, on average, the tax burden in the Basque Country in 1994 would have been 0.92% higher if the interannual increase in the amount of refunds granted had been identical to that of the Spanish state.

Thus, the 1994 tax burden indicator would have been as follows on the basis of the various income indicators.

Table 32:
1994 Tax burden ratios
Tax receipt data adjusted for level of refund

	Resulting Tax Burden		
	Total Revenues	**Total Taxation**	**Devolved taxes**
GDP at market prices (INE/EUSTAT)	34.47	22.19	18.69
GAV at market prices (INE/EUSTAT)	37.11	23.88	20.12
GAV at factor costs (INE/INE)	38.18	24.57	20.70
Average of Indicators	**36.59**	**23.55**	**19.84**

Consequently, the differences obtained for 1994 with regard to the level of the tax burden in the Common Territory were as follows.

Table 33:
Differences in tax burden between the Basque Country and the rest of the Spanish State in 1994
Basque tax receipts adjusted for the level of refunds

	Differences in Tax Burden		
	Total Revenues	**Total Taxation**	**Devolved taxes**
GDP at market price (INE/EUSTAT)	-0.33	-0.36	-0.17
GAV at market price (INE/EUSTAT)	0.13	-0.08	0.09
GAV at factor costs (INE/INE)	0.5	0.15	0.28
Average of Indicators	**0.1**	**-0.1**	**0.07**

By comparing the figures in the table above with those obtained from the actual tax receipts, it can be deduced that the differences are the opposite for most of the indicators considered; consequently, the tax burden was higher in the Basque Country. In any case, both the positive and negative differences are of relatively little importance and, therefore, it is more appropriate to refer to say that the level of tax burden were practically identical than that they differed slightly.

8.2.3 Possible adjustments to tax receipts

8.2.3.a) Introduction

We have been measuring the overall effective tax burden as the ratio, in percentage terms, between tax receipts (as numerator) and income (as denominator).

Throughout Chapter 7 and in preceding chapters a number of tax burden ratios were presented which were obtained directly from exogenous tax data and from statistical or macro-economic data but at no time analyzing whether or not there was a minimal level of correlation between what was being measured by each of the above-mentioned two groups of data.

It was unknown in advance whether or not the tax receipts information was obtained from the same tax payers and taxable events as those which were used in measuring the income used in the ratio for each tax burden indicator. This is worth considering in so far as the handles established in the Economic Agreement might not be appropriate for comparing tax receipts calculated in one territory and income produced or obtained in another.

Both the INE (National Institute of Statistics) and EUSTAT (the Basque Statistics Institute) follow the methodology of the European System of Integrated Accounts (SEC) whereby the Gross Domestic Product of a country or geographical area is the final result of the output of the number of residents, i.e. those who are deemed to have a centre of interest in said geographical area. Nevertheless, as indicated by the Research Service of BBV, "The production factors, capital and labour, do not always reside in the province or community where the product is obtained, which reveals the possible existence of certain 'mismatches' in measuring a territory's income."

The fact that tax receipts are dependent upon the Economic Agreement and its handles presents a further difficulty when determining whether or not the comparing the tax receipts in an area (in this case the Basque Country) with the income indicators really reflects the true tax burden on its residents.

Therefore, the existence of possible adjustments to the tax receipts of the Basque Country and the rest of the State will be analyzed in order to quantify as accurately as possible the true overall effective tax burden in both

territories. Also, another type of known factors will be included in the analysis to facilitate better comprehension and interpretation of the results obtained in the preceding chapter.

8.2.3.b) Receipts from Devolved taxes

i) Adjustment to Direct Taxation

The adjustment to direct taxation accounts for the effect of taxation of Basque residents which for various reasons (mainly personal income tax withholdings from civil servants residing in theBasque Country, withholdings from interest income paid by state owned banks, withholdings on State debt securities, etc.) is paid to the State tax administration.

The adjustment, reached by agreement rather than an exhaustive valuation of the above-mentioned items, may or may not accurately reflect their real effect on the Basque Country's tax receipts; consequently, the resulting tax burden may differ from the real, effective tax burden.

Taxation accrued in the Basque Country in connection with Personal Income Tax withholdings from earnings on State debt securities (which are exclusively collected by the State Administration) was quantified for 1993 by a global calculation which is by no means exhaustive, but it may reflect a shortfall in the adjustment to direct taxation.

On 31 December 1993 there were approximately 26.6 billion pesetas outstanding in State debt securities. The income earned on 15.3 billion pesetas of the above-mentioned securities was subject to withholding tax.

Assuming that the yield on those securities was 10% and that residents in the Basque Country owned 6.5% of them (this is the same percentage as the Basque Country's income in relation to the State's total income in that year), the following results would be obtained:

- Residents in the Basque Country would have earned approximately 100,000 million pesetas of interest income.
- Consequently, the withholdings on the income would have amounted to approximately 25,000 million pesetas.

The above calculation did not include the amount of debt securities issued by other Autonomous Communities which might also be owned by residents in the Basque Autonomous Community.

Taking into account that the direct taxation adjustment amounted to 28,440 million pesetas in 1993, it is unlikely that it includes all the taxation effects of all the items which it should in theory include (such as withholdings on State debt securities, personal income tax withholdings of State civil servants in the Basque Country, Taxation of non-residents, State-owned banks, monopolies, etc.) if only one of the items the adjustment covers

accounts for approximately 90% of the total adjustment made.

Consequently, the tax burden in the Basque Country as measured by the ratio between the Basque Treasuries' receipts (appropriately adjusted) and income might be understated to the same extent that the tax burden of the Common Territory might be overstated, although this would be of relatively lesser importance.

ii) Indirect Taxation: adjustment to VAT on exports and to the internal market

In chapter VI it was stated that the adjustment to VAT accounted for approximately 50% of computed VAT receipts in the Basque Country (40% after 1993). As in the case above it is not possible to affirm that VAT receipts in both territories correspond to the VAT which really accrued there, since the above-mentioned adjustments, which have been calculated in the same way since the Economic Agreement first took effect, do not necessarily reflect the figures which should have been computed.

8.2.3.c) Receipts from Central Taxes

For the purposes of quantifying the tax burden arising from total taxation and from total coercive revenues collected in the Basque Country, the measurement of the tax burden (the results of which are presented above) includes the possible effect of central taxes, mainly excise taxes (hydrocarbons tax and tax on alcoholic beverages) as well as levies and other revenues not devolved under the Economic Agreement and collected by the State.

It is not possible to objectively ascertain the taxation borne by residents in the Basque Country in view of the fact that these taxes are collected exclusively by the State and that the territory in which they are collected (State tax offices) does not clearly correspond to the territory where the taxable event arose.

Consequently, for the purposes of this study, it was estimated that the Basque Country's share of these taxes amounted to 6.24% of the total, which is equal to the imputation index established when the Economic Agreement was approved.

Logically, this might assign tax burden levels to the Basque Country which differ from the real levels. In order to judge whether or not this estimate is reasonable, the percentage the Basque Country accounts for in total State consumption was analyzed since these taxes (particularly excise taxes) are basically levied on consumption. It is sufficient to say that total consumption of the Basque Country represents 6.4% of total State consumption (6.7% taking private consumption only).

Also, with regard to certain excise taxes, for example, the hydrocarbons tax, alternative indexes could be used, such as the rate of industrial consumption,

as it is reasonable to assume that the industrial sector will require products subject to this tax to a greater extent. In this case, given that the importance of said sector is slightly higher in the Basque country than in the rest of the Spanish State, it could be inferred that the tax receipts which accrued in the Basque Country were higher than those attributed by the 6.24% index.

On the basis of the above-mentioned data it could be inferred that the estimate made is reasonable since there are no major differences between the above-mentioned rates of consumption and the imputation index of the Economic Agreement. However, if the rates of consumption had been used as the imputation index for collection of central taxes, the tax burden indicators would have been 0.1% to 0.3% higher (as a percentage of GDP).

8.2.3.d) State Tax Receipts in the Basque Country

It was discussed earlier that, as a result of the handles established under the Economic Agreement (which are summarized for all main taxes in chapter 7), the tax receipts of the Basque Country and the Common Territory might not match the taxes which really accrued in these areas since certain tax receipts are imputed on the basis of certain previously agreed indexes.

As a result, the tax burden indexes obtained might not correspond to the tax burden actually borne by individuals in the territories under consideration, even after solving the theoretical problems of the concept of tax burden and the indicators used to measure it. It is worth remembering in this connection the remarks made regarding the VAT adjustment.

In any case, it is doubtful whether it is possible to quantify in practice the adjustments which would have to be made to computed tax receipts in the Basque Country and the Common Territory so that they actually included the amounts actually accrued in each territory, and consequently, the results obtained from the levels of tax burden should be treated with caution.

It is worth mentioning indirect and direct tax receipts obtained by the State tax offices in the Basque country for the period 1989-1995 to see what the transfer of tax receipts from one territory to another via the handles of the Economic Agreement might be:

Table 34:
Tax receipts from State Tax Offices in the Basque Country

Year	Direct Taxes	Indirect Taxes	Total Taxation
1990	116,095	102,689	218,784
1991	109,129	108,465	217,594
1992	138,284	77,573	215,857
1993	137,262	49,234	186,496
1994	120,056	63,019	183,075
1995	127,705	79,032	206,737

(Source: "Ventana Económica" June 1996)

On the basis of the figures in the table above, the potential effect on the tax burden indicator of transferring the tax receipts from one territory to another as a result of the handles established by the Economic Agreement may be of great importance. Obviously, the figures in the table above do not correspond in any way to the quantification of the effects of the handles on tax receipts because there may be State Tax Offices which are not located in the Basque Country, but which collect taxes accrued there or conversely, revenues imputed as tax receipts of the Basque Provincial Governments might have accrued in the rest of the State.

In any case it is worth reiterating the potential quantitative importance of the amounts involved, as is clear in the table above.

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