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The EU and substate fiscal autonomy, obstacle or opportunity? Lessons from the Basque region of Spain

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Summary

The Basque and Navarran regions of Spain have the most substantial fiscal autonomy at substate level in the EU. As such, they offer important learning experiences for other EU member states where regions or nations seek greater authority over fiscal decisions, in particular the UK as it starts to devolve greater fiscal powers to Scotland. Through a focus on the Basque experience under its Economic Agreement (*Concierto Económico*, hereafter *Concierto*) with Spain, this research brief considers the implications of the EU framework for the feasibility of developing substate fiscal autonomy verging on sovereignty within member states.

Highlights

- The development of Basque fiscal autonomy in the EU context has raised debate over two main issues: (1) the compatibility of Basque authority over corporation tax with the common market; and (2) the scope for representation of Basque regional authorities in EU forums on fiscal matters.
- These debates have been shaped by Spanish-Basque discrepancies in conceptualisations of the Basque fiscal autonomy model, as well as by what is technically possible within the EU itself.
- The Azores tax ruling of 2006 and the development of the principle of subsidiarity in the Treaty on European Union have done much to safeguard and strengthen Basque fiscal autonomy in the EU.
- Yet the state-centric EU framework continues to pose obstacles to the fullest development of substate fiscal autonomy often sought by nationalist or regionally-based parties.

Basque fiscal autonomy in brief

- For historical reasons, the Basque and Navarran regions have their own bilateral economic agreements with Spanish government (the *Concierto* and the *Convenio*, respectively) which afford them substantial fiscal autonomy, rather than participating in the revenue-sharing common financing system in force in the remaining 15 Spanish regions since 1980.
- The predominance of nationalist-led government in the Basque region under the Basque Nationalist Party (PNV) has contributed to the more concerted push there to update and develop the Basque *Concierto* since the first model of the democratic period was approved in 1981, including to the EU context.
- The Basque provincial treasuries collect almost all taxes (both direct and indirect) apart from customs duties and are responsible for all related tasks such as tax inspection.
- Beyond collection powers, the Basque provinces have almost full legislative autonomy to design the main direct taxes (income, wealth, corporation, inheritance and non-resident taxes) and some minor indirect taxes. They only lack legislative autonomy over the main indirect taxes (VAT and excises), where they adhere to the relevant Spanish legislation, which is in turn circumscribed by EU legislation.
- The *Concierto* affords tax-raising powers to each of the three Basque provinces (again for historical reasons), rather than the regional government. This brings the total number of treasuries in Spain to five, including the Spanish and Navarran treasuries.
- The Basque treasuries are subject to some general (and rather ambiguous) harmonisation rules with Spanish legislation: most notably, they must not distort competition among firms or free movement among Spanish regions, and overall fiscal pressure (tax to GDP ratio) in the Basque provinces should be 'equivalent' to that in the rest of Spain.
- The Basque treasuries are subject to the Spanish tax system in that they do not have the right to create their own taxes from scratch. Every time Spain introduces a tax, Spanish and Basque delegations must negotiate bilaterally how to delegate the relevant tax-raising power.
- These features of the *Concierto* contribute to different Spanish-Basque conceptualisations of it: nationalist-led Basque authorities consider the provinces fiscally sovereign almost to the same extent as Spain or any other EU member state given their legislative capacity over direct taxes, while Spanish authorities consider Basque fiscal powers to be more limited by their subordination to harmonisation with Spanish tax legislation and to the Spanish tax system in general.
- The Basque government pays an annual quota to Spanish government to cover its share of the relatively few remaining centralised policy competences, such as foreign affairs and defence. In recent years, this has accounted for around 7%-12% of the region's total tax collection.
- The *Concierto* governs revenue-raising and the quota payment only. In other financial matters such as debt issuance and deficit targets, the Basque region is subject to the same rules set by Spain for the country's other regions.



First debate: To what extent can the Basque treasuries set different corporation tax legislation from the Spanish treasury?

This became the first fundamental area of dispute over the *Concierto* in both Spain and the EU from the late 1980s and would not be resolved until two decades later. The Basque provincial treasuries first started to make full use of their regulatory powers over corporation tax to introduce a series of tax exemptions, deductions and other incentives for businesses in 1988, 1993 and 1995, followed by a more comprehensive corporation tax reform in 1996 – all of which created more favourable tax conditions for businesses in the Basque provinces than elsewhere in Spain. This unleashed extensive internal debate and legal challenges within Spain given the conflicting Spanish-Basque interpretations of the extent of harmonisation required with Spanish legislation.

These domestic debates would become intertwined with questioning at EU level over compatibility with the rules of the common market. European Advocate General Antonio Saggio's preliminary conclusion in 1999 that Basque corporation tax incentives could be considered a 'regionally selective' state aid which infringed freedom of competition within the EU, since they only applied to one region within a wider member state, threatened the capacity of the Basque treasuries to set even minimally different legislation from the Spanish state. Eventually, however, the Azores tax ruling of 2006 would clarify matters considerably by asserting the right of a region to set different tax legislation from its member state if the region fulfilled specific requirements of procedural, institutional and economic autonomy.

Latest debate: Should the Basques be represented in the Economic and Financial Affairs Council (Ecofin)?

Gradual changes to the Treaty on European Union from Maastricht to Lisbon would increasingly make possible the participation of regional representatives within state delegations to the Council of Ministers under the principle of subsidiarity, where relevant to their competences. In this context, from the turn of the century the Basque authorities began to seek representation within the Spanish delegation to the working groups and meetings of the Ecofin configuration of the Council, which deals with tax harmonisation among many other economic policy issues, since they have legislative competence over direct taxes.

While EU member states retain a very large degree of sovereignty over taxation, relevant steps have nevertheless been taken to prevent discrepancies in tax systems where these might hinder the functioning of the single market. The EU authorities regulate customs duties as well as significant aspects of other indirect taxes under the provisions of Article 113 of the Treaty on the Functioning of the European Union. For Value-Added Tax (VAT), for example, the EU sets a standardised tax base, as well as a range of tax rates which member states must choose from. Steps towards harmonisation in the sphere of direct taxes, which mainly affect corporate taxes, are more limited and governed instead by the provisions of Article 115. They usually take the form of recommendations or soft law rather than legally-binding directives. One significant effort underway is the work towards a Common Consolidated Corporate Tax Base (CCCTB) to develop a set of common rules to determine the tax base of companies with operations in several member states.

In 2004 Spain would start to make provisions for representatives of Spain's 17 regional governments to participate in the Spanish delegation to four of the Council's ten configurations where relevant to their interests (e.g. Agriculture and Fisheries). This did not however include Ecofin, where only the Basque and Navarran regions have sufficient fiscal competences to seek representation. Only in mid 2010 would the then Spanish minority socialist government eventually agree to Basque (and subsequently also Navarran) participation in select Ecofin working groups – a request which the Basque delegation had first tabled back in 2001 when negotiating a new *Concierto* agreement. The deal in 2010 was struck as part of a political bargaining arrangement in return for parliamentary support from the Basque Nationalist Party for the socialist government's 2011 Spanish budget. Basque provincial treasury representatives ultimately aspire to go further still and achieve co-representation within the Spanish delegation at Ecofin meetings themselves (not just the working groups).

The EU context: Evolving favorably to substate demands for fiscal authority?

The Azores tax ruling and the development of the principle of subsidiarity have safeguarded Basque fiscal autonomy in the EU and opened up the potential for Basque participation in EU fiscal forums. Therefore, the Basque authorities now tend to point the finger at Spanish government rather than the EU framework itself, arguing that it has lagged behind other federal and decentralised states in Europe – especially Germany, Belgium and Austria – in introducing mechanisms to ensure regional participation in Council formations where relevant to their competences. The Spanish authorities have not considered Basque representation in Ecofin as imperative as the Basque nationalist authorities themselves have, arguing that Basque fiscal powers are circumscribed by Spanish tax legislation (see p.2) and the Basque regional and provincial authorities do not have wider economic policy competences.

Beyond the question of political will and consensus, however, the state-centric EU framework still poses considerable obstacles to the fullest development of substate fiscal autonomy such as that sought by Basque nationalist authorities:

- EU rules permit the devolution of authority over direct taxes to the substate level but they seriously limit it in the case of indirect taxes: most notably, each state can only charge one VAT rate, which can be collected but not varied at regional government level (as occurs in the Basque case).
- While the principle of subsidiarity encourages state delegations to take into account regional interests where relevant, these must inevitably remain subordinate to the overriding state interest represented in EU Council meetings. Individual regional interests also usually remain subordinate to the common position of all regions in a particular member state (and participation by regional representatives in the state delegation at such meetings is almost always on a rotational basis). In the Basque case, such a framework cannot easily accommodate the PNV's view of the Basque treasuries as almost equally competent in matters of direct taxation as the Spanish treasury, and its aspiration to a fully equal bilateral Spanish-Basque relationship over taxation and other issues.
- The EU also still puts serious constraints on the devolution of corporation tax. Since the Basque region raises almost all its own taxes and bears the full risk of what happens to these revenues, the Azores tax ruling clarified that it can set different corporate tax rates and incentives from the Spanish treasury. Why? Since it is an institutionally distinct body with its own economic and political accountability. Nevertheless, fulfilling these criteria is not a straightforward matter, especially where regions or nations (e.g. Scotland) seek greater fiscal powers but might still rely to a degree on revenue transfers or other payments from central government. There would remain a risk of infringing EU rules on regionally selective state aids if corporation tax were devolved unless appropriate care were taken, for example, to avoid any fiscal equalisation payments that could be construed as compensation in the event of a shortfall in receipts.

Conclusion

Blame is often laid squarely on member state governments for lack of political will to devolve the greater fiscal authority increasingly sought by substate regions and nations. Yet analysis of the Basque experience shows that the EU context exercises legal and technical constraints on what is practically possible.

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