



# The Economic Agreement between the Basque Country and Spain

Ignacio Zubiri Oria

# **THE ECONOMIC AGREEMENT BETWEEN THE BASQUE COUNTRY AND SPAIN**

Principles, Characteristics and Economic Implications

**Ignacio Zubiri**  
University of the Basque Country

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## PREFACE

The Economic Agreement is a pact between the Basque Country and the rest of Spain. It basically says that all taxes (except social security contributions) belong to the Basque Country and that the Basque Country will annually pay a Quota to the Central Government as a compensation for its expenditures in the Basque Country. The Economic Agreement model of financing dates back to 1876 and it is the only last remaining prerogative of a wider set of rights, the *Fueros* (Charters), the Basque Territories had since the 12th and 13th centuries when they joined the Crown of Castile.

The purpose of this book is to analyze and explain the Economic Agreement: what it is, its historical origin, the use made by the Basque Country of the tax autonomy given by the Economic Agreement and the economic implications of the Economic Agreement. The book also reviews the differences and similarities between the financing systems of *Foral* Autonomous Communities (the Basque Country and Navarre) and the other Autonomous Communities in Spain (the so called Common system of financing). The last part of the book shows the compatibility of the Economic Agreement with the *EU* regulations.

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1. [http://www.adconcordiam.net/ca\\_index.html](http://www.adconcordiam.net/ca_index.html)



## **EXECUTIVE SUMMARY**

## Political Organization

1. The Basque Country has three provinces (Alava, Biscay and Guipuzcoa), also called Historical Territories (*HT*). Each *HT* has its own Parliament (*Juntas Generales* or General Council) and is governed by a Provincial Council called Foral Deputation. On top of provincial Parliaments and governments, there is a regional Parliament and a regional government. Following the historical tradition, the *HTs* play a fundamental political and economic role in the functioning of the Basque Country.

## Economic characteristics

2. The Basque Country is a small, highly industrialized region. The productivity of labour is high and wages are considerably higher than in the rest of Spain. The unemployment rate is substantially lower than in other Spanish regions. The Basque Country is one of the richest regions in Spain and its wealth is well above the *EU* average. In fact, when price differentials are eliminated (using purchasing power standards) the Basque Country is richer than almost any *EU* country.

## Historical Background

3. The *Foral* system is the continuation of a historical tradition of fiscal autonomy, which dates back to the 12th and 13th centuries when the Basque Territories joined the Crown of Castile. Until 1876 the Basque Territories had *Fueros* (Charters) giving them ample autonomy (administrative autonomy, own Territorial Law, exemption from military and fiscal contributions to the Crown, and no customs duties). In 1876, after several wars (called *Carlist* wars) the *Fueros* were abolished and the only autonomy left was the fiscal autonomy. This fiscal autonomy was materialized in Economic Agreements. The system of Agreements lasted until Franco's dictatorship in 1936. However, even under Franco Alava maintained its Economic Agreement. The 1978 Constitution restored the historical tradition of Economic Agreements

## Characteristics of the Foral Model

4. The *Foral* model of financing and, by extension, the Economic Agreement, is based on two principles: (A) Fiscal Autonomy. All taxes belong to the *HTs* which

administer and, subject to some harmonization principles, regulate those taxes. The taxes that belong to the *HT* are called *agreed taxes*. (B) Payment of a Quota to the State as compensation for the expenditures made by the State on behalf of the residents in the Basque Country and as a contribution to the solidarity among regions.

## Public Sector in the Basque Country

5. In the Basque Country there are four levels of government (plus, of course, the *EU*). All of them (Central Government, Basque Government, Foral Deputations, and Municipalities) spend, but one of them (Foral Deputations) collects most of the taxes. This leads to a complex scheme of transfers which redistributes tax revenue from the Foral Deputations towards the other tiers of government.

6. Public expenditure in the Basque Country is about 45% of *GDP*, which is very similar to the *EU27* average (46%). The Central Government makes almost 60% of total public expenditure. The Basque Government is responsible for nearly 25% of the public expenditure. Foral Deputations expenditures account for 8% public sector expenditure and municipalities spend about 10% of the public sector budget.

7 The Central Government provides general government (Defence, Foreign Relations, etc.) and Social Security (Pensions and Unemployment Benefits). The main expenditure functions of the Basque Government are Education and Health. The Foral Deputations spend, mainly, on Social Services and on Transportation, Roads and Highways. The municipalities provide the usual municipal services.

8. The Central Government finances its expenditures in the Basque Country with the Quota (which pays for General Expenditure) and Social Security Contributions (which pay for Social Security expenditure). The Basque Government is financed almost exclusively by transfers (Contributions) from the Foral Deputations. The Foral Deputations collect almost all taxes, but they transfer the largest part of what they collect to other levels of government (Quota, Contributions, etc.). The municipalities finance their expenditures with local taxes, user fees and transfers from the Foral Deputations.

9. The *EU* finances (with transfers to other levels of government) expenditures that amount to 0.3% of Basque *GDP*. The cost of the *EU* for the Basque Country is 1% of *GDP*. This implies that the Basque Country is a net contributor to the *EU*. The cost of the *EU* for the Basque Country is about 0.7% of its *GDP*.

## Fiscal Autonomy of the Basque Country

10. The Central Government almost does not collect taxes in the Basque Country. All general taxes (Personal Income Tax, Corporation Income Tax, *VAT*, excises and so on) are collected by the *HTs*. In a basic sense, the Basque Country is the region in the world with highest fiscal autonomy because it is the only region in the world in which its Central Government does not collect any general tax.

11. In direct taxes the Basque Country has the right to tax the income of its residents and the income generated within its territory. In the Corporation Income Tax, though, several simplifications have been made to simplify the administration and to facilitate compliance by firms. Indirect taxes are paid using the origin principle (*VAT* and manufacturing excises) or, wherever possible, the destination principle (other indirect taxes). When the origin principle is used, there are *ex post* adjustments to ensure that the final collection of the Basque Country is equal to the taxes paid by its residents.

12. The Economic Agreement says that (a) The *HTs* have almost full autonomy in direct taxes and almost no autonomy in indirect taxes and (b) The taxes of the *HTs* should not distort the competence among firms or the free movement among regions, and the fiscal pressure (tax to *GDP* ratio) in the Basque Country has to be *equivalent* to that existing in the rest of the Spain.

13. The Economic Agreement is contradictory when says that the *HTs* have full autonomy in the Corporation Income Tax but at the same time says that their taxes should not distort the economy. This contradiction is at the core of the conflicts between the State (Central Government) and the *HTs* about the legality of the Corporation Income Tax regulations approved by the *HTs*. The Courts have been unable to find a reasonable equilibrium between no distortion and Corporation Income Tax autonomy.

14. In principle, each Territory can have different taxes. However, there is a high degree of internal harmonization and the taxes in the three *HTs* are very similar (although not identical). To harmonize taxes within the Basque Country, there is a *Tax Coordination Body* (in which are represented the Basque Government and the three *HTs*) and a harmonization Law.

## Financial Autonomy of the Basque Country

15. The Basque Country pays the State a Quota for the expenditures made in favour of the residents of the Basque Country. The Basque Country pays 6.24% of the expenditures made in all Spain by the State on items that benefit the residents in the Basque Country. This 6.24% is equal to the relative income of the Basque Country. Since 1997, the Quota has been equal to about 2.5% of *GDP* and 11.5% of the agreed taxes. The 2008 crisis has temporarily reduced these figures.

16. There are several transfers from the State to the Basque Country. The most important ones are the *VAT* and Excises adjustments. They ensure that the final collection in the Basque Country is equal to the consumption taxes paid by its residents.

17. The resources of the Central Government in the Basque Country (the Quota) are independent of the tax collection in the Basque Country, but the resources of Basque Country change exactly as its tax collection. This means that the Basque Country assumes all the collection risks associated with changes in the economic conjuncture, and the financial consequences of any tax change. Since

the Basque Country assumes all the collection risks, the Economic Agreement implies that there is a *unilateral risk* (borne entirely by the Basque Country).

### **Distribution of Agreed Resources**

18. The Foral Deputations transfer most of their tax collection to other levels of government. They transfer a Quota to the Central Government, Contributions to the Basque Government and endow Municipal Funds to finance the municipalities. In the year 2008, after all the transfers, they only kept for themselves about 17% of their tax collection. The Basque Government (which collects nothing) received more than 60% of what the Foral Deputations collected. The State (via quota) received around 10% and the municipalities (via Municipal Funds) almost 12%.

### **Economic results of the Agreement**

19. For more than twenty years the Basque Country has gone through a tough economic restructuring and, after that, it has recovered its traditional position as the most economically advanced region in Spain. The Economic Agreement has been an essential instrument (for the incentives it creates, for the tax autonomy it gives, for the resources it provides) in the recovery and restructuring of the Basque economy.

20. In 2007, taxes in the Basque Country collected almost 35.5% of *GDP*. That is the same level of taxes as in countries like Germany and the *UK*. In general, taxes in the Basque Country are not very different from taxes in Common Territory (the rest of Spain excluding Navarre). The two main differences are: first, that the personal income tax in the Basque Country is slightly lower and more progressive than in Common Territory and, second, that the Basque Corporation Income Tax has a slightly lower tax rate and more tax incentives (to investment and job creation). Total tax collection as a percentage of the *GDP* is nearly the same in the Basque Country and in Common Territory but since the Basque Country is substantially richer, it obtains 30% more of per capita tax revenues.

21. Public Services in the Basque Country are provided efficiently. For instance, the Education and Health Services in the Basque Country rank among the best in Spain. The Basque Country also has the highest density of roads and a stock of public capital that is almost 30% above the Spanish average.

22. The Basque Country has followed a cautious financial policy. It is the Autonomous Community with the lowest debt and the highest credit ratings. Its rating is also above that of Spain.

### **The Economics of the Economic Agreement**

23. Tax decentralization produces economic and political gains. On the economic side, tax decentralization, if done properly, may increase accountability and responsibility. The accountability and responsibility plus the risk of migrations

(of individuals or productive factors) in response to overtaxation, lead to more efficient regional taxes and expenditures. On the political side, tax decentralization is the natural response to self government demands of many regions.

24. Both the theory and the practical experience of the most advanced federations (Switzerland, Canada and United States) show that the decentralization of even all the taxes is unlikely to produce significant delocalizations (of persons or firms) or economic inefficiencies.

25. The Economic Agreement assigns all taxes to the *HTs*. They administer the taxes, and regulate all the direct taxes and some minor indirect taxes. The model is based on *unilateral risk*, which means that the *HTs* bear the full cost of any tax decrease and benefit from any tax increase. The Economic Agreement model produces a maximum of accountability and responsibility for the *HTs*. This is consistent with the recommendations of the theory and the experience of the most advanced federations.

### Comparison between the Common and Foral Systems

26. *Tax Autonomy*. Both the Foral and the Common Systems allow Autonomous Communities to adjust their tax revenues (upwards or downwards) to their preferred expenditure levels. In both systems, most of the tax autonomy is concentrated on direct taxes (probably because the *EU* does not allow regional differences in the main indirect taxes). The main differences are that Foral Autonomous Communities collect all the taxes, and have tax autonomy in the Corporation Income Tax. In Common Regime the State collects most of the taxes (including some taxes of the Autonomous Communities).

27. *Financial Capacity*. In the Common System, the resources of each Autonomous Community depend on its estimated need. In the Foral System, the resources depend on fiscal capacity. The Foral System produces more resources but many of the differences are compensated by the State with its own budget.

### The Economic Agreement in the European Union

28. The European Union has never questioned the legitimacy of the Economic Agreement model. However, in the past, there have been doubts about whether or not the tax autonomy of the *HTs* in the Corporation Tax was compatible with the *EC Treaty*. The basic question was if a lower effective corporation income tax rate in a region of a country was or not regionally selective State Aid.

29. In 2006 the European Court of Justice analyzed in detail the concept of *regional selectivity of tax rules*. The Court did not consider that the country had to be the reference framework to define general tax systems and spatial selectivity. It admitted that tax rules adopted by a local or regional authority could be general if that authority is sufficiently autonomous in relation to the Central Government of the country. The Court required three types of autonomies: Institutional Autonomy, Procedural Autonomy and Financial Autonomy.

30. The High Court of Justice of the Basque Country has already recognized that the *HTs* meet the three autonomy conditions, and the European Court of Justice has dismissed several claims that they don't. Now it is clear that the Corporation Income Tax rules of the *HTs* cannot be questioned arguing that they are regional State Aid.

31. In any case, the tax autonomy of the *HTs* is subject to two types of restrictions. First, like the other tax authorities of the *EU*, the *HTs* cannot approve selective or harmful tax measures. Second, the *HTs* have to respect the harmonization principles established in the Economic Agreement.

## **Conclusion**

32. Taking it all into account, the Economic Agreement has proven to be a good model of regional financing that induces efficient government and does not create significant economic distortions.

## 1. INTRODUCTION

The Economic Agreement is a pact between the Basque Country and the Central Government of Spain. According to this pact, the Basque Country<sup>1</sup> collects almost all the taxes within its territory (the so called agreed taxes<sup>2</sup>) and in return it pays the Central Government a certain amount of money (the Quota). This payment is a compensation for the expenditure made by the Central Government on behalf of the residents in Basque Country and includes a contribution to the solidarity among regions. The Economic Agreement model dates back to 1876 and it was only interrupted during the dictatorship of Franco (1939-1975)<sup>3</sup>. Before 1876 the provinces of the Basque Country had a self government that extended far beyond economic aspects (the so called *Foral rights*). On the economic side, this self-government implied, among other things, that the Basque Territories collected most of the taxes and only made occasional contributions to the Central Government.

The objective of this book is to describe the Economic Agreement model and to analyze its economic properties. The book also revises the disagreements with the State about the interpretation of the Economic Agreement and the compatibility of the Economic Agreement with the *acquis communautaire*.

The starting point is an overview of the political organization and economic characteristics of the Basque Country (section 2). To explain the political justification of the Economic Agreement model and the popular support it commands, section 3 revises the historical precedents of the Economic Agreement model. Section 4 describes in detail the Public Sector in the Basque Country. It pays special attention to the assignment of taxes and expenditures to different levels of government and to the financial relations among those levels of government.

The two basic elements of the Economic Agreement model are the fiscal autonomy and the financial autonomy. Section 5 focuses on the fiscal autonomy

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<sup>1</sup> Strictly speaking, the Historical Territories (provinces) of the Basque Country are the ones collecting the taxes.

<sup>2</sup> Basically all taxes except the Social Security Contributions are agreed (see section 5.1)

<sup>3</sup> However, even during that period one of the provinces of the Basque Country (Alava) maintained the Economic Agreement.



of the Basque Country. Section 6 first describes the financial relationships between the Basque Country and the Central Government, and then analyzes the financial capacity of the Basque Country (after collecting taxes and paying the Quota).

All the agreed taxes are collected by the Historical Territories (provinces). The Basque Public Sector has, however, two other levels of government with expenditure responsibilities (the Basque Government and the municipalities). Then, the taxes collected by the Historical Territories have to be distributed among all the levels of government. Section 7 describes the rules that have been established to divide the agreed taxes among all the levels of government.

Section 8 is devoted to the economic results of the Economic Agreement and it reviews its effects on growth and employment, the level and structure of taxes in the Basque Country and the levels of public expenditure and debt. Section 9 evaluates the Economic Agreement from the perspective of the theory of fiscal federalism and the experience of other federations. Section 10 compares the Economic Agreement model with the system of financing of the common regime Autonomous Communities<sup>4</sup>. Section 11 is devoted to justify that, as it has been ratified recently by the European Court of Justice, the Economic Agreement model is fully consistent with the *EU* regulations. The book concludes with a summary of the main conclusions (section 12).

## 2. BASQUE COUNTRY: POLITICAL ORGANIZATION AND ECONOMIC CHARACTERISTICS

The Basque Country is a prosperous small region with a complex political organization. The Basque Country is the only Autonomous Community (AC) in Spain with provincial Parliaments. As a result, while in all the other ACs there is only one regional Parliament, in the Basque Country there are four Parliaments (one regional Parliament and three provincial Parliaments). What follows describes the political structure of the Basque Country and its main economic characteristics.

### 2.1. Political Organization

The Basque Country has three provinces: Alava (whose capital is Vitoria), Biscay (Vizcaya, with its capital in Bilbao) and Guipuzcoa (San Sebastian)<sup>5</sup>. The provinces are also called Historical Territories (*HTs*) because historically they have been the basic political decision units in the Basque Country. In the past, except during the Franco dictatorship (1939-1975), each Territory has always had

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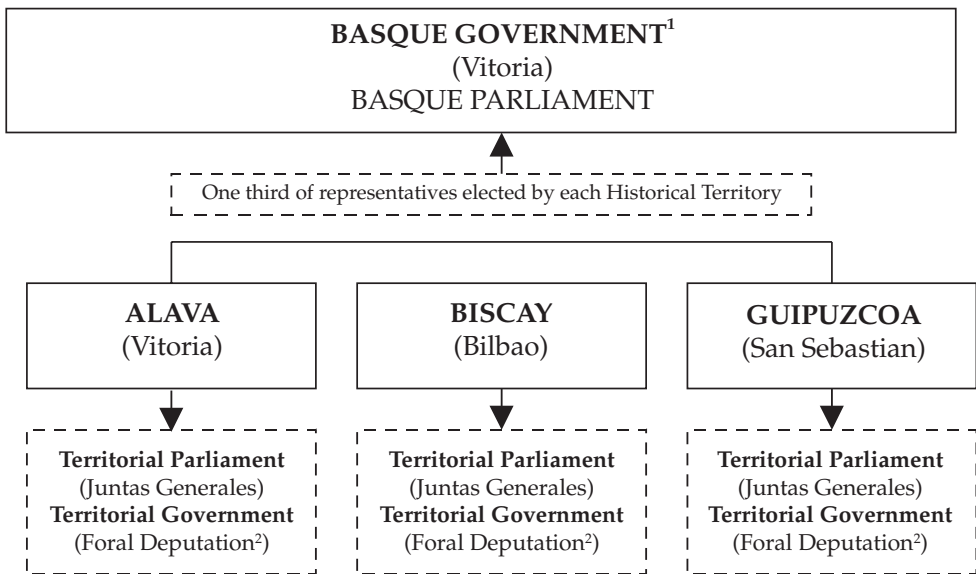
<sup>4</sup> The Common Regime AC include all the other Autonomous Communities of Spain, except Navarre. Navarre has a financing system very similar to the one of the Basque Country, and most of what is said in this book for the Basque Country also applies to Navarre.

<sup>5</sup> The names in Basque of the Territories are *Araba* (*capital Gasteiz*), *Bizkaia* (*Bilbo*) and *Gipuzkoa* (*Donostia*). Sometimes, the Basque toponyms are also used in Spanish.

its own Political Institutions (Parliament and Government), Laws and *Fueros*<sup>6</sup> (Charters). It is because of this historical tradition that after the restoration of regional autonomy in 1978, the *HTs* assumed a pivotal political role and the Autonomous Community of the Basque Country (*BCAC*) was designed almost like a confederation among the three *HTs*.

Figure 1, sketches the political organization of the Basque Country<sup>7</sup>. Each *HT* has its own Parliament (*Juntas Generales* or General Council) and is governed by a Provincial Council called *Diputacion Foral* (literally, Foral Deputation). The Provincial Councils are structured like governments, with a President (*Diputado General* or General Deputy) and Provincial Ministers of different areas (*Diputados Forales* or Foral Deputies). The main responsibilities of Foral Deputations are the collection of all the agreed taxes and the provision of social services (old age, dependency, social exclusion, etc.) and public works (mostly roads).

**Figure 1: Political Organization of the Basque Country**



<sup>1</sup> The president is called *Lehendakari* and the regional ministers Counsellors (*Consejeros*).

<sup>2</sup> The Foral Deputations are provincial councils. The president is of each Deputation is called General Deputy (*Diputado General*) and the provincial ministers Foral Deputies (*Diputados Forales*).

The city in brackets is the capital of the Region. In Basque the names are Araba (Gasteiz), Bizkaia (Bilbo) and Gipuzkoa (Donosti).

<sup>6</sup> The *Fueros* are local laws and customs together with special economic and political immunities underwritten by the kings of Castile (later by the kings of Spain) in return for political allegiance to the monarchy.

<sup>7</sup> Basque Country (*Euskadi* in Basque) refers to the region formed by the three provinces of Alava, Biscay and Guipuzcoa. There are, however other regions in Spain (Navarre) and in the south of France (Basse Navarre, Labourd and Soule) with Basque traditions and culture. The name *Euskal-Herria* (literally Basque people) refers to the seven Territories with Basque culture and traditions.

On top of the provincial Parliaments and governments, there are a regional Parliament and a regional government. The seats of the regional government (the Basque Government) and the regional Parliament (the Basque Parliament) are in Vitoria which is the capital of both Alava and the Basque Country. Although the size of the population differs considerably among the *HTs*, each of the Territories elects one third of the members of the Basque Parliament. This implies that, to be elected, a representative for Biscay needs almost four times the votes of a representative for Alava and one and a half time the votes of a representative for Guipuzcoa.

The Basque Government is elected by the Basque Parliament and has a president (in Basque *Lehendakari*) and Regional Ministers (in Spanish *Consejeros*). The Basque Government is responsible for most of the public expenditures (significantly for Education and Health). It doesn't collect any taxes, and almost all its revenue comes from transfers from the *HTs*.

## 2.2. Economic Characteristics

Traditionally, the Basque Country has been a highly industrialized region. The economic crises in the last quarter of the 20th century considerably reduced the size of the industrial sector. Despite that, the Basque Country remains today as one of the most industrialized regions in Spain. It is also more industrialized than almost any *EU* country. The per capita income of the Basque Country is one of the highest (in 2008, in fact, the highest) in Spain and, when it is adjusted for price differentials (measured in *PPS*<sup>8</sup>), it is also one of the highest in the *EU*, well above the per capita income of countries like France, Germany or the *UK*. What follows, gives the details of the economic characteristics of the Basque Country.

### 2.2.1. Economic Structure of the Basque Country

Table 1 compares the economic and demographic importance of the three *HTs* of the Basque Country. As shown in the Table, Alava has the largest area and represents more than 40% of the Basque Country. It is, however, sparsely populated in comparison to the other two *HTs* and, as a result, it has the smallest population. The area of Biscay is only a little larger than the area of Guipuzcoa but it is much more densely populated. Biscay is, then, the *HT* with the largest population.

Broadly speaking, Biscay represents a little more than 50% of the Basque Country in terms of both population and production. Guipuzcoa is slightly less than 35% of the Basque Country, and Alava about 15%. The differences in per capita income<sup>9</sup> among the *HTs* are small. The richest *HT*, Alava, is a 15% richer than the poorest, Biscay. The per capita income of Guipuzcoa is just in the middle, and it is basically equal to the average of the Basque Country<sup>10</sup>.

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<sup>8</sup> Purchasing Power Standards. The *PPS* is an artificial currency unit that can buy the same amount of goods and services in each country.

<sup>9</sup> Measured by the per capita *GDP*.

<sup>10</sup> The relative population size and income of the *HTs* has remained fairly stable in the last 20 years.

**Table 1: Basic Economic Data of the Historical Territories of the Basque Country (2008)**

	Area		Population		Population Density <sup>1</sup>	GDP <sup>2</sup>		Per Capita GDP	
	Km <sup>2</sup>	%	Number	%		Mill €	%	€	Index
Alava	2,963	41.8	313,819	14.4	106	11,291	16.5	36,091	114
Guipuzcoa	1,909	26.9	705,698	32.5	370	22,513	32.9	32,409	102
Biscay	2,217	31.3	1,152,658	53.1	520	34,625	50.6	30,100	95
<b>Basque Country</b>	<b>7,089</b>	<b>100</b>	<b>2,172,175</b>	<b>100</b>	<b>306</b>	<b>68,429</b>	<b>100</b>	<b>31,712</b>	<b>100</b>

<sup>1</sup> Inhabitants per square km. <sup>2</sup> Gross Domestic Product (*GDP*)

Source: Basque Institute of Statistics, *EUSTAT* ([www.eustat.es](http://www.eustat.es))

Table 2 summarizes the economic structure of the Basque Country and compares it with the structures of Spain and the *EU27*. The main characteristic of the Basque Country is its high industrialization by Spanish or even European standards. As Table 2 shows 30% of the Gross Value Added<sup>11</sup> (*GVA*) of the Basque Country comes from industry while in Spain only 14.5% of the *GVA* is industrial. The industrialization of the Basque Country (relative to the rest of Spain) is well illustrated by the fact that the Basque Country, with an economy that only represents 6.3% of the Spanish economy, accounts for almost 11% of the industrial *GVA* of Spain. In fact, the Basque Country is, along with Navarre, the most industrialized region in Spain<sup>12</sup>.

**Table 2: Composition of the Gross Value Added<sup>1</sup> (*GVA*) in the Basque Country, Spain and the *EU27* (2008)**

Branch of Activity	Composition of <i>GVA</i>			Share of the <i>BC</i> in the <i>GVA</i> of Spain
	Basque Country ( <i>BC</i> )	Spain	European Union 27	
Agriculture, hunting, forestry and fishing	1.0	2.6	1.8	2.4
Industry	29.4	17.0	20.1	10.9
Construction	9.6	11.4	6.4	5.3
Services	60.0	69.0	71.7	5.5
<b>TOTAL</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>6.3</b>

<sup>1</sup> *GVA* is equal to *GDP* less indirect taxes

Source: National Statistics Institute, *INE*, Regional Accounts ([www.ine.es](http://www.ine.es)) and Eurostat ([epp.eurostat.ec.europa.eu](http://epp.eurostat.ec.europa.eu))

<sup>11</sup> The Gross Value Added is equal to *GDP* less indirect taxes. The *GVA* is basically the new production of the economy.

<sup>12</sup> In 2008, for instance, industry accounted for 21.3% of the *GVA* of Catalonia and 12.9% of the *GVA* of Madrid. In Navarre the 29.1% of the *GVA* was generated by industry.

The industrialization of the Basque Country is also high by European standards. In the *EU* only two countries (the Czech Republic and Slovakia<sup>13</sup>) have larger industrial sectors than the Basque Country. In Germany industry generates 26% of the *GVA*, in Italy 20.8%, in the *UK* just 17.5% and in France only 13%<sup>14</sup>.

The main industry in the Basque Country is the production of capital goods. This sector comprises a large number of companies engaged in a wide range of activities involving the design, manufacture and assembly of mechanical and electronic products. It accounts for approximately 5% of Basque *GVA*. There is also a dense network of small and medium-sized companies working in aerospace, telecommunications, energy, environment, electronics, white line, machine tools, automotive, chemical, shipbuilding, paper, rubber and plastic, glass, metal articles, furniture and engineering industries. In recent years some non industrial sectors such as tourism and commerce are playing a growing role in the Basque economy.

### 2.2.2. The Labour Market

Table 3 gives the distribution of employment by branch of activity in both the Basque Country and Spain. Not surprisingly, employment is concentrated where the Value Added is created. In the Basque Country this means that approximately 65% of the employment is in the service sector and almost 25% in the industrial sector. The equivalent figures in Spain are 70% (services) and 15% (industry). Therefore, a larger share of the Basque Country employment is in the industry branch, which again shows that the Basque Country is much more industrialized than Spain.

**Table 3: Employment in the Basque Country and Spain by Branch of Activity (2008)**

Branch of Activity	Basque Country (BC)	Spain	Share of the BC in the GDP of Spain
Agriculture, hunting, forestry and fishing	1.8	4.3	2.3
Industry	24.3	14.9	8.6
Construction	8.7	11.3	4.1
Services	65.2	69.5	5.0
<b>TOTAL</b>	<b>100</b>	<b>100</b>	<b>5.3</b>

Source: National Statistics Institute, INE, Regional Accounts ([www.ine.es](http://www.ine.es))

The comparison of Tables 2 and 3 show that with the 5.3% of the employment of Spain, the Basque Country produces 6.3% of the *GVA*. This suggests that labour

<sup>13</sup> According to Eurostat data, in 2008 industry accounted for 31% of the *GVA* of the Czech Republic and for 29.7% of the *GVA* of Slovakia.

<sup>14</sup> See Eurostat (see [http://epp.eurostat.ec.europa.eu/portal/page/portal/national\\_accounts/data](http://epp.eurostat.ec.europa.eu/portal/page/portal/national_accounts/data)).

is much more productive in the Basque Country than in Spain. Table 4 confirms this suggestion. As the Table shows, the productivity of labour in the Basque Country is almost a 30% higher than that in the rest of Spain. An immediate consequence of this is that wages in the Basque Country are much higher than in the rest of Spain. In 2008, for instance, Basque wages were 16% above the Spanish average<sup>15</sup>. In fact, the Basque Country had the highest wages in Spain. Table 4 also shows that, after adjusting for price differentials<sup>16</sup>, labour productivity in the Basque Country is one of the highest in the EU27. In the Basque Country, labour is 32% more productive than in the EU27 average and only Luxembourg and Ireland have a labour that is more productive.

**Table 4: Productivity of Labour<sup>1</sup> in the Basque Country, Spain and the EU27 (2008)**

Country	Index	Country	Index
Luxembourg	160.8	Cyprus	86.1
Ireland	134.1	Slovakia	78.8
Belgium	124.6	Czech Republic	72.2
France	120.9	Portugal	70.6
Netherlands	115.3	Hungary	69.4
Austria	113.3	Estonia	64.6
Sweden	111.5	Poland	62.8
United Kingdom	110.6	Lithuania	61.4
Finland	109.5	Latvia	51.1
Italy	108.1	Rumania	47.6
Germany	107.4	Bulgaria	36.6
<b>Spain</b>	<b>104.8</b>		
Greece	102.2	<i>EU 27</i>	<b>100</b>
Denmark	101.0		
Malta	86.5	<b>Basque Country</b>	<b>132.0</b>
Slovenia	84.0	United States	144.6

<sup>1</sup> GDP per worker, adjusted by differences in prices (measured in PPS, see note 16).  
Source: For the Basque Country, Basque Statistical Institute, Eustat ([www.eustat.es](http://www.eustat.es)).  
For the rest Eurostat.

<sup>15</sup> According to the labour cost survey of the Spanish National Statistics Institute (INE) (<http://www.ine.es/INEBASE/temas/tmp/ETCLhist2.html>).

<sup>16</sup> The adjustment for price differentials is made using price indices called *Purchasing Power Parities*. (PPP). *Purchasing Power Standards* (PPS) are derived by dividing any economic aggregate of a country in national currency by its respective PPP. The adjustment by PPP is made regularly in the EU. For instance, to determine which regions should receive structural funds or which countries will be beneficiaries of the cohesion fund, the per capita GDP or the income is always divided by PPPs.

Table 5 shows the evolution of unemployment in the Basque Country and compares it with the evolution in Spain and in the *EU27*. The economic crises of the last quarter of the 20th century had a high incidence in the Basque Country because its economy depended on some of the worst hit industries (for instance iron and steel industry and shipbuilding)<sup>17</sup>. The result was that unemployment in the Basque Country rose up to 22.5% and that until 1995 the Basque Country had a higher unemployment rate than the rest of Spain. The reconversion of the Basque economy and the economic bonanza started in 1995 changed the scenario and the unemployment rate began to decline. The decrease in the Basque Country was faster and larger than in the rest of Spain. By 2005, the unemployment rate in the Basque Country was even lower than in the *EU27*. As in all countries, the financial crisis of 2007 raised again unemployment in the Basque Country. However, probably due to the restructuring of the economy in the last part of the 20th century, the increase of unemployment in the Basque Country was not as steep as in the rest of Spain. In 2009, the unemployment rate of the Basque Country (11%) was more similar to the rate of the *EU27* (8.9%) than to that of the rest of Spain (18%).

**Table 5: Unemployment Rate in the Basque Country, Spain and the *EU27***

	1980	1985	1990	1995	2000	2005	2009
Basque Country	12.4	23.0	18.6	22.5	12.1	7.3	11.0
Spain	11.4	21.5	16.2	22.9	13.9	9.2	18.0
<i>EU27</i>					8.7	8.9	8.9

Sources: For the Basque Country and Spain *INE*, Regional Accounts ([www.ine.es](http://www.ine.es)), for the *EU27* Eurostat.

### 2.2.3. *Income of the Basque Country*

Table 6 shows the demographic and economic importance of the Basque Country in Spain. It also compares the Basque Country with other *ACs*. As the table shows, in Spain there are 17 *ACs*, but 60% of the population and of the *GDP* is concentrated in just four of them (Andalusia, Catalonia, Madrid and Valencia). The Basque Country is in the group of medium size *ACs*. Its population represents 4.6% of Spain's population, and the Basque Country produces 6.3% of Spanish *GDP*. The Basque Country is the richest region in Spain with a per capita *GDP* almost 35% higher than the average.

Madrid and Navarre are the only Spanish regions with a per capita *GDP* similar to that of the Basque Country. On the other hand, the Basque Country has a per capita *GDP* that is 15% higher than that of Catalonia. The per capita *GDP* of the poorest regions in Spain (Extremadura, Castile-La Mancha and Andalusia) is about 55% the per capita *GDP* of the Basque Country.

<sup>17</sup> See section 8.1 for further details.



**Table 6: Basic Economic Data of the Autonomous Communities of Spain (2008)**

	Population		GDP		Per Capita GDP	
	Number	%	Millions €	%	€	Index
<i>Basque Country</i>	2,172,175	4.6	68,282	6.3	31,952	134
Madrid	6,386,932	13.7	193,478	17.8	30,998	130
Navarre	630,578	1.3	18,544	1.7	30,402	127
Catalonia	7,475,420	16.0	202,806	18.6	27,914	117
Aragón	1,345,473	2.9	34,088	3.1	26,107	109
Balearic Islands	1,095,426	2.3	27,335	2.5	25,838	108
La Rioja	321,702	0.7	8,034	0.7	25,621	107
Cantabria	589,235	1.3	14,028	1.3	24,466	102
Castile and Leon	2,563,521	5.5	58,068	5.3	23,183	97
Asturias (Principality of)	1,085,289	2.3	23,753	2.2	22,443	94
Valencian Community	5,094,675	10.9	105,554	9.7	21,336	89
Canary Islands	2,103,992	4.5	43,249	4.0	20,994	88
Galicia	2,796,089	6.0	56,290	5.2	20,572	86
Murcia	1,446,520	3.1	27,944	2.6	19,541	82
Andalusia	8,302,923	17.8	148,711	13.7	18,359	77
Castile-La Mancha	2,081,313	4.5	36,448	3.3	18,222	76
Extremadura	1,102,410	2.4	18,034	1.7	16,714	70
Other <sup>1</sup>	152,134	0.3	3,858	0.4	–	–
<b>Total SPAIN</b>	<b>46,745,807</b>	<b>100</b>	<b>1,088,502</b>	<b>100</b>	<b>23,874</b>	<b>100</b>

<sup>1</sup> Includes the Cities with Statute of Autonomy (Ceuta y Melilla) and the extra-territorial GDP.

Source: National Statistics Institute, INE, Regional Accounts (www.ine.es).

Table 7 compares the per capita GDP of the Basque Country and that of the EU countries. In euro terms (fourth column of Table 7) the per capita GDP of the Basque Country is almost 20% above the EU average. This puts the Basque Country in the medium to high range of wealth, at the same level as, for instance, Germany or France. When, as is the usual practice in the EU, the income is adjusted for price differences (second column in Table 7), the relative position of the Basque Country improves considerably. Its per capita GDP becomes 35% higher than the EU average and only Luxembourg and Ireland<sup>18</sup> are richer than the Basque Country.

<sup>18</sup> In both Ireland and Luxembourg the GDP overestimates the wealth of residents. In Ireland the cause is that many firms are foreign-owned. In Luxembourg the problem is that it has a large number of cross-border workers relative to its residents (according to some estimations there are 90.000 cross-border workers in a country with a population of 450.000)



**Table 7: Per Capita GDP in the EU (2007)**

	GDP per inhabitant, PPS		GDP per inhabitant, EUR	
	Euros (000)	Index (EU27=100)	Euros (000)	Index (EU27=100)
Luxembourg	68.5	275.1	78.1	313.7
Ireland	36.9	148.2	43.6	175.1
<b>Basque Country</b>	<b>34.1</b>	<b>136.9</b>	<b>30.6</b>	<b>122.9</b>
Netherlands	32.9	132.1	34.7	139.4
Austria	30.6	122.9	32.6	130.9
Sweden	30.6	122.9	36.2	145.4
Denmark	30.2	121.3	41.6	167.1
Finland	29.4	118.1	34.0	136.5
United Kingdom	29.1	116.9	33.5	134.5
Belgium	28.8	115.7	31.5	126.5
Germany	28.8	115.7	29.5	118.5
France	27,0	108.4	29.7	119.3
Spain	26.2	105.2	23.5	94.4
Italy	25.8	103.6	26	104.4
<b>EU27</b>	<b>24.9</b>	<b>100.0</b>	<b>24.9</b>	<b>100.0</b>
Cyprus	23.3	93.6	20.3	81.5
Greece	23.1	92.8	20.2	81.1
Slovenia	22.1	88.8	17.1	68.7
Czech Republic	19.9	79.9	12.3	49.4
Malta	19,0	76.3	13.3	53.4
Portugal	18.8	75.5	15.4	61.8
Estonia	17.1	68.7	11.6	46.6
Slovakia	16.9	67.9	10.2	41.0
Hungary	15.6	62.7	10.1	40.6
Lithuania	14.8	59.4	8.5	34.1
Latvia	13.9	55.8	9.3	37.3
Poland	13.6	54.6	8.2	32.9
Romania	10.4	41.8	5.8	23.3
Bulgaria	9.4	37.8	3.8	15.3

Source: Eurostat

## 2.3 Conclusions

The Basque Country is a small, highly industrialized region. The productivity of labour is high and, not surprisingly, wages are considerably higher than in the rest of Spain. The unemployment rate is substantially lower than in other regions of Spain. The Basque Country is the richest regions in Spain and its wealth is well above the EU average. In fact, when price differentials are eliminated, the Basque Country is richer than almost all the EU countries.

### 3. HISTORICAL BACKGROUND

The political structure of the Basque Country (in which the *HTs* play an essential political and economic role) and the special financial and fiscal relations with the Government of Spain (the *Foral System*), are the continuation of a historical tradition that dates back to the 13th century, and that was only interrupted during the Franco dictatorship. To have a complete view of the nature of the *Foral System* and to understand why it commands a strong social support in the Basque Country, it is important to outline the basics of the historical evolution of the financial and fiscal relations between the Central Government and the *HTs*<sup>19</sup>.

#### 3.1. The Foral Period (1200-1876)

There are very few historical references to the Territories of Alava, Biscay and Guipuzcoa before the 11th century. It seems, however, that parts of Alava and Biscay were under the influence of the Kingdom of Asturias. During the 12th century the three Territories fluctuated under the influence of the Kingdoms of Castile, and Navarre. The (at that time) Counties of Alava and Guipuzcoa were definitely incorporated into the Kingdom of Castile in the year 1200. Alava was incorporated after the Castilian troops took Vitoria<sup>20</sup>. For Guipuzcoa there is no clear evidence to determine if the incorporation to Castile was the result of a military seizure or simply a voluntary annexation.

The incorporation of the Lordship (*Señorío*) of Biscay to Castile was different. Since the end of the 12th century, the main part of what today is the Territory of Biscay was within the sphere of influence of Castile. However, Biscay was not definitely integrated into Castile until 1379 when Juan I, who had inherited the title of Lord of Biscay, became King of Castile<sup>21</sup>. Therefore, the incorporation of Biscay to Castile was the result of the accumulation of two titles in one person. Since then, first the Kings of Castile and later the Kings of Spain<sup>22</sup> were the Lords of Biscay, and had the obligation to go to Biscay to swear allegiance to the *Fueros* (charters) of the Territory<sup>23</sup>.

Since their integration in Castile, the three Basque Territories maintained their traditional *Fueros*. Each Territory had different *Fueros*<sup>24</sup>, and the Foral provisions

<sup>19</sup> For a more detailed review of the History of the Basque Country, see García de Cortazar and Montero (1983), on which parts of this section are based.

<sup>20</sup> A part of the County of Alava remained under the jurisdiction of the so called *Cofradía de Arriaga* (a mixed assembly of nobles and clergy). In 1332, after the voluntary handover of the *Cofradía*, all Alava became part of Castile.

<sup>21</sup> Juan I was the son of Enrique II (Henry the second) of Castile and his mother had inherited the Lordship of Biscay.

<sup>22</sup> After Carlos I (Charles the first of Spain and the fifth of Germany, 1500-1558), it was the King of Spain who was the Lord of Biscay.

<sup>23</sup> The main oath took place in the village of Guernica (*Gernika* in Basque). However, even though all the Kings swore the *Fueros*, only a few of them actually went to Guernica.

<sup>24</sup> In general, Alava had a lower level of Foral Autonomy than Biscay and Guipuzcoa.

changed with time. In essence, the *Fueros* guaranteed the Basque Territories a strong respect for their traditional Laws<sup>25</sup>, a considerable administrative autonomy and, subject to some limitations, exemption from conscription and King's taxes<sup>26</sup>. In each Territory the *Juntas* (an assembly of representatives of the towns and districts of the Territory) took the public decisions and the *Foral Deputations* (name given to the Territorial Governments) carried them out. The powers of the *Juntas* included public appointments, road construction, settlement of conflicts among towns, and approval of the budget (revenue and expenditure) of the Territory. Those institutions are, obviously, the historical precedents of the present-day *Diputaciones Forales* (Provincial Councils) and *Juntas Generales* (Regional Parliaments).

Even with the *Fueros*, the three Territories were under the authority of the King of Castile (later Spain). The King took all the major political decisions (war, alliances, etc.), legislated on matters not covered by the *Fueros*, and supervised the application of Justice (subject to *Foral Law*) and the decisions of the municipalities. Nevertheless, the Historical Territories always had the right to veto any royal mandate if they thought it was contrary to the *Fueros*<sup>27</sup>. This veto power, known as the *Foral Approval* (*Pase Foral*) reinforced the political autonomy of the Historical Territories.

The *Fueros* conveyed a high degree of economic independence from the rest of Spain. To begin with, the customs borders of Spain were established in the frontier between Castile and the Basque Territories (this was called the *inland customs*). As a result, the imported goods entered the Basque Territories free of taxes. The Territories also had their own commercial Laws, which were made to encourage free trade within the Territories<sup>28</sup>. Almost all the taxes were levied by the Territories, and the collection was used to finance the expenditure of the Territories such as roads<sup>29</sup> and, when necessary, the cost of the army.

Despite their economic autonomy, the Basque Territories contributed some money to finance the Crown. First, the Crown levied some taxes in the Basque Territories. The collection was, however, very small especially in Biscay and Guipuzcoa. Second, the Crown could ask for contributions (named *donations*) to finance special expenditures (for instance, a war or a special need). The donations were voluntary contributions subject to the approval of the *Junta* of each Territory. However, after bargaining, the territorial *Juntas* usually ended up approving the donation requested by the King. Since the taxes paid to the Crown by the *Foral*

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<sup>25</sup> This included the application of the traditional Civil Law in Biscay and Guipuzcoa, and the preservation of the traditional Criminal Law in Biscay. Most of Alava was, however, ruled by the Law of the King.

<sup>26</sup> The exemption wasn't full because, as explained later, the Crown of Castile collected some taxes in the Basque Territories. The Territories also made non periodical contributions (called donations) to finance the Crown.

<sup>27</sup> The formula to veto a royal order was "be obeyed but not complied with".

<sup>28</sup> The laws ensured everyone's right to buy and sell in his house, free transit of roads, no taxes on the movement of goods, etc.

<sup>29</sup> In the rest of Spain the roads were built by the Crown.

Territories were very low, the donations were the basic mechanism by which the Territories contributed to finance the Crown.

In comparison to other regions in Spain, the contributions to the Crown of the Basque Territories were always very low. The contributions were particularly low in the 16th and 17th centuries, and the Basque Territories became known as *exempt provinces*.

In the History of Spain, many other regions besides the Basque Country had special relationships with the Crown. In fact, during the Middle Ages almost all the regions annexed to the Crown of Castile maintained some of their traditions and peculiarities. However, after the unification of Spain by the Catholic Kings<sup>30</sup> in the 15th century, the only regions that maintained their *Fueros* were the Basque Territories, Navarre and the Territories of what previously was the Crown of Aragon (Aragon, Catalonia, Balearic Islands and Valencia). After the *Succession War* (1702-1714)<sup>31</sup> Phillip V, the first King of the Bourbon dynasty in Spain, abolished the *Fueros* of the Territories of the former Crown of Aragon because of their support for the other claimant to the throne, the Archduke Charles of Austria (of the House of Habsburg). As a result, at the beginning of the 18th century, only the three Basque Provinces and Navarre kept their *Fueros*.

A centralist monarchy like the Bourbons was not too enthusiastic about the Basque and Navarre *Fueros*. The Bourbons maintained them because they feared popular uprisings if the *Fueros* were repealed. Nevertheless, since the beginning of the 18th century, the Kings of Spain tried to limit the extent of the *Foral* rights. For instance, in 1717 the King Philip V moved the customs to the coast. The subsequent riots forced the King to restore the inland customs in 1723. At the end of the 18th century, Charles III tried again (unsuccessfully) to move the customs to the shore and temporarily eliminated the *Foral* Approval.

The advance of liberalism in Spain complicated the position of the Basque *Fueros*. The liberalism supported a unitary and uniform idea of Spain, and the singularity of the *Fueros* did not fit well with that view. The liberal principles were behind the Spanish Constitution approved in 1812<sup>32</sup> which, de facto, abolished the *Fueros*. This, however, did not have any practical implication because the Constitution was not in force for a long time. The Constitution was approved in the midst of the Independence War against the Napoleonic troops and after the

<sup>30</sup> Isabella of Castile and Fernando of Aragon (called the Catholic Kings) completed the unification of Spain in 1492, after the conquest of the Moorish kingdom of Granada.

<sup>31</sup> In 1700, the King of Spain Charles II died. Not having a son, in his will named Philip of France (the grandson of his sister) as his successor. The Archduke Charles of Austria (of the House of Habsburg) also claimed the throne. This led to the Succession War. The war, fought in several countries, was concluded by the Treaties of Utrecht (1713) and Rastatt (1714). Philip V remained King of Spain but, to avert a possible unification of Spain and France, was removed from the French line of succession. The Austrians gained most of the Spanish territories in Italy and the Netherlands.

<sup>32</sup> The Constitution was approved by the Cadiz *Cortes* (in Spain the Parliament is known as the *Cortes*). During the French occupation of Spain in the course of Napoleonic Wars, the *Cortes* met in Cadiz. The Cadiz *Cortes* were a major step towards liberalism and democracy in the history of Spain.

war, when Ferdinand VII returned to power in 1814<sup>33</sup>, he abolished the Constitution and re-established the traditional autocratic monarchy. During his reign, which extended until 1833, the *Fueros* were unquestioned. After his death there was a dynastic conflict that ultimately led to the abrogation of the *Foral* system. The conflict opposed the supporters of Ferdinand's daughter, Isabella II, to the defenders of Ferdinand's brother, Carlos María Isidro, and resulted in a Succession War called the *First Carlist*<sup>34</sup> War (1833-1840). The War was also a confrontation between the traditionalism (absolute monarchy and respect for the traditions), of Carlos Maria Isidro, and the liberalism of Isabella II. The majority of the Basque Country joined the *Carlist* side<sup>35</sup> because the *Carlism* defended the traditional values (including the catholic religion and the *Fueros*<sup>36</sup>).

The *Carlists* were defeated and the generals Espartero (commander in chief of the liberal army) and Maroto (commander of the *Carlist* army) signed a peace treaty known as the Vergara Convention<sup>37</sup> (*Convenio de Vergara*). By this agreement Espartero vaguely acquired the commitment to defend the *Fueros* before the Spanish Government. In 1839, the Spanish Parliament (known as the *Cortes*) approved a Law endorsing the *Fueros* with the qualification "as long as they don't collide with the unity of the Constitutional monarchy".

On the basis of that qualification, the government tried to limit the *Fueros* several times, but the Basque Provinces opposed any change. In this context of tensions about the *Fueros*, there was a revolt in the Basque Country questioning the authority of the at the time regent of Spain Espartero<sup>38</sup>. Espartero's response was to abolish by Decree almost all the *Fueros* in 1841. Among other things, the decree unified the system of justice, terminated with the *foral approval* and established the customs of Spain in the shore. The only provisions of the *Fueros* maintained were the fiscal and military exemptions.

In 1844 Espartero's Decree was partially repealed by a moderate liberal government<sup>39</sup> and both, the *Foral* Deputations and the *Juntas* recovered some of their traditional functions such as the control of the expenditure and revenue of municipalities. The ousting of Queen Isabella II in 1869 by progressive liberals was the beginning of the end of the *Fueros*. The progressive liberals appointed Amedeo of Savoy as King in 1870. After a short reign without almost any support, he

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<sup>33</sup> Ferdinand VII was named King of Spain in 1808. He was forced to abdicate by Napoleon that same year and returned as King of Spain after the defeat of Napoleon in 1813. Between 1808 and 1813 Napoleon put his brother, Joseph Bonaparte, as King of Spain.

<sup>34</sup> Carlos María Isidro wanted to reign as Charles V (Carlos V).

<sup>35</sup> Navarre, La Rioja, Catalonia and some parts of Aragon and Valencia also joined the *Carlist* ranks.

<sup>36</sup> The support of the *Carlist* cause was massive in the rural areas of the Basque Country. However, the main cities (San Sebastian and Bilbao) sided with the liberals.

<sup>37</sup> This is the name of the town in Guipuzcoa where the agreement was signed. Its name in Basque is Bergara.

<sup>38</sup> He assumed the regency of Spain for almost two years (16 September 1840 to 21 May 1841).

<sup>39</sup> Nevertheless, the government maintained the unification of the system of justice, the elimination of the *foral approval* and the customs in the shore.

abdicated in 1873. Then, there was a new *Carlist* uprising, claiming the throne for Carlos María de Bourbon (Charles VII in the *Carlist* dynasty). After the defeat of the *Carlists* in 1876, the King of Spain, Alfonso XII, definitively abolished the *Fueros*.

### 3.2. The Economic Agreements (1876-1936)

The abrogation of the *Fueros* in 1876 implied the end of the military and fiscal exemption of the Basque Territories. These came on top of the 1841 elimination of the *foral approval*, the inland customs and the Basque judiciary differences. Furthermore, the *Juntas* of the Historical Territories were dissolved.

However, despite the abrogation, there was still a strong popular support for the *Fueros* and even the most liberal Basque parliamentarians defended some sort of *Foral* specificity. Besides that, the Government did not want that the *Foral* abolishment was seen as a vengeance of the King for the Basque support to the *Carlist* cause. As a result, the 1876 abrogation Law included a clause that allowed the establishment of special fiscal regimes between the Government and each of the three Basque Provinces. This clause was the legal basis for the Economic Agreements between the Central Government and each of the Basque Provinces<sup>40</sup>.

The first Economic Agreement was signed in 1878, and it was expected to be a transitory system. This first Agreement stipulated that:

- a) The State (Central Government) would collect some taxes in the Basque Territories<sup>41</sup>.
- b) The other taxes, henceforth called *agreed taxes*<sup>42</sup>, would be collected by the Foral Deputations. In exchange for the taxes, each Territory had to pay the Central Government a certain amount of money (the precedent of the current Quota). This amount was equal to the estimated collection of the agreed taxes less the sum of three items: the collection costs, the expenditures that in the Basque Country were made by the Foral Deputations and in the rest of Spain by the Central Government, and the tax exemptions<sup>43</sup>.

The 1878 Agreement established a Fiscal Regime that, in principle, was temporary. It became a definitive system with the signature of the second Economic Agreement in 1887. There were later other Agreements in 1894, 1906 and 1925. The duration of the Agreements was variable. For instance, the duration of the 1925 Agreement was 25 years. However, it was ended abruptly by the outburst of the Spanish Civil war in 1936.

<sup>40</sup> Since the *Juntas* did not exist anymore, the Economic Agreements were negotiated between the Central Government and the Foral Deputations.

<sup>41</sup> The State levied taxes on mining, transport and tobacco.

<sup>42</sup> These included taxes on real state, agriculture, production and trade, consumption of salt and cereals, and stamp duties.

<sup>43</sup> Some villages were exempt from taxes because they had supported the liberals during the *Carlist* wars.

The contents of all the Agreements were essentially the same. The State retained some taxes and agreed others with the Basque Territories. The Basque Territories paid the State a Quota. The Quota was obtained subtracting from the estimated collection of agreed taxes the collection costs and a compensation for the expenditure of the Foral Deputations (on public services provided in the rest of Spain by the Central Government). The items included under each heading varied in time. The tendency was, however, an increase in both agreed taxes and compensations because during the period 1878-1936 the role of the Foral Deputations was substantially strengthened. On the one hand, since the *Juntas* had disappeared, the Foral Deputations overcame their traditional advisory role and assumed all the decision powers on the public affairs of the Territories. On the other hand, the expenditure responsibilities of the Territories increased progressively. Traditionally, the main functions of the Historical Territories had been police and road construction. Between 1878 and 1936 they assumed many other functions such as social assistance, education and penitentiary institutions. Also, the control of municipalities, previously done by the Central Government, was handed over to the Foral Deputations. The result was that the economic importance of the Territorial Institutions increased considerably.

On the tax side, the Foral Deputations also had broad powers. In particular, they could establish any tax they wished to collect the money they needed to pay for the Quota and to finance any other expenditure they decided to make. The result was that taxes were different in each *HT*. Also, in general, taxes in the *HTs*, especially business taxes, were lower than in the rest of Spain.

### 3.3. The Statute of Autonomy of 1936

The 1925 Economic Agreement was to last 25 years. However, the end of monarchy<sup>44</sup> and the proclamation of the II Spanish Republic in 1931 changed the scenario. The new Constitution approved that year established that Spain was a unitary State “compatible with the autonomy of municipalities and regions”. This constitutional provision was the legal basis to approve Statutes of Autonomy for the regions with the strongest desire for self-government. The regions that obtained a Statute of Autonomy were the Basque Country, Catalonia and Galicia<sup>45</sup>.

The Statute of Autonomy of the Basque Country was the result of a very complex process. The Basque political parties had different views about how and up to what point self government should be implemented, and the Central Government had serious reserves about the whole process. After two failed attempts to include Navarre in the process, in 1932 the parties reached an agreement on a draft Statute limited to the three *HTs*. This Statute was approved in a referendum by 84% of the Basque population. However, the Statute was turned

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<sup>44</sup> On April of 1931, a coalition of republican parties won the local elections in most urban areas of Spain. After that, the Republic was proclaimed, and the bourbon King Alfonso XIII (grandfather of the current King of Spain Juan Carlos I) went into exile.

<sup>45</sup> Aragon also had a draft of Statute, but because of the civil war, it was never approved.



down by the Spanish Parliament arguing that the text got less than 50% of the votes in the Territory of Alava<sup>46</sup>.

The approval of a Basque Statute was delayed until 1936, and took place during the Spanish Civil War (1936-1939). The finally approved text was a simplified version of the 1933 draft. The Statute endorsed the system of Economic Agreement and recognised the right of the Basque Country to freely establish its fiscal system. In any case, due to the defeat of the constitutionalists in the war, the Statute was in effect just for seven months and only in the province of Biscay.

### 3.4. The Economic Agreement during the Franco dictatorship (1936-1977)

In 1937, during the Civil War, the dictator Franco abolished the Economic Agreement with Biscay and Guipuzcoa because those provinces did not support his military rebellion to overthrow the democratic republican government. Alava, however, maintained its Economic Agreement during all Franco era because it joined the rebellion since the beginning<sup>47</sup>. The Economic Agreement of Alava had the same structure as the Agreements before 1936. That is, some taxes were agreed and the provincial government paid a Quota equal to the estimated collection of the agreed taxes minus the cost of the services provided by the Foral Deputation of Alava.

### 3.5. Conclusions

The Basque Country has managed its own taxes since more than 800 years ago; long before most *EU* countries even existed. The *Foral* system is, simply, the continuation of a historical tradition of fiscal autonomy which dates back to the 12th and 13th centuries when the Basque Territories joined the Crown of Castile. According to that tradition, to a large extent, the Basque Territories can decide their taxes and expenditures. This principle was only suspended during the Franco dictatorship. But even then one of the *HTs*, Alava, maintained its fiscal autonomy.

In fact, until 1876 the autonomy of the Basque Territories went much further than the fiscal matters. Each Territory had its own *Fueros* which gave it administrative autonomy, his own Territorial Law and exemption from military and fiscal contributions to the Crown. Even more, until the mid 19th century, the customs of Spain were in the frontier between Spain and the Basque Territories which, thereby, were almost a free trade area. In 1876, after several wars (called *Carlist* wars) the *Fueros* were abolished and the only autonomy left was the fiscal autonomy. This fiscal autonomy was materialized in Economic Agreements. The system of Economic Agreements was eliminated (except for Alava) by the dictator Franco in 1936. The reinstatement of democracy and the approval of the Constitution in 1978 restored the historical tradition of Economic Agreements between the Central Government and the Basque Country.

<sup>46</sup> In Alava only 47% of the census voted in favour of the Statute.

<sup>47</sup> Navarre, because of its support of Franco also kept its Economic Agreement.



## 4. THE PUBLIC SECTOR IN THE BASQUE COUNTRY

The Constitution approved in 1978 set the basis for restoring the traditional tax and expenditure autonomy of the *HTs*. Many of the traditional *Foral* Institutions were restored and the *HTs* developed their own public Sectors. What follows describes the main characteristics of this Basque Public Sector.

### 4.1. General Overview

The structure of the Public Sector in the Basque Country Autonomous Community (*BCAC*) is the result of the decentralization process that followed the approval of the 1978 Constitution. The Constitution, in the first additional provision, establishes that:

The Constitution protects and respects the historic rights of the territories with traditional *Fueros* (charters). The general updating of historic rights shall be carried out, where appropriate, within the framework of the Constitution and of the Statutes of Autonomy.

With this provision, the Constitution sets up the legal framework for the restoration of the *Foral* model in the Basque Country and Navarre. At the same time, it establishes a difference between these two *ACs* and the other *ACs*. The constitutional first additional provision is, therefore, the reason why in Spain there are two different systems of financing the *ACs*<sup>48</sup>: the *Foral System* (applied in the Basque Country and Navarre) and the *Common System* (applied in all the other *ACs*<sup>49</sup>).

The way to restore the *Foral* model was to establish, as in the 19th and early 20th centuries, an Economic Agreement to regulate the fiscal and financial relations between the Central Government and the Basque Country<sup>50</sup>. The *Foral* financing model, and therefore the Economic Agreement, is based on two principles:

- a) **Fiscal Autonomy.** The main taxes<sup>51</sup> belong to the *BCAC* which levies, manages, administers, settles, inspects, collects and, subject to some harmonization principles, regulates those taxes. The taxes that belong to the *BCAC* are called *agreed taxes*. Following the historical tradition, the tax power was transferred, not to the Government of the Basque Country (the Basque Government) but to the Governments of the three *HTs* (the *Foral* Deputations). This means that in the Basque Country there are three fiscal systems and three independent tax authorities. In principle, each Territory can have different taxes. However, there is a high degree of harmoniza-

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<sup>48</sup> On the expenditure side there are no differences among *ACs* due to historical (*Foral*) traditions.

<sup>49</sup> The Canary Islands *AC*, although in general follow the common system, has some singularities. In particular it has a special fiscal regime that exempts it from some taxes paid in the rest of Spain (like the *VAT*) and allows the Government of the Islands to establish new taxes and keep the revenue. This is not contrary to the *EU* tax rules because the Canary Islands are considered an ultraperipheral region.

<sup>50</sup> There is a similar Agreement between Navarre and the State, called the Covenant (*Convenio*).

<sup>51</sup> This includes, among others, the Personal Income Tax, Corporation Income Tax, the Value Added Tax, and the Excises.

tion<sup>52</sup> and the taxes in the three Territories are very similar (although not identical).

- b) **Payment of a Quota.** The *BCAC* pays the Central Government (also called the *State*) a certain amount of money (the Quota) as compensation for the expenditures made by the State on behalf of the residents in the Basque Country<sup>53</sup>, and as a contribution to the solidarity among regions. Even though taxes are assigned to the Territories, the Quota is determined globally for the Basque Country. Each territory pays a share of the Quota which depends on its relative *GDP* and tax collection efficiency<sup>54</sup>.

In Spain, as in most countries, a large part of the resources of municipalities comes from transfers from the Central Government. Since in the *BCAC* the Foral Deputations collect almost all the taxes, they have the obligation to finance the municipalities in their Territories. Accordingly, each Foral Deputations has established its own rules as to how much to transfer to its municipalities and how to distribute this amount among them. In the rest of Spain (except in Navarre) the municipalities are financed by the Central Government. The rules established by the Foral Deputations to finance municipalities are very different from the rules in the rest of Spain<sup>55</sup>.

The result of this institutional design is a Public Sector with four levels of government spending in the Basque Country (Central Government, Basque Government, Foral Deputations and Municipalities) but basically only one of them (the Foral Deputations) collecting taxes<sup>56</sup>. This leads to a complex scheme of transfers which redistributes taxes from the Foral Deputations toward the other tiers of government. Obviously, the European Union (*EU*) is the fifth level of government in the Basque Country. The EU, besides regulating many issues, spends and obtains revenue indirectly through transfers.

## 4.2. The Institutional Setting

The Basque Public Sector (*BPS*) is made up of all the governments operating exclusively in the *BCAC*. The *BPS* includes the Basque Government, the Foral Deputations and the Municipal Governments. Figure 2, summarises the institutional setting of the *BPS* and its financial and fiscal relations with the State.

<sup>52</sup> There is a harmonization Law among the *HTs* but so far all the harmonization has been voluntary (see section 5.4).

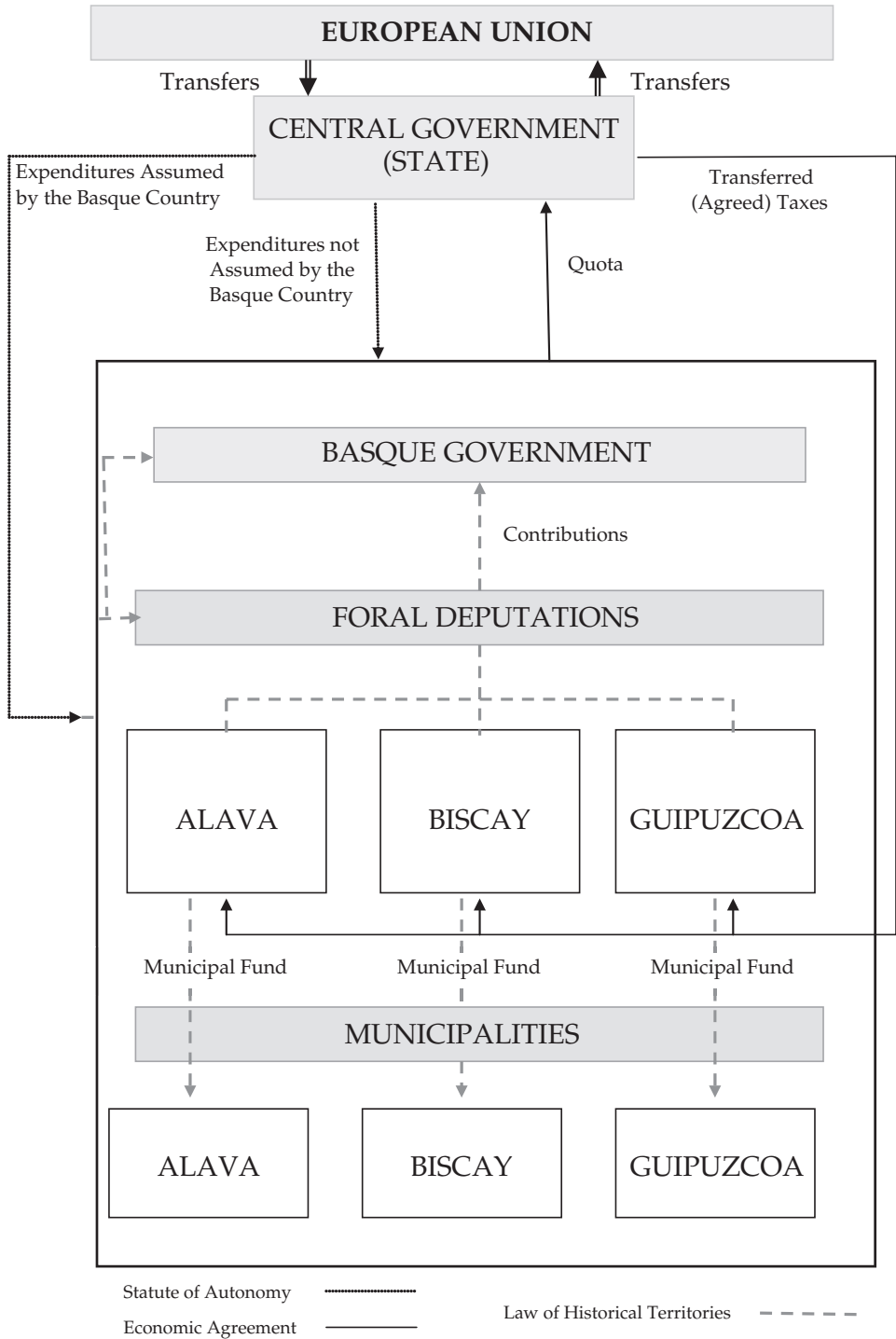
<sup>53</sup> Some of the expenditures that benefit residents in the Basque Country are made in the Basque Country (for instance, expenditure on ports and airports) and others outside the Basque Country (foreign relations, defence, etc.).

<sup>54</sup> The share is determined by the Contribution Law (*Ley de Aportaciones*). See section 7.2 for further details.

<sup>55</sup> See section 7.3 for details.

<sup>56</sup> The municipalities collect some taxes, but their collection is only a small percentage of all the taxes collected in the Basque Country. The municipal taxes represent around 20% of the municipal revenues. The Social Security (which is under the control of the Central Government) also collects contributions that are used to finance pensions and unemployment benefits.

**Figure 2: Public Sector in the Basque Country Autonomous Community**



The Basque Country reached autonomy under the Article 151 of the Constitution<sup>57</sup>. Its Statute of Autonomy was approved in 1979. The Statute determines the expenditure responsibilities of the *BCAC* and establishes the general principles that configure the financial and fiscal relations between the Basque Country and the State.

On the expenditure side, the Basque Country has basically the same responsibilities as the other *ACs*. The only significant differences are that the Basque Country has a much more developed Regional Police (the *Ertzaintza*, in Basque) than any other *AC*<sup>58</sup> and that, following the historical tradition, the Basque Country is responsible for all the roads (including the national roads, see note 57). Although the Statute delimits the expenditure responsibilities of the Basque Country, in many cases it is not clear if the responsibility belongs to the Basque Government or to the Foral Deputations.

On the revenue side, the Statute assigns all the agreed taxes to the Foral Deputations. Nevertheless, the Statute says that the Basque Government can create new taxes and piggyback on some of the Foral Deputation taxes (on all direct taxes, except the Corporation Income Tax and on some minor indirect taxes)<sup>59</sup>. The Statute provides also that the Foral Deputations have to transfer some of their tax revenues to the Basque Government. These transfers are called Contributions (*Aportaciones*). The Statute, however, does not say anything about how to determine those Contributions.

Finally, following the Constitutional mandate, the Autonomy Statute establishes that the financial relations between the Basque Country and the State shall be regulated by the “*traditional system of Economic Agreement*”. As already explained this means that the Basque Country collects most of the taxes and pays a Quota as a compensation for the expenditure of the Central Government on behalf

<sup>57</sup> At the beginning of the decentralization process, in the 1980’s, there were *ACs* with high powers and *ACs* with low powers. They differed in the expenditure powers they had. The *ACs* with high powers (Basque Country, Catalonia, Galicia, Valencia, Andalusia and the Canary Islands) had the same expenditure responsibilities as the *ACs* with low level competencies plus Education and Health. The equalization of expenditure responsibilities was a long process that did not finish until 2002, when the few *ACs* that still did not provide health care, assumed that responsibility. Despite this equalization of basic responsibilities, there have always been some differences among *ACs*. The main difference is that some *ACs* (like the Basque Country and to less extent Navarre and Catalonia) have a well developed regional police while in the rest the regional police is symbolic or simply non existent. Other important difference is that some *ACs* (Basque Country, Navarre, Balearic Islands and Canary Islands) are responsible for all the roads in the region (including national roads) while others only take care of regional roads. Differences of lesser importance include the responsibility for penitentiary institutions, national parks and other minor expenditure functions.

<sup>58</sup> The Basque Police is responsible for almost all the usual police functions. Other *ACs* like Navarre and Catalonia have also significant regional police forces but with fewer functions than the Basque Police.

<sup>59</sup> This derives from the *LOFCA* (Organic Law on Financing the Autonomous Communities), which establishes that all the *ACs* can create new taxes and piggyback on certain taxes of the central government. However, the *ACs* have made very little use of this and, at best, have established small yield taxes that are not unpopular (for instance environmental taxes or taxes on gambling). The Basque Government has only gambling taxes.

of the residents in the Basque Country and as a contribution to the solidarity among regions. The sum of these two items is called *Non Assumed (by the Basque Country) Charges*.

The details of the Economic Agreement are contained in the *Economic Agreement Act*. The first Economic Agreement of the new era was signed in 1981<sup>60</sup>. It had a 20-year duration and ended in 2001. After complex negotiations, a new Agreement was signed in 2002<sup>61</sup>. The new Agreement was very similar to the previous one, but with an indefinite duration.

The Economic Agreement is the financial pillar of the Basque Autonomy. It regulates the two basic elements of the *Foral* system: the tax autonomy of the *BCAC* and the financial relations between the State and the *BCAC*. As for the tax autonomy, the Economic Agreement establishes:

- a) Which taxes belong to the *HTs*. That is, which *Taxes* are *Agreed*.
- b) Which taxpayers have to pay taxes to each Tax Authority (State or Foral Deputations) and if a taxpayer has to pay to more than one Tax Authority, how to divide the tax base among them and which tax law applies. The criteria to determine who has to pay taxes to each Tax Authority, how to divide tax bases among Tax Authorities (if taxes have to be paid to more than one) and which tax law (State or Foral) applies are called *Points of Connection*.
- c) The autonomy that *HTs* have to regulate their taxes. That is if the *HTs* have (or do not have) restrictions to define the bases, rates and deductions of the Agreed Taxes.

After delimiting the tax autonomy of the *HTs*, the Economic Agreement establishes a series of transfers between the Basque Country and the State. The most important one is the Quota paid by the Basque Country to the State. There are also several transfers from the State to the Basque Country. The most important ones are the adjustments for VAT and Excises<sup>62</sup>. There are also other transfers such as the share of Basque municipalities on the non agreed taxes<sup>63</sup> or the financial compensations to the Basque Country<sup>64</sup>. All the payments are established globally for the Basque Country. The division among *HTs* of these joint payments is left to be decided by the Basque Country.

The Statute of Autonomy and the Economic Agreement arrange the division of expenditure and revenue competencies between the State and the Basque Country. However, they leave undefined several elements of the institutional design within the Basque Country. First, there is not a clear division of expenditure responsibilities between the Basque Government and the Foral Deputations.

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<sup>60</sup> Ley 12/1981, de 13 de Mayo.

<sup>61</sup> See Economic Agreement (2002), Ley 12/2002 de 23 de Mayo (annex 3).

<sup>62</sup> See sections 6.1.2 and 6.1.3 for details.

<sup>63</sup> These are the taxes paid by Basque Country residents but collected by State.

<sup>64</sup> See section 6.1.

Second, the Statute and the Agreement give almost all tax powers to the Foral Deputations. Those Laws also provide that Foral Deputations will make financial Contributions to the Basque Government and that the *BCAC* shall pay the State a Quota. However, the Statute and the Agreement say nothing about how much each Territory has to contribute to the Basque Government and about how to distribute the Quota among the *HTs*. Nor is there any indication as to how Basque municipalities have to be financed. These ambiguities made necessary a Law to organize the expenditure competencies and the financial relations within the *BCAC*. This Law, *The Historical Territories Law*<sup>65</sup>, was approved in 1983 and established two types of arrangements:

- a) On the expenditure side, the Law clarifies the division of expenditure powers between the Basque Government and the Foral Deputations. That is, it determines the expenditure responsibilities of each level of government<sup>66</sup>.
- b) On the revenue side, the Law establishes the methodology and basic principles to determine the Contribution of the Foral Deputations to the Basque Government and how to distribute this Contribution among the three Foral Deputations. These principles are developed in Contributions Acts<sup>67</sup> that are approved every five years. The percentage of the Contribution paid by each *HT* is called *horizontal coefficient*. The horizontal coefficients are also used to determine the share of each Territory in the Quota to be paid to the State<sup>68</sup>.

The Historical Territories Law also says that Foral Deputations have to fund municipalities with at least as much money as they would receive in Common Territory<sup>69</sup>. This means that Basque municipalities have to receive a transfer from Foral Deputations that is equal or larger than the transfer they would receive applying the financing rules that the Central Government uses with the municipalities in Common Territory. To finance the municipalities, the Foral Deputations have established funds of unconditional transfers called Municipal Funds. Following the provisions of the Historical Territories Law, the municipalities receive transfers from those funds that are much higher than the transfers received by municipalities in Common Territory.

For completeness, Figure 2 also includes the European Union, which is the fifth level of government in the *BCAC*. The main source of revenue of the *EU* is transfers from Central Governments (the *BCAC* pays its share of these transfers to

<sup>65</sup> See Ley 27/83 de Relaciones entre las Instituciones comunes de la *CAPV* y Órganos Forales de sus TT.HH. (1983), de 25 de Noviembre.

<sup>66</sup> The expenditure powers of the municipalities are determined by a national law applied also in the *BCAC* (Ley 7/1985, Reguladora de las Bases del Régimen Local).

<sup>67</sup> See Ley 2/2007 de Aportaciones 2007-2011 de 23 de Marzo (annex4). This Act is agreed within the *Basque Council of Finance*, which is a deliberative body formed by one representative from each Foral Deputation and three from the Basque Government.

<sup>68</sup> See section 7 for a detailed analysis.

<sup>69</sup> This is Spain except Foral *ACs* (Basque country and Navarre)

the *EU* via Quota). On the other hand, the *EU* spends in the *BCAC* indirectly giving transfers to other levels of government that spend in the *BCAC* (for instance, transfers to the Central Government or to the Basque Government).

### 4.3. Tax and Expenditure Assignment

Tables 8 and 9 describe the expenditure and tax assignments in the *BCAC*. Table 8 lists the main expenditure and revenue responsibilities of each level of government. Table 9 gives the share of each tier of government in the consolidated<sup>70</sup> expenditure and tax collection of the Public Sector in the *BCAC*.

The first level of government in Table 8 is the *EU*. The *EU* does not spend directly in the *BCAC*, but it makes conditional transfers to other levels of government. For that reason, the expenditure of the *EU* is included in the budget of other governments. The *EU* transfers are linked to the regional and agricultural policies and, therefore, finance investments in economic development, support farmers' incomes and finance rural development. The *EU* transfers amount to 0.3% of the *GDP* of the Basque Country and represent 0.6% of Public Sector expenditure in the *BCAC*.

The *EU* costs the *BCAC* about 1% of its *GDP*. Most of this cost is paid via Quota<sup>71</sup>. Therefore, the Basque Country is a net contributor to the *EU* because it pays more than what it gets. The deficit is equal to 0.7% of the Basque *GDP*. In any case, the influence of the *EU* in the Basque economy goes far beyond its expenditure because the main *EU* functions (regulation and monetary control) do not entail any expenditure.

The second level of government in the *BCAC* is the Central Government (State). It makes two types of expenditures in benefit of the residents in the Basque Country. First, through the Social Security, the Central Government pays pensions and unemployment benefits. These expenditures are financed with Social Security Contributions collected by the Social Security Administration. The second group includes expenditures made in the Basque Country (for instance, national railways, ports and airports of national interest) and expenditures made outside the Basque Country that benefit residents in the Basque Country (for instance, defence, foreign relations and, payment of the *UE* contribution<sup>72</sup>). To finance the second group of expenditures, the Central Government receives the Quota and

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<sup>70</sup> Consolidation means that the expenditure of a government is reduced in the transfers made to other levels of government. This avoids counting twice the expenditure (in the budgets of the donor and the beneficiary) and imputes the expenditure to the government that effectively makes it (the recipient of the transfer).

<sup>71</sup> Through the Quota the Basque Country pays 6.24% of the transfers of the Central Government to the *EU* (see section 6.1.1). On the other hand, part of the traditional own resources of the *EU* (custom duties, agricultural duties and sugar levies) collected in Spain are paid by residents in the Basque Country.

<sup>72</sup> If the Basque Country was a separate Country in the *EU*, it would have to pay a contribution to the *EU*. That contribution is now included in the contribution of Spain.



**Table 8: Expenditure and Revenue Assignment in the BCAC**

GOVERNMENT	EXPENDITURE COMPETENCIES			FINANCING
<b>EUROPEAN UNION</b>	<b>Development</b> (Regional Policy) <b>Support Agricultural Income and Rural Development</b> (Common Agricultural Policy). <b>Regulation</b> (Environment, Competition, etc.) <b>Monetary Policy.</b>			<b>Transfers from Central Government</b> (paid by the <i>BCAC</i> via Quota) custom duties and agricultural resources.
<b>CENTRAL GOVERNMENT (STATE<sup>1</sup>)</b>	General Administration	{ General Administration Defence Foreign Relations Railways, Ports and Airports of National Interest Contributions to <i>EU</i> Traffic <sup>2</sup> Justice <sup>3</sup> Other		<b>Quota</b> Some minor fiscal revenues
	Social Security	<b>Unemployment Benefits Pensions</b>		<b>Social Security Contributions</b>
<b>BASQUE GOVERNMENT</b>	General Administration <b>Health</b> <b>Education</b> Regional Police ( <i>Ertzaintza</i> ) Justice Welfare Programs <sup>4</sup> Promotion of Economic Activity Culture	Public Works Economic Development Housing and Urbanism Regional Railways Labour	Commerce and Tourism Transportation Environmental Protection Agriculture and Fishing Industrial Policy Others	The main source is <b>Transfers From Foral Deputations</b> (Contributions). It also receives some transfers from the Central Government and the <i>EU</i> . Its tax collection (a tax on gambling) is negligible.
<b>FORAL DEPUTATIONS</b>	General Administration <b>Social Services<sup>5</sup></b> <b>Roads and Transportation</b>	Promotion of Economic Activity Public Works <sup>6</sup> Culture	Agriculture, Cattle, Forestry and Fishing Others	<b>Taxes</b> (all except social security contributions and local taxes) and some transfers from the Central Government and the <i>EU</i> .
<b>MUNICIPALITIES</b>	<b>General Administration</b> <b>Local Services<sup>7</sup></b> <b>Culture and Sports</b> <b>Housing</b> <b>Urbanism</b>	Urban Transportation <sup>8</sup> <b>Streets</b> Local Police Environmental Protection <sup>8</sup>	Social Services <sup>9</sup> Civil Protection <sup>9</sup> Firefighting <sup>9</sup> Others	<b>Local Taxes and Transfers from Foral Deputations.</b> They also charge fees and receive transfer from the Central Government and the <i>EU</i> .

<sup>1</sup> In the legal texts the Central Government is referred to as the State. <sup>2</sup> Driver's licence and car registration. <sup>3</sup> Penitentiary Institutions, National Courts (Supreme, Constitutional). <sup>4</sup> Social Services, anti poverty measures (such as guaranteed minimum income), Workplace Safety, Collective Insurance. <sup>5</sup> Social Assistance, Community Development, Inequality, Social Exclusion, etc. <sup>6</sup> With effects only in the Territory. <sup>7</sup> Water Supply, Sanitation, Waste Cleaning, Gas, etc. <sup>8</sup> Only municipalities with at least 50.000 people. <sup>9</sup> At least 20.000 people.

In bold the most important items (expenditure or revenue).



collects some minor fiscal revenues<sup>73</sup>. The expenditure of the Central Government is about 60% of all the public expenditure in the *BCAC*. This expenditure is split almost equally between General Government expenditures and Social Security expenditures. In percentage of the *GDP*, the expenditure of Central Government is slightly more than 25%.

On the revenue side, the taxes collected by Central Government represent somewhat less than 40% of total taxes. Almost all the Central Government tax collection comes from Social Security Contributions, which amount to 11.2% of *GDP*. The rest is mainly withholding taxes<sup>74</sup>.

The Basque Government is the third level of government. Its two basic expenditure responsibilities are Education and Health. In the 2009 budget, these two items accounted for almost 60% of total expenditure. The next two items in importance are Infrastructures and Transportation (9.4% of the budget) and Police (6.3%). These four items absorb almost 75% of the budget.

**Table 9: Expenditure and Revenue in the *BCAC* by Government Level (2006)**

	EXPENDITURE <sup>1</sup>		TAXES	
	% of Total Expenditure	% of <i>GDP</i>	% of Total Taxes	% of <i>GDP</i>
1. European Union	(0.6) <sup>2</sup>	(0.3) <sup>2</sup>	(3.0) <sup>3</sup>	(1.0) <sup>3</sup>
2. Central Government	58.3	25.8	37.8	13.2
2.1. General Government <sup>4</sup>	32.1	14.2	3.2	1.1
2.2. Social Security	26.2	11.6	34.7	12.1
3. Basque Government	23.8	10.5	0.0	0.0
4. Foral Deputations	7.6	3.4	59.3	20.7
5. Municipalities	10.3	4.6	2.9	1.0
<b>TOTAL</b>	<b>100.0</b>	<b>44.3</b>	<b>100.0</b>	<b>34.9<sup>6</sup></b>

<sup>1</sup> Consolidated. <sup>2</sup> Transfers to other levels of government. <sup>3</sup> Share of the Basque Country (6.24%) in the payment of Spain to the *EU* (includes the four *EU* resources). <sup>4</sup> Expenditures and taxes valued as in the determination of the Quota. <sup>5</sup> Includes *VAT* and excises adjustments. <sup>6</sup> It does not include import taxes (most of them belong to the *EU*).

Source: Own elaboration using Public Sector Executed Budgets (*EUSTAT*), Economic Accounts of the Public Sector (*EUSTAT*) and Organo de Coordinación Tributaria (various years).

The Basque Government spends 10.5% of *GDP*, equivalent to almost 25% of Public Sector expenditure. The expenditure of the Basque Government is more than the combined expenditures of Foral Deputations and Municipalities. If we look only at the Basque Public Sector (Basque Government, Foral Deputations and Municipalities), the Basque Government is responsible for 60% of total

<sup>73</sup> See Table 9 below.

<sup>74</sup> The Central Government withdraws the wages of its public servants working in the *BCAC* and the interest of the debt issued by the Central Government or Common Regime *ACs*.

expenditure. Despite his predominant role on the expenditure side, the Basque Government collects almost no taxes<sup>75</sup> and its sole significant source of revenue is a transfer from the Foral Deputations (the Contributions).

The Foral Deputations constitute the fourth level of government. In terms of expenditure the Foral Deputations are the smallest level of government. They represent about 7.5% of the total Public Sector and 20% of the Basque Public Sector. The main expenditure responsibilities of Foral Deputations are Social Services, Transportation and Territorial Roads. Despite their limited role as spenders, the Foral Deputations are responsible for collecting almost all taxes. The only taxes they do not collect are the Social Security Contributions (collected by the Social Security Administration to finance pensions and unemployment benefits) and the municipal taxes. After collecting the taxes, the Foral Deputations transfer most of their collection to other levels of governments.

The last tier of government is the Municipal level. Municipalities provide the usual local services such as sanitation, water, streets, urban transportation, and so on. Their expenditure is somewhat less than 5% of *GDP*, equivalent to 10% of total public expenditure. The taxes collected by municipalities represent 1% of *GDP*. The municipal taxes are less than 3% of total taxes. The municipalities cover the difference between expenditures and taxes with transfers from the Foral Deputations and, to a lesser extent, with user fees.

In conclusion, in the *BCAC* there are five government levels that spend about 45% of *GDP*. That is well above the expenditure in Spain (less than 40%) and very similar to the *EU27* average (about 46%). Most of the expenditure in the *BCAC* is made by the Central Government and the Basque Government. The Central Government makes about 60% of total expenditure and the Basque Government almost 25%. The Central Government provides general government (defence, foreign relations, etc.) and Social Security (pensions and unemployment benefits) while the main expenditure functions of the Basque Government are Education and Health. The Central Government finances its expenditure in the Basque Country with the Quota (general expenditure) and Social Security Contributions (Social Security). The Basque Government is financed almost exclusively by transfers (Contributions) from the Foral Deputations. Foral Deputations spend on Social Services and on Transportation, Roads and Highways. Their expenditure is about 7.5% of total expenditure. This is less than the expenditure of any other level of government (except the *EU*). Despite their limited expenditure powers, Foral Deputations collect almost all taxes. They, however, transfer the largest part of what they collect to other levels of government (Quota, Contributions, etc.). The Municipalities make around 10% of the expenditure and finance it with local taxes, user fees and transfers from the Foral Deputations. Finally, the *EU* finances (with transfers to other levels of government) expenditures that amount to 0.3% of Basque *GDP*. The cost of the *EU* for the Basque Country is 1% of *GDP*. This implies that the Basque Country is a net contributor to the *EU*. The net cost of the *EU* for the Basque Country is 0.7% of its *GDP*.

<sup>75</sup> It only collects a tax on bingo gambling.

## 5. FISCAL AUTONOMY OF THE BASQUE COUNTRY

This section will review the three elements that configure the fiscal autonomy of the Basque Country:

- (a) **Agreed Taxes.** Which taxes have been agreed and, therefore, belong the *HTs*.
- (b) **Points of Connection.** Which are the criteria to determine who has to pay taxes to the *HTs*, what percentage of their economic activity (consumption, income, etc.) is subject to the taxation in the *HTs* and which Tax Law applies.
- (c) **Tax Regulation Powers.** What elements of the taxes (bases, rates and deductions) can be legislated by the *HTs*.

### 5.1. Agreed Taxes

Table 10 details the fiscal revenues that have not been agreed with the *HTs* of the *BCAC*. As the Table shows, all the taxes have been agreed with only three exceptions. First, withholding taxes on the wages of State (Central Government) employees (civil servants or other). Second, withholding taxes on the interest of assets issued by the State or any *AC* or Municipality of Common Territory or Navarre. Third, Custom Duties, which as in the rest of the *EU* countries, are a resource of the *EU*<sup>76</sup>.

As for withholding taxes collected by the State, it should be first pointed out that everybody living in the Basque Country<sup>77</sup> (including all Central Government employees) has to file taxes in one of the *HTs* of the *BCAC* and report all his income in the Personal Income Tax (including the income from assets issued by the State or the *ACs* and municipalities of common regime and Navarre). Therefore, even though the State collects the withheld taxes on certain incomes, that income is also reported to the Basque Tax Authorities<sup>78</sup>. To compensate the *HTs* for the revenue loss, an estimation of the taxes withheld by the State in the Basque Country is subtracted from the Quota (item 6 in Annex 1).

The second group on non agreed fiscal revenues includes user fees and public prices. That is, what the State charges for services provided in the Basque Country. Again, these resources obtained by the State in the *BCAC* are subtracted from the Quota (item 4 in Annex 1).

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<sup>76</sup> In Spain, the Canary Islands impose some custom duties of their own that they keep as own revenue.

<sup>77</sup> This means that in a given year the person lives in the *BCAC* at least 183 days.

<sup>78</sup> Since withheld taxes are credited against personal income tax liabilities, this means that the State collects the withholding taxes and the *BCAC* gives them back to taxpayers in the form of a tax credit. Reciprocally the *BCAC* withholds the wages of its employees working outside the *BCAC* and the interests on any asset issued by the Basque Public Sector (even if paid to a non resident in the *BCAC*).

**Table 10: Non Agreed Fiscal Revenues (2010)****a) Taxes**

Custom Duties.

Withholding tax on wages of State employees.

Withholding tax on interests of the Debt (or any other interest-bearing asset) issued by the State, or any AC or municipality in common territory or Navarre.

**b) User Fees and Public Prices**

User Fees, Public Prices, and other revenue linked to expenditures made by the State (expenditure responsibilities not assumed by the BCAC).

**c) Social Security Contributions**

Finally, the State (strictly speaking the Social Security Administration) collects Social Security Contributions in the Basque Country. This is natural, because in Spain Social Security Contributions are used exclusively to finance pensions and unemployment benefits<sup>79</sup>. Since the State provides in the BCAC both, pensions and unemployment benefits, it also collects the necessary Social Security Contributions<sup>80</sup>. Obviously, the BCAC would only collect the Social Security Contributions if it assumed the responsibility to provide pensions and unemployment benefits. That is, if the Basque Country had a Social Security separated from that of the rest of Spain.

In conclusion, the Central Government almost does not collect taxes in the BCAC. All the general taxes (Personal Income Tax, Corporation Income Tax, VAT, excises and so on) are collected by the HTs of the BCAC. This implies that, in a basic sense, the BCAC is the region in the world with highest fiscal autonomy. Simply, the BCAC is the only region in the world (including the most autonomous regions such as the Swiss Cantons, the US States and the province of Quebec in Canada) in which its Central Government does not collect any tax.

**5.2. Points of Connection**

The points of connection are the criteria to determine who pays taxes in the Basque Country, in what proportion and according to which tax Law (State or Foral). Table 11 gives the points of connection established in the Economic Agreement.

<sup>79</sup> In Health, Spain has a National Health Service (NHS) that provides free universal coverage, and it is financed exclusively with taxes. Other countries with a SHS system include United Kingdom, Sweden, Ireland, Italy and Portugal.

<sup>80</sup> Social Security contributions are not subtracted from the Quota because the costs of pension and unemployment benefits are not included in the expenditures the BCAC has to pay to the State. The Social Security System pays benefits and collects revenue separately from the Central Government (although if necessary it receives transfers from Central Government).

**Table 11: Points of Connection and Applicable Tax Legislation (2010)**

Tax		Points of Connection (what is taxed in the Basque Country)	Applicable Legislation
<b>A. DIRECT TAXES</b>			
Personal Income Tax	Withholding tax on labour income	Income earned in the Basque Country (except civil servants and employees of the State).	Foral Legislation
	Withholding tax on capital income	<ol style="list-style-type: none"> <li>1. Interests paid by. <ol style="list-style-type: none"> <li>A. Firms. In the same proportion as the Corporation Tax paid in the Basque Country.</li> <li>B. Public Sector. Those paid by Basque Public Administrations.</li> <li>C. Financial Institutions: Those paid to residents in the Basque Country</li> </ol> </li> <li>2. Dividends. In the same proportion as the Corporation Tax paid in the Basque Country.</li> <li>3. Other capital income. <ol style="list-style-type: none"> <li>A. Income from the rental of goods, rights, businesses or mines and similar, when they are located in Basque Territory.</li> <li>B. Rest, when the beneficiary has his residence in the Basque Country.</li> </ol> </li> </ol>	Common Legislation
	Filing	Taxpayers with habitual residence in the Basque Country.	Foral Legislation
Corporation Income Tax		A. Pay taxes only in the Basque Country firms whose fiscal domicile is in the Basque Country and either have a volume of operations below 7 million euros or above that, but all its sales are in the Basque Country. Firms with fiscal domicile outside the Basque Country, sales below 7 million euros and 100% of the sales in the Basque Country also pay taxes in the Basque Country.	Foral Legislation
		B. Do not pay taxes in the Basque Country firms with domicile outside the Basque country and sales below 7 million Euros, even if some of the sales are in the Basque Country.	Common Legislation or Navarre depending on fiscal domicile
		C. Pay taxes in proportion to the volume of operations <sup>1</sup> in the Basque Country if volume of operations larger than 7 million Euro.	
		C.1. If fiscal domicile is in the Basque Country, and the volume of operations in the Basque Country is larger than 25%.	Foral Legislation
		C.2. If fiscal domicile is in the Basque Country and the volume of operations in the Basque Country is smaller than 25%.	Common Legislation
		Other.	Common Legislation

Non Residents Income Tax <sup>2</sup>	Persons or Entities operating through a permanent establishment pay taxes according to the rules of the Corporation Income Tax.	Foral Legislation or Common as in Corporation Tax
	Persons or Entities operating without a permanent establishment when income is understood to have been obtained or produced in the Basque Country.	Common Legislation
Wealth Tax <sup>3</sup>	Taxpayers who have habitual residence in the Basque Country.	Foral Legislation
Inheritance and Gift Taxes	<i>Inheritances</i> : when the decedent's place of habitual residence is in the Basque Country. <i>Gifts</i> : Real property when it is located in Basque Territory. Rest when the habitual residence of the transferee is in the Basque Country.	Foral Legislation
<b>B. INDIRECT TAXES</b>		
VAT	Same rules as in Corporation Tax (A, B, C above).	Common Legislation
Excises	Manufacturing: When liability arises in the Basque Country <sup>4</sup> .	Common Legislation
	Certain Means of Transport: Vehicles registered in Basque Territory.	Common Legislation <sup>5</sup>
	Retail Sales of Certain Mineral Oils: Sales in establishments located in Basque Territory.	Common Legislation <sup>5</sup>
Tax on Insurance Premiums	When risk or commitment in insurance and capitalisation operations arises in Basque Territory.	Common Legislation
Capital Transfer Tax and Stamp Duty	Varies with the type of transfer: A. Transfers of real property: Assets located in the Basque Country. B. Transfers of shares and similar: Place of formalization of the transaction. C. Other Transfers of movable property: When the purchaser is a resident in the Basque Country (person) or has the fiscal domicile in the Basque Country (firm). D. Certain corporate operations: When the fiscal domicile in the Basque Country. E. Other: Depending on the transfer of financial operation, when the good is in the Basque Country, when the residence of the person or the fiscal domicile of the firm is in the Basque Country or when the statements, deeds and certificates are authorised or issued in Basque Territory.	Foral Legislation except in cases of (a) certain company operations (b) bills of exchange and documents used in their stead or serving the purposes of a draft, which are regulated always by common legislation.
Gaming duties	When the taxable event is performed in the Basque Country.	Foral Legislation

<sup>1</sup> Volume of operations in a region is equal to the sales (VAT excluded) in that region. <sup>2</sup> This tax is levied on the income of non residents (individuals or firms). It is the union of the personal and corporation taxes applicable to non residents. <sup>3</sup> This tax was abolished in 2008 in the State, Alava and Biscay and in 2009 in Guipuzcoa. <sup>4</sup> Basically means that the producers or the bonded warehouses are in the Basque Country. <sup>5</sup> The tax rate established by the State can be increased (with limits) by the Basque Country.

Source: Economic Agreement.

In the Personal Income Tax, the *HTs* tax the worldwide income of residents in the *BCAC*<sup>81</sup> and the income earned in the Basque Country by non residents in the *BCAC* (but residents in Spain<sup>82</sup>). This combination of residence and territoriality is used in personal income taxation by all *EU* countries.

The division of the tax base in the Corporation Income Tax is a combination of simplicity (for small firms) and relative sales (for large firms). Basically, small Basque firms pay taxes only in the Basque Country and large firms (Basque or not) with sales in the Basque Country pay taxes in the Basque Country in proportion to their sales in Basque Territory (volume of operations). The Tax Law applicable to firms depends on size and fiscal domicile. Small Basque firms and large firms with the fiscal domicile in the Basque Country and a significant part of their sales in the Basque Country (at least 25% of sales), are subject to Basque Tax Legislation. The rest of firms, even if they file in the Basque Country, are subject to Common Tax Rules. The result is that small Basque firms only pay taxes to the *HTs* and always with Foral Legislation. Large Basque firms pay taxes to both the State and the *HTs*<sup>83</sup>. If a significant share of their sales is in the Basque Country they pay according to Foral Legislation. Otherwise, they apply Common Legislation. Finally large non Basque firms pay taxes in the Basque Country according to their sales and under Common Legislation.

The Non Resident Income Tax uses the same criteria as the Corporation Income Tax. The Inheritance and Gift Tax of the *HTs* is paid by residents (inheritance and gifts other than real property) and owners of real property (in the case of gifts).

The *VAT* is paid according to the origin principle. That is, the *HTs* collect the *VAT* due on the production (value added) of the Basque Country. This gives rise to an ex post adjustment<sup>84</sup> for the differences between what the Basque Country collects (*VAT* on the value added created in the Basque Country), and what it should collect (*VAT* on the consumption of the residents in the Basque Country). The Basque Country collects the manufacturing excises<sup>85</sup> when the liability arises in the Basque Country<sup>86</sup>. Since the liability does not arise at the consumption point, in the manufacturing excises, as it happens in the *VAT*, there is also an adjustment to eliminate the differences between what *HTs* collect and what they should collect (according to the consumption of Basque residents).

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<sup>81</sup> As already mentioned, there are some exceptions like the wages of public servants and employees of the State and the interests paid by the State and other *AC*.

<sup>82</sup> The income obtained by non residents in Spain is taxed in the Non Residents Income Tax (see below).

<sup>83</sup> And possibly to Navarre.

<sup>84</sup> See section 6.1.2.

<sup>85</sup> These are the excises on alcohol and alcoholic beverages, intermediate products (also a tax on alcohol), beer, mineral oils, manufactured tobacco and electricity.

<sup>86</sup> Manufacturing Excises are paid by manufacturers, importers, and keepers of bonded warehouses for dutiable products.



The tax on Certain Means of Transport<sup>87</sup> is paid by vehicles registered in the Basque Country. The tax on Retail Sales of Certain Mineral Oils<sup>88</sup> is applied in establishments located in Basque Territory, and the Tax on Insurance Premiums is charged on risks insured in the Basque Country. Finally, the Gaming Duties apply to gambling activities in the Basque Country.

Summing up, the points of connection in direct taxes give the Basque Country the right to tax the income of residents and the income generated in the territory. This mix of residence and territoriality is also used by all *EU* countries in direct taxation. In the case of the Corporation Income Tax, though, several simplifications have been made to simplify the administration and to facilitate compliance by firms.

In the indirect taxes, the points of connection are established using the origin principle (*VAT* and manufacturing excises), or where possible, the destination principle (other indirect taxes). When the origin principle is used, there are *ex post* adjustments to ensure that the final collection of the Basque Country is equal to the taxes paid by its residents.

### 5.3. Limits to the fiscal Autonomy of the Basque Country: Harmonization Principles

The fiscal autonomy of the *HTs* is subject to two types of constraints. First, there is a set of general restrictions that apply to the fiscal system as a whole. Second, there are specific restrictions on each tax.

#### 5.3.1. General Harmonization Principles

The general principles of harmonization that the fiscal systems of the *HTs* have to satisfy are summarized in Table 12. As the Table shows, the fiscal systems of the *HTs* are subject to, basically, three constraints:

- a) Submission to the International Agreements or Treaties signed by Spain.
- b) They should not distort the competence among firms or the free movement among regions (*principle of no distortion*).
- c) The fiscal pressure (tax to *GDP* ratio) in the *BCAC*<sup>89</sup> has to be *equivalent* to that existing in the rest of Spain.

Obviously, some of these principles are, to say the least, ambiguous. For instance, it is not clear what *equivalent* fiscal pressure means. Does it mean that fiscal pressure in the *BCAC* cannot differ more than 10% (above or below) from fiscal pressure in the rest of Spain? Or the relevant figure is 5%? More importantly, the main cause of the conflicts between the State and the *BCAC* is the principle of no

<sup>87</sup> It is a tax on the registration of new cars.

<sup>88</sup> This is a fuel tax.

<sup>89</sup> Notice that the requisite applies to the whole Basque Country, not to each Territory.



distortion (B.3. in table 12). The principle has, however, a high degree of subjectivity. The reason is simple. Distortion is a matter of degree and any tax difference between the *BCAC* and the rest of Spain, no matter how small it is, will cause *some* distortion<sup>90</sup>. Simply, any tax difference will introduce *some* discrimination, reduce *somewhat* free competition and, and as long as productive factors are mobile, give rise to *some* changes in the allocation of resources. The fact that distortion is a matter of grade, introduces a high degree of subjectivity in the decision about whether or not a tax measure is distortionary.

**Table 12: Harmonization Principles between the Tax Systems of the *BCAC* and the State (2010)**

<b>A. General Principles</b>
<ol style="list-style-type: none"> <li>1. Respect for the principle of solidarity in the terms laid down in the Constitution and in the Statute of Autonomy.</li> <li>2. Regard for the general taxation structure of the State.</li> <li>3. Coordination, fiscal harmonization and cooperation with the State, in accordance with the rules laid down in the Economic Agreement.</li> <li>4. Coordination, fiscal harmonization and mutual cooperation between the Institutions of the Historical Territories pursuant to the regulations enacted by the Basque Parliament for these purposes.</li> <li>5. Submission to the International Agreements or Treaties signed by Spain.</li> </ol>
<b>B. Fiscal Harmonization</b>
<ol style="list-style-type: none"> <li>1. Respect the General Tax Law in matters of terminology and concepts.</li> <li>2. Use the same system for classifying livestock, mining, industrial, commercial, service, professional and artistic activities as is used in the so-called common territory.</li> <li>3. Respect and guarantee freedom of movement and establishment of persons and the free movement of goods, capital and services throughout the territory of Spain, without giving rise to discrimination or a lessening of the possibilities of commercial competition or to distortion in the allocation of resources.</li> <li>4. Maintain an overall effective fiscal pressure <i>equivalent</i> to that in force in the rest of the State.</li> </ol>

Source: Economic Agreement

The problem is further complicated because there is not a clear method to measure the level of distortion created by a tax difference. Simply, there is not a clear rule to determine how distortionary is, say, a two point reduction in the Corporation Income Tax rate or if this reduction is more distortionary (or less) than, for instance, an investment incentive.

<sup>90</sup> There will be a distortion whether the taxes in the *BCAC* are higher or lower than in the State.

The answer to the question of how much a tax difference distorts the competition or the spatial distribution of productive factors is not as evident as it may appear. In many countries, like for instance Switzerland, the *US* or Canada, there are substantial regional tax differences in both the personal and the Corporation Income Taxes. However, those differences do not seem to have hindered economic growth or disrupted market unity. Also, within the *EU* there are enormous differences among countries in personal and corporate taxes<sup>91</sup>. Again, this seems not to have undermined competition or economic growth. In fact, now the *EU* does not consider necessary to harmonize capital taxes, nor even to reduce differences in capital taxes<sup>92</sup>.

### 5.3.2. *Specific Harmonization Principles*

The specific harmonization rules limit the tax autonomy in each of the agreed taxes. Table 13 summarizes these limits. The Table shows that the *HTs* have full autonomy in all direct taxes. The only restriction is that they have to adopt the same withholding tax rates on capital income and capital gains that the State establishes in Common Territory. Beyond that, the Economic Agreement says that the *HTs* can design direct taxes as they want. In particular, the *HTs* can freely design the Corporation Income Tax (for firms subject to Basque tax rules<sup>93</sup>) and the Non Residents Income Tax (for non residents with a permanent establishment in the *BCAC*).

On the other hand, the tax autonomy of the *HTs* is very limited in the indirect taxes. All the components (tax rates, tax bases, deductions and so on) of the main indirect taxes (*VAT* and Manufacturing Excises) are determined by the State. The legislative autonomy in the gambling duties is full, and limited in the Capital Transfer Tax and the Stamp Duty. Finally, in the cases of the tax on Certain Means of Transport and the Retail Sales Tax on Certain Mineral Oils, the *HTs* can change the tax rates within some limits established by the Central Government. The autonomy in the indirect taxes is very limited because the *EU* Commission does not allow regional differences in the main indirect taxes.

Broadly speaking, therefore, the *HTs* of the Basque Country have almost full autonomy in direct taxes and almost no autonomy in indirect taxes. This is quite similar to what happens within the *EU*, where indirect taxes are more harmonized than direct taxes.

<sup>91</sup> In Ireland, for instance, the Corporate Income tax rate is 12,5% while in other *EU* countries is above 30% (France and Belgium, for instance).

<sup>92</sup> The *EU* gave up long ago any attempt to harmonize capital taxes. The objectives are now to avoid international double taxation (of corporate profits, interest and dividends), to ensure that delocalization of savings does not reduce the tax bill of the owner of the income (wherever savings are invested, savings income pay the tax rate of the country of the owner of the savings) and to reduce the so-called *harmful tax measures* (selective tax measures in the corporation tax). Although an agreement on this matter seems complicated, the European Commission also wants to eliminate the existing tax obstacles for companies operating in more than one Member State (introducing a common tax base for firms that operate in more than one country).

<sup>93</sup> Recall that as said in section 5.2, there are firms (mainly the large ones) paying taxes in the *BCAC* according to the tax rules of the central government.

**Table 13: Tax Autonomy of Foral Deputations (2010)**

<b>A. DIREC TAXES</b>	
1. Personal Income Tax	Full Autonomy except in capital income and capital gains withholding rates. The withholding tax rate on capital income and capital gains is established by the State. All the other components of the tax are freely decided by the Foral Deputations.
2. Wealth tax	Full Autonomy.
3. Corporation Income Tax	Full Autonomy for firms subject to Basque Tax Laws.
4. Non Residents	Full Autonomy in the case of non residents with a permanent establishment in the <i>BCAC</i> . None in other case.
5. Inheritance and Gift taxes	Full Autonomy.
<b>B. INDIRECT TAXES</b>	
6. VAT	Filing and payment forms. The <i>HTs</i> may also set payment deadlines, which shall not be substantially different from those set by the State.
7. Capital Transfer Tax and Stamp Duty	Full legislative Autonomy except in cases of certain company operations, bills of exchange and documents used in their stead or serving the purposes of a draft, which shall be regulated by States' legislation.
8. Insurance Premiums Tax	Filing and payment forms. The <i>HTs</i> may also set payment deadlines which shall not be substantially different from those set by the State.
9. Excises <sup>1</sup>	In the Excise Duty on Certain Means of Transport <sup>2</sup> , the Historical Territories can increase up to 15 points the tax rate set by the State. In the rest, filing, payment forms and payment deadlines which shall not be substantially different from those set by the State.
10. Excise Duty on Retail Sales of Certain Mineral Oils <sup>3</sup>	Tax rates within an interval established by the State.
11. Gaming Duties	Full Autonomy with the restriction that taxable events and taxable persons shall be those established at any given time by the State.

<sup>1</sup> The excises in Spain and in the Basque Country are: Alcohol and Alcoholic Beverages, Intermediate Products (also a tax on alcohol), Beer, Mineral Oils and Manufactured Tobacco, Electricity and Certain Means of Transport. <sup>2</sup> Is a tax paid upon the first registration of, basically, cars. <sup>3</sup> It is a tax on the retail sales of fuel

Source: Economic Agreement

It should be remembered that all the taxes agreed with the *HTs* are also subject to the general harmonization principles laid down in Table 12. In particular, the taxes of the *HTs* should not interfere with free market or distort the spatial distribution of inputs (capital and labour), and the fiscal pressure in the Basque country should be similar to that in the State. The attempt to conciliate these general principles of harmonization (Table 12) with the autonomy granted to the *HTs* in certain taxes (Table 13) is, to say the least, complicated. For instance, in the Corporation Income Tax it seems quite difficult to reconcile autonomy (as granted by the Economic Agreement and described in Table 13) with non distortion (as demanded by the Agreement and listed in B.3 of Table 12). If, for example, the *HTs* reduce the effective tax rate<sup>94</sup> on corporations, are they using the tax autonomy given to them by the Economic Agreement, or giving economic privileges that will distort the economy and are contrary to the Economic Agreement? The answer is that, with a strict interpretation of the non distortion concept, probably both. Because, as already mentioned, with that kind of interpretation, any Corporation Income Tax difference is distorting.

In the end, the problem is that there is an obvious conflict between a strict interpretation of the general principles of harmonization established in the Economic Agreement, and the tax autonomy that, at the same time, it grants to the *HTs*. This contradiction is at the heart of almost all the disagreements between the State and the Basque Territories about the lawfulness of many tax regulations of the *HTs*.

### 5.3.3. *Conflicts with the State*

Almost all the conflicts between the State and the *HTs* about the legality of the tax rules approved by the *HTs* have concerned the regulation of the Corporation Income Tax.

The *BCAC* has traditionally been one of the most industrialized regions in Spain. For that reason, it was specially hit by the economic crisis of the 80's and the recession at the beginning of the 90's. The consequence was that between 1980 and 1990 the *BCAC* per capita income (relative to the average of Spain) decreased nearly 15% and the unemployment rate reached almost 25%, well above the Spanish average. And things remained the same well through the nineties<sup>95</sup>. Like many countries of the *EU*, the *BCAC* tried to stimulate the economy reducing the effective tax rate of the Corporation Income Tax. As a result the Corporation Tax in the *BCAC* started to be lower than in the rest of Spain, and it has remained that way for a long time. The size of the differences has, though, changed over time. Now, although there are some significant differences, the Corporation Taxes in the *BCAC* and the State are more similar than in the past<sup>96</sup>.

<sup>94</sup> This can be done in several ways: reducing the nominal tax rate, increasing tax incentives (for investment or employment) or depreciation allowances, and so on.

<sup>95</sup> See section 8.1.

<sup>96</sup> The main differences are that the tax rate in the *HTs* (28%) is two points below the rate of the State (30%) and that the incentives in the *HTs* are higher than in Common Territory.

For many years the Central Government opposed any Corporate Tax reduction in the *HTs* and systematically brought actions before the national Courts asking for the annulment of the Corporate Tax provisions approved by the *HTs*. The argument was always that the Corporate Tax cuts of the *HTs* were distortioary and, therefore, contrary to the Economic Agreement (see B.3 in Table 12).

Navarre has also always had a Corporation Income Tax below that of the State, and often with tax provisions very similar to those of the *HT*. Perhaps surprisingly, the State has seldom brought any action against Navarre. Part of the difference of treatment between Navarre and the *HTs* can be explained because until 2010 the tax regulations of Navarre had a higher legal rank than the tax regulations of the *BCAC* and, therefore, were easier to suit in Court. The reason was that the tax regulations of Navarre are approved by a regional parliament and for that reason have the rank of Law. On the other hand, the tax regulations of the *HTs* are approved by the provincial Parliaments (not by the Basque Parliament) and for that reason until 2010 they had a lower legal status<sup>97</sup> (basically administrative provisions<sup>98</sup>). That difference was important because Tax Laws can only be appealed to the Constitutional Court while Tax Provisions can be appealed to the Contentious Administrative Court (which is a lower level Court). More importantly, almost anyone can bring an action against a Tax Provision (this includes trade unions and entrepreneur associations), while the right to bring an action against a Tax Law is much more restricted. Therefore, the regulations of the State, Navarre and all the common regime *ACs*<sup>99</sup> are Laws that can only be contested in the Constitutional Court while up to 2010 the tax regulations of the *HTs* were provisions that almost anyone could contest in a lower level Court.

The different legal status of tax regulations cannot, however, explain alone the continuous actions of the State against the Corporate Tax regulations of the *HTs* and the systematic acceptance of the Corporate Tax regulations of Navarre. Probably, there are other reasons, like a lack of political understanding between the State and the Basque Country, that explain these differences.

In any case from a legal viewpoint, the conflicts between the State and the *HTs* arise because, as already mentioned, the Economic Agreement is contradictory when, at the same time, says that the *HTs* can freely regulate the Corporation Income Tax but that the regulation should not distort the economy. The actions of the State have left the Courts the task of finding a reasonable balance between tax autonomy and no distortion. However, the Courts have been unable to find such a balance and many of their rulings have been contradictory and lacking much economic sense<sup>100</sup>. This is not surprising because what the judges were asked to

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<sup>97</sup> In 2010 the Spanish Parliament voted a Law that will give rank of Law to the tax regulations of the *HTs* despite not having been approved by a regional parliament.

<sup>98</sup> Their rank in Spanish is called *Norma*. For that reason, the tax regulations of the *HTs* are called *Normas Forales*.

<sup>99</sup> The Common Regime *ACs* also have some tax powers (see section 10.2).

<sup>100</sup> See Zubiri (2000) for more details.

decide was: (a) what is economic distortion, (b) how much distortion is consistent with the Economic Agreement and (c) how distortionary are different tax measures. However, none of the questions has an easy answer. In fact, in some cases it may not even have an answer<sup>101</sup>. The legal confusion is increased by the fact that the whole judicial process<sup>102</sup> may take more than a decade.

The result has been a considerable confusion and legal insecurity for firms subject to the tax rules of the *HTs*. A tax measure can be repealed one month or even one week before coming into effect. The measure enters then a judicial process that may take many years and with an outcome that is impossible to foresee because everything depends on how judges interpret what distortion is.

The reasonable way to solve these problems is with cooperation and trust between the State and the *HTs*. However, goodwill may evaporate soon when there is a change of political circumstances. A more pragmatic approach would be, simply, to interpret the meaning of tax distortion within Spain in the same sense the *EU* interprets distortion between countries. Then, a Corporate Tax measure adopted by the *HTs* would be distortionary only if it is selective. This simply would mean that the type of tax differentials between countries that the *EU* does not consider harmful to efficiency, are also allowed between the Basque Country and the State. Obviously, with that criterion the State could not have brought most of the actions it brought in the past against the tax regulations of the *HTs*.

Furthermore, as already mentioned, until 2010 due to the legal status of the tax regulations of the *HTs* almost any group or institution (trade unions, governments of other *ACs*, etc.) could bring an action against them. In the past, this has happened regularly<sup>103</sup>. To avoid it, the Basque authorities had long demanded a legal change so that the tax provisions of the *HTs* become Laws<sup>104</sup>. In 2010 the Spanish Parliament finally approved the necessary legal changes. This means the tax regulations of the *HTs* will have the same legal status as those issued by the State or other *ACs*. At the same time, the litigation on the Basque tax rules will be reduced substantially.

#### 5.4. Tax Harmonization among the Historical Territories

The Statute of Autonomy and the Economic Agreement transfer the taxes to the *HTs*. This means that, in principle, each Territory can have its own tax system different from the others. However, in 1989 the Basque Parliament approved

<sup>101</sup> For instance, it is not clear how much distortion introduces a difference of two points in the Corporation Tax rate or if that difference is more (or less) distortive than, say, an investment incentive.

<sup>102</sup> Since an action is brought against a tax measure until the Constitutional Court reaches a final decision.

<sup>103</sup> For instance, the government of La Rioja (a neighbouring *AC*) systematically brings an action against almost any change in the Corporation Taxes of the *HTs*.

<sup>104</sup> This has become known as the *armouring* (*blindaje*) of the Economic Agreement.

the *Tax Harmonization Law*<sup>105</sup> that allowed the Basque Parliament to eliminate, if necessary, essential differences among the tax systems of the *HTs* (for instance, in tax rates or the tax treatment of certain items). The Law also created the *Tax Coordination Body of the Basque Country*<sup>106</sup>. This institution is a Council made up of six representatives (three of the Basque Government and one of each Foral Deputation) whose function is to encourage fiscal harmonization, cooperation and collaboration among the Foral Deputations. According to the Law, the Foral Deputations have to inform the Tax Coordination Body of any tax change. Then, the Body has to issue a report confirming whether or not the projected reform complies with the Harmonization Law. If it does not and the reform is enacted the Basque Parliament could force the harmonization<sup>107</sup>.

In practice, the Harmonization Law has never been applied and the Territories have used the Tax Coordination Body to decide jointly the main tax elements. The result of this voluntary harmonization is that taxes are very similar (although not identical) in the three Territories.

## 6. FINANCIAL CAPACITY OF THE BASQUE COUNTRY

The Economic Agreement model gives rise to several transfers between the State (Central Government) and the *HTs*. The most important one is the Quota, which is the payment of the Basque Country to the State for its expenditures on behalf of the residents in the Basque Country. The other transfers are adjustments for the differences between what the *HTs* collect in taxes and what the residents in the Basque Country pay in taxes. Most of these transfers are from the State to the Basque Country. These differences are generally due to the definition of the points of connection.

The first part of this section analyzes in detail the transfers between the State and the Basque Country. The second part is devoted to the fiscal capacity of the Basque Country. That is, the tax collection of the Basque Country less the net balance of transfers to the State.

### 6.1. Financial Flows between the Basque country and the State

The main transfers derived from the Economic Agreement are the Quota (from the *HTs* to the State) and the adjustments for *VAT* and excises (from the State to the *HTs*). There are also other minor transfers like the share of the Basque municipalities in the revenue from non agreed taxes, the financial compensations or the share of the Basque Country in the revenue from national lotteries.

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<sup>105</sup> See Ley 3/1989, de 30 de mayo, de Armonización, Coordinación y Colaboración Fiscal.

<sup>106</sup> Órgano de Coordinación Tributaria de Euskadi.

<sup>107</sup> There is, though, some debate about whether or not the Parliament is legitimized to repeal a Tax Law approved by the Parliament of a *HT* (see, for instance, Juntas Generales de Gipuzkoa [2009]).



### 6.1.1. The Quota

The Quota is the amount the Basque Country has to pay the State for the expenditures made by the State on behalf of the residents in the Basque Country. The general principles to determine the Quota are laid down in the Statute of Autonomy and the Economic Agreement. The Quota is regulated by five year Acts based on those principles. The Act now in force is for the period 2007-2011<sup>108</sup>. All the Acts approved in the last 30 years are almost identical<sup>109</sup>, though.

#### A) General Principles

The Quota is the payment to the State for the expenditures on behalf of the residents in the Basque Country<sup>110</sup>. This suggests that the quota,  $Q$ , should be equal to:

$$Q = SE^{BC} \quad [1]$$

where  $SE^{BC}$  is the expenditure of the State that benefits the residents in the Basque Country. This expenditure ( $SE^{BC}$ ) is usually called *non assumed charges of the State (by the Basque Country)*.

However, equation [1] is not the Quota paid by the Basque Country. The Quota finally paid is given by:

$$Q = SE^{BC} - SR^{BC} - D^{BC} \quad [2]$$

where  $SR^{BC}$  is the revenue obtained in the Basque Country by the State, and  $D^{BC}$  is the part of the State deficit imputable to the non assumed charges.

Equation [2] adjusts the Quota for two factors. First, it deducts the revenues obtained by State in the Basque Country. These include non agreed taxes, charges, user fees and the non tax revenue (like income from property). The revenues also include an estimation of the taxes withheld by the State on the wages and interest paid by it (or any regional non foral government) to the residents in the Basque Country<sup>111</sup>.

Second, equation [2] subtracts the part of the non assumed charges financed with deficit. The reason is that if the deficit was not subtracted from the Quota, the Basque Country would be paying with taxes what the Central Government is paying with debt. Should that be the case, the Basque Country would bear the economic cost of the deficit of the State (inflation, rising interest rates and crowding out) without obtaining its benefits (delaying the payment of expenditures).

<sup>108</sup> See Five Year Quota Act 2007-2011.

<sup>109</sup> Even the main parameters to determine the quota (like the imputation index discussed below) have remained unchanged.

<sup>110</sup> It includes also a contribution to the solidarity among ACs.

<sup>111</sup> See Table 10 and Annex 1.



Since the deficit (on the non assumed charges) is subtracted from the Quota, the Basque Country has to pay the interest and repayment of the debt and loans taken to finance that deficit. Both items are considered non assumed charges and, therefore, increase the quota of subsequent periods<sup>112</sup>.

The deduction of withheld taxes in equation [2] is called *adjustment for direct taxes* and the deduction of Central Government revenues and deficit, *compensations*.

Equation [2] shows that, to be precise, the Quota is the payment of the Basque Country for the tax financed expenditures made by the State in benefit of the Basque Country, not covered by the revenues of the State in the Basque Country.

The measurement of the non assumed charges ( $SE^{BC}$ ), the State revenues in the Basque Country ( $SR^{BC}$ ) and the part of the deficit due to the non assumed charges ( $D^{BC}$ ) in equation [2] is made using an *imputation method*. This method does not measure the actual value of each relevant variable in the Basque Country. Instead, it measures the value of the variable for all Spain and imputes a fixed percentage to the Basque Country. For instance, instead of measuring how much the State invests in the Basque Country (in a non assumed charge), it is measured how much it invests in all Spain and then it is assumed that a fixed percentage of that is spent in the Basque Country. The percentage,  $i$ , imputed to the Basque Country is called *imputation index*. The same imputation index is used for all the variables (non assumed charges, revenues of the Central Government in the Basque Country and deficit). Since 1981 the imputation index used has been always 6.24%. Therefore for the determination of the Quota it is assumed that:

$$SE^{BC} = 0.0624SE^E \quad SR^{BC} = 0.0624SR^E \quad \text{and} \quad D^{BC} = 0.0624D^E \quad [3]$$

where  $SE^E$  is what the State spends in all Spain in competencies not assumed by the Basque Country,  $SR^E$  is what it obtains in all Spain from revenues not agreed with the Basque Country and  $D^E$  is the deficit of State budget.

In practice, for simplicity, the expenditure of the State in Spain in competencies not assumed by the Basque Country (the non assumed charges) is determined as the difference between the total expenditure of the State (its budget) and the expenditure of the State in competencies assumed by the Basque Country. That is, if  $SE^T$  is the budget of the State and  $SE^{NE}$  the part of the budget of the State spent in competencies assumed by the Basque Country (that is, in goods and services provided in the Basque Country by the Basque Government or the Foral Deputations), the non assumed charges,  $SE^E$ , are computed as<sup>113</sup>:

$$SE^E = SE^T - SE^{NE} \quad [4]$$

<sup>112</sup> The Quota could have been defined without subtracting the deficit and not including the interest and debt repayment in the non assumed charges. In that case, though, the Basque Country would stand the economic cost of central government deficit without any gain.

<sup>113</sup> See annex 1 for further details.

With the imputation method, the Quota becomes:

$$\begin{aligned} NQ &= iSE^E - iSR^E - iD^E \\ &= 0.0624SE^E - 0.0624SR^E - 0.0624D^E \\ &= 0.0624(SE^E - SR^E - D^E) \end{aligned} \quad [5]$$

The amount [5] is called the *Net Quota (NQ)*. It is not, however the final payment of the Basque Country because there are several additional deductions (called compensations). First, there are compensations for various possible causes such as new competencies assumed by the Basque Country, the share of the Basque Country in some transfers from the State<sup>114</sup> or the share in the Social Security contributions that before 2002 financed Health<sup>115</sup>. Second, there is a compensation to Alava for some specific competencies only assumed by this *HT*<sup>116</sup>. The difference between the Net Quota and these additional compensations (*ACOM*) is called *Net Quota Payable (NQP)*. Therefore:

$$NQP = 0.0624(SE^E - SR^{BC} - D^E) - ACOM = NQ - ACOM \quad [6]$$

In practice the Quota is not determined calculating [6] every year. What is done is to approve five-year Quota Acts. The computation of [6] is done just for one year (called the base year) and the Quota of the other four years is obtained simply updating the Quota of the base year. Therefore, for every five-year period, the determination of the Quota is made in two steps:

Step 1: The *Net Quota Payable (NQP)* of the first year of the five-year period (the base year<sup>117</sup>) is calculated using equation [7]. Calling 1 to that first year, the Quota of the base year will be:

$$NQP_1 = 0.0624 (SE_1^E - SR_1^E - D_1^E) - ACOM_1 = NQ_1 - ACOM_1 \quad [7]$$

where  $SE_1^E$  is the sum allocated in the base year State budget to competencies not assumed by the Basque Country,  $SR_1^E$  is the budget figure for revenues non agreed with the Basque Country,  $D_1^E$  is the budget deficit<sup>118</sup> and  $ACOM_1$  are the additional compensations in the base year. Annex 1 gives the details of how the Quota in the base year (2007) of the period 2007-2001 was calculated.

<sup>114</sup> The State may give a transfer to all ACs to improve a given service (for instance, Health or Social Services). Then, usually, the Basque Country receives a compensation in the Quota equal to the transfer it would have to receive from the State.

<sup>115</sup> In Spain, before 2002 a part of the Social Security Contributions was used to finance Health and Social Services. The rest was used to pay pensions and unemployment benefits. The Basque Country received a share of the contributions used for Health and Social Services because it provided those services. In 2002 there was a reform and all the Contributions were devoted to pensions and unemployment benefits. The Basque Country lost then its share in the Social Security Contributions. To compensate the Basque Country, it was agreed to introduce a deduction from the Quota equal to the loss of Social Security Contributions.

<sup>116</sup> This amount goes exclusively to the *HT* of Alava.

<sup>117</sup> If the State budget of the first year is not approved at the time of writing the five year Act, the base year used is a year prior to the five-year period. The Quota of all the years of the five year-year period is then obtained updating the base year Quota (step 2).

<sup>118</sup> If there was a surplus,  $D_1^E$  would be negative and, therefore, it would increase the Quota.

Step 2: The Quota of the other years is calculated updating the Net Quota of the base year and subtracting the compensations of the year. The updating index of any year is equal to the ratio between that year State collection (in all of Spain) of taxes that have been agreed with the Basque Country, and that same collection in the first (base) year<sup>119</sup>. Therefore, the Quota to be paid in year  $t$  is:

$$NQP_t = NQP_1(1+\alpha_t) - ACOM_t = NQ_t - ACOM_t \quad [8]$$

where  $ACOM_t$  are the additional compensations in year  $t$ <sup>120</sup> and  $\alpha_t$  is the updating index defined as:

$$\alpha_t = \frac{ATC_t}{ATC_1} \quad [9]$$

where  $ATC_1$  and  $ATC_t$  are what the State collects (in all of Spain) from agreed taxes<sup>121</sup> in, respectively, the first (base) year and year  $t$ .

The Quota is set provisionally using the initial State budget data on expenditure ( $ACOM$ ) and revenue ( $ATC$ ). The initial Quota is called *provisional Quota*. This initial Quota is settled once the actual revenue and expenditure of the State become known. The resulting quota is called *definitive Quota*.

### B) Imputation Index

The imputation index is the percentage of the non assumed charges (including a contribution to solidarity) paid by the Basque Country. That is, the share of State expenditures in non assumed competencies that the Basque Country pays. In theory the contribution of the Basque Country to State expenditures could be determined progressively, regressively or neutrally. In the first case, the contribution of the Basque Country would be proportional to its wealth, and the imputation index should be the relative (to the total of Spain) income of the Basque Country. A second possible choice would be to set the contribution proportional to the population of the Basque Country. The contribution would then be regressive (in terms of income) and the imputation index would be the relative population of the Basque Country. Finally, the contribution of the Basque Country could be determined expenditure by expenditure according to the estimated benefit pattern of the expenditure. The imputation index of each expenditure would then be income, population or other depending on whether the benefits of the expenditure are proportional to income (like, for instance, the Spanish contribution to the *EU*),

<sup>119</sup> The Quota Act says that the updating index is the ratio between expected revenues from taxes covered by the Economic Agreement, excluding those transferred in their entirety to the (common regime) Autonomous Communities, as stated in Chapters I and II of the State Budget for the tax year to which the net quota refers, and the duly adjusted revenues expected by the State for the same tax items in the base year of the five year period.

<sup>120</sup> The compensations are updated according to their real value, not using an index.

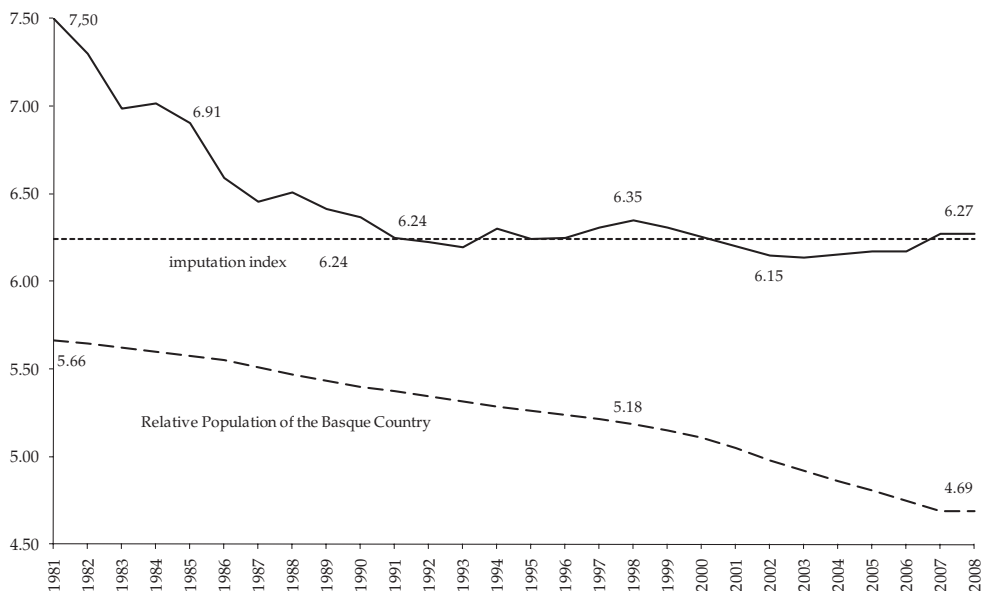
<sup>121</sup> The tax collection of the State is net of the share of the common regime  $ACs$  in the taxes collected by the State. Obviously  $ATC$  does not include the taxes agreed with the Basque Country that in other regions have been transferred to the  $ACs$  (Wealth tax, Inheritance and Gift Tax, Capital Transfer Tax and Stamp duty, Gambling Taxes and several Excises).

proportional to population (like, probably, in the case of foreign relations) or proportional to other variable<sup>122</sup>. The contribution of the Basque Country would be based on the benefit principle and, therefore, would be neutral from a distributive viewpoint.

Among the three options, the Economic Agreement chooses the first one and, as already said, establishes that the imputation index “shall be determined basically in accordance with the income of the Historical Territories relative to that of the State”<sup>123</sup>. In practice, however, the imputation index has been basically a political agreement and not the result of any formula. The most obvious evidence of this is that the value of the imputation index has never been changed in the almost 30 years of application of the Economic Agreement. It was set at 6.24% in 1981 and that value has been maintained since then.

Figure 3 explores the relationship between the imputation index and the relative income and population of the Basque Country. In 1981 the relative income of the Basque Country was 7.5% and the relative population 5.66%. The imputation index chosen was 6.24% which is almost halfway between them. It seems reasonable to conjecture that the 6.24% was a political compromise between the progressive (income) and regressive (population) indices.

**Figure 3: Relative GDP and Relative Population of the Basque Country (% over total of Spain) 1981-2008**



Source: Population and GDP of INE (www.ine.es)

<sup>122</sup> Obviously, in many cases it is difficult to agree on a pattern of benefits. For instance, it is not clear if defence or justice is more valuable to the rich (and therefore should be paid for in proportion to income) or it is equally valuable to all (and paid for in a per capita basis).

<sup>123</sup> See art 57 of the Economic Agreement.

However, time has changed things. As Figure 3 shows, the relative population of the Basque Country has been decreasing since 1981<sup>124</sup> going from 5.66% in 1981 to 4.69% in 2008. Until 1991 the relative income also decreased from 7.5% to 6.24%. Since then, the relative income has fluctuated around 6.24%. Obviously, the decline of relative population combined with the constancy of relative income has led to an increase in the relative per capita income of the Basque Country<sup>125</sup>.

In any case, due to the decrease in the relative income of the Basque Country, since 1991 the imputation index is basically equal to the relative income of the Basque Country. This simply means that the Basque Country contributes to the expenditure of the State according to its ability to pay. The imputation index is then progressive and contains a contribution to the solidarity among ACs<sup>126</sup>.

### C) Size of the Quota

Table 14 shows the size of the Quota in the period 1997-2009<sup>127</sup>. Between 1999 and 2007, the Quota has been equal to about 2.5% of GDP and 11.5% of the agreed taxes. In the year 2007 the total payment was almost 1,600 millions of Euros, which amounted to almost 750 Euros per resident in the Basque Country.

The 2.5% of GDP and 11.5% of the Agreed Taxes are the figures that characterize the Quota in *normal* times. However, the economic crisis that started in 2008 changed things significantly and in just two years the Quota halved as a percentage of both GDP and Agreed Taxes. The reason is that the Quota increases, basically, at the same rate as the State collection of Agreed taxes (see equation [9]). The sharp drop in the State tax collection explains the decrease of the Quota as a percentage of GDP<sup>128</sup>. On the other hand, the fact that the tax collection in the Basque Country fell less than in the State (strictly speaking less than the updating index [9]) explains the decrease of the Quota as a percentage of the Agreed Taxes collected by the Basque Country.

The evolution of the Quota in the last two years illustrates well the meaning and importance of what has been called *unilateral risk*<sup>129</sup> (borne by the Basque Country). The Quota increases at the rate of the tax collection of the State. It is independent, then, of the tax collection of the Basque Country. If the Basque Country increases its tax collection faster than the State, it keeps all the extra revenue.

<sup>124</sup> In absolute terms, the population has oscillated around 2,1 million people since 1981.

<sup>125</sup> For further details, see section 7.1.

<sup>126</sup> In the non assumed charges there is also a contribution to solidarity because the so called Inter-Territorial Compensation Fund (a fund created to finance investments in poor ACs) is considered a non assumed charge.

<sup>127</sup> The Quota depends basically on what the State spends and collects in the Basque Country. Up to 1997 the State collected in the Basque Country many excises and the Quota prior to that year is not comparable to the Quota afterwards.

<sup>128</sup> Tax collection in Spain dropped from 37.2% of GDP in 2007 to 33% in 2008 and to 30% in 2009. No other developed country in the world experienced an even barely comparable decrease of tax collection.

<sup>129</sup> See section 6.2.

If, on the other hand, its collection increases more slowly, the Basque Country stands all the cost. For example, if in the years 2008 and 2009 the tax collection in the Basque Country had decreased faster than in the State, the Quota would have increased (as a percentage of the tax collection of the Basque Country).

**Table 14: The Quota<sup>1</sup> (1997-2009)**

	Euros		As a percentage of	
	Millions	Per capita	GDP	Agreed Taxes
1997	742.2	358	2.4	12.6
1998	753.3	364	2.2	11.1
1999	836.6	404	2.3	11.4
2000	932.0	449	2.3	11.6
2001	979.7	471	2.3	11.9
2002	1064.2	510	2.4	12.3
2003	1123.3	537	2.3	12.2
2004	1188.8	566	2.3	12.0
2005	1357.0	644	2.4	12.0
2006	1497.7	707	2.5	11.9
2007	1595.9	749	2.5	11.6
2008	1172.9	548	1.7	9.1
2009	721.8	339	1.1	6.7

<sup>1</sup> Net Quota payable after settlement. Does not include the compensation to Alava.

Source: OCTE (several years), webhacienda y webgipuzkoa. MEH (several years) and INE.

### 6.1.2. The VAT Adjustment

The VAT collected by the HTs differs from the VAT paid by the residents in the Basque Country for two reasons:

- a) The VAT on imported goods (from outside the EU) is collected by the State, but some of those goods are consumed in the Basque Country. To give the Basque Country its share on that VAT revenue, the State makes a transfer equal to the relative (to the total of Spain) consumption of the Basque Country multiplied by the VAT collected on imported goods. This transfer is called the *VAT Adjustment for Imported goods*.
- b) The VAT is a tax on consumption (of the individuals) that is collected through a tax on the value added (of the firms). Therefore, the VAT collected by the Basque Country is basically proportional to the value added created by the firms in the region. On the other hand, the VAT paid by the residents in the Basque Country is proportional to their consumption. It is necessary, then, to adjust for the differences between consumption and value added of the Basque Country. According to the economic data, the

relative consumption of the Basque Country is larger than the relative VAT base (basically value added less exports) in the Basque Country<sup>130</sup>. This means the residents in the Basque country are paying more VAT than what the HTs are collecting, and the State has to make a transfer for the difference. This transfer is called the *VAT Adjustment for Internal Market*<sup>131</sup>.

The VAT adjustment is simply the sum of the adjustments for imported goods and internal market. Annex 2 gives the technical details of this adjustment.

### 6.1.3. Other financial flows

The Quota and the VAT are the main financial flows between the Basque Country and the State<sup>132</sup>. There are, however, other transfers between both regions:

- a) *Adjustment for Excise Duties*. As in the VAT, in the five basic excises<sup>133</sup> there is an adjustment for the differences between what the Basque Country collects and what the Basque residents pay. These adjustments are calculated with the same methodology used in VAT adjustment. Thereby, for each of the excises, the Basque Country receives a share (equal to the relative consumption of the taxed good<sup>134</sup>) on the collection on the imports of the good, and receives (or pays) a compensation for the difference between the relative tax base<sup>135</sup> of the good in the Basque Country and the relative consumption of Basque residents. The adjustment for mineral oils is negative (implying a transfer from the Basque Country to the State) and all the other adjustments are positive. The sum of all the excise adjustments is negative and, therefore, the final result is a transfer from the Basque Country to the State.
- b) *Share of the Basque Municipalities in the non agreed fiscal revenues*. In Spain one of the resources of the municipalities is a share on the taxes of the State. The HTs pay the share of Basque municipalities in the agreed taxes<sup>136</sup>. There are, however, some fiscal revenues that have not been agreed and the State makes a transfer to Basque Municipalities for their share on those non agreed fiscal revenues.

<sup>130</sup> This means that the Basque Country is a net importer of goods from the rest of Spain.

<sup>131</sup> This adjustment is equal to the one that would have to take place among countries if, as intended by the commission, the VAT in the EU was paid at origin.

<sup>132</sup> Notice that the Quota is a transfer from the Basque Country to the State, while the VAT goes the other way around.

<sup>133</sup> Excises on Alcohol and Alcoholic Beverages, Intermediate Products, Beer, Mineral Oils and Manufactured Tobacco. The adjustment for the two first excises (Alcohol and Alcoholic Beverages and Intermediate Products) is made jointly, so that in practice there are only four adjustments.

<sup>134</sup> Obviously, relative to all Spain. That is, equal to  $C_{BC}/C_S$  where  $C$  is the consumption of the good in the Basque Country or Spain.

<sup>135</sup> Manufacturing excises are paid by manufacturers, importers, and keepers of bonded warehouses for dutiable products. Obviously, in general, the places of collection and consumption are different.

<sup>136</sup> See section 7.3 for details.



- c) *Financial Compensations*. The excises were transferred to the HTs in 1997. At the time it was agreed that the transfer should not change substantially (up or down) the resources of the Basque Country. To ensure the financial neutrality of the transfer of the excises, it was established a system of compensatory payments between the Basque Country and the State<sup>137</sup>. Those payments could be in either direction. In practice, the financial compensation for mineral oils is paid by the Basque Country and the compensation for all the other excises is paid by the State. The balance is, though, favourable to the Basque Country.
- d) *Other transfers*. Outside de Economic Agreement there are other transfers such as conditional transfers for joint investment programs, or the share of the Basque Country in the revenue from national lotteries.

#### 6.1.4. The Balance of Economic Flows

Table 15 gives the size of the transfers between the State and the Basque Country. The Quota is a transfer made by the Basque Country, while all the other transfers are made by the State. As the Table shows the two basic transfers are the Quota and the VAT adjustment. The other transfers play a minor role.

In 2003 and 2004 the Basque Country had a surplus. That is, it received a net transfer from the State. This, however, does not mean that the State was subsidizing the Basque Country. It simply means that what the State collected from residents in the Basque Country was larger than its *tax financed*<sup>138</sup> expenditure in favour of residents in the Basque Country.

**Table 15: Financial Flows Between the State and the Basque Country (2003-2009)<sup>1</sup>**

	2003	2004	2005	2006	2007	2008	2009
1. Quota	1123.3	1188.8	1357.0	1497.7	1595.9	1172.9	721.8
2. VAT Adjustment	1163.5	1241.3	1212.7	1208.9	1176.3	1092.2	768.9
3. Excises Adjustments	-88.9	-63.0	-52.3	-56.0	-106.9	-123.5	-114.5
4. Other	62.2	66.9	72.6	75.5	98.3	na	na
<b>5. Net Payment of the BC (NPBC) = 1-2-3-4</b>	-13.4	-56.3	124.0	269.3	428.2	204.2	67.4
6. NPBC per capita <sup>2</sup>	-6.4	-26.8	58.8	127.2	201.0	95.5	31.5
7. NPBC as % of GDP	-0.03	-0.11	0.22	0.44	0.66	0.30	0.10

<sup>1</sup> Millions of Euros. <sup>2</sup> Euros

Source: OCTE (several years), webhacienda, MEH (several years) and INE

<sup>137</sup> The payments are equal to the compensations of 1997 updated according to variation of the collection of each excise. Who pays and who receives the compensation depends, therefore, on the situation in 1997.

<sup>138</sup> Recall that the State deficit is subtracted from the Quota so that it only pays for the expenditures financed with taxes.



Since 2004 the balance has changed, and the Basque Country has been giving a transfer to the State. At the beginning, when Spain was growing at a high rate, the Quota rose quickly<sup>139</sup> and the net transfer from the Basque Country to the State increased every year. The economic downturn of 2008 and the sharp drop in the tax collection of the State<sup>140</sup> brought about a decrease in the net transfer from the Basque Country that, nevertheless, remained positive.

In any case, positive or negative, the net balance always has been small. The main transfers from both governments, the Quota and the VAT, are roughly of the same order of magnitude, and as a result the net balance (in either direction) almost never reaches 0.5% of GDP.

## 6.2. Financial Capacity of the Basque Country and the unilateral risk

The financial capacity of the Basque Country ( $R^{BC}$ ) is equal to its tax collection<sup>141</sup> ( $T^{BC}$ ) minus the Quota ( $Q$ ) paid to the Central Government plus/minus other transfers between the State and the Basque Country<sup>142</sup>, ( $OT$ ):

$$R^{BC} = T^{BC} - Q \pm OT \quad [10]$$

As shown in section 6.1.1 the Quota is equal to the part of the *tax financed* State expenditure that benefits the residents in the Basque Country, net of the revenues obtained by the Central Government in the Basque Country. The Quota, in the base year depends, therefore, on three elements (see equation [5]):

- a) What the State spends *in all Spain* in competencies not assumed by the Basque Country.
- b) What the State collects *in all Spain* from taxes agreed with the Basque Country
- c) The Deficit *in all Spain* of the State budget<sup>143</sup>.

The evolution of the Quota in the remaining years of each five year Quota Act, depends on:

- d) The increase of the State collection in Spain from taxes agreed with the Basque Country<sup>144</sup>. That is, taxes that in the Basque Country are collected by the Foral Deputations and in the rest of Spain by the State.

Obviously, a), b) c) and d) do not depend on what the HTs collect from Agreed Taxes. That is, the Quota depends on what the State spends and collects (in all

<sup>139</sup> Because it increased at the rate of a State tax collection that was increasing rapidly.

<sup>140</sup> As already mentioned, seven points of GDP in just two years.

<sup>141</sup> Obviously, the tax collection of the Basque Country includes the VAT and Excise adjustments.

<sup>142</sup> Those included in lines 2 to 4 of Table 15.

<sup>143</sup> As explained in section 6.1.1. the Quota is obtained basically imputing the 6.24% of a) to c) to the Basque Country ( $Q = 6.24\%(a-b-c)$ ).

<sup>144</sup> The Agreed Taxes that in Common Territory have been transferred to the ACs are excluded from the calculation. See equation [8] for more details.

Spain) but not on what the *HTs* collect. One implication of this is that the tax changes made by the *HTs* (an increase or decrease of any tax) do not change the Quota.

As it is evident from section 6.1.3, the same is true for the other transfers, *OT*, in equation [10]. Or, to say it another way, *OT* does not depend on how much the *HTs* collect. Since neither the Quota nor the Other Transfers depend on what the *HTs* collect, any change in the tax collection of the *HTs* ( $\Delta T^{BC}$ ) produces an equal change of the resources available to the Basque Country ( $\Delta R^{BC}$ ). That is:

$$\Delta R^{BC} = \Delta T^{BC} \quad [11]$$

This implies that the Basque Country keeps every euro of increase in its tax collection and loses every euro of decrease in its tax collection. And it does not matter whether the additional (reduced) collection comes from a higher (lower) economic growth or from a tax increase (cut) made by the *HTs*.

Hence, there is a basic asymmetry in the consequences of a change in the tax collection of the *HTs*. The resources obtained by the State in the Basque Country (almost exclusively the Quota) are independent of how much the *HTs* collect. On the other hand, every change in the tax collection of the *HTs* translates in an equal change in the resources of the Basque Country. This simply means that the Basque Country assumes all the collection risks associated with changes in the economic situation. Obviously, as already mentioned, the Basque Country also assumes fully the financial consequences of any tax change<sup>145</sup>.

Since the Basque Country assumes all the collection risks, the Economic Agreement implies that there is a *unilateral risk* (assumed by the Basque Country). Simply, if the tax collection in the Basque Country grows faster than in the rest of Spain the Basque Country keeps all the additional revenue. Conversely, if the tax collection grows more slowly than in the rest of Spain, the Basque Country bears all the cost.

Table 14 provides a good illustration of the implications of the *unilateral risk*. Since the tax collection of the State fell more than the tax collection of the *HTs*, the Quota decreased as a percentage of the tax collection of the *HTs*. If the tax collection of the *HTs* had fallen more, the Quota would have increased (as a percentage of the tax collection of the *HTs*).

## 7. DISTRIBUTION OF AGREED RESOURCES AMONG THE BASQUE LEVELS OF GOVERNMENT

Due to historical tradition, the Basque Public Sector has been organized in such a way that there are three levels of governments spending (Basque Government, Foral Deputations and Municipalities), but only one (Foral Deputations) collecting

<sup>145</sup> Recall that the tax changes can be made by the *HTs* (direct taxes) or by the State (indirect taxes).see Table 11.

taxes<sup>146</sup>. The Basque Country also has to pay a joint Quota to a fourth level of Government (the Central Government or State). As a result, there is a complex set of transfers from the Foral Deputations to other levels of governments.

The basic principles to divide the revenue from Agreed Taxes among the Basque levels of government are set in the Law of Historical Territories (1983)<sup>147</sup>. These principles are the base of Contribution Acts (*Leyes de Aportaciones*) approved every five years. Each Contribution Act determines, for the following five years, how much of their tax collection the Foral Deputations have to transfer to the other levels of government, and how much of the Quota each Foral Deputation has to pay. The Act now in force is for the period 2007-2011<sup>148</sup>. In practice, though, all the Contribution Acts approved so far have been almost identical

The starting point of the division of resources is the principle that, as established by the Law of Historical Territories, all the Agreed Revenues<sup>149</sup>, no matter who collects them, are considered joint revenues of all the Basque levels of government (Basque Government, Foral Deputations and Municipalities). This way, if  $R_i$  is the amount collected from Agreed Taxes by the  $i^{\text{th}}$  Foral Deputation ( $i= 1,2,3$  for Alava, Biscay and Guipuzcoa) the joint resources of all Basque Public Administrations are:

$$R = \sum_i^3 R_i \quad [12]$$

To determine the common resources to be shared, three quantities are subtracted from [12]:

- a) The Quota ( $Q$ ) paid to the State. Since the Quota is a joint payment, it is deducted<sup>150</sup> from the common resources to be distributed.
- b) The value of the additional cost<sup>151</sup> of the autonomous Police and any extra financing given by the Central Government to expenditure competencies of the Basque Country ( $\Delta V$ ). The idea of this adjustment is that the additional resources for some competencies will not be shared. Instead, those resources will be given to the level of government that has the competency<sup>152</sup>.

<sup>146</sup> This refers to the agreed taxes because the municipalities collect local taxes. The Basque Government also collects a tax on gambling. See section 4.3 for more details.

<sup>147</sup> See Ley de Relaciones entre las Instituciones Comunes de la CAPV y Organos Forales de sus TT.HH. (1983).

<sup>148</sup> See Ley de Aportaciones 2007-2011.

<sup>149</sup> This is basically equal to the Agreed Taxes. It includes, though, a very small amount of bank interests produced by the collection of agreed taxes.

<sup>150</sup> What is deducted in a given year is the provisional net payable quota plus/less the results of the settlement of the net payable quota of the previous year.

<sup>151</sup> This additional cost is measured in comparison to the cost in 2002.

<sup>152</sup> If it is a competence of the Basque Government the additional cost of provision will be paid for later by the Foral Deputations via additional Contributions.

- c) Special Deductions ( $P$ ). Some expenditure policies of the Basque Government have a special financing<sup>153</sup>. The cost of these policies is subtracted from the common resources and financed with special contributions. The deductions include the cost of policies to promote economic development and the cost of measures aimed at ensuring the political and economic stability of the Basque Country.

After deducting a) to c) from [12], the agreed resources to be distributed,  $RS$ , become:

$$RS = R - (Q - \Delta V - P) = R - (\Delta V^{BG} - \Delta V^{FD} - P) \quad [13]$$

where the extra cost (or financing<sup>154</sup>),  $\Delta V$ , has been divided into extra cost of the Basque Government,  $\Delta V^{BG}$ , and extra cost of the Foral Deputations,  $\Delta V^{FD}$ . The common resources [13] are distributed in three steps:

- a) In the first step  $RS$  is distributed between the Basque Government and the Foral Deputations. The method to divide the resources between the Basque Government and the Foral Deputations is called the *vertical model of distribution*.
- b) All the Agreed Revenues are obtained by the Foral Deputations. In the first step it has been determined how much of those resources belong to the Basque Government. The second step is, then, to decide how much has to pay each Foral Deputation of the total resources that the Basque Government has to receive. The rules established to determine the contribution of each Foral Deputation are called the *horizontal model of distribution*. The amounts paid to the Basque Government by the Foral Deputations are called Contributions (*Aportaciones*).
- c) The resources of each Foral Deputation are equal to its tax collection minus what it pays the State (the share of the Quota paid by the Foral Deputation) and the Basque Government (the Contribution). The final step is to determine how much money each Foral Deputation has to give to the municipalities in its Territory. The Contribution Acts always recommend a minimum transfer but Foral Deputations are free to give the municipalities any amount they want<sup>155</sup>. They can also establish the criteria to distribute the municipal transfers among their municipalities. In practice, there are differences among the *HTs* in both, the amount of resources given to the municipalities and the criteria used to distribute these resources among them.

<sup>153</sup> They are mostly non recurrent expenditures.

<sup>154</sup> Notice that both an extra cost of a competence of the Basque Country, and an extra financing of a competence (the central government giving more resources to finance a competence) result in a reduction of the Quota.

<sup>155</sup> The Contribution Acts recommend the Foral Deputations to give at least 54.7% of their resources to the municipalities. It is a non binding recommendation but in practice all the Deputations follow it. See 7.3 below.

## 7.1. The Vertical Model

From the viewpoint of financing, the Basque Government has two types of expenditure competencies. First, there are general competencies that have to be financed with common revenues ( $RS$ ). Second, there are some special competencies ( $\Delta V^{BG}$ ) and expenditures ( $P$ ) that receive specific financing.

The general expenditure competencies of the Basque Government are financed with its share in the common resources,  $RS$ . The distribution of the common resources between the Basque Government and the Foral Deputations is based on the relative importance of the expenditure competencies of each level of government. Simply, it is estimated how much each level of government needs to spend on its competencies, and each one receives a share on the common resources equal to its relative needs. The resulting shares are called *vertical coefficients*.

To be precise, if  $E^{BG}$  and  $E^{FG}$  are the estimated needs of, respectively, the Basque Government and the Foral Deputations, the vertical coefficients of the Basque Government ( $\pi^{BG}$ ) and the Foral Deputations ( $\pi^{FD}$ ) will be,

$$\pi^{BG} = \frac{E^{BG}}{E^{BG} + E^{FD}} \quad \pi^{FD} = \frac{E^{FD}}{E^{BG} + E^{FD}} \quad [14]$$

The vertical coefficients are calculated in the Contribution Acts and, therefore, are modified only every five years. In the Act for the period 2007-2011 it has been established that the Basque Government will receive 70.04% of the common resources and the Foral Deputations (jointly) the remaining 29.96%. Up to now, the historical tendency has been an increase in the share of the Basque Government in the common resources<sup>156</sup>.

The result of multiplying the vertical coefficient of the Basque Country by the common resources is called *General Contribution* ( $GC$ ) (from the de Foral Deputations to the Basque Government). In addition to that, the Foral Deputations have to finance directly some competencies ( $\Delta V^{BG}$ ) and expenditures ( $P$ ). The resources to finance those competencies and expenditures are called *Specific Contributions* ( $SC$ ). The total resources that the Foral Deputations contribute to the financing of the Basque Government,  $R^{BG}$ , are then:

$$R^{BG} = 0.7004RD + (\Delta V^{BG} + P) = GC + SC \quad [15]$$

## 7.2. The Horizontal Model

The amount  $R^{BG}$  is what the three Foral Deputations have to transfer jointly to the Basque Government. In principle, it may seem reasonable that each Foral Deputation paid a share of this total equal to its relative collection of Agreed Revenues. Then, the  $i^{th}$  Foral Deputation would pay a share  $R_i/R$  of the total Contribution ( $R^{BG}$ ). However, this would mean that as the tax collection of a Foral Deputation

<sup>156</sup> The evolution of the share of the Basque government has been 64.25% (1986-88), 65.14% (1989-1991), 66.30% (1992-96), 66.25% (1997-2001), 70.44% (2002-06), 70.04% (2007-11).

decreases, so does the share of the expenditures of the Basque Government it pays. This would introduce incentives to lower effective taxation, either reducing the nominal tax rates or via poor administration. To eliminate these disincentives, the share of the Contribution paid by each Foral Deputation is determined using indicators of tax capacity instead of the actual tax collection. The shares of the Foral Deputations are called *Horizontal Coefficients of Contribution*. The coefficient of each *HT*,  $\alpha_i$  ( $i=1,2,3$  for Alava, Biscay and Guipuzcoa) is determined according to the following formula:

$$\alpha_i = 0,7 \frac{Y_i}{Y} + 0,3 \frac{TC_i / FE_i}{\sum_{i=1}^3 (TC_i / FE_i)} \quad [16]$$

where  $Y_i$  is the income in the  $i^{\text{th}}$  *HT*<sup>157</sup>,  $Y$  ( $= \sum Y_i$ ) is the total income of the Basque Country,  $TC_i$  the relative tax capacity of the  $i^{\text{th}}$  *HT*<sup>158</sup>, and  $FE_i$  the tax level in  $i^{\text{th}}$  *HT*<sup>159</sup>.

According to this formula, 70% of the Contribution of each *HT* depends on its relative income and 30% on its relative tax effort. The horizontal coefficients  $\alpha_i$  are used not only to pay the Contributions to the Basque Government but also to divide the Quota among the *HTs*.

To ensure that there are not large differences between the horizontal contribution coefficients and the actual collection shares, there are two adjustments:

- a) The collection in the Basque Country of the main indirect taxes (manufacturing excises, *VAT* and Excise Duty on Retail Sales of Certain Mineral Oils) is redistributed among the *HTs* using the horizontal coefficients<sup>160</sup>. After this redistribution, each *HT* obtains a share of those taxes equal to its horizontal coefficient. The result is that what a *HT* finally obtains from the main indirect taxes is independent of its actual tax collection.
- b) There is a fund, called *General Fund of Adjustment*, to ensure that the share of any *HT* in total tax collection (after the adjustment described in the previous paragraph and the transfer from the fund) is equal to at least 99% of its horizontal coefficient. The Fund is endowed with contributions from the Basque Government (according to its vertical coefficient) and from the Foral Deputations whose relative tax collection is above 99% of its horizontal coefficient. The maximum size of the Fund is 1% of the common resources to be shared (*RS*)<sup>161</sup>. Traditionally this Fund benefited Biscay. In the last years, however, the beneficiary has been Guipuzcoa.

<sup>157</sup> Measured as the average *GPD* of the four last years.

<sup>158</sup> It is measured using indicators of the relative base of each tax in each *HT*. Most of the indicators are taken from regional accounts or other statistical sources.

<sup>159</sup> Measured as the tax to *GDP* ratio.

<sup>160</sup> The *VAT* and excise adjustments are also distributed according to the horizontal coefficients.

<sup>161</sup> This limit is small and often is binding. When this happens, not all the Foral Deputations reach at least 99% of their horizontal coefficient.

The horizontal coefficients are calculated every year. In the year 2010, the horizontal coefficients were 16.91% for Alava, 50.14% for Biscay and 32.95% for Guipuzcoa. The historical tendency has been a decrease in the coefficient of Biscay, an increase in the coefficient of Alava and stability in the coefficient of Guipuzcoa<sup>162</sup>.

Table 16 summarizes the working of the horizontal model in the year 2008. As already said that year the adjustment fund benefited Alava and Guipuzcoa while Biscay was a net contributor to the fund. Notice that the fund is not redistributive. For instance, in 2008 the only net contributor was Biscay, which was the *HT* with the lowest per capita *GDP*. This is not surprising because the fund does not have a redistributive objective. Its purpose is to eliminate the differences between the contribution coefficients and the shares of the *HTs* on total resources.

**Table 16: Resources of Foral Deputations<sup>1</sup> (2008)**

	Wealth Index <sup>2</sup>	Horizontal coefficient	Agreed Taxes (A)	Share in Quota (B)	Contributions (C)	Adjustment Fund (D)	Resources				
							Total A-B-C+D	Per capita		% of GDP	
								euros	index	value	index
Alava	114	16.91	2,034.2	198.8	1,338.4	69.1	566.1	1,803.8	101	5.0	89
Gipúzcoa	102	32.95	4,128.9	386.5	2,601.8	41.6	1,182.3	1,675.3	94	5.3	93
Biscay	95	50.14	6,671.1	587.6	3,956.0	0.0 <sup>3</sup>	2,127.6	1,845.8	103	6.1	108
<b>TOTAL</b>	<b>100</b>	<b>100.0</b>	<b>12,834.2</b>	<b>1172.9</b>	<b>7896,1</b>	<b>110.7</b>	<b>3,875.9</b>	<b>1,784.3</b>	<b>100</b>	<b>5.7</b>	<b>100</b>

<sup>1</sup> In millions of euros. <sup>2</sup> Per capita *GDP*. <sup>3</sup> The contribution to the fund of Biscay (and the other *HTs*) is included in C. Source: OCTE (several years), www.bizkaia.net, www.gipuzkoa.net, and EUSTAT (www.eustat.es).

The last columns of Table 16 give the final distribution of resources after the horizontal model has been applied. The results show, again, that the model is not egalitarian and allows significant differences in the resources of *HTs*, both in per capita terms and as a percentage of *GDP*.

### 7.3. The Share of Municipalities

The resources of a *HT* after paying the Quota and the Contributions are divided between the Foral Deputation and the municipalities of the Territory. In principle, each *HT* can decide freely how many resources to assign to the municipalities, and how will distribute this amount among the municipalities. However, the Contribution Acts include a provision recommending a minimum share of municipalities in the resources of the Territories. So far, this recommendation has been always accepted by the Foral Deputations. For the period 2007-2011 this minimum recommended is 54.7% of the resources of the Foral Deputation. That is, 54.7% of what is left after paying the *Institutional Obligations* (Quota and Contributions).

The resources of the *i*<sup>th</sup> *HT* after Institutional Obligations,  $RA_i$ , are:

$$RA_i = R_i - \alpha_i(GC + SC + Q) \pm GFA_i \quad [17]$$

<sup>162</sup> For instance in 1985 the coefficients were 14.42% (A), 52.49% (B) and 33.09% (G). In 2000 the coefficients were 15.96% (A), 51.32% (B) and 32.72% (G)



where  $R_i$  are the agreed revenues obtained by the  $i^{\text{th}}$  Territory<sup>163</sup>,  $\alpha_i$  the horizontal coefficient of the *HT*, *GC* and *SC* the general and specific contributions,  $Q$  the quota and  $GFA_i$  the contribution to (or benefit from) the general adjustment fund. If  $\beta_i$  is the share of the municipalities in the resources of the  $i^{\text{th}}$  Territory, what the municipalities receive is  $\beta_i R A_i$ . The amounts assigned to the municipalities ( $\beta_i R A_i$ ) are called *Foral Municipal Funds (FMF)*. As already said, the Contributions Act establishes that  $\beta_i \geq 54.7\%$ . In practice, though, the *HTs* assign to the municipalities more than the minimum. In the year 2010, for instance Alava endowed its *FMF* with 56% of the resources of the Territory, Biscay with 56% and Guipuzcoa with 57%.

The distribution of the *FMF* among municipalities is decided by each *HT*, and in practice the formulae used are very different. That is one of the reasons why similar municipalities in different *HTs* may receive different resources<sup>164</sup>.

#### 7.4. The Apportionment of Agreed Resources

Figure 4 summarizes the rules described in the previous sections to distribute the Agreed Resources among levels of Government. Figure 5 gives the result of those rules in 2008.

Figure 4 allows to measure the marginal effects of tax collection. If Foral Deputations collect one euro more, they keep about 13 cents<sup>165</sup>. The rest goes to the Basque Government (about 70 cents) and to the municipalities (about 17 cents). The marginal gain of the State is zero because the Quota does not depend on what the Basque Country collects but, as already explained, on what the State collects. It may seem that since the level of government responsible for collecting taxes only keeps 13% of its marginal tax collection, the financing model gives very few incentives for good tax administration<sup>166</sup>. However, the available evidence shows that tax evasion in the Basque Country is lower than in Common Territory<sup>167</sup>. The two main reasons for the lower evasion are the mutual surveillance in the Tax Coordination Body and the acceptance by the Deputations of their role as providers of the necessary resources for the Basque Public Sector.

As Figure 5 shows the Foral Deputations, although they collect all the Agreed taxes, only keep for themselves about 18% of what they collect. On the other extreme, the Basque Government (who collects nothing) receives more than 60%

<sup>163</sup> Including the adjustments for manufacturing excises and VAT (see sections 6.1.2 and 6.1.3).

<sup>164</sup> The other reason is, obviously, that different *HTs* have different resources (per capita and as percentage of GDP).

<sup>165</sup> The figure is the average for all the Foral Deputations. Each a Deputation has a different marginal effect of its own tax collection.

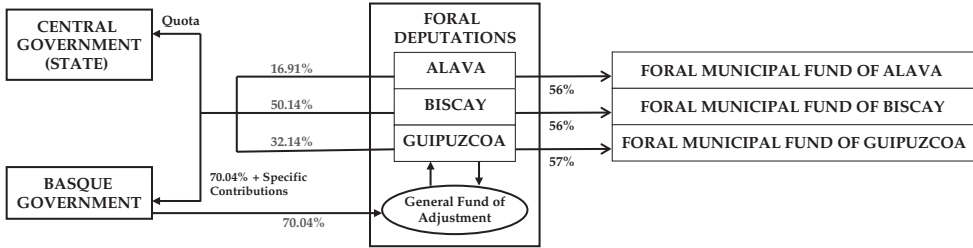
<sup>166</sup> Recall that due to the Harmonization Law the tax rates cannot be very different (see section 5.4).

<sup>167</sup> In Gallastegui, et al (2006) it is shown that tax Evasion in the Basque Country is around 18% while in the rest of Spain is 21%. Therefore, tax evasion in Spain is almost 17% higher than in the Basque Country.

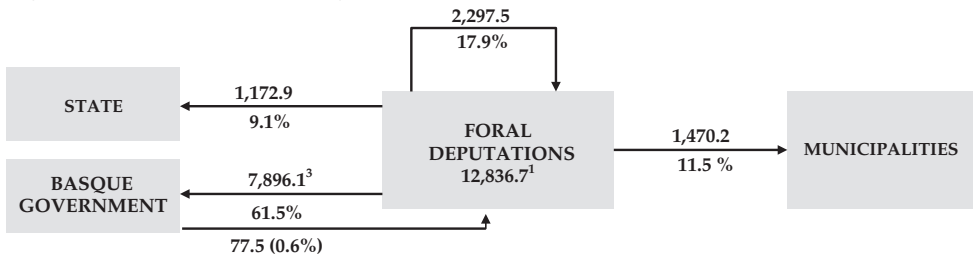


of total collection. Finally, the State (via quota) receives almost 10% and the municipalities (via Foral Municipal Funds) slightly more than 11%<sup>168</sup>.

**Figure 4: Rules to Distribute the Agreed Taxes among Levels of Government (2010)**



**Figure 5: Distribution of Agreed Revenues<sup>2</sup> (2008)**



<sup>1</sup> 1.6 millions are interests. The rest agreed taxes. <sup>2</sup> Millions of Euros. <sup>3</sup> The general contribution is 7,754.8 millions (98.2%) and the specific 141.4 millions (1.8%)

## 8. ECONOMIC RESULTS OF THE AGREEMENT

The Economic Agreement has been a very important economic tool to help the Basque Country to overcome the industrial crises of the last quarter of the 20th century and to restructure its economy. The Economic Agreement has also been crucial for the development of a Basque Public Sector which has effectively promoted economic growth and social protection.

### 8.1. Economic Growth and Employment

The decentralization in Spain took place in tough economic times. Due to the 1973 and 1979 oil crises<sup>169</sup> the 1975-1985 decade was a period of world economic

<sup>168</sup> This distribution of Agreed Revenues is for the year 2008. The results are similar for any other year since 1997. The only significant change in the distribution of resources since 1997 is that in the last two years the share of the State has decreased because its tax collection (which is what determines the size of the Quota) has plummeted. Table 14 shows that the usual share of the State is between 11% and 12%.

<sup>169</sup> In 1973 the Arab members of OPEC proclaimed an oil embargo in response to the US support of Israel during the Yom Kippur war. As a result the price of oil quadrupled. In 1979 the initial cause was the Iranian revolution.

slowdown with unemployment and prices on the rise (stagflation) in many countries. The recession was even deeper in Spain for two reasons. First, due to the transition to democracy<sup>170</sup> the successive Spanish governments did not have enough strength to implement the necessary economic policy measures. Second, the Spanish economy was technologically retarded and productivity was low. In the Basque Country things were even worse because the crisis hit very hard many of the productive sectors that had been traditionally the base of the Basque economy. This included, among other sectors, ship building, iron and steel industry and the home appliances sector.

The result of that long period of crisis was that, as Figure 6 shows, between 1977 and 1985 the unemployment rate in Spain rose from 5.2% to 21.5%. In the Basque Country unemployment grew even more, jumping from 3.9% to 23%. In the other Foral Territory, Navarre, unemployment also increased reaching 18.7% in 1985. Even though this was a very high unemployment rate, it was still a smaller rate than that of the Basque Country or the rest of Spain. The employment balance of the next decade, 1985-1995, was again negative in all three areas (Spain, Basque Country and Navarre). At the beginning of the decade, in 1986, the growth of the world economy and the stimulus provided by the accession of Spain to the European Community seemed to have improved the economic performance of Spain, Navarre and the Basque Country. However, a new world economic crisis combined with an overvalued Spanish currency skyrocketed unemployment rates in Spain and the Basque Country to a historical maximum of almost 24 percent in 1994. In Navarre the increase of unemployment was also high but the unemployment rate rose only to 14.6%.

The year 1995 was a turning point for unemployment in Spain. Employment started to grow at a very high rate and in a few years the unemployment rate dropped below 10% almost to the levels of the late seventies<sup>171</sup>. In 2007 the unemployment rate in Spain reached 8.3%, its lowest value in several decades. As it could not be otherwise the unemployment in Navarre and the Basque Country evolved as in the rest of Spain. Between 1995 and 2007 dropped from 24.4% to 6.1% in the Basque Country and from 14.6% to 4.8% in Navarre.

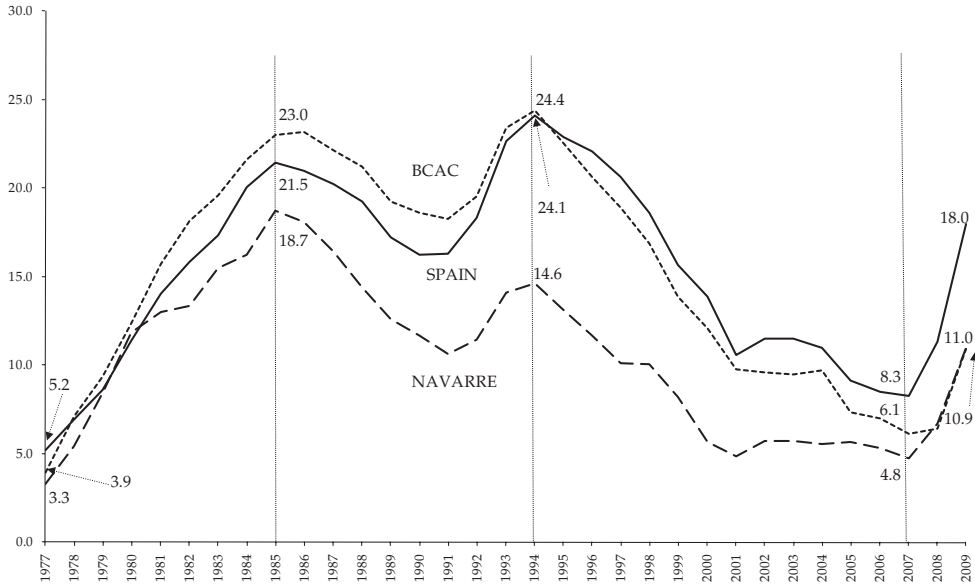
The world financial crisis that erupted in 2008, combined with the weak foundations of Spanish economic growth<sup>172</sup>, gave rise to a spectacular increase in unemployment rates. The unemployment rate in Spain more than doubled in two years, reaching 18% in 2009 which is almost the same level as in 1985. The unemployment rates in Navarre and the Basque Country also increased sharply, but remained well below the average rate of unemployment in Spain and very far from the 1985 unemployment levels.

<sup>170</sup> The transition to democracy refers to the economic, political and social changes that took place in Spain after the death of Franco in 1975.

<sup>171</sup> For a more detailed analysis of the unemployment in Spain, see for instance, Zubiri (2007) and the references therein.

<sup>172</sup> A large part of the Spanish growth of the last decades was based on a real estate bubble and a booming financial sector.

**Figure 6: Unemployment Rate in Spain, Navarre and the Basque Country 1977-2009**



Source: Statistical Bulletin of the Central Bank of Spain

A significant change shown in Figure 6 is that before 1995 the unemployment rate in the Basque Country was above the one in Spain but after that year, the unemployment rate of the Basque Country has always been lower. In 2009, for instance, the unemployment rate in Spain was seven points higher than in the Basque Country. The change of tendency is the result of the economic restructuring made by the Basque Country during the eighties.

During the seventies and early eighties, the number of jobs in the Basque Country declined steadily and between 1977 and 1986 almost 140 thousand jobs (nearly 20% of the total jobs) were lost. The intensity of the loss was higher than in the rest of Spain because, as already mentioned, the economic crises hit severely the productive sectors that had been traditionally the base of the Basque economy. The Basque Country had to embark on an essential economic restructuring and traditional industry was replaced by more technological and productive activities. In the way, industry lost weight in the economy and services gained importance. For instance, in the late seventies 45% of the workers had industrial jobs. By the early nineties, the figure had dropped to 30% and since then the decrease has continued, although at a slower pace. In 2008 only 23.5% of the employees worked in industry. Conversely, there has been a sharp increase in the employment in services. In 1977, only 38.5% of the employees worked in the services sector. The figure rose to 58.5% in the early nineties and to 65.5% in 2008.

Figure 7 summarises the evolution of the wealth of the Basque Country (measured by the per capita *GDP*) relative to that of Spain and Navarre<sup>173</sup>. As the Figure shows, at the beginning of the eighties the wealth of the Basque Country was 36% higher than that of the Spanish average and almost identical to the wealth of Navarre. At that time, the Basque Country was, in fact, the richest region in Spain. During the next ten years, the relative income of the Basque Country declined. The main reason was that the 1975-1985 recessions hit harder industrial regions like the Basque Country and, as a result, the loss of jobs and income was larger than in the average of Spain.

After the decrease in the eighties, for most of the nineties the relative wealth of the Basque Country stabilized around 120% of the national average and 95% of Navarre's wealth. The turning point was 1997. That year the relative wealth of the Basque Country started to grow and in ten years it returned to the situation of the early eighties. One of the reasons why the Basque Country grew faster than the rest of Spain was the economic restructuring that took place during the previous fifteen years (basically a shift from heavy industry to more technological activities).

In 2008 the Basque Country has regained its traditional position as the richest region in Spain, with almost 35% more (per capita) income than Spain and 5% more than Navarre.

**Figure 7: Relative per capita *GDP* of the Basque Country (BC), Spain and Navarre 1981-2008**



Source: Own elaboration using the National Statistics Institute data (Regional Accounts [www.ine.es](http://www.ine.es))

<sup>173</sup> 100 means that the Basque Country has the same per capita *GDP* as the other region, 120 that the Basque per capita *GDP* is 20% higher, and 80 that the Basque per capita *GDP* is 20% lower.

Summing up, during more than twenty years the Basque Country has gone through a tough economic restructuring and after that the economy has recovered its traditional position as the most economically advanced region in Spain. In all this process, the Economic Agreement has played a substantial role for several reasons.

*a) It makes the Basque institutions feel fully responsible for the economic situation of the AC.* When an AC of the common regime has an economic problem the usual reaction is to turn to the Central Government asking for more resources. With the Economic Agreement that is impossible. If more resources are needed, the Basque Country has to raise them (via taxes, debt or other). The fact that the Basque authorities<sup>174</sup> control all the public resources makes them play a leading economic role, especially during economic crises. That is what happened during the crises of the eighties and nineties when the Basque authorities implemented a host of economic policies and measures that led in the end to economic recovery and to the restructuring of the Basque Country. The measures adopted included different types of helps for firms with financial problems<sup>175</sup>, incentives for new technologies, support for the creation of new firms, encouragement of research and so on. In general, even without crises, the Basque authorities always have been very involved with leading the regional economy because the Economic Agreement increases the sense responsibility of regional governments.

*b) The Economic Agreement provides tools to intervene effectively in the economy.* The Economic Agreement not only gives good reasons (sense of responsibility) to intervene in the economy. It also provides some important instruments to do it. The main instrument is a large tax autonomy that during the eighties and nineties was used in many ways to facilitate the exit from the crisis and the restructuring of the Basque economy. To begin with, the tax autonomy allowed the Basque Country to collect whatever resources the public sector considered necessary to promote recovery and economic restructuring.

Second, that tax autonomy made easier the access to financial markets (issuing debt, borrowing from financial institutions, etc.). Simply, when you have a full tax system your solvency increases considerably<sup>176</sup>.

Third, the fiscal autonomy in the Corporation Income Tax can be used to help firms that are in trouble and to stimulate economic activity. The effectiveness of tax incentives (reducing tax rates, increasing deductions, etc.) to stimulate economic activity is rather questionable<sup>177</sup>. Even if incentives were effective, it is not clear that they are desirable because they are costly<sup>178</sup> and may end up

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<sup>174</sup> This refers to both, the Basque Government and the Foral Deputations.

<sup>175</sup> This was done, for instance, helping firms without access to credit markets.

<sup>176</sup> As shown in section 8.3, the credit rating of the Basque Country has always been very high.

<sup>177</sup> It is quite unlikely that a tax cut will induce firms to invest or hire workers in bad economy times.

<sup>178</sup> For instance, a tax incentive for investment benefits all investments. That is, it benefits not only the investment induced by the incentive (if any) but also the investment that would have been made even without the incentive.

inducing inefficient investments<sup>179</sup>. Despite that, during the eighties the Basque Country was facing a recession deeper and longer than the rest of Spain and decided to use the Corporation Tax as an instrument of industrial policy. Simply, the Foral Deputations introduced many tax incentives and exemptions to reduce the effective tax rate on corporations. Several of those tax measures caused conflicts with the State (who often claimed they were against the Economic Agreement) and the European Commission. However, what the Basque Territories did was not very different from what other European Tax Authorities were doing at that time. For instance, in 1999 the Code of Conduct Group, which was established by the EU's Finance Ministers to find harmful tax measures in the Member States<sup>180</sup>, considered that about 285 tax measures adopted by EU countries were potentially harmful. After a more detailed study (perhaps it is better to say after political compromise) 66 measures were considered harmful<sup>181</sup>. Of the initial 285 measures, only two were tax measures of the Basque Territories<sup>182</sup>. Of the final list of 66 measures, only one belonged to the Basque Territories<sup>183</sup>. This shows that the measures taken by the Basque Tax Authorities were not particularly harmful or aggressive, at least in comparison to what EU countries had done.

Finally, the tax autonomy was used to help firms in trouble (offering, for instance, tax postponements) and to give tax breaks and subsidies to persons without jobs. These measures reduced to some extent the social consequences of the recession.

## 8.2. The Level and Structure of taxes

Table 17 compares the tax level (measured as a percentage of the GDP) in the Basque Country, Common Territory, Navarre and several EU and non EU countries. As the Table shows, the tax to GDP ratio in the Basque Country is 35.4%, which is very similar to that of Navarre<sup>184</sup>. The tax ratio in the Basque Country is only slightly below that of Spain. The difference is one point of GDP, and about half of that difference is due to lower agreed taxes (0.5 points of GDP<sup>185</sup>). The other half is due to smaller municipal taxes (0.5 points of GDP<sup>186</sup>).

<sup>179</sup> If an investment is profitable only after a tax incentive, probably it is not an efficient investment.

<sup>180</sup> The Commission considers harmful any tax measures that can affect the location of business activity.

<sup>181</sup> See ECOFIN Council (1999)-

<sup>182</sup> The measures were a start up relief and the tax treatment of Coordination Centres. Since Navarre also had a start up relief and rules on Coordination Centres, it also had those two measures in the list.

<sup>183</sup> The measure was the regulation of Coordination Centres. The start up relief had already been eliminated in 1999 and for that reason was not included in the list of measures to be removed by the countries. Navarre also had the regulation of Coordination Centres in the final list.

<sup>184</sup> The tax to GDP ratio of Navarre reported in Table 17 is one point below the figure of the Basque Country. However the data of Navarre does not include the non agreed taxes.

<sup>185</sup> See Table 18.

<sup>186</sup> See Zubiri (2008).

**Table 17: Tax Revenue as a percentage of GDP (2007)**

	<b>TOTAL</b>	<b>Excluding Social Security Contributions</b>
Denmark	48.7	47.7
Sweden	48.3	35.7
Belgium	43.9	30.3
France	43.5	27.4
Italy	43.5	30.4
Finland	43.0	31.1
Austria	42.3	28.0
Hungary	39.5	26.6
Netherlands	37.5	24.0
Czech Republic	37.4	21.1
Luxembourg	36.5	26.4
<i>Common Territory</i>	<b>36.4</b>	<b>24.2</b>
Portugal	36.4	24.7
Germany	36.2	22.9
United Kingdom	36.1	29.5
<i>Basque Country</i>	<b>35.4</b>	<b>23.3</b>
Poland	34.9	22.9
<i>Navarre<sup>1</sup></i>	<b>34.4</b>	<b>21.5</b>
Greece	32.0	20.4
Ireland	30.8	26.1
Slovak Republic	29.4	17.7
<i>EU19<sup>2</sup></i>	<b>38.6</b>	<b>27.2</b>
Switzerland	28.9	22.2
United States	28.3	21.7
Japan	28.3	19.0
OECD Total <sup>1</sup>	35.8	26.7

<sup>1</sup> It does not include non agreed taxes. <sup>2</sup> Unweighted average  
Source: OECD (2009) and own calculations for Common Territory, Navarre, and the Basque country.

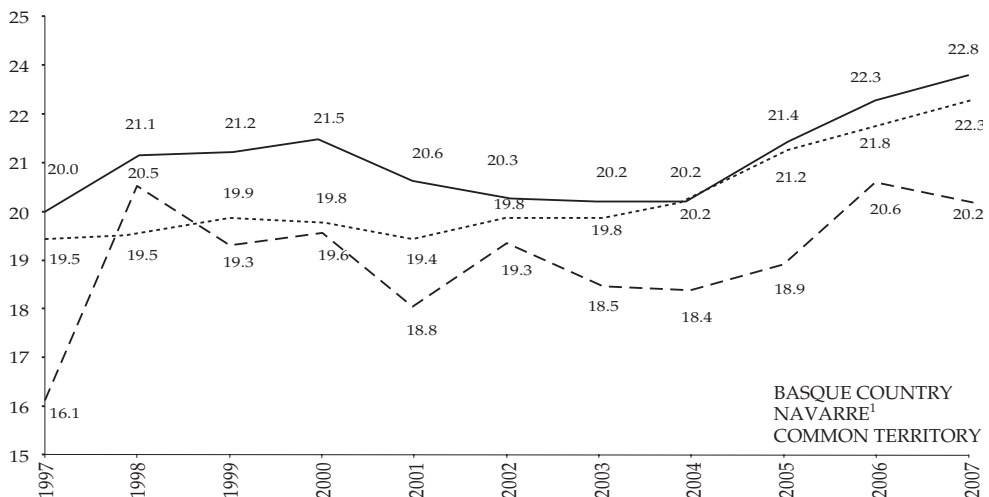
In comparison to *EU* countries, taxes in the Basque Country (and also in Navarre and the rest of Spain) are three points (of *GDP*) below the average. The tax level in the Basque Country is similar to that of Germany and the *UK*, and is well above the tax level of non *EU* countries like Switzerland or the *US*. If we exclude Social Security Contributions from the tax to *GDP* ratio, the difference to the *EU19* average increases from three to four *GDP* points. This simply reflects the

fact that Social Security Contributions in the Basque Country (which amount to 12.2% of *GDP*) are higher than in the *EU19* average (11.4% of *GDP*).

On the basis of the comparisons above, it is obvious that taxes in the Basque Country are not low either by *EU* or Spanish standards. By the standards of non *EU* countries like the *US*, Japan or Switzerland, Basque taxes are even high.

Figure 8 focuses on the Agreed Taxes and compares tax collection (as a percentage of the *GDP*) in the Basque Country, Navarre and Common Territory. The figure shows that between 1997 and 2001 tax collection in the Basque Country was about one and a half *GDP* points higher than the tax collection in Common Territory. After that, the difference started to decrease and from 2005 to 2007 tax collection in Common Territory has been slightly higher than in the Basque Country. This change is not due to any decrease of tax rates in the Basque Country (relative to Common Territory), but to the fact that the property bubble and the booming of financial services increased the tax collection in Common Territory much more than in the Basque Country.

**Figure 8: Agreed Taxes (as a percentage of *GDP* in Navarre and the Basque Country 1997-2007**



<sup>1</sup> It does not include non agreed taxes.

Perhaps the main conclusion from Figure 8 is that the tax levels in the Basque Country and Common Territory are not very different. The tax to *GDP* ratios are not equal but none of them collects systematically more than the other. The Basque Country collects more or less than Common Territory depending on the economic circumstances and the timing of tax reforms.

The comparison with Navarre is more complicated because Figure 8 does not include any estimation for the non agreed taxes. Nevertheless, most of the time the tax collection in Navarre is around two *GDP* points below the tax collection in the Basque Country. This suggests that probably, even after the correction for non



agreed taxes, taxes in Navarre would be lower than in the Basque Country and Common Territory.

Table 18 disaggregates by taxes the total tax collection in 2007. For each tax, the table compares tax collection in the Basque Country, Navarre and Common Territory both in per capita terms and as a percentage of the *GDP*.

The Personal Income Tax has the same basic structure in the Basque Country, Navarre and Common Territory<sup>187</sup>. There are no large differences in the tax parameters (rates, amounts of deductions, and so on) but taxes are not identical. In general tax deductions in the Basque Country are slightly higher than in Common Territory and the tax schedule is a bit more progressive.<sup>188</sup> Navarre has a lower Personal Income Tax than the Basque Country and Common Territory due mainly to smaller tax rates, and greater deductions to, basically, medium and high incomes. The result is that, as a percentage of the *GDP*, the Personal Income Tax in the Basque Country is 10% lower than in Common Territory, and 10% higher than in Navarre. However, the real difference between the Basque Country and Common Territory is smaller than 10% because the withholding taxes on some incomes of the Basque residents are collected by the Central Government<sup>189</sup>. This is a sizable amount, because as Table 18 shows, the Non Agreed Direct Taxes (which are basically withheld taxes) amount to 0.7% of *GDP*.

In terms of per capita collection, things are quite different and the Basque Country collects more for the Personal Income Tax than the other two regions. Even setting aside the Non Agreed Direct Taxes, the Basque Country collects 20% more than Common Territory and 15% more than Navarre. In the case of Navarre the reason is that the Basque Country has a higher personal income tax. In the case of Common Territory, the Basque Country collects more (with a lower effective tax rate<sup>190</sup>) because it is 30% richer and the Personal Income Tax is progressive.

The Corporation Income Tax collection in the Basque Country is 2.9% of *GDP*<sup>191</sup>. This is 35% less than in Common Territory and 10% less than in Navarre. Several reasons explain the difference with Common Territory. In the first place, the effective Corporation Income Tax rate in the Basque Country is lower than in

<sup>187</sup> In the three regions (Basque Country, Navarre and the Common Territory) the personal income tax is a dual tax with capital income taxed at lower rates than labour income. Capital income is taxed at a flat rate in the Basque Country (20% in the year 2010) and with an almost flat rate in Common Territory (there are two rates, 19% and 21%) and Navarre (two rates, 18% and 21%). Non capital income is taxed using a progressive schedule. The three regions have also the same basic deductions (mortgage, pension plans and family) although the amounts allowed for each deduction are different.

<sup>188</sup> In the year 2010, for instance the marginal tax rates for non capital income run from 23% to 45% in the Basque Country and from 24% to 43% in Common Territory.

<sup>189</sup> See section 5.2.

<sup>190</sup> Notice that the tax to *GDP* ratio is the global average tax rate.

<sup>191</sup> The collection of the Corporation Tax (as a percentage of *GDP*) is highly correlated with the economic situation. The year 2007 was a high growth year in the Basque Country, Navarre and Common Territory and, therefore, it was also a high collection year.

**Table 18: Agreed Taxes, per capita and as a percentage of GDP (2007)**

	% of GDP			Per Capita		
	Basque Country	Navarre	Common Territory	Basque Country	Navarre	Common Territory
Personal Income	6.8	6.1	7.5	2,063	1,803	1,716
Corporation Income	2.9	3.3	4.6	895	988	1,064
Non Residents	0.3	0.1	0.3	83	18	58
Inheritance and Gifts	0.1	0.2	0.3	36	72	67
Wealth <sup>1</sup>	0.2	0.3	0.2	72	103	44
Non Agreed Direct Taxes <sup>2</sup>	0.7	nd	0.0	203	nd	-10
<b>TOTAL DIRECT (A)</b>	<b>11.0</b>	<b>10.1<sup>3</sup></b>	<b>12.8</b>	<b>3,351</b>	<b>2,984</b>	<b>2,937</b>
VAT <sup>4</sup>	7.5	6.6	5.8	2,271	1,948	1,325
Excises <sup>4</sup>	2.3	2.4	2.1	691	699	472
Fuel Tax <sup>5</sup>	0.1	0.1	0.1	24	37	30
Capital Transfer Tax	0.6	0.5	0.9	175	134	203
Stamp duty	0.2	0.3	0.8	63	88	187
Insurance Premiums Tax	0.1	0.1	0.2	37	36	35
Gaming duties	0.1	0.1	0.2	32	22	45
Other	0.1	0.1	0.1	24	27	14
Non Agreed Taxes	0.4	nd	0.0	115	nd	-6
<b>TOTAL INDIRECT (B)</b>	<b>11.3</b>	<b>10.1</b>	<b>10.0</b>	<b>3,432</b>	<b>2,991</b>	<b>2,307</b>
<b>TOTAL AGREED (A+B)</b>	<b>22.3</b>	<b>20.2<sup>4</sup></b>	<b>22.8</b>	<b>6,783</b>	<b>5,976</b>	<b>5,244</b>
<i>Pro memory</i>	<b>Euros</b>			<b>Index</b>		
Per Capita GDP	30,431	29,531	22,970	132	129	100

<sup>1</sup> Eliminated in 2008 (Common Territory, Navarre, Alava and Biscay) and 2009 (Guipuzcoa). <sup>2</sup> As valued in the calculation of the Quota. <sup>3</sup> Excluded non agreed taxes. <sup>4</sup> Sum of own collection plus adjustment <sup>5</sup> Called Excise Duty on Retail Sales of Certain Mineral Oils.

Source. Own elaboration.

Common Territory<sup>192</sup>. Second, in the Basque Country there is a higher concentration of firms (for instance, cooperatives) subject to below standard tax rates. Third, that a part of the Non Agreed taxes (taxes paid by Basque residents but collected by the State) are Corporate Taxes. Fourth, the points of connection have not been established to divide Corporation Tax bases between the Basque Country and Common Territory in proportion to relative GDP. The truth is that the points of connection are based on administrative simplicity and relative sales and not on

<sup>192</sup> In the year 2010 the main differences are that the tax rate is lower (28% in the Basque Country and 30% in Common Territory) and that the Corporation taxes of the HTs have more tax incentives for investment and employment.

relative *GDP*. The implication is that even with identical Corporation Taxes, there is no reason why the ratio of collection to *GDP* should be equal or even similar in two regions. For instance, although Corporation Taxes are the same in the three *HTs*, in 2007 the ratio Corporation Tax to *GDP* was 2.9% in Alava, 3.3% in Biscay and 2.3% in Guipuzcoa.

As for Navarre, its Corporation Tax is very close to the Corporation Taxes of the *HTs*<sup>193</sup> and the tax collection is also similar. In any case, to put in a proper perspective the Corporation Income Tax collection of the Basque Country, it is worth recalling that according to Eurostat, in 2007 the Corporation Tax to *GDP* ratio was 2.7% in Austria, 3% in France, 3.2% in Italy and 3.5% in the Netherlands. This means that the Corporation Tax in the Basque Country is far from being low, at least by *EU* standards.

Total collection (as percentage of *GDP*) from indirect taxes is very similar in all the regions (Basque Country, Navarre and Common Territory). There are, however, some differences in individual taxes. The Capital Transfer and Stamp duty taxes are higher in Common Territory than in the Basque Country and Navarre. The *VAT* collects a much larger share of *GDP* in the *Foral* regions (Basque Country and Navarre) than in Common Territory. Finally, the excises collect about the same in the three regions.

In the case of the Capital Transfer and Stamp duty taxes the main reason for the difference is that some tax rates in the *Foral* Regions are lower than in most *ACs* of Common Territory<sup>194</sup>. In the *VAT* the tax rates in the *Foral* Territories are the same as in Common Territory because the *Foral* Territories don't have any discretion on *VAT* tax rates<sup>195</sup>. The higher collection of the *Foral* Territories could be explained by greater collection efficiency and, more likely, by a *VAT* adjustment that may overestimate the relative consumption of the *Foral* regions<sup>196</sup>.

Taking into account all the agreed taxes, Table 18 shows that in the year 2007 tax collection (as a share of the *GDP*) in the Basque Country was only slightly lower than in Common Territory (half a point of *GDP*, equivalent to 2% of total tax collection) and larger than in Navarre. Since the Basque Country is considerably richer than Common Territory, the almost equal global effective tax rate (ratio Tax collection to *GDP*) produced 30% more per capita revenue. The Basque Country also collected (per capita) nearly 15% more than Navarre.

The conclusion is that, in general, taxes in the Basque Country are not very different from taxes in Common Territory. The *HTs* know they are a small part of

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<sup>193</sup> In 2010 the tax incentives (for investment and employment) in Navarre are very similar to the tax incentive in the Basque Country. The main difference is that the tax rate in Navarre is 30% while in the Basque Country is 28%.

<sup>194</sup> In the common Regime the Capital Transfer and Stamp duty taxes are taxes of the *ACs* (see section 10.2).

<sup>195</sup> The central government chooses the rates that will apply in all the country, including the *foral* regions.

<sup>196</sup> See Monasterio (2009) for an analysis of the *VAT* adjustment.

a larger economic area and have decided not to establish taxes too different from those of the State. The main differences are that the Personal Income Tax is slightly lower and more progressive, and that the Corporation Income Tax has a lower tax rate (28% vs 30% in the year 2010) and more tax incentives (to job creation and investment). Total tax collection as a percentage of the *GDP* is nearly the same in the Basque Country and in Common Territory, but since the Basque Country is substantially richer, it obtains 30% more of per capita tax collection.

### 8.3. Expenditure and Debt

To assess the efficiency of public action is complicated. Table 19 provides, however, some indicators of the level and efficiency of some of the three most important expenditures made by the Basque Public Sector: Health, Education and Public Infrastructures.

In the Basque Country, the expenditure (per user) in primary and secondary education is 30% higher than the Spanish average. The resulting system of Education is considered one of the best in Spain. For instance, a study reviewing 50 indicators of quality<sup>197</sup>, gave the Education system of the Basque Country 9.4 points out of 10. This was, by far, the highest score attained by any *AC*. The expenditure on Health is 9.5% higher than the Spanish average. The analysis of 17 indicators<sup>198</sup> rates the Public Health Care System of the Basque Country among the best in Spain. The score of the Basque Country is 6.5 out of ten, while the average of all the *ACs* is only 5.7. Finally, Table 19 shows that the Basque Country has the highest density of roads and a stock of public capital<sup>199</sup> that is almost 30% above the average. Taken altogether, the data in Table 19 suggest that the expenditure in the Basque Country is somewhat higher than in other *ACs* and the quality of the public services is substantially better.

Figure 9 gives the evolution of the debt of the Basque Country and other *ACs*. The Figure shows that around 1995 the debt of the Basque Country was above the average of other *ACs*. To a large extent, this high level of debt was the aftermath of the economic crises of the eighties and beginning of the nineties. As already mentioned the Basque Country was particularly hit by those crises because it was highly industrialized. To find the needed resources to restructure its economy, the Basque Country had to issue a substantial amount of debt. The booming economy after 1995 increased tax collection and reduced the expenditures related to the crisis. The new resources allowed the Basque Country to reduce its debt drastically from almost 8% of *GDP* to slightly more than 1%. The economic crisis that erupted in 2008 has produced a new increase in the debt to *GDP* ratio. The pattern is, therefore, that the Basque Country increases its debt in bad times and reduces it in good times.

<sup>197</sup> See Profesionales por la Etica (2008).

<sup>198</sup> See Federación de Asociaciones para la Defensa de la Sanidad Pública (2008).

<sup>199</sup> It includes all public infrastructures and the value of capital in public services (health, education, and so on).

**Table 19: Indicators of Public Sector Expenditure and Efficiency in the Basque Country**

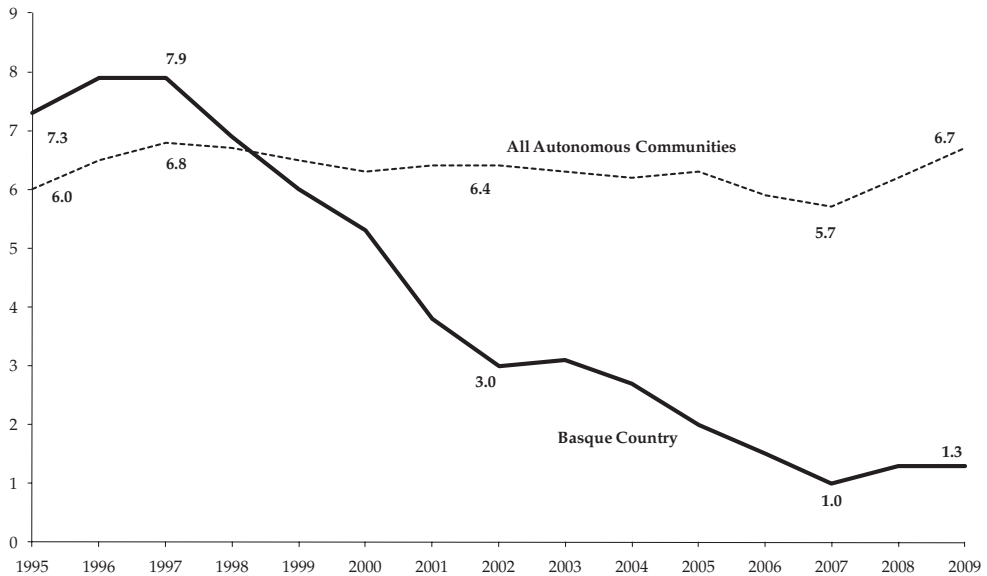
	Education		Health		Capital	
	Expenditure per Student <sup>1</sup>	Quality <sup>2</sup>	Expenditure per capita <sup>3</sup>	Quality <sup>4</sup>	Roads Per sq. Km <sup>5</sup>	Public Capital Per Capita <sup>6</sup>
Andalusia	87.4	2.1	93.5	6.6	89.3	86.2
Aragón	99.6	6.3	110.8	5.9	47.8	152.5
Asturias (Principality of)	120.4	7.3	110.4	6.8	199.4	135.9
Balearic Islands	104.4	3.1	102.7	5.7	100.4	82.6
Canary Islands	102.6	2.4	105.1	4.3	244.4	95.5
Cantabria	113.3	6.1	122.0	5.4	210.7	131.5
Castile and Leon	109.3	6.5	107.9	6.3	56.2	139.5
Castile-La Mancha	103.8	2.5	106.0	6.2	43.0	117.8
Catalonia	98.5	5.5	97.0	6.3	207.4	83.0
Valencian Community	92.2	4.0	94.3	3.8	184.4	84.8
Extremadura	101.6	2.7	109.9	6.2	39.6	125.4
Galicia	113.4	5.7	102.8	5.0	144.6	107.5
Madrid	94.5	6.6	94.0	4.6	407.1	94.7
Murcia	86.2	2.5	102.1	4.6	84.8	78.6
Navarre	120.6	7.4	110.4	6.5	113.8	132.0
<i>Basque Country</i>	<b>127.9</b>	<b>9.4</b>	<b>109.5</b>	<b>6.5</b>	<b>451.9</b>	<b>123.6</b>
La Rioja	102.5	4.9	112.6	5.6	122.5	128.2
<b>SPAIN</b>	<b>100</b>	<b>5.0</b>	<b>100</b>	<b>5.7</b>	<b>100</b>	<b>100</b>

<sup>1</sup> 2007, primary and secondary education. Index relative to the mean. <sup>2</sup> 2007, average of 50 indicators of quality (graduation rate, students per teacher, and so on) each valued from 0 to 10. For details see Profesionales por la Ética (2008). <sup>3</sup> 2005. <sup>4</sup> 2008, average of 17 indicators of quality (characteristics of the Health system and opinion of the users). For details see Federación de Asociaciones para la Defensa de la Sanidad Pública (2008). <sup>5</sup> 2005, money value of the roads per Km<sup>2</sup>. Index relative to the mean. For more details see Fundación BBVA (2009). <sup>6</sup> It includes all public infrastructures and the value of capital in public services (health, education, and so on). Index relative to the mean. For more details see Fundación BBVA (2009).

Figure 9 also shows that since 1995 the debt of the other ACs has remained stable around 6.5% of GDP. As in the Basque Country the crisis has forced Common Regime ACs to increase their debt in the last years. In the good times the debt of the Basque Country decreased while the debt of the Common Regime ACs remained stable. The result is that while in 1995 the debt of the Basque Country was higher than the debt of Common Regime ACs, in 2009 it was only one third the debt of Common Regime ACs.

The debt of the Basque Country is small in comparison to its financial capacity. For that reason, the credit rating of the Basque Country has always been very high, similar to the ratings of the most solvent countries in the world and well above the ratings of any other AC or even Spain<sup>200</sup>.

**Figure 9: Debt of the Autonomous Communities as a percentage of GDP (1995-2009)**



Source: Statistical Bulletin of the Bank of Spain ([www.bde.es](http://www.bde.es)).

## 9. THE ECONOMICS OF THE ECONOMIC AGREEMENT

The Economic Agreement exists for political and historical reasons. It has, however, good economic properties. In particular, it gives the Basque Country a high degree of tax autonomy. This is consistent with the recommendations of the most recent theories of fiscal federalism and with the practice in the most advanced federations (such as Switzerland, the United States and Canada).

This section reviews what the theory of fiscal federalism says about tax decentralization, the practice in some federations and the economic properties of the Economic Agreement model.

<sup>200</sup> In 2009, the credit rating given by Standard&Poors to the Basque Country was AAA. Navarre also had AAA while the other AC and Spain had AA. Germany and France also had AAA. The ratings given by Fitch and Moody's are very similar. In 2010 following the reduction of the credit rating of Spain from AA+ to AA, Standard&Poors lowered also the rating of the Basque Country to AA+.

## 9.1. The Theory of Decentralization

The traditional theory of Fiscal Federalism focuses on the gains from decentralizing expenditures and discusses at length which expenditures should be decentralised. However, it pays much less attention to the financing of sub-central governments. The dominant view in the traditional theory is that sub-central governments should be financed with a mix of transfers (designed to attain equity among regions and internalize intraregional *spillovers*) and taxes that allow sub-central governments to increase the provision of public goods (above what can be financed with the transfers received) if so they want<sup>201</sup>. The power of a sub-central government to raise taxes to finance additional expenditures is called *marginal fiscal autonomy*.

As for the taxes that should be assigned to sub-central governments to ensure marginal fiscal autonomy, the traditional view says that they have to satisfy two conditions:

- (1) Fall on the residents<sup>202</sup> of the sub-central government's jurisdiction.
- (2) Be levied on bases that are relatively immobile across jurisdictions.

Also, ideally, sub-central taxes should not redistribute income across individuals<sup>203</sup> and should be easy to administer. As McLure (2007) and Bird (2008) point out, this leads basically to a tax model in which local governments are left only with property and user charges to finance marginal increases in expenditure. Regional governments may also use linear income taxes and retail sales taxes<sup>204</sup>.

This conventional view on the financing sub-central governments is based on two assumptions:

- (a) Sub-central governments act on behalf of their residents and do not have any other objective of their own. Therefore, it is assumed that sub-central governments are benevolent dictators acting for the good of their residents.
- (b) Sub-central governments do not act strategically. That is, they do not use fiscal policies (expenditure or taxation) to attract high income individuals or capital from no residents. Either they do not exert political pressures on central government to obtain more transfers or other privileges.

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<sup>201</sup> If transfers are high and exceed the optimal provision level of a regional government, the efficiency requires that sub-central governments reduce the taxes. To do so, a regional government must have the capacity to reduce the taxes paid by the residents in his jurisdiction.

<sup>202</sup> This is to guarantee that those receiving the marginal benefit also pay the marginal cost. This ensures that the expenditure will be raised until the efficient *samuelsonian* level of provision (in which marginal costs and benefits of provision are equal) is satisfied.

<sup>203</sup> According to the *musgravian* division of expenditure functions among government tiers, redistribution should be the responsibility of central government.

<sup>204</sup> There are other proposals. For instance, Musgrave (2000) suggests that sub-central governments could use payroll taxes and even taxes on non resident's income (earned within the jurisdiction of the taxing government).



The traditional model of fiscal federalism also ignores that decentralization is essentially a political phenomenon with economic implications. Simply, no country has ever decentralised its public sector for economic reasons<sup>205</sup>. Therefore, the decentralization can never be analyzed only from an economic viewpoint. Furthermore, it is possible that the political and social acceptance of a decentralized model requires the introduction of some economic inefficiencies.

The idea that governments are benevolent dictators without objectives of their own has long been questioned. For instance, Niskanen (1971) argued that the objective of the public sector bureaucrats was to maximize the size of their budgets. This idea was applied to fiscal federalism by Brennan and Buchanan (1980). They assumed that governments are revenue maximizing agents whose only objective is to aggrandize its size<sup>206</sup>. Under this assumption, they argued that:

- (1\*) Sub-national governments should finance all their expenditures (not just marginal expenditures) with taxes.
- (2\*) Sub central taxes should be levied on mobile bases (the opposite of the conventional view).

The rationale for 1\* and 2\* is that when bases are highly mobile, tax hikes not compensated with efficient expenditures will cause the flight of tax bases. Conversely, low taxes and efficient expenditures will attract mobile tax bases. This way, the mobility of tax bases will limit tax increases and inefficient expansions of the expenditure. This effect will be largest when most of the sub-national governments' expenditures are financed by own taxes. This idea –that mobile tax bases will limit excessive taxation and promote expenditure efficiency– has been used frequently to justify the non harmonization of capital taxes within the EU.

The benevolent dictator model is essentially normative. It says what should be done if governments acted on behalf of their residents. Following the analysis of Brennan and Buchanan, a sizable part of recent the literature on fiscal federalism has been devoted to analyze decentralization in more realistic settings in which politicians, voters and interest group interact in a context of imperfect information. The objective is to establish mechanisms and institutional designs that create incentives for decision makers to take the right expenditure and taxation decisions. In a sense, the new literature, branded as Second-Generation Theory (*SGT*) of Fiscal Federalism, makes a positive analysis of decentralization that complements the traditional normative analysis (also called First-Generation Theory (*FGT*) of Fiscal Federalism<sup>207</sup>).

<sup>205</sup> This refers to the creation of well developed second tier levels of government (provinces, states, cantons, länder, etc.).

<sup>206</sup> This has become known as the Leviathan model in reference to the 1651 book written by Thomas Hobbes. Leviathan (a sea monster referred to in the Old Testament) is the name for the impersonal forces (social forces, bureaucrats, technocrats and so on) governing the State machine.

<sup>207</sup> For a review of Second Generations Models, see Weingast (2006). For a comparison between First and Second Generation models see Oates (2005).



Many of the Second Generation models suggest that sub-national governments should have a high degree of tax autonomy. This means that they should finance most of their expenditures (ideally all<sup>208</sup>) with own taxes and have enough tax autonomy to decide how much to collect. The main difference with the *FGT* analysis is that *SGT* suggests that efficiency demands total (or average) tax autonomy instead of just marginal tax autonomy.

The *SGT* offers different justifications for average tax autonomy. Weingast (2006) argues that tax autonomy creates a fiscal interest in the sub-national governments. If sub-national governments own the taxes, they will have incentives to enact market-enhancing fiscal policies (expenditure and taxes) because they will receive as additional tax collection a part of the growth induced<sup>209</sup>. He also argues that the fear to loss revenue will reduce corruption and inefficient expenditures.

A second reason for average tax autonomy is that it increases efficiency because it makes the cost of expenditure visible to tax payers. The taxpayers will, then, exert more control on the expenditure and vote out of office governments expending inefficiently. In a basic sense, tax autonomy increases accountability.

Thirdly, it is argued that average tax autonomy forces fiscal discipline. If a substantial part of their revenue comes from transfers, sub-central governments will have incentives to expand their expenditures beyond their means and later ask for a bailout from Central Government (via cash transfers or forgivable loans). The possibility of resort to the Central Government in case of financial problems has been called “operation under a *soft budget constraint*”<sup>210</sup>. Full tax autonomy reduces the justification for Central Government bailouts and induces fiscal discipline. The evidence confirms that, and there is a growing empirical literature showing that when sub-central governments rely on own taxes the size of government is smaller<sup>211</sup>.

One potential problem with average tax autonomy is that it may give rise to a fiscal competence that would lead inefficiently low levels of taxation and regional expenditure. However, the fact that mobility penalizes inefficiency (including low expenditure inefficiency) reduces the risk that governments decide not to make expenditures that are efficient<sup>212</sup>.

Finally, it is worth recalling that decentralization (at least to the regions) even if it has important economic implications, is a process essentially driven by politi-

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<sup>208</sup> Rich jurisdictions can finance all of their expenditure with own taxes but poor jurisdictions have to rely, at least partly, on equalization grants.

<sup>209</sup> This is, obviously, a restatement of the assumption already introduced by Brennan and Buchanan that sub central governments want to maximize tax revenue.

<sup>210</sup> The term “soft budget constraint” was introduced by Janos Kornai in reference to state-owned firms in socialist economies that could count on being bailed out by the state from chronic financial losses.

<sup>211</sup> See, for instance, Feld, L, Kirchgässner, G. and Schaltegger, Rodden, J. (2003) and Fiva (2006).

<sup>212</sup> Under some circumstances, though, the fiscal competence may lead to a prisoner’s dilemma type inefficient strategic equilibrium (see, for instance, Albi, Gonzalez Páramo and Zubiri [2009]).

cal reasons. In this context, average tax autonomy may satisfy the political demands of the regions.

To sum up, even though the theory does not provide a definite model of tax assignment, it suggests several principles to be followed in assigning taxes to sub Central Governments. Bird (2008) summarises these principles as follows:

- (1) Own source revenues should be sufficient to enable at least the richest sub national governments to finance from their own resources all locally provided services primarily benefiting local residents.
- (2) Sub-national revenues should burden only local residents, preferably in relation to the perceived benefits they receive from local services.
- (3) All levels should bear significant responsibility at the margin for financing the expenditures for which they are politically responsible.
- (4) Sub national taxes should not unduly distort the allocation of resources.

## 9.2. Economic properties of the Agreement model

The Economic Agreement assigns almost all the taxes to Basque Country, which has to raise the revenue necessary to finance its expenditure and to pay for the Quota. The Basque Country administers all the taxes and has full autonomy (in the determination of bases, rates and deductions) in the direct taxes. To avoid distortions, though, the autonomy in the direct taxes is limited by some general harmonization principles. In the main indirect taxes the bases and tax rates are established by the Central Government

This description shows that the Economic Agreement model of tax decentralization puts the emphasis in accountability and no distortion. Therefore, it is consistent with the principles of tax decentralization derived from the Second Generation of models of fiscal federalism.

### 9.2.1. Efficiency of the Economic Agreement

The Economic Agreement promotes efficient government because it forces the Basque Public Sector to raise the taxes necessary to finance all its expenditure. The HTs not only have to decide how much to collect, they also have to make the tax collection because they administer all the taxes. In a basic sense, the Foral Deputations have to face the taxpayers to obtain the money they need. This increases *accountability* and by extent efficiency because the Foral Deputations know that they may lose the next election if they spend inefficiently the taxes they collect.

The principle of unilateral risk also induces efficiency in tax administration. The *unilateral risk* means that the Basque Country keeps every additional euro it collects (and loses every euro it does not collect). As shown in section 5.2 this property is simply a consequence of the fact that the Quota is independent of the tax collection of the Basque Country. The unilateral risk is a very important property of the Economic Agreement model because it induces efficiency in both, the level and the administration of taxes.

With *unilateral risk*, the cost for the Basque Country of one euro lost in collection (because of poor administration) is one euro. The Basque Country bears, then, all the cost of bad administration, which induces efficient administration. If the risk, instead of being unilateral, was shared with the State<sup>213</sup>, part of the cost of a euro lost because of bad administration would be borne by the State. The opportunity cost of bad administration would then decrease, and the *HTs* would have incentives for bad administration of taxes.

A similar reasoning applies to the level of taxes. If the State received (via higher Quota) a share of a tax hike or bore the cost of any tax cut, the Basque Country would have incentives to establish inefficiently low taxes. Since what happens is that the Basque Country keeps all the tax increases and bears the cost of any tax reduction, the unilateral risk induces efficient tax levels.

### 9.2.2. *Effects on the allocation of resources*

The Basque Country has full autonomy in the direct taxes. Using this autonomy the *HTs* have approved direct taxes that are different from those established by the State. In all cases the basic structure of the tax is the same as in Common Territory and the *HTs* change some of the components of the tax (tax rates, deductions and so on).

In the Personal Income Tax, the differences between the *HTs* and Common Territory have never been very substantial<sup>214</sup>. In any case, it is very unlikely that even large differences in the Personal Income Tax would cause any significant migration of individuals. First, the tax differences may be compensated by differences in expenditure benefits. In that case, the fiscal residual of individuals<sup>215</sup> will be the same in all the regions, and there will be no migrations. Second, migration between regions has important personal (leaving family and friends) and economic (change of house, perhaps of job, etc.) costs and, therefore, it is very unlikely that many people would migrate in response to even large tax differentials. Third, tax differences may be capitalized into house prices making migrations even more difficult. Finally, even if individuals change their place of residence, they may not change their job. The migration then would not affect the allocation of resources. Taking all this into account, it seems safe to assume that even large differences in the Personal Income Tax will not cause significant distortions or loss of economic efficiency.

In the Corporation Income Tax, the possible distortions caused by the fact that the effective tax rate in the *HTs* is lower than in Common Territory are limited by two factors. First, the harmonization principles established in the Economic Agreement preclude the *HTs* from adopting tax measures that distort the eco-

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<sup>213</sup> This would happen if the Quota depended of the tax collection of the Basque Country. Obviously, this would make sense only if the tax collection of the Basque Country was assessed, not at the tax rates established by the *HTs*, but at the tax rates of the State.

<sup>214</sup> See section 8.2 for the details.

<sup>215</sup> This is defined for each individual as the difference between the benefits he receives from public expenditure and the taxes he pays.

nomy<sup>216</sup>. This limits the type of tax measures that can be implemented by the *HTs*. Second, to apply the tax rules of the *HTs*, companies ought to have a significant part of their sales (at least 25%) in the Basque Country<sup>217</sup>. Then, for companies operating nationwide it would be almost impossible to benefit from the tax rules of the *HTs* delocalizing the production to the Basque Country.

In any case, it is not clear how distorting regional tax differentials in the Corporation Income Tax are. Even a casual observation shows that regional differences in effective Corporation Tax rates within a unified economic area (a country or a free trade area like the *EU*) are compatible with economic growth and a reasonable, even high, level of Corporate Taxes. For instance, in United States, Canada and Switzerland<sup>218</sup> the Corporation Income Tax is a regional tax. In all the cases, the regions have full autonomy to decide the tax rates, the tax base and the deductions. The regions also administer the tax<sup>219</sup>. Harmonizing the effective tax rates has never been a priority for those countries which, on the other hand, are generally regarded as productively efficient. Furthermore, the Corporation Tax collection (in percentage of the *GDP*) in those countries is significantly larger than in countries with a uniform Corporation Income Tax like, for instance, France or Germany<sup>220</sup>.

It is also worth mentioning the case of the *EU*. The *EU* is a free trade area and each member state has a different effective Corporate Tax rate. The large differences in corporate taxes<sup>221</sup> have never been of sufficient concern so as to harmonize them or even to establish a minimum tax rate. Again, the *EU* is one of the most productively efficient regions in the world, and so far there has not been race to the bottom in the effective tax rates. In fact, the Corporation Income Tax collection for the whole *EU* is now larger than it was ten or twenty years ago.

All the examples above suggest that Corporation Taxes may be decentralized without significant economic distortions (whether delocalization or others). This is especially true when, as in the Economic Agreement, there are provisions to limit the tax differentials among regions and, by extension, possible tax competitions.

Beyond these examples, there is a large literature devoted to analyze the effects of tax differences on the spatial allocations or resources. The theory says that the location of a *new* firm depends on many factors. Among them, wage

<sup>216</sup> See Table 12.

<sup>217</sup> Small companies (sales of less than 7 million euros) with fiscal residence in the Basque Country are also subject to the tax rules of the *HTs*. See Table 11.

<sup>218</sup> See Table 17 below.

<sup>219</sup> In Canada the provinces can save costs transferring the administration of the Corporation Tax to the federal government. The only requisite is that they adopt the federal definition of tax base and the same tax deductions. The idea is that any province that voluntarily harmonizes its Corporation Tax will receive as compensation the saving of the collection costs. All provinces except Quebec and Alberta have accepted the deal. See section 9.3.

<sup>220</sup> According to the *OECD* (*OECD* [2009]) in the year 2007 the tax collection (as share of the *GDP*) was 3.7% in Canada, 3.1% in Switzerland and 3.1% in the United States. In Germany the collection was 2.2% and in France 3.0%.

<sup>221</sup> In 2010, the nominal tax rate in Ireland was 12.5% while in Germany it was almost 39% (including local taxes) and in France 34.43%.

differentials, proximity to markets, economies of agglomeration<sup>222</sup>, labour and environmental regulations, price of land, infrastructures (roads, ports and similar), taxes (Corporation Tax, Social Security Contributions, Personal Income Taxes) and many other. What is then the relative importance of taxes among so many factors? Obviously, the rest being the same, firms will locate where taxes are lower. The problem is that things are seldom the same. When regions differ in many things, taxes are simply a factor more that firms will take into account when deciding their location. But, probably, it is neither the first, nor the more important.

For existing firms the risk of delocalization for tax reasons is much smaller than for new firms because there are cost associated to delocalization (for instance compensations for firing old workers, cost of the production facilities, and so on). For that reason, only a few firms (those with low delocalization costs such as financial firms or Coordination Centres) may even consider to delocalize for tax reasons.

The theory suggests that taxes affect location, but that in most cases<sup>223</sup> it is unlikely that they will play a crucial role in localization decisions. The empirical evidence has not been able to shed much light on this question. To start with, given the multiplicity of factors that influence the location decision, it is not clear that you can find a relationship between taxes and delocalization that is valid for all types of firms, all countries or even all the regions in a country. Secondly, the empirical measurement is plagued with technical (econometric), measurement (for instance, the relevant tax rates or the variable that better measures “quantity” of productive activity delocalized) and quality of data problems. Not surprisingly, the econometric studies have not been able to produce plausible estimates of the elasticity of foreign investment with respect to tax rates. De Mooij and Ederveen (2005) revise 427 estimations of the tax elasticity of foreign investment reported in the literature. They concluded that the average tax semi-elasticity<sup>224</sup> reported was -4.0. This means that when the effective tax rate is reduced one percentage point (from, say, 30% to 29%), foreign direct investment increases in 4%. The variance they found was, however, very large and more than half of the studies reported a zero elasticity. In another survey of the empirical evidence on the effects of taxes on location Devereux (2006) points out that it would be misleading to give an estimate of the quantitative effect of taxes on capital flows because the empirical studies differ in many aspects (data, measures of tax rates, econometric techniques) that make them not comparable. He considers that much remains to be done to identify the impact of taxation on firm behaviour.

<sup>222</sup> These are the benefits that firms obtain when locating near each other. The benefits include, cost reductions (because firms have many competing suppliers, greater specialization of labour), more sales (a cluster attracts more customers than a single firm), access to specialized goods and services provided for the clustering firms, and quicker diffusion and adoption of ideas.

<sup>223</sup> One can imagine extreme situations (such as an effective tax rate of 0% vs an effective rate of 80%) in which taxes may be very important or even decisive. But those situations are almost never found in the real world.

<sup>224</sup> The semi-elasticity is equal to  $\partial \ln(FDI) / \partial t$ . It measures the percentage change in foreign direct investment (*FDI*) when the tax rate changes one point (for example, from 30% to 29%). The ordinary elasticity is  $\partial \ln(FDI) / \partial \ln t$ , and measures percentage change in *FDI* in response to a 1% change in the tax (for example, a decline from 30% to 29.7%).

The state of the empirical evidence is well summarized in the study of the Commission *Taxation in the Internal Market* where it is said that:

«To conclude, the empirical studies show, to different degrees, that there is a negative correlation between the size of taxation and location decisions. Nevertheless, most of the empirical studies suffer methodological weaknesses or are tailored to study just the effect of local business taxation. It is therefore difficult to have “the” quantitative measure of this impact even if the existence of such a relation is generally undisputed.»<sup>225</sup>

### 9.3. Tax Decentralization in Federal Countries

Table 20 summarizes the tax autonomy of regional governments in some of the most important federations. In the federal countries of the *UE*, the choice between regional tax autonomy and tax harmonization has been largely decided in favour of harmonization. For instance, in both Germany and Austria the regional governments (Länder or States) do not have almost any tax autonomy, even in their own taxes. Their principal sources of revenue are a share on the main federal taxes (Personal Income Tax, Corporation Tax and *VAT*) and equalization transfers. In Germany, although regional governments do not have any tax autonomy, they administer all the taxes including the federal taxes. In Belgium, regional governments have full autonomy in their own taxes. They also have some autonomy in the Personal Income Tax, and they can establish a surcharge (no region has done it yet) and introduce regional deductions (the Flemish region has done it).

Outside the *EU*, there are some federations in which the tax autonomy of regions is much larger in a double sense. First, regions can use almost any tax to finance their expenditure. Second, they have nearly full tax autonomy. And this happens in countries like Switzerland, Canada and United States that are among the most prosperous in the world. This shows clearly that regional tax autonomy is not at odds with economic efficiency and growth.

In Switzerland the regions (cantons), can use basically any tax, except the *VAT*, which is reserved for the federal government. The federal government also uses direct taxes. There is, however, a *de facto* division which implies that the federal government relies mainly on consumption (indirect) taxes and the cantons on income and wealth taxes (direct). Following the approval of the Harmonization Law of 1990 (which was not fully applied until 2001<sup>226</sup>) the structure of some taxes (Personal Income Tax, Corporation Income, Wealth Taxes and Real Estate Transfer Tax) was harmonized. The autonomy remains, however, very high and the Cantons can determine the level and structure of all their taxes<sup>227</sup>. The Cantons collect their own taxes but they also have the legal obligation to collect the federal taxes on individual income and corporate profits.

<sup>225</sup> See *COM* (2001) 582, final, box 6, page. 85.

<sup>226</sup> The law was enforced on 1 January 1993, granting an eight-year transition period to the cantons.

<sup>227</sup> In the personal income tax, for instance, the definition of tax base and the list and definitions of the possible deductions and allowances have been harmonized. The Cantons can, however, decide their own tax scales, tax rates and the amounts of the allowances and deductions.



**Table 20: Tax Decentralization in Selected Federations**

COUNTRY	MAIN CHARACTERISTICS OF THE FINANCING SYSTEM	MAIN TAXES OF REGIONAL GOVERNMENTS	TAX AUTONOMY
GERMANY	16 Länder. They have a share in the main federal ( <i>PIT</i> , <i>CT</i> and <i>VAT</i> ) and in a local tax (trade tax). They also have own taxes and receive (give) transfers in a horizontal equalization scheme.	Beer Tax, Betting and lottery, Motor vehicles tax, Inheritance and Gift tax, Real Property Transfer Tax. Other minor taxes.	Almost none. Only tax rate of the Real Property Transfer Tax.
BELGIUM	3 Regions and 3 Communities. They have a share in some federal taxes ( <i>PIT</i> , and <i>VAT</i> ) and in a local tax (trade tax). They also have own taxes and receive equalization grants. They can surcharge the <i>PIT</i> and modify the deductions.	Tax On Traffic Circulation, Advance Tax Payment on Property, Registration Rights, Mortgage Rights and Court Rights, Tax on the Entry into Traffic Service ( <i>TES</i> ), Eurovignette, Inheritance Tax and Transfer Duty upon Death. Other minor taxes.	Almost full autonomy in regional taxes. In the <i>PIT</i> , the regions can establish a surcharge (no region has done it) and introduce regional deductions (the Flemish region has done it).
AUSTRIA	In Austria there are 9 States (regions). The main taxes are shared between the three levels of government (federal, regional, local). The shared taxes include the <i>PIT</i> , <i>CT</i> , <i>VAT</i> and main Excises. The regional governments have own taxes and receive equalization grants.	Contribution for Residential Construction (gross income tax ) and many minor taxes (Fire Protection tax, Tax on Radio and TV licences, Tax on Tourism and so on).	None in the gross income tax, large in the minor taxes.
SWITZERLAND	26 Cantons. The Cantons have own taxes, a share on federal taxes ( <i>PIT</i> ) and equalization transfers.	<i>PIT</i> and Net Wealth Taxes, <i>CT</i> and Net Worth Taxes, Real Estate Capital Gains Taxes, Real Estate Taxes, Real Estate Transfer Taxes, Inheritance and Gift Taxes, Motor Vehicle Taxes. Other minor taxes.	The Harmonization Law sets limits to the definition of taxable base and to the allowances and deductions in several taxes ( <i>PIT</i> , <i>CT</i> , wealth taxes and real state transfer tax). In the rest full autonomy.

COUNTRY	MAIN CHARACTERISTICS OF THE FINANCING SYSTEM	MAIN TAXES OF REGIONAL GOVERNMENTS	TAX AUTONOMY
CANADA	<p>There are 10 provinces. They have own taxes and receive equalization grants. The main direct taxes (<i>PIT</i> and <i>CT</i>) are used by the federal and the provincial governments (concurrent taxes).</p>	<p><b>Common revenue sources with the Federal Government</b>  <i>PIT, CT, Sales, Payroll</i></p> <p><b>Unique provincial revenue sources</b>  Resource royalties within provincial jurisdiction, Gaming, liquor profit, Property tax.  <i>PIT</i>: In 9 provinces the provincial tax is applied on top of the federal tax, and the federal government administers the tax. Quebec has its own <i>PIT</i> and administers it.  <i>CT</i>: In 8 provinces the provincial tax is applied on top of the federal tax, and the federal government administers the tax. 2 provinces (Quebec, y Alberta) have their own <i>CT</i> and administer the tax.  Sales: 9 provinces have a sales tax. 3 apply a Harmonized <i>VAT</i> administered by the federal government. Quebec has also a Harmonized <i>VAT</i> but it administers the <i>VAT</i>. 5 provinces have retail sales taxes. Alberta does not have sales taxes.</p>	<p>Full autonomy.</p> <p>The provinces that voluntarily harmonize their taxes with the federal tax (<i>PIT</i> or <i>CT</i>) have to adopt the federal definition of tax base. They can, however, set the tax rates and establish tax credits.</p>
USA	<p>50 States (plus the District of Columbia). The States can establish almost any tax they wish. There is not a general equalization system among States. They receive conditional transfers from federal government.</p>	<p>Sales, <i>PIT, CT, Excises, Inheritances and Gift taxes.</i>  <i>PIT</i> used by 43 States  <i>CT</i> Used by 44 sates</p>	<p>Full autonomy (including the decision to establish the tax).</p>

*PIT*: Personal Income Tax, *CT*: Corporation Income Tax, *VAT*: Value Added Tax



The case of Switzerland is especially significant because it is a very small country that you can traverse in a few hours. The small size increases the risks of inefficiencies and delocalization for tax differences among regions. Despite those risks Switzerland is a competitive economy with a high economic growth and a quite efficient public sector.

In Canada provinces can use any tax they want (except customs import duties and taxes on non-residents) and have full autonomy on their taxes. They can also administer and collect their taxes. Most provinces have, though, accepted to establish the federal tax base in the Personal and Corporation Taxes. In exchange the federal government collects the provincial taxes, and provinces save the collection costs. There has been, therefore, a voluntary tax harmonization. In the indirect taxes only three provinces have accepted the harmonization of sales taxes.

In Canada the province of Quebec is different from the rest because it is the only province that has preferred fiscal autonomy to saving the collection costs. Quebec even administers the federal VAT within the province. The case of Quebec shows that political considerations (tax autonomy) may outweigh economic considerations (saving collection costs). It also shows that the administration of all taxes by only one region of a country does not entail significant global or local costs. In a basic sense the situation in Quebec is similar to the situation in the Basque Country. It is the only region in the country administering all the taxes, and there is a strong popular support for tax autonomy.

Finally, in the United States the States have full tax autonomy. Each State can establish the taxes it wants and can administer those taxes as it pleases. In practice, however, there is almost a distribution of taxes among levels of government. The federal government relies basically on direct taxes and the States on indirect taxes. Despite that, almost all the States have some direct taxes (Personal Income Taxes, Corporation Taxes or both). Most of them, however, adopt as the starting point of their Personal and Corporation Taxes the federal definition of tax base.

## 9.4. Conclusions

Tax decentralization produces economic and political gains. On the economic side, tax decentralization, if done properly, may increase accountability and responsibility<sup>228</sup>. The accountability and responsibility plus the risk of migrations (of individuals or productive factors) in response to over taxation, lead to more efficient regional taxes and expenditures. On the political side, tax decentralization is the natural response to self government demands of many regions.

Both the theory and the practical experience of the most advanced federations (Switzerland, Canada and United States) show that the decentralization of even all the taxes is unlikely to produce significant delocalizations (of persons or firms) or economic inefficiencies.

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<sup>228</sup> This is acceptance by regional governments that they are responsible for financing regional expenditures, and that they have to solve regional economic problems (linked to their competencies).

The Economic Agreement model decentralizes all the taxes to the *HTs*. The *HTs* regulate all the direct taxes and some minor indirect taxes. They administer all the taxes (direct on indirect). The model is based on *unilateral risk*, which means that the *HTs* bear the cost of any tax decrease and benefit from any tax increase. The Economic Agreement model gives rise to a maximum of accountability and responsibility of the *HTs*. This is consistent with the recommendations of the theory and the experience of the most advanced federations.

## 10. A COMPARISON BETWEEN THE COMMON AND THE FORAL SYSTEMS

The Basque Country is, with Navarre, the only *AC* with a Foral System of financing<sup>229</sup>. The other 15 *ACs* have the so called Common System of financing. This section describes the Common System and compares it with the Foral System.

### 10.1. The Basics of the Common System of Financing<sup>230</sup>

The system of financing of the Common Regime *ACs* has been reformed many times. However, the basic structure of the system has been always the same. The starting point is to determine the total amount of money assigned to the *ACs* in a base year<sup>231</sup>. Then, these resources are distributed among *ACs* according to different indicators of need (relative population, relative area and others). The resulting amount is an estimation of the need of each *AC*. The estimated total need of the  $i^{\text{th}}$  *AC*,  $N_i$ , is then:

$$N_i = N (\sum_j b_j I_{ij}) \quad [18]$$

where  $N$  is the total money given to the *ACs*,  $b_j$  the part of  $N$  distributed in proportion to indicator  $j$  (population, area, and so on) and  $I_{ij}$  the relative value of indicator  $j$  in the  $i^{\text{th}}$  *AC* (relative population of the  $i^{\text{th}}$  *AC*, relative area and so on).

The estimated need of each *AC* is financed with two sources of revenue: transferred taxes ( $T$ ) and an equalizing transfer from the Central Government ( $S$ ). Then, if  $T_i$  is the estimated tax collection<sup>232</sup> of taxes transferred to the  $i^{\text{th}}$  *AC*, the transfer it receives from Central Government,  $S_i$ , is:

$$S_i = N_i - T_i \quad [19]$$

<sup>229</sup> The Foral System of Navarre is essentially equal to the Foral System of the Basque Country. Navarre, though, has only one province and all the taxes belong to the Regional Government (which assumes the functions of the Foral Deputations).

<sup>230</sup> For more on the common system see, for instance, López Laborda, Martínez Vázquez, and Monasterio (2007) or Zubiri (2009).

<sup>231</sup> In all the reforms of the system, this amount was equal what the *ACs* received previous to the reform plus some additional contribution from the Central Government.

<sup>232</sup> This is equal to what the tax should collect in each *AC* at standard tax rates.

After the base year, the transfer from the Central Government ( $S_i$ ) increases at the same rate as the Central Government's tax collection. The transferred taxes ( $T_i$ ) increase, obviously, at the same rate as the tax collection in the  $i^{th}$  AC<sup>233</sup>.

Notice that the system is very egalitarian because each AC receives resources according to its needs. Furthermore, what an AC receives is independent of its fiscal capacity. In a basic sense, rich regions contribute to the financing of poor regions all their tax collection above their estimated need.

Up to 2009 almost all the reforms of the system have increased the taxes transferred to the ACs ( $T_i$ ). From a financial viewpoint, the impact of these additional taxes was null in the base year because each euro transferred in taxes was offset by a reduction of one euro in equalizing transfer from the Central Government. Basically, the ACs substituted transfers for own taxes. One consequence of the process of transferring more taxes was that in the system approved in 2002 the equalizing transfer from the Central Government ( $S_i$ ) was negative for two ACs<sup>234</sup> (Madrid and the Balearic Islands).

As already said, a transfer of taxes does not change the resources of an AC in the base year. After the base year, the transfer of more taxes increases (decreases) the resources of the ACs whose tax collection grows faster (more slowly) than the tax collection of Central Government<sup>235</sup>. This favours high growth ACs<sup>236</sup>, and may open a wedge between the resources of an AC and its estimated need. However, this effect is quantitatively small and takes place slowly.

The 2009 reform has apparently changed things (see Box 1). Up to then, the system distributed all the resources assigned to the ACs according to need. There was, therefore, 100% equalization. The main change was that, starting 2009, the equalization was limited to *basic public services provided by the ACs*. The public services considered as basic are Education, Health and Social Services. The reform creates a fund to finance those basic services in all the AC. The fund, called Fund of Guarantee of Basic Public Services, is endowed with 75% of the taxes transferred to the ACs and with a contribution from the Central Government. The distribution among ACs of this Fund is made according to indicators of need. Then, the need of basic services of an AC,  $N_{i,t}^*$  is:

$$N_i^* = N^* (\sum_j c_j I_{ij}) \quad [20]$$

<sup>233</sup> This rate will depend on to the economic growth of the AC.

<sup>234</sup> This means that the collection of transferred taxes is larger than the estimated need and, as a consequence, the AC has to transfer the difference to the Central Government.

<sup>235</sup> Notice that the additional resources of an AC after a transfer of taxes grow at the same rate as the tax collection (from the new taxes) while the resources lost (the equalizing transfer) grew at the rate of the tax collection of the State.

<sup>236</sup> There is a tendency to convergence of per capita income, which implies that, in general, poor ACs will grow faster than rich ACs.

where  $N^*$  are the total resources given to the ACs to finance *basic services* (the Fund of Guarantee of Basic Public Services);  $c_j$  is the part of  $N^*$  distributed in proportion to indicator  $j$  and  $I_{ij}$  is the relative value of indicator  $j$  in the  $i^{\text{th}}$  AC. Since  $N^*$  is, approximately, 80% of all the resources assigned to the AC, the new system equalizes 80% of the need while the previous system equalized 100% of the need.

Each AC has to devote 75% of its tax collection to finance its basic needs. Then, to ensure the same coverage of basic needs in all the ACs, each AC receives a transfer from the Central Government called *Transfer of Guarantee* (TG) equal to:

$$TG_i = N_i^* - 0.75T_i \quad [21]$$

where  $T_i$  is the estimated collection of the taxes transferred to the  $i^{\text{th}}$  AC. The transfer is negative for rich ACs because for them 75% of the transferred taxes ( $0.75T_i$ ) is more than their estimated basic needs ( $N_i^*$ ).

The system is completed with a sufficiency fund and two convergence funds (the competitiveness fund and the cooperation fund). The first fund is distributed among ACs to ensure that none of them receives with the new system less than an enlarged version of what they received with the previous financing system. The enlarged version of what they received is simply the sum of what they received with the previous system plus a share of the additional resources given to the AC in the new system<sup>237</sup>. That is, the enlarged previous need of the  $i^{\text{th}}$  AC,  $EN_i$ , is:

$$EN_i = N_i^{t-1} + B_i \quad [22]$$

where  $N_i^{t-1}$  is what the AC received with the previous system and  $B_i$  is its share in the new resources that the Central Government gives to the ACs<sup>238</sup>.

If with the transferred taxes and the transfer of guarantee an AC receives less (more) than its enlarged need, then it receives (has to make) a transfer from (to) the Central Government for the difference. This transfer is called the *Transfer of Sufficiency*,  $TS_i$ . It is defined as:

$$TS_i = EN_i - T_i - TG_i \quad [23]$$

where  $EN_i$  is the enlarged need of the  $i^{\text{th}}$  AC.

<sup>237</sup> To reach an agreement with the AC, the Central Government increased in almost 12% the resources given to the AC ( $N$  in equation [18]).

<sup>238</sup> The share of each AC in the new resources is determined according to ad hoc indicators of need (which, somewhat surprisingly, are different from the indicators used to establish basic needs in equation [20]).

## **BOX 1: The Common System of Financing<sup>1</sup>**

The existing system of financing was approved in 2009. It is in force since 2010

### **1. OBJETIVE**

The objective of the system is to equalize the financing of basic services (health, education and social services). The resources to finance the basic services represent about 80% of the total resources given to the AC. In practice the equalization is larger due to the sufficiency transfers.

### **2. RESOURCES OF THE ACs**

The resources of the AC are taxes (own and shared) and transfers from the central government.

#### **A. Taxes of the ACs**

Shared taxes: 50% of the personal income tax, 50% of the VAT and 58% of manufacturing excises (Alcohol and Alcoholic Beverages, Intermediate Products (also a tax on alcohol), Beer, Mineral Oils and Manufactured Tobacco). Own taxes: Inheritance and Gift taxes, Electricity tax, Capital Transfer Tax and Stamp Duty, Duty on Certain Means of Transport, Excise Duty on Retail Sales of Certain Mineral Oils and Gaming Duties.

#### **B. Transfers to the ACs**

There are three types of transfers:

**B.1. Guarantee of Basic Services Transfer.** Each AC has to devote 75% of its collection to financing basic services. The transfer it receives is then equal to its estimated need of Basic Services minus 75% of its estimated tax collection from taxes transferred to the AC. The need is estimated in two steps. First an amount of money is allocated to finance the Basic Service of all the AC (the amount is equal to 75% of the estimated collection of transferred taxes plus a contribution from the central government. The sum of these two elements is equal to about 80% of all the resources given to the AC). Second, the estimated need of each AC is obtained distributing the total amount among the ACs using indicators of relative need (relative population, relative size, and so on). For rich AC the transfer is negative (they have to transfer money to the central government) because 75% of their collection is more than their estimated needs.

**B2. Sufficiency Transfer.** The basic resources of an AC are defined as what it received with the previous financing system plus an increase decided on grounds such as the recent evolution of population and other variables. The sufficiency transfer ensures that no AC receives with the system approved in 2009 fewer resources than its basic resources. It is equal to the basic resources of the AC minus its estimated collection from transferred taxes minus the Transfer of Guarantee. The Sufficiency Transfer can be positive (if the estimated collection of transferred taxes is smaller than the basic resources) or negative (otherwise).

**B.3. Convergence Transfers.** The system includes two additional transfers under the heading of convergence transfers. The first one, called competitiveness transfer<sup>2</sup> is to compensate the ACs that receive less per capita<sup>3</sup> funds (estimated collection of transferred taxes plus transfers of guarantee and sufficiency) than the average. The second transfer, called the cooperation transfer, is distributed among the ACs with a per capita GDP below 90% the average, the ACs with low density of population, and the ACs with both low density and population growth below average.

The Guarantee and Sufficiency Transfers are computed for a base year. After that year, they are increased basically at the same rate as the tax collection of the Central Government<sup>4</sup>. The transferred taxes increase, obviously, at the same rate as the tax collection of each AC.

The system is somewhat surprising because what really determines most of the resources of each AC is the Sufficiency Transfer, which guarantees that each AC receives what it received with the previous system plus an additional amount. The result is that approximately 90% of the resources are distributed as in the old system and most of the remaining 10% is also determined by an ad hoc distribution of the additional resources (see main text for details).

<sup>1</sup> See Consejo de Política Fiscal y Financiera (2009). <sup>2</sup> Despite its name, the transfer has nothing to do with competitiveness. <sup>3</sup> To compute this it is used a definition of *adjusted population* that is equal to the real population adjusted by some indicators of the number of beneficiaries (of Health, Education and Social Services) and of the cost of provision (area of the AC). <sup>4</sup> The guarantee fund of each year is distributed among ACs updating the relative indicators of need (changes in relative populations, for instance). The distribution of the sufficiency transfers never changes.

The resources of an *AC* in the base year (before convergence funds),  $RB_i$ , are equal to the transferred taxes plus the Transfers of Guarantee and Sufficiency. That is:

$$RB_i = T_i + TG_i + TS_i = EN_i \quad [24]$$

This is a rather surprising result. Despite all the complexity of the model, what an *AC* receives in the base year (before convergence funds) is equal to, simply, what it received with the previous system plus a share of the new resources.

The final resources in the base year are obtained adding the convergence transfers (competitiveness and cooperation) to [24]. The competitiveness fund (which despite its name has nothing to do with competitiveness) is distributed among the *ACs* whose adjusted per capita resources are below the average. The cooperation fund benefits poor *ACs* (with a per capita *GDP* below 90% of the average), the *ACs* with low population density, and those with both low density and an increase of population in the last three years that is below 90% the average of all *ACs*. Calling  $TC_i$  to the Convergence Transfers, the resources of an *AC*,  $R_i$ , are finally<sup>239</sup>:

$$R_i = T_i + TG_i + TS_i + TC_i = RB_i + TC_i \quad [25]$$

which, using equation [24] becomes,

$$R_i = EN_i + TC_i \quad [26]$$

This equation shows that, even though in theory only 80% of the resources are distributed according to need, in practice, at least in the base year, almost all the resources (all but the competitiveness fund, which is slightly more than 2% of the total resources of the *ACs*) are distributed according to indicators of need. Or, to put it another way, the resources of an *AC* in the base year are independent of its fiscal capacity.

After the base year, each of the components of the financing system (transferred taxes and transfers) increases at a different rate. Basically, the transferred taxes increase at the rate of tax collection in the *AC*, while the transfers (guarantee<sup>240</sup>, sufficiency and convergence) increase at the same rate as the tax collection of Central Government. As already said, the result is that the resources of the *ACs* that grow faster will increase more than the resources of the *ACs* that grow more slowly.

## 10.2. Tax Autonomy of Common Regime Autonomous Communities

Table 21 summarizes the tax autonomy of the common regime *ACs*. As the Table shows, they have two types of taxes.

<sup>239</sup> The poor *AC* receive also a transfer from the so called Inter Territorial Compensation Fund, which is an equalization fund outside the general financing system.

<sup>240</sup> The Guarantee Fund of each year is distributed among *AC* updating the relative indicators of need (changes in relative populations, for instance).

**Table 21: Tax Autonomy of the AC of Common Regime (2010)**

<b>1. Personal Income Tax</b>	<b>Shared Tax. 50% assigned to the ACs. On their share of the tax the ACs can change:</b> a) Tax scale with the condition that it has to be progressive b) Tax Deductions and Credits. The ACs can establish personal and family allowances, non business investment tax credits, credits for some uses of income (donations, some expenses as rents). They can also change up to 50% (increasing or decreasing it) the mortgages deduction established by the State <sup>2</sup> .
<b>2. Wealth tax</b>	<b>Tax of the ACs<sup>5</sup></b> Full Autonomy
<b>3. Corporation Income Tax</b>	<b>Tax of the Central Government, not shared with the ACs</b>
<b>4. Non Residents</b>	<b>Tax of the Central Government, not shared with the ACs</b>
<b>5. Inheritance and Gift taxes<sup>1</sup></b>	<b>Tax of the ACs<sup>5</sup></b> Full Autonomy
<b>6. VAT</b>	<b>Shared Tax. 50% assigned to the ACs without any autonomy</b>
<b>7. Capital Transfer Tax and Stamp Duty<sup>1</sup></b>	<b>Tax of the ACs<sup>5</sup></b> a) Tax rates on notarial documents, purchases of real estate, establishing rights <i>in rem</i> (e.g. a usufruct) and acquisition of a registered interest in property. b) Deductions and reliefs on the same items in which they can change the tax rates.
<b>8. Insurance Premiums Tax</b>	<b>Tax of the Central Government, not shared with the ACs</b>
<b>9. Excises</b>	<b>Tax of the ACs<sup>3</sup></b> In the Excise Duty on Certain Means of Transport <sup>4</sup> , the ACs can increase up to 15 points the tax rate set by the Central Government. <b>The Electricity Tax and the Excise Duty on Certain Means of Transport are taxes of the ACs. The rest of excises are Shared Taxes, In all the cases the AC receives 58% of the tax collected in its region. The ACs do not have any autonomy in these Excise.</b>
<b>10. Excise Duty on Retail Sales of Certain Mineral Oils<sup>3</sup></b>	<b>Tax of the ACs<sup>5</sup></b> Tax rates within an interval established by the State.
<b>11. Gaming Duties<sup>1</sup></b>	<b>Tax of the ACs<sup>5</sup></b> Exemptions, Tax Base, Tax rates, Lump Sums on slot machines and Bonifications.

<sup>1</sup> Administered by the ACs. The rest are administered by the Central Government. <sup>2</sup> In general the ACs have to accept 50% the tax credits given by the Central Government. <sup>3</sup> The excises in Spain and in the Basque Country are: Alcohol and Alcoholic Beverages, Intermediate Products (also a tax on alcohol), Beer, Mineral Oils and Manufactured Tobacco, Electricity and Certain Means of Transport. <sup>4</sup> It is a tax paid upon the first registration of, basically, cars. <sup>5</sup> Eliminated by all the AC in 2008. Navarra, Alava and Biscay eliminated this tax in 2008 and Guipuzcoa in 2009.



- a) Taxes shared with the Central Government. The shared taxes are the Personal Income Tax (of which the ACs receive 50%), the VAT (50%) and the manufacturing excises<sup>241</sup> (58%).
- b) ACs' own taxes. The ACs' own taxes are the wealth tax<sup>242</sup>, the Inheritance and Gift taxes, the Electricity tax, the Capital Transfer Tax and Stamp Duty, the Duty on Certain Means of Transport, the Excise Duty on Retail Sales of Certain Mineral Oils and the Gaming Duties.

As for the autonomy, the ACs have full autonomy in the Wealth Tax<sup>243</sup>, and in the Inheritance and Gift taxes. There is also a substantial autonomy in the Personal Income Tax (the ACs can determine tax rates, deductions and allowances). In the indirect taxes, the ACs have a large autonomy in the Capital Transfer Tax and Stamp Duty and in the Gaming Duties. They can also establish surcharges on the rates set by the Central Government in the Duty on Certain Means of Transport and the Excise Duty on Retail Sales of Certain Mineral Oils. Finally, they have no autonomy in the VAT and the manufacturing excises.

The Common System ACs can therefore, set almost without restrictions the (effective) tax rates of (their share of) the Personal Income Tax, and of all other direct taxes (except the Corporation Income Tax). They also have some discretion on some indirect taxes. The Common Regime ACs have, then, a significant tax autonomy that allows them to increase taxes as much as they need to finance any additional expenditure they want. The Common Regime ACs can also reduce direct taxes if they want to spend less

A basic difference with the Foral ACs is that in the Common Regime ACs almost all the taxes are administered by the Central Government. The ACs only administer the Inheritance and Gift Taxes, the Capital Transfer Tax and Stamp Duty and the Gaming Duties.

### **10.3. Main differences and similarities**

The two main characteristics of a financing system are the tax autonomy and the financial capacity of the regions. What follows compares both characteristics in the Common and Foral Regimes.

#### **10.3.1. Tax Autonomy**

From the viewpoint of tax autonomy, there are several similarities and differences between the ACs of the Foral and those of the Common system. The main similarities are:

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<sup>241</sup> Alcohol and Alcoholic Beverages, Intermediate Products (also a tax on alcohol), Beer, Mineral Oils and Manufactured Tobacco

<sup>242</sup> This tax was eliminated in 2008 in all the Common Regime AC and Navarre. In the Basque Country Alava and Biscay eliminated the tax in 2008 and Guipuzcoa in 2009.

<sup>243</sup> If one AC wants to reinstate it, it can do it.

- a) Both systems allow *ACs* to adjust their tax revenues (upward or downward) to their preferred expenditure levels. In both cases the *ACs* have a substantial autonomy in the direct taxes and very little autonomy in the indirect taxes. To a large extent, the difference in autonomy between direct and indirect taxes is due to the fact that the *EU* Commission does not allow regional differences in the main indirect taxes.

Since both types of *ACs* can change their tax collection, they can spend as much (or as little) as their residents want. In practice, though, the *ACs* of the Common Regime have been very reluctant to increase their taxes and, instead, they have preferred to demand more resources<sup>244</sup> from the Central Government. In fact, what they have usually done is, at the same time, decrease their own taxes and demand more resources.

- b) The Foral *ACs* and the Common Regime rich *ACs* finance all their expenditures with own taxes<sup>245</sup>. The evolution of their resources depends, therefore, on the evolution of their regional economy.

On the other hand, there are several important differences:

- a) The Foral *ACs* collect all the taxes while in the Common Regime most of the taxes (including some taxes that belong exclusively to the *ACs*<sup>246</sup>) are collected by the Central Government. One of the consequences of this is that Foral *ACs* have a much more developed Tax Administration. In fact, Foral Tax Administrations have the same functions as the Tax Administration of any *EU* country. Since Foral *ACs* collect all their taxes, they bear all the collection costs. In contrast, in Common Regime *ACs* most of the collection cost is borne by the State.

The collection of all taxes makes the Foral *ACs* much more accountable than the Common Regime *ACs*. This leads, probably, to more efficient governments. Furthermore, since the Central Government does not collect any tax in the region, the Foral governments feel more responsible (than the Common Regime *ACs*) for their finances and the public polices in their regions<sup>247</sup>.

- b) The Foral *ACs* can change the level and the structure of the Corporation Income Tax while in the Common Regime the Corporation Tax belongs exclusively to the central Government. The Foral *ACs* have, then, more

<sup>244</sup> This has been done demanding either more transfers or a larger share in the taxes collected by the central government. For political reasons (basically the central government need of votes to obtain a majority in the Parliament) the *AC* have been successful very often. For more details see Zubiri (2009). In 2010, with the Central Government in the midst of a financial crisis, a few *ACs* increased a little their taxes to reduce their big fiscal deficits.

<sup>245</sup> What a Common Regime rich *AC* obtains from transferred taxes will in general exceed its estimated needs. As a result its sufficiency transfer will be negative (see equation [23]).

<sup>246</sup> See Table 21.

<sup>247</sup> This means that they feel obliged to solve the economic problems without resorting to the central government (for more funds or policy measures).

tax instruments than the Common Regime ACs. The Corporation Tax gives the ACs not only an additional instrument to increase (or decrease) tax collection. More importantly, it is a valuable tool for industrial policy that is often used by governments, especially in economic downturns<sup>248</sup>.

- c) The Foral ACs can change all the structure of the Personal Income Tax, while the Common Regime ACs can only change the structure of 50% of the income tax. This difference, however, does not have significant practical implications<sup>249</sup>.

### 10.3.2. Financial Capacity

In the Common System, the resources of each AC depend basically on its estimated need<sup>250</sup>. In the Foral System things are different. The resources of an AC are equal to what it collects minus a Quota<sup>251</sup>. Since the Quota is independent of the tax collection of the AC, the resources of a Foral AC (Basque Country or Navarre) depend on what it collects. That is, on its fiscal capacity.

For a rich AC like the Basque Country or Navarre a system based on capacity produces more resources than a system based on need. It is not surprising then that the Basque Country and Navarre obtain about 50% more per capita resources than the average Common Regime AC<sup>252</sup>. As a percentage of the GDP the differences are much smaller and the Basque Country and Navarre receive about 25% more than the average Common Regime AC.

Many of the differences of resources due to the financing system are, however, compensated by the Central Government with its own budget. For instance, De La Fuente (2009)<sup>253</sup> points out that, without a clear legal asymmetry with other ACs that justifies it, there are several areas in which the State spends very little (in comparison to other ACs) or nothing in the Basque Country. This happens, for instance, in housing, social services, culture and agriculture.

One of the main instruments used by the State to make compensations is investment. For instance, the Basque Country is about 6.3% of the economy of Spain. Despite that, in the last ten years the Basque Country has never received much more than 2% of the total investment of the Central Government. The Basque Country has to compensate this difference with its own resources. And that is a sizable amount of money because, for instance, in the year 2008 the investment of the Central Government was above 2.5% of the Spanish GDP.

<sup>248</sup> The effectiveness of reducing Corporation Taxes in economic downturns is quite dubious. However, in the past most governments have reacted reducing Corporation Taxes in times of crisis.

<sup>249</sup> Notice that from the perspective of the tax payer it is the same to increase the tax rate one point in 100% of the tax base than two points in 50% of the tax base.

<sup>250</sup> Recall that although in theory only 80 % of the resources are based on need, the Sufficiency Transfer (equation [23]) equalizes a large part of the remaining 20%.

<sup>251</sup> See section 6.2. In the case of Navarre, the Quota is called the Contribution.

<sup>252</sup> For more details, see Zubiri (2006).

<sup>253</sup> See also De La Fuente (2001)

## 11. THE ECONOMIC AGREEMENT IN THE EUROPEAN UNION

The European Union has never questioned the legitimacy of the Economic Agreement model. However, in the past there have been doubts about whether or not the tax autonomy of the *HTs* in the Corporation Tax was compatible with the European Community (*EC*) Treaty. The basic question was if:

- a) A region with a tax autonomy constitutionally sanctioned (like the Basque Country) could establish an effective Corporation Tax rate lower than the one in force in the rest of the country, or
- b) Since the tax reduction applies only to a part of the country it would be a selective (regional) state aid contrary to the *EC* Treaty.

In case b), the *HTs* could not establish Corporate Taxes below those of the State, which would imply that they could not have autonomy in the Corporation Income Tax. More generally, b) would mean that regional autonomy in the Corporation Income Tax is contrary to the Treaty and, therefore, the *EU* countries could never give that autonomy to their regions.

The question reached the Court of Justice of the European Communities in 1997 because the High Court of Justice of the Basque Country (*Tribunal Superior de Justicia del País Vasco*) asked for a preliminary ruling on some tax investment incentives given by the *HTs*. The High Court of the Basque Country wanted to know if some tax incentives introduced in 1993 by the three *HTs* in their Corporation Taxes were precluded by the articles 52 (about freedom of establishment) or 92.1 (on state aid) of the *EC* Treaty<sup>254</sup> because the incentives only applied to companies that were tax residents of the Basque Country<sup>255</sup>.

On July 1999 the Advocate General in charge of the case, Mr. Saggio, presented his opinion<sup>256</sup>. In his view, the tax incentives of the *HT*:

- (a) Were contrary to the freedom of establishment because since all the non residents operating in the Basque Country were subject to the fiscal legislation of the State, they were excluded from the benefits provided by the Basque tax regulations. This problem had to do with the points of connection<sup>257</sup> and since then it has been solved because the points of connection for non residents have been changed. Now (see Table 11) non resident companies operating through a permanent establishment are subject to Basque fiscal regulations in the same conditions as resident companies.

<sup>254</sup> After the amendments of the Treaty, art 42 is art 53 and 92.1 is art 87.1.

<sup>255</sup> As seen in section 5.2, the Basque regulations in the Corporation Income Tax apply to small firms or to large firms with tax residence in the Basque Country whose volume of transactions in the Basque Country exceeds 25% of their total volume of transactions.

<sup>256</sup> See Opinion of Mr Advocate General Saggio delivered on 1 July 1999 on Joined cases C-400/97, C-401/97 and C-402/97.

<sup>257</sup> Those are the criteria to determine which tax payers pay taxes to each Tax Administration and by how much. See section 5.2.

- (b) Constituted State Aid. According to the Advocate General, the tax incentives are “intended exclusively for companies situated in a particular region of the Member State (...) and constitute for them an advantage which companies intending to carry out similar economic operations in other areas in the same State cannot enjoy”. In his view, this implies that the incentives are selective measures and should, therefore, be considered State Aids contrary to the EC Treaty.

He goes even further to assert that “The fact that the measures (...) were adopted by regional authorities with exclusive competence under national law is (...) merely a matter of form, which is not sufficient to justify the preferential treatment reserved to companies which fall within the scope of the provincial laws. If this were not the case, the State could easily avoid the application, in part of its own territory, of provisions of Community law on State aid simply by making changes to the internal allocation of competence on certain matters thus raising the ‘general’ nature, for that territory, of the measure in question”.

His conclusion was that the tax incentives had to be considered contrary to the freedom of establishment and State Aid because they “not include among those to which those measures apply other natural and legal persons resident in the State itself or in another Member State of the European Community”.

In a basic sense, this opinion was saying that the Basque Country could not regulate the Corporation Income Tax or even the Personal Income Tax on business income because any difference with the State would be State Aid<sup>258</sup>. By extension, the opinion implied that no region of the EU could have different business taxes than the country it belongs to. Or to put in other words, no country could decentralize business taxes.

The opinion was never analyzed by the Court because the High Court of Justice of the Basque Country withdrew the request for a preliminary ruling<sup>259</sup>. However, for a long time it was a Damocles’ sword over the Economic Agreement. Or, to be more precise, over the tax autonomy on the Corporation Income Tax.

The opinion of the Advocate General was, though, more than dubious from a legal and economic viewpoint. Furthermore, it had implications that were unacceptable.

To start with, there was a legal problem. The Commission defines as general measures “Tax measures which are open to all economic agents operating within a Member State”<sup>260</sup>. According to that, it is obvious that the tax systems of the HTs

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<sup>258</sup> Strictly speaking the opinion referred only to Corporate Tax reductions. However, a similar reasoning could be applied to taxes higher than in the rest of Spain. With a higher tax rate in the Basque country any company that is tax resident in the Basque Country, could complain that it suffers a competitive disadvantage in comparison to other Spanish firms.

<sup>259</sup> The reason was that after reaching an agreement with the HTs, the State withdrew the lawsuit in the High Court of Justice of the Basque Country against the tax incentives given by the HTs.

<sup>260</sup> See EC (1998).

are not general. However, the tax system of the State is neither general because, for instance, companies filing taxes in the Basque Country cannot apply the tax incentives given by the State. What happens is, obviously, that in Spain there is not a general system and therefore one cannot argue that taxes in the Basque Country are selective in regional scope. If the Basque Country tax regulations are selective, so are the tax regulations of the State. Simply, the notion of general tax system (which is defined from a unitary country viewpoint and uses the whole country as the reference framework) has to be redefined in federal countries like Spain where taxes are decentralized<sup>261</sup>.

In the second place, the opinion was more than questionable from an economic viewpoint. The opinion said that if the Basque Country has its own tax system, and has decided to have a Corporation Income Tax (slightly<sup>262</sup>) below the one in the rest of Spain, then that tax is distorting regional State Aid. However, according to the Commission if a country like, for instance, Ireland decides to have a Corporation Income Tax much lower than any other country, then that tax is non distorting, even efficiency enhancing, healthy fiscal competence. Putting both arguments together, the bottom line seems to be: Business tax differences among regions of a country (even if very small) are distortionary and efficiency reducing. However, business tax differences among countries (even if very large) are non distortionary and efficiency enhancing. From an economic viewpoint that is, to say the least, difficult to sustain.

On the other hand, if the *EU* accepts national differences in Corporation Taxes not for economic reasons but for political reasons (the political right of countries to decide the Corporation Tax level they want), it should also respect the political reasons behind the decentralization of Corporation Taxes to regions (the right of countries to decide its political organization).

In any case, it is worth pointing out the difference made by the Commission between general tax measures (considered always non distorting) and selective tax measures (considered always distorting) is very questionable from an economic viewpoint. It is just not clear why the Commission considers non distorting setting a tax rate 20 points below the tax rate of any other country but thinks that giving a tax benefit to, for instance, firms making large investments is very distorting.

Finally, the third problem regarding Mr. Saggio's opinion was that its implications were unacceptable. First, countries like Switzerland where business taxes are decentralized could never join the *EU*, unless they changed their model of decentralization<sup>263</sup>. Second, many *EU* countries would have to eliminate the differences

<sup>261</sup> From a legal viewpoint Spain is not a federation. However, from an economic and even political viewpoint (there are regional parliaments with wide powers), it is a federation.

<sup>262</sup> The harmonization principles shown in Table 12 preclude big differences.

<sup>263</sup> As shown in Table 20, Canada and the United States also allow regions to levy a regional Corporation Income Tax.

they have in business taxes among regions (Portugal and Italy<sup>264</sup>) and municipalities (for instance, France, Germany and Luxembourg) because, according to his opinion, they were distorting.

Things remained ambiguous for several years, but under the threat of, on one hand, an opinion (not presented to the Court) that considered contrary to the EC Treaty all regional differences in business taxation and, on the other, a Commission that did not like too much regional tax differences. In 2006 there was, however, a substantial turnaround of the situation. In a case of a reduction of Personal and Corporation Income Taxes in the Azores islands that had been considered State Aid by the Commission, the Court analyzed in detail the concept of *regional selectivity of tax rules*<sup>265</sup>. The main change was that Court did not consider that the country had to be the reference framework to define general tax systems and spatial selectivity. It admitted that tax rules adopted by a local or regional authority could be general if that authority is sufficiently autonomous in relation to the Central Government of the country. Or to put it in other words, given enough autonomy, a territory (region, province or municipality) is the reference framework to consider a tax measure as general.

To determine if a lower taxation in a region of a country is, or not, regional State Aid the Court distinguished three cases:

1. The Central Government unilaterally decides that the applicable national tax rate should be reduced within a defined geographical area.
2. In the country, there is a distribution of tax competencies in which all the local authorities at the same level (regions, districts or others) have the autonomous power to decide, within the limit of the powers conferred on them, the tax rate applicable in the territory within their competence.
3. A regional or local authority adopts, in the exercise of sufficiently autonomous powers in relation to the central power which other authorities do not hold (asymmetry), a tax rate lower than the national rate which is applicable only to undertakings present in the territory within its competence.

Before analyzing the three cases it should be remembered that the concept of State Aid refers to measures that favour certain firms or the production of certain goods. Therefore, in principle, the judgement of the Court applies only to business taxes<sup>266</sup>.

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<sup>264</sup> In Portugal the provinces can surcharge the corporation income tax up to 10%. In Italy the regions can surcharge (up to 1%) the regional tax on productive activities (which is a tax on value added. That is on benefits plus wages plus interest). In France there is a local business tax (*Taxe professionnelle*) in Germany a trade tax (*Gewerbesteuer*) and in Luxembourg a corporation-trade tax (*Impôt commercial communal*).

<sup>265</sup> See *Portuguese Republic v Commission of the European Communities*, C 88/03, 6 September 2006.

<sup>266</sup> This certainly includes corporation taxes and, probably, social security contributions. In principle, it has nothing to do with indirect taxes, although some of the arguments of the Court could be used to justify differences in some indirect taxes (some excises, for instance).



In the first case, the Court indicates that, as it is obvious, the reference framework is the country. The lower tax in a region is a selective measure and, therefore, regional State Aid. In the second case, there is not a normal tax rate applied in the whole country. Then, according to the Court, any tax measure taken by a local authority is not selective because it is impossible to determine a normal tax rate capable of constituting the reference framework. Simply, it can no be said that a region has a rate lower than the normal rate in the country because such a normal rate does not exist. Consequently, in the case of taxes decentralized to all local authorities, the reference framework has to be the jurisdiction of the local authorities (region, municipalities, districts and so on).

It should be noted that the difference between cases one and two is reasonable from a legal or even from a political viewpoint. However it is more than questionable from an economic viewpoint. To see this, consider a country divided into two regions *A* and *B*. In region *A* the effective tax rate of, say, the Corporation Income Tax is 20%. In *B* the tax rate is 10%. According to the Court if tax rates are determined by the Central Government, the tax rate in *B* is an inefficient and distorting regional State Aid that should be removed. If, however, the Corporation tax is a tax of the regions and each has decided the tax rate, there is no inefficient selectivity and nothing has to be removed. The problem is that independently of who determines the tax rates, the economic result is the same. That is, the allocation of resources (efficient or inefficient) is the same in both cases.

In the third case, which is the one that applies to the Basque Country<sup>267</sup>, the Court established that the tax rules adopted by a local or regional authority could be general if it is sufficiently autonomous in relation to the Central Government of its country. The Court also defined what enough autonomy of a Territory means. According to its judgement enough autonomy means that the following three criteria are met cumulatively:

- a) **Institutional Autonomy.** The regional or local authority has, from a constitutional point of view, a political and administrative status separate from that of the Central Government.
- b) **Procedural Autonomy.** The tax rule must have been adopted without the Central Government being able to intervene directly as regards its content.
- c) **Financial Autonomy.** The financial consequences of a reduction of the national tax rate for undertakings in the region concerned must not be offset by aid or subsidies from other regions or the Central Government.

Conditions a) to c) ensure that the regional government regulates the tax freely and fully bears the financial consequences of a tax reduction. Putting it simply, a) to c) mean that the regional government is the only responsible for the tax within its region. When that is the case, the Court says that the region is the reference framework to assess the generality of taxes. The implication is that a

<sup>267</sup> Recall that the Basque Country and Navarre have more tax autonomy than any other AC (see Tables 13 and 21).



business tax in a region lower than in the rest of the country is not a regional State Aid, and regions with enough autonomy can have lower business taxes if they want.

This new approach to the assessment of regional tax differences is the only reasonable from a legal, economic or political viewpoint. Economically, with free movement of productive factors (both among countries and within each country) it does not make much sense to say that the application of different tax systems in two countries is non distorting, but the application of different tax systems in two regions of a country is distorting<sup>268</sup>. Simply, from the viewpoint of economic efficiency (or inefficiency), there is not any difference between a tax difference between countries and a tax difference between regions of a country. Therefore, on efficiency grounds, if the Commission accepts tax differences between countries, it should accept regional tax differentials, at least under some conditions.

From a legal viewpoint if the tax sovereignty over the country is divided among several Tax Administrations, as the sentence points out, there is nothing such as a *normal tax rate* applied in the country. Then there is not a national reference framework and the concept of regional State Aid lacks any sense.

Finally, from a political perspective, the acceptance of regional tax differences implies that the Commission will not interfere with the right of countries to decentralise business taxes if for economic or political reasons (or both) they want to do so.

For the Basque Country, the acceptance by the Court of tax differences within a country meant that after a long period of doubts (due basically to the 1997 opinion of Mr. Saggio and the misgivings of the Commission about regional tax differences) it was definitively clear that the tax autonomy of the HTs in the Corporation Income Tax was not contrary to the EC treaty. In particular, an effective Corporation Tax rate lower than the one in the State is not a regional State Aid and therefore, is not precluded by the EU regulations.

After the judgement, the only question left was not if the HTs could have autonomy in the Corporation Income Tax, but if they complied with the three conditions established by the Court. It is easy to see that the answer is affirmative<sup>269</sup>.

- a) **Institutional Autonomy.** As already mentioned, the Spanish Constitution in the first additional provision “*recognizes and respects the historic rights of the territories*”. Following this recognition of historic rights, each Territory has its own Territorial Parliament (*Juntas Generales*) and Territorial Government (Foral Deputation). Each Territory has also its own Public Administration, including a Tax Administration (treasury, inspectors, and so on). There is no doubt, therefore, of the institutional autonomy of the HTs.

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<sup>268</sup> Notice that if a region has all the tax power (and bears all the financial consequences of any tax reduction) its tax decisions will be based on the same criteria and will have the same effects on resource allocation than the decisions of a Central Government.

<sup>269</sup> The High Court of Justice of the Basque Country answered this question affirmatively in several sentences in December 2008.

- b) **Procedural Autonomy.** Each *HT* has full autonomy in the Corporation Income Tax. Simply, they are free to decide the tax base, tax rate, and so on. Certainly there are some general harmonization principles they should respect<sup>270</sup>. However, those principles do not determine how the tax has to be (rates, bases deductions, and so on). They say how the tax cannot be or, to be more precise, what economic effects cannot have. But the level, the structure and the details of the tax are decided by the *HTs*. In fact, saying that the *HTs* do not have procedural autonomy because of the harmonization principles is like saying that because of the tax restrictions established by Community Law<sup>271</sup>, the *EU* countries are not free to determine their business taxes and, therefore, lack procedural autonomy.
- c) **Financial Autonomy.** The Quota is independent of the tax collection of the *HTs*<sup>272</sup> and there is no other transfer between the State and the Basque Country that depends on the tax collection of the *HTs*. As a result, as shown in detail in section 6.2, if the tax collection of a *HT* decreases (increases) one euro due to a tax change, the *HT* has one euro less (more) to finance its expenditure. Therefore, each *HT* fully bears the financial consequences of a tax change. Simply, the Economic Agreement model implies that Basque Country bears the full loss of any tax collection reduction (due to an economic recession, a reduction of the effective tax rates or any other cause) and benefits fully from any increase in tax collection. On the other hand, the revenue the Central Government obtains in the Basque Country (the Quota) is independent of what the Basque Country collects<sup>273</sup>. As already said, this property of the Economic Agreement is called *unilateral risk* (borne by the Basque Country).

The High Court of Justice of the Basque Country has already recognized that the *HTs* comply with the three conditions and the *EC* of Justice has dismissed several claims that they don't. These recognitions have been the result of an action brought in 2006 by two neighbouring *ACs* and a Trade Union against some tax measures taken by the *HTs*<sup>274</sup>. Following this action, and in the view that the

<sup>270</sup> See B1 to B4 in Table 12.

<sup>271</sup> Countries cannot, for instance, approve tax measures that are considered State Aid or harmful.

<sup>272</sup> It depends on what the central government spends in benefit of the residents in the Basque Country (see section 6.2) and in the tax collection of the State, but not in the tax collection of the Basque Country.

<sup>273</sup> The Social Security collects contributions to finance unemployment benefits and pensions. Obviously, what the Social Security collects has nothing to do with the tax collection or the tax regulations of the *HTs*.

<sup>274</sup> In the year 2005 the *HTs* reformed their Corporation Taxes reducing the tax rate to 32.5% (in the State it was 35%), and introducing investment incentives (more generous depreciation rules and an investment tax deduction). The neighbouring regions of La Rioja and Castile and León, and the trade union *UGT-Rioja* (Unión General de Trabajadores de La Rioja) brought actions before the High Court of Justice of the Basque Country claiming that the new tax rules were State Aids and, therefore, infringing the *EC* Treaty. As a result of this, and in the view of the opinion of Advocate General of the Azores case, Mr. Geelhoed, the High Court of Justice of the Basque Country asked the *EC* of Justice for a preliminary ruling concerning the interpretation of State Aid.

Azores case introduced a new approach to the definition of regional selectivity of tax rules, the High Court of Justice of the Basque Country asked the *EC* of Justice for a preliminary ruling on the question that if some tax reductions made by the *HTs* should be considered regional State Aid (in the sense of Article 87(1) *EC*).

The preliminary judgment of the *EC* of Justice did not have to say if the *HTs* met the conditions because that is a responsibility of national courts<sup>275</sup>. The *EC* of Justice only had to clarify the meaning of the conditions established in the Azores judgment, so that the High Court of Justice of the Basque Country could decide if the tax measures of the *HTs* were or not regional State Aids. In the proceedings before the *EC* of Justice, though, several interested parties submitted observations. Among those were the Commission and the *ACs* of La Rioja and Castile and León<sup>276</sup>. All three argued that, for different reasons, the *HTs* did not meet the three criteria established in the Azores Judgement. However, first the Advocate General of the case Juliane Kokott in her Opinion<sup>277</sup> and later the Court in its Judgement<sup>278</sup> dismissed all the allegations of the Commission, La Rioja and Castile and León. The Court did not say that the tax rules of the *HTs* were not regional State Aid because it could not say so, but dismissed all the arguments given by the Commission and the two Spanish *ACs* questioning the autonomy (institutional, procedural and financial) of the *HTs*.

After dismissing the arguments of the interested parties, the Judgement of the Court of Justice of the *EC* (in September 2008) said that to assess whether a measure is selective it should be determined if the adopting authority has institutional, procedural and economic autonomy. The judgement also said that only the High Court of the Basque Country had jurisdiction to identify the national law applicable and to apply Community law to the cases before it. That is, the High Court of the Basque Country had to decide if the three autonomy criteria were met by the *HTs*.

Upon receiving this Judgment the High Court of Justice of the Basque Country analyzed if the *HTs* comply with the three autonomies (institutional, procedural and economic) and ruled that they do. The Court then (in December 2008) dismissed the actions against the tax rules of the *HTs*.

In the end, the debate about the compatibility of the Basque Tax regulations with the *EU* regulations can be summarized in two main conclusions:

- a) After the Azores judgment it is clear that *EU* countries, if they wish, can decentralize business taxes to all or (under certain autonomy conditions) only to some sub-central governments (regional or local).

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<sup>275</sup> The national court has to apply Community law to the cases before it, and has to identify and interpret the national law applicable to the case.

<sup>276</sup> It should be noted that the United Kingdom and Italy submitted observations in favour of the *HTs*. Several Basque Organizations and Institutions also argued in favour of the *HTs*.

<sup>277</sup> See Opinion of Advocate General Kokott, delivered on 8 May 2008, Celex code 62006J0428

<sup>278</sup> Judgment of the Court, Joined cases C-428/06 to C-434/06 ) of 11 September 2008, Celex code 62006J0428.

- b) In the Basque Country, the required autonomy conditions are fully satisfied by the *HTs*. This means that they can regulate the Corporation Income Tax. If in the use of their tax powers the *HTs* decide to set a lower effective tax rate than in the rest of Spain, the lower rate will not be regional State Aid.

Obviously, the conclusion b) does not mean that the *HTs* do not have any restriction in the regulation of the Corporation Income Tax. It simply means that their tax rules cannot be questioned arguing that they are regional State Aid. And that is important because that has happened quite often in the past. On the other hand, the tax autonomy of the *HTs* is subject to two types of restrictions. First, like the other tax authorities of the *EU*, the *HTs* cannot approve selective or harmful tax measures. Second, the *HTs* have to respect the harmonization principles established in the Economic Agreement.

## 12. CONCLUSIONS

The Economic Agreement is a regional financing model based on fiscal autonomy. The Basque Country collects all the taxes and assumes the consequences of doing so. If the economy goes bad or if the Basque tax authorities reduce the taxes, the Basque Country will bear the financial consequences. Conversely, if the economy booms or tax rates are increased, the Basque Country will have more resources. The model also includes a transfer to the Central Government (the Quota) to pay for its expenditures on behalf of the residents in the Basque Country and as a contribution to solidarity among regions.

The Economic Agreement model has been established for political reasons. It is the continuation of a more than 800 years historical tradition and has a strong political and social support in the Basque Country. But beyond political considerations, the Economic Agreement model has economic properties such as the accountability and the responsibility (acceptance by regional governments that they are responsible for financing regional expenditures, and that they have to solve regional economic problems) that promote efficient government. The Economic Agreement is in fact consistent with the prescriptions of the new theory of fiscal federalism.

In practice, the Economic Agreement model has produced efficient government and has been a basic instrument in the restructuring and modernization of the Basque Country. The Basque Country has also an efficient tax administration and taxes that are similar (in level and structure) to the rest of the country. In comparison to the *EU*, the taxes in the Basque Country are somewhat below average at the same level as, for instance, Germany.

One of the most conflicting aspects of the development of the Economic Agreement has been the tax autonomy in the Corporation Income Tax. In the past, the Basque Country used this tax to stimulate economic activity. This was nothing different from what other countries did, but caused some problems with

the Central Government and the European Commission. After many years of uncertainty the Court of Justice of Luxembourg has made clear that tax autonomy in the Corporation Tax is not contrary to the *EU* regulations. This will reduce substantially the conflicts about the Basque regulations.

Taking all into account, the Economic Agreement has proven to be a good model of regional financing that induces efficient government and does not create significant economic distortions.

# ANNEXES

## ANNEX 1

### **Provisional Quota for the Autonomous Community of the Basque Country for Base Year 2007**

Table A1 gives the details of the computation of the Quota for the base year 2007. The starting point is to determine the value of the non assumed charges in all Spain (3). As the Table shows this is obtained as the difference between the total expenditure of the Central Government (State) (2) and the value of the assumed charges (1).

The part of the non assumed charges that the Basque Country has to pay is obtained multiplying the non assumed expenditures in all Spain by the imputation index (3). The total revenue obtained in the Basque Country by the Central Government (7) is the sum of non agreed taxes (4), fees and other non fiscal revenue (5) and direct taxes<sup>279</sup> (6). The deficit of the State multiplied by the imputation index gives the part of the non assumed charges financed with deficit (8).

The total deductions (9) are equal to the taxes collected by the Central Government (7) plus the part of the non agreed expenditures financed with deficit (8). The difference between what the Basque Country has to pay (3) and the deductions (9) gives the Net Quota (10).

There are also some additional compensations for various reasons (lost of social security contributions, police force, and so on). Notice that the additional compensations of 2007 contained a deduction (12) that was applied only that year. In general, the additional compensations may change from year to year. The difference between the Net Quota (10) and the additional compensations (14) gives the Net Amount Payable (15).

Finally, as already explained in section 6.1.1., in the remaining years of the five-year period, the Net Quota is obtained updating the Net Quota in the Base year (10) with an index equal to the growth of State's tax collection from agreed taxes. The additional compensations (14) are updated according to the change in their real value. Most of the additional compensations are temporary. For that reason some of the items may change from year to year.

<sup>279</sup> Withholding taxes on public sector employees and some interests (see section 5.1.)

**Table A1: Provisional Quota for the Autonomous Community of the Basque Country for Base Year 2007 (thousands of euros)**

	State Budget	Imputation Index	Imputed to the Basque Country
Expenditure			
1. Total expenditure of the State	188,417,352.98		
2. Charges assumed by the Autonomous Community	102,664,732.79		
<b>3. Total non assumed charges (<math>SE^{BC}</math>) = 2-1</b>	<b>85,752,620.19</b>	<b>0.0624</b>	<b>5,350,963.50</b>
Revenue			
4. For taxes not covered by the Economic Agreement	3,942,605.41	0.0624	246,018.58
5. For other non tax income	7,589,293.77	0.0624	473,571.93
6. For direct taxes covered by the Economic Agreement			432,774.68
<b>7. Total Revenue (<math>SR^{BC}</math>) = 4+5+6+</b>			<b>1,152,365.19</b>
Deficit			
<b>8. For Budget Deficit (<math>D^{BC}</math>)</b>	<b>40,872,263.17</b>		<b>2,550,429.22</b>
9. Compensation and adjustments to be deducted ( $SR^{BC}+D^{BC}$ ) = 7+8			3,702,794.41
<b>10. Net Quota (<math>NQ = SE^{BC} - SR^{BC} - D^{BC}</math>) = 3-7-8</b>			<b>1,648,169.09</b>
Additional Compensations			
11. Compensations article 6 (Two), Quota Act <sup>1</sup>			82,088.07
12. Sole transitional provision, Quota Act <sup>2</sup>			(-)2,980.31
13. Alava Compensations <sup>3</sup>			3,823.80
<b>14. Total Additional Compensations (ACOM) = 11+12+13</b>			<b>82,931.56</b>
<b>15. Net amount payable (NQP = <math>NQ - ACOM</math>) = 10-14</b>			<b>1,565,237.53</b>

<sup>1</sup> Compensation for the social security contribution used to finance Health before 2002 (see section 5.1.1). <sup>2</sup> This was a compensation in favour of the State for some savings in the cost of the Autonomous Police Force. This compensation was only for the year 2007. <sup>3</sup> Compensation for expenditure competencies only assumed by Alava.

Source: Five-year Quota Act, 2007-2011.



## ANNEX 2

### Adjustment to consumption of Value Added Tax Collection

The *VAT* adjustment is a compensation for the difference between what the *VAT* paid by the residents in the Basque Country (which depends on their consumption) and the tax collection of the *HTs* (which depends on the Value Added created in the Basque Country). The *VAT* adjustment is the sum of two elements.

- (a) The *VAT* on imports (from outside the *EU*) is collected by the State. Some of those goods are, though, consumed by Basque residents. Then, the State has to give the Basque Country its share in the *VAT* collection on imports. This part of adjustment always entails a transfer from the State to the Basque Country.
- (b) The internal consumption adjustment. This covers the difference between what the Basque Country collects (*VAT* in the Basque Country) and the consumption in the Basque Country of goods produced in the *EU*. In theory this part of the adjustment may imply a transfer either from the State to the Basque Country or the other way around. Everything depends on whether the Basque Country is a net importer from the rest of Spain (consumption larger than *VAT*) or exporter to the rest of Spain (*VAT* larger than consumption). As shown below, in practice the Basque Country receives the transfer.

The *VAT* adjustment is computed for the whole Basque Country. The *HTs* can decide how to divide among them the adjustment (positive or negative) and they have agreed to share the adjustment in proportion to the horizontal coefficients (see section 7.2.).

In practice the *VAT* adjustment is computed as follows. The starting point is the determination of the total *VAT* collection the Basque Country should have after the *VAT* adjustment. The Economic Agreement establishes that this amount,  $FR_{BC}$ , has to be equal to:

$$FR_{BC} = RR_{BC} + aRR_I + (a-b)H \quad [a1]$$

where,

$$H = \frac{RR_{BC}}{b} \quad \text{if} \quad \frac{RR_{BC}}{RR_{CT}} \leq \frac{b}{1-b}; \quad H = \frac{RR_{TC}}{1-b} \quad \text{if} \quad \frac{RR_{BC}}{RR_{CT}} \geq \frac{b}{1-b}$$

$FR_{BC}$  = Final annual revenue for the Basque Country

$RR_{BC}$  = Real annual revenue of the Basque Country

$RR_{CT}$  = Real annual revenue of the common territory

$RR_I$  = Real annual revenue from imports

$$a = \frac{\text{Consumption of residents of the Basque Country}}{\text{Consumption of residents of the State (minus Canary Islands, Ceuta and Melilla)}}$$

$$b = \frac{v - f - e + i}{V - F - E + I}$$

$v$  = Gross added value of the Basque Country at factor cost

$V$  = Gross added value of the State (minus Canary Islands, Ceuta and Melilla)

$f$  = Gross capital formation of the Basque Country

$F$  = Gross added value of the State (minus Canary Islands, Ceuta and Melilla)

$e$  = Exports from the Basque Country

$E$  = Exports from the State (minus Canary Islands, Ceuta and Melilla)

$i$  = Intra-community acquisitions of goods in the Basque Country

$I$  = Intra-community acquisitions of goods in the State (minus Canary Islands, Ceuta and Melilla)

Equation [a1] implies, obviously, that the VAT adjustment,  $VATA$ , is equal to

$$VATA = aRR_I + (a-b)H \quad [a2]$$

This equation includes the two sub adjustments mentioned above:

- a) Imports Adjustment. The VAT on imported goods (from outside the EU) is collected by the Central Government. The Basque Country receives then a share equal to its relative (to Spain) consumption ( $a$ ).
- b) Internal consumption Adjustment. The VAT collected by the HTs depends on the added value created in the Basque Country. On the other hand, the VAT paid by residents in the Basque Country depends on their consumption. The adjustment for internal consumption adjusts for the difference between the taxes paid by Basque residents ( $a$ ) and tax collection ( $b$ ).

The adjustment ( $a-b$ ) is applied to a virtual tax collection  $H$  which is what would be collected in Spain with the lower of two effective tax rates; the tax rate in the Basque Country and the tax rate in the rest of Spain. The reason to use the virtual tax collection  $H$  is to introduce an incentive for efficient tax administration.

Since the introduction of the VAT in Spain, the values used of  $a$  and  $b$  have been the same:

$$a = 0.06875$$

$$b = 0.0576$$

## ANNEX 3

### Economic Agreement Law<sup>1</sup>

The Economic Agreement between the Basque Country and Spain must be seen as one of the most genuine, essential, unique, or even exclusive examples, if you like, of the Basque Country's model of self-government.

Aside from being a legal instrument, it is as element of bilateral relationship in the area of taxation and finance, a maximum exponent of recognition of the historical rights of the Basque people and a key factor in modernising these rights. The very etymology of the word used to describe this type of pact, *concertado* (agreed or harmonised) clearly illustrates the spirit with which this instrument was conceived. It is not the outcome of a process of competency decentralization or of transferring state taxes; instead, its genesis lies precisely in a reverse process in which a set of powers remains in the hands of the Historical Territories after having ceded others to the State as a result of the abolition of the *fuero* system in place throughout the nineteenth century.

It is also an instrument for economic progress, and to improve the quality of life and well-being of the Basque society as a whole. In fact, it would be difficult to comprehend the development and progress experienced by the Basque society in the past two decades in terms of economic growth and social cohesion without the help of an instrument like the Economic Agreement.

Therefore, the current tax legislation is in tune with the Basque reality in Europe and alert to the needs and demands of the Basque society, a society that has its own social and productive structure - essentially industrial and consisting primarily of small and medium businesses. The Economic Agreement has been one of the cornerstones of our economic development in recent years.

In the same light, Basque society's sense of solidarity and the job of our public institutions have been decisive in making the Economic Agreement an element for redistribution of tax revenues. The outcome is that today in the Basque Country we

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<sup>1</sup> As translated in web page of the Basque Government  
[http://www.ogasun.ejgv.euskadi.net/r51-341/es/contenidos/informacion/concierto\\_quinquenal/es\\_4177/adjuntos/concierto\\_economico.pdf](http://www.ogasun.ejgv.euskadi.net/r51-341/es/contenidos/informacion/concierto_quinquenal/es_4177/adjuntos/concierto_economico.pdf)

have model social policies in the areas of public health, education and social services, in addition to policies which promote integration and cover basic social needs. All of this has contributed to enhanced quality of life and well-being for all Basque citizens.

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## CHAPTER I TAXES

### SECTION 1 GENERAL REGULATIONS

#### *Article 1.*—Competences of the Institutions of the Historical Territories

One. The competent Institutions of the Historical Territories may maintain, establish and regulate, within their territory, their taxation system.

Two. The levying, administration, settlement, inspection, revision and collection of the taxes and duties comprising the taxation system of the Historical Territories shall be the responsibility of the respective Territorial Governments.

#### *Article 2.*—General principles

One. The taxation system established by the Historical Territories shall be in accordance with the following principles:

First. Respect for the principle of solidarity in the terms laid down in the Constitution and in the Statute of Autonomy.

Second. Regard for the general taxation structure of the State.

Third. Coordination, fiscal harmonisation and cooperation with the State, in accordance with the rules laid down in the present Economic Agreement.

Fourth. Coordination, fiscal harmonisation and mutual cooperation between the Institutions of the Historical Territories pursuant to the regulations enacted by the Basque Parliament for these purposes.

Fifth. Submission to the International Agreements or Treaties signed and ratified or adhered to by the Spanish State.

In particular, it shall comply with the provisions laid down in the International Agreements signed by Spain to avoid double taxation, as well as fiscal harmonisation measures of the European Union, and shall be responsible for making the refunds called for, pursuant to application of said Agreements and rules.

Two. The rules laid down herein shall be interpreted in accordance with the provisions contained in the General Tax Law for the interpretation of tax regulations.

#### *Article 3.*—Fiscal harmonisation

In drafting their tax legislation, the Historical Territories shall:

- a) Respect the General Tax Law in matters of terminology and concepts, without prejudice to the peculiarities established in the present Economic Agreement.
- b) Maintain an overall effective fiscal pressure equivalent to that in force in the rest of the State.

- c) Respect and guarantee freedom of movement and establishment of persons and the free movement of goods, capital and services throughout the territory of Spain, without giving rise to discrimination or a lessening of the possibilities of commercial competition or to distortion in the allocation of resources.
- d) Use the same system for classifying livestock, mining, industrial, commercial, service, professional and artistic activities as is used in the so-called common territory, without prejudice to further itemisations that might be made.

#### *Article 4.–Cooperation principles*

One. The competent institutions of the Historical Territories shall inform the State Administration with due notice prior to their coming into effect of any draft bills on tax regulations.

Similarly, the State Administration shall likewise inform the aforementioned institutions.

Two. The State shall devise mechanisms for allowing the Institutions of the Basque Country to collaborate in any international Agreements affecting the application of the present Economic Agreement.

Three. The State and the Historical Territories, in the exercise of functions within their powers regarding the administration, inspection and collection of taxes, shall exchange any information and records deemed necessary for levying them more efficiently.

In particular, both Administrations shall:

- a) Provide each other, through their data processing centres, with any information they may require. To this end, the necessary technical connections between them shall be set up. A jointly coordinated fiscal information system plan shall be drawn up on a yearly basis.
- b) The inspection services shall draw up joint inspection plans concerning objectives, sectors and coordinated selective procedures, and concerning taxable persons who have changed their address, entities declaring under the tax transparency system and organisations subject to taxation proportionate to turnover for Corporation Tax purposes.

Four. The State and the Institutions of the Basque Country shall introduce procedures for the exchange of information that will ensure the implementation of international Agreements or Treaties of the State, in particular European Union legislation in matters of administrative cooperation and mutual assistance.

#### *Article 5.–Competences exclusive to the State*

The following competences shall be considered exclusive to the State:

First. The regulation, administration, inspection, revision and collection of the import duties and import levies included under Excise Duties and Value Added Tax.

Second. Official inspection of the application of the present Economic Agreement, for which purpose the State agencies responsible for said inspection shall issue, with the collaboration of the Basque Government and the Territorial Governments, an annual report on the results of said application.

## SECTION 2 PERSONAL INCOME TAX

### *Article 6.*—Applicable legislation and levying of the Tax

One. The Personal Income Tax is agreed to be a tax subject to autonomous legislation by the Basque authorities. It shall be levied by the Territorial Government deemed competent by virtue of the Historical Territory when the taxpayer has habitual residence in the Basque Country.

Two. In the event that taxable persons integrated in a family unit have their habitual residence in different territories and choose to file a joint return, the competent tax authority shall be the Administration of the territory wherein lies the habitual residence of the family member having the largest tax base calculated according to the respective regulations.

### *Article 7.*—Income tax withholdings and payments on account

One. Withholdings and payments on account associated with earned income shall be exacted, according to the respective regulations, by the competent Territorial Government in each Historical Territory when linked to the following types of income:

- a) Income from work or services performed in the Basque Country. In the event that the work or services are performed in both the common territory and the basque territory, the services shall be understood, unless proven otherwise, to be performed in the Basque Country when the place of work to which the worker is affiliated is located in this territory.
- b) Income from pensions, passive income and loans received from Social Security and Pensioners, National Employment Institute, Assistance Funds, Mutual Benefit Societies, Employment Promotion Funds, Pension Plans, Voluntary Social Prevision Entities and passive benefits from companies and other entities when the benefactor resides habitually in the Basque Country.
- c) Remunerations of any kind received by company chairpersons and members of boards of directors and or any other type of representative body, when the fiscal domicile of the paying entity is located in the Basque Country. In event of entities liable to payment of the Corporation Tax levied by the State and by the Territorial Governments, the withholdings shall correspond to both Administrations according to the relative turnover generated in each territory. For this purpose, the proportion determined shall be in accordance with the last tax return for Corporation Tax. The withholdings



shall be exacted, pursuant to territorial or common territory legislation, depending on whether the paying entity is governed by territorial or common territory legislation on Corporation Tax. Inspection thereof shall be performed by the competent bodies of the corresponding Administration, applying the same criteria. The above notwithstanding, the rules regarding place, form and deadline for presenting the tax returns shall be determined by the competent Administration for levying the tax.

Two. The preceding paragraph notwithstanding, the State Administration shall exact withholdings on active or passive remunerations, including pensions generated by a person other than the payee, paid by the State to civil servants and employees of the State.

Exception to the preceding paragraph shall be made for civil servants and employees of autonomous Bodies and public business Enterprises.

*Article 8.*—Payments on account on income earned from professional activities

One. Withholdings and payments on account associated with income from professional activities shall be exacted, according to the respective regulations, by the competent Territorial Government in the respective Historical Territory when the habitual residence or fiscal domicile of the taxpayer responsible for withholding or paying on account is in the Basque Country. In any event, the withholdings or payments on account shall be exacted by the Administration of the State or by the competent Territorial Governments when they correspond to remunerations paid by them.

In exacting the withholdings and payments referred to in this article, the Governments of the Historical Territories shall apply rates identical to those of the common territory.

Two. Payments in instalments of Personal Income Tax shall be exacted, according to the respective regulations, by the competent Territorial Government in the respective Historical Territory when the habitual residence or fiscal domicile of the taxpayer is in the Basque Country.

*Article 9.*—Withholdings and payments on account of the tax on income from capital

One. Withholdings and payments on account associated with income earned from capital shall be exacted, according to the respective regulations, by the competent Territorial Government in each Historical Territory in accordance with the following rules:

First. The competent Territorial Government in each Historical Territory shall exact the withholdings corresponding to:

- a) Income earned from equity holdings in any entity, and from interest and other revenues earned from similar bonds and securities, when such earnings are paid by entities filing tax returns for Corporation Tax exclusively in basque territory.

In the event of entities that are liable to payment of the Corporation Tax levied by the State and by the Territorial Governments of the Historical Territories, the withholding shall correspond to both Administrations according to the volume of operations performed in each territory. For this purpose, the proportion determined shall be in accordance with the last tax return for Corporation Tax. The withholdings shall be exacted, pursuant to Territorial or common territory legislation, depending on whether the paying entity is governed by Territorial or common territory legislation on Corporation Tax. Inspection thereof shall be performed by the competent bodies of the corresponding Administration, applying the same criteria. The above notwithstanding, the rules regarding place, form and deadline for presenting the tax returns shall be determined by the competent Administration for levying the tax.

- b) Interest and other revenues on bonds and debentures issued by the Autonomous Community, the Territorial Governments of the Historical Territories, Town Councils and other bodies of the territorial and institutional Administration of the Basque Country, wherever they are paid. Those corresponding to issues by the State, other Autonomous Communities, Town Councils in the common territory and other bodies of their territorial and institutional Administrations, even when paid in basque territory, shall be exacted by the State.
- c) Interest and other revenues from deposit transactions at Banks, Savings Banks, Cooperative Credit Banks and similar entities, as well as at any other credit or financial institutions, when the beneficiary thereof has his or her habitual residence or fiscal domicile in the Basque Country.
- d) Income derived from capitalisation and life or disability insurance transactions when the beneficiary thereof, or the policy holder in the case of redemption, has his or her habitual residence or fiscal domicile in the Basque Country.
- e) Life annuities and other rents which are the result of the investment of capital, when the beneficiary thereof has his or her habitual residence or fiscal domicile in the Basque Country.

In the case of withholdings on pensions generated by a person other than the payee and paid by the Administration of the State, such withholdings shall be exacted by the Administration of the State.

- f) Income from intellectual property when the taxable person is not the author and, in all cases, from industrial property and from rendering technical assistance when the person or entity paying same has its fiscal domicile in the Basque Country.
- g) Income from the rental of goods, rights, businesses or mines and similar, when they are located in basque territory.

Second. In the case of interest on loans secured by chattel mortgages, the Administration of the territory where the mortgaged assets are located shall be competent to exact the withholding.

When the mortgaged assets are located in both the common territory and the basque territory, both Administrations shall exact the withholding, to which end the interest shall be apportioned proportionally to the value of the mortgaged assets, except in the event of special assignment of the guarantee, in which case this figure shall be used as the basis for apportionment.

Third. In the case of interest on loans secured with real estate mortgages, the Administration of the territory where the mortgaged assets are located shall be competent to exact the withholding.

Fourth. In the case of interest on simple loans, deferral of purchase-sale price and other income from the placement of capital, the withholdings shall be exacted by the Administration of the territory wherein lies the establishment or habitual residence or fiscal domicile of the entity or person obliged to make the withholding.

Two. In exacting the withholdings and payments referred to in this article, the Governments of the Historical Territories shall apply rates identical to those of the common territory.

#### *Article 10.*—Withholdings and payments on account of the tax on income from specific capital gains

One. Withholdings associated with capital gains from the transfer or payment of shares and holdings in Collective Investment Institutions shall be exacted, according to the respective regulations, by the Administration of the State or the competent Territorial Government in each Historical Territory, depending on whether the share or stakeholder has his or her habitual residence or fiscal domicile in the Basque Country.

Two. Withholdings and payments on account corresponding to prizes awarded as a result of participation in games, contests, raffles or random combinations, whether linked or not to the offer, promotion or sale of certain goods, products or services, shall be exacted by the Administration of the State or by the competent Territorial Government in each Historical Territory, according to whether the payer of same is domiciled in the common or basque territory. In any event, the withholdings or payments on account shall be exacted by the Administration of the State or by the competent Territorial Governments when they correspond to remunerations for prizes.

In exacting the withholdings and payments referred to in this article, the Governments of the Historical Territories shall apply rates identical to those of the common territory.

#### *Article 11.*—Other payments on account

One. Withholdings and payments on account associated with income from the leasing and subleasing of property shall be exacted, according to the respective regulations, by the competent Territorial Government in the respective Historical Territory when the habitual residence or fiscal domicile of the taxpayer responsible for withholding or paying on account is in the Basque Country.

Two. Withholdings and payments on account for amounts paid to entities, which, by virtue of the income tax system, should be attributed to payers of Personal Income Tax shall be exacted, according to the respective regulations, by the competent Territorial Government in the respective Historical Territory when the habitual residence or fiscal domicile of the taxpayer responsible for withholding or paying on account is in the Basque Country.

*Article 12.*—Effectiveness of payments on account

For the purposes of payment of Personal Income Tax, payments on account made in either territory on behalf of the taxable person shall be valid, without this implying, should said payments on account have been paid into a non-competent Administration, the waiver by the other party of its right to demand from the Administration the amount to which it is entitled.

*Article 13.*—Taxation by imputation and attribution of income

One. Entities filing returns under the imputation system must abide by the rules laid down in Section 3 of this Chapter. The tax liability attributed to the entity's partners shall be computed taking into account the rules concerning the Personal Income Tax or the Corporation Tax referred to herein, depending on the type of tax for which they are liable.

Two. In cases of attribution of income, the administration and inspection of the taxable entities filing under this system shall fall to the Administration of the territory where the fiscal domicile is located.

The tax liability attributed to the entity's partners shall be computed taking into account the rules concerning the Personal Income Tax, the Non-resident Income Tax or the Corporation Tax referred to in the Economic Agreement, depending on the type of tax for which they are liable.

### SECTION 3 CORPORATION TAX

*Article 14.*—Applicable legislation

One. The Corporation Tax is agreed to be a tax subject to autonomous legislation by the Basque authorities for taxable persons with fiscal domicile in the Basque Country.

However, taxable persons whose total business turnover in the previous year exceeded seven million euros, and who performed 75 per cent or more of their total operations in the common territory, shall be subject to the legislation of that territory.

Also subject to autonomous legislation are taxable persons with fiscal domicile in the common territory whose total business turnover in the previous year exceeded seven million euros and whose entire operations were performed in the Basque Country.

Two. For the purposes of this rule, total turnover shall be understood as the total consideration, net of Value Added Tax and the equivalency surcharge, where applicable, obtained for supplies of goods and of services performed in the course of the taxable person's business or professional activity.

The operations defined as such in the legislation on Added Value Tax shall have the consideration of supplies of goods and of services.

Should the first year of the activity fail to coincide with the calendar year, a full year's turnover shall be calculated for computing the aforesaid figure.

Three. For the purposes of the provisions contained in the preceding article, a taxable person shall be deemed to operate in one territory or the other when, pursuant to the criteria laid down in article 16, said taxable person performs the supply of goods or services therein.

Four. In cases where the activity is being started, the turnover shall be computed on the basis of business volume registered during the first year. Should the first year of the activity fail to coincide with the calendar year, a full year's turnover shall be calculated for computing the aforesaid figure. Until the volume and place of realisation of the transactions in the year are known, those estimated by the taxable person based on its turnover forecasts for the start-up year shall be taken as such to all effects.

#### *Article 15.–Levying of the Tax*

One. The Territorial Governments of the Basque Country shall be responsible for levying the Corporation Tax on persons with fiscal domicile in the Basque Country whose business turnover in the previous year did not exceed seven million euros.

Two. Those taxable persons whose business turnover in the previous year exceeded seven million euros, regardless of where they have their fiscal domicile, shall file a return to the Territorial Government, the Administration of the State or jointly to both Administrations according to the turnover generated in each territory during the year.

The proportion of business turnover performed in each territory in the year shall be in accordance with rules laid down in the articles herebelow, and shall be expressed as a percentage rounded to the nearest one hundredth of one per cent.

#### *Article 16.–Determination of place of transactions*

The following transactions shall be understood to be performed in the Basque Country:

##### A) Supplies of goods:

1st. Supplies of movable tangible property when delivery to the purchaser is performed from basque territory. When the goods must be shipped in order to be delivered to the purchaser, the supplies shall be understood to

have been performed in the place where the goods were located at the moment of initiating the dispatch or shipment. This rule shall have the following exceptions:

- a) In the case of goods processed by the supplier, the supply shall be understood to be made in basque territory if the final processing of the goods in question was performed in that territory.
- b) In the case of supplies involving the installation of industrial facilities outside the Basque Country, said supplies shall be deemed performed in basque territory if the preparation and manufacturing work is done in said territory and the cost of the installation or assembly does not account for over 15 per cent of the total remuneration.

Conversely, supplies involving the installation of industrial facilities in the Basque Country shall not be deemed performed in basque territory if the preparation and manufacturing work is done in the common territory and the cost of the installation or assembly does not exceed 15 per cent of the total remuneration.

2nd. Supplies made by electric power producers when the power generation plants are located in basque territory.

3rd. The handing-over of real property, when the properties are located in basque territory.

B) Supplies of services:

1st. Supplies of services shall be deemed performed in basque territory when they are effected from that territory.

2nd. Exceptions to the preceding paragraph are services directly related to real property, which shall be considered performed in the Basque Country when said assets lie in basque territory.

3rd. Moreover, excepted from the provisions contained in the preceding paragraphs are insurance and capitalisation transactions, regarding which the rules laid down in article 32 of the present Economic Agreement shall apply.

C) The provisions contained in letters A) and B) hereabove notwithstanding, the transactions specified below shall be considered performed in the Basque Country when the taxable person performing them has his or her fiscal domicile in basque territory:

1st. Supplies made by agricultural, forestry, livestock or fishing operations, and fishing boat owners, each harvesting directly from its own fields, forests or nets, of unprocessed natural products.

2nd. Transport services, including removals, towing and crane operations.

3rd. Lease or rental of means of transport.

- D) The transactions which in accordance with the criteria laid down in this article are considered performed abroad shall be attributed to one or the other Administration, as the case may be, in the same proportion as the other operations.
- E) Entities not performing the transactions set forth in article 14, number two, second paragraph, shall file their returns with the Territorial Governments of the Historical Territories of the Basque Country when they have their fiscal domicile in basque territory.

#### *Article 17.*—Payments on account of tax

One. Withholdings and payment on account of the Corporation Tax shall correspond to one or the other Administration according to criteria laid down in the present Economic Agreement for Personal Income Tax. The provisions laid down in article 12 on the efficiency of payments on account made in one of the other Administration shall apply.

Two. Taxable persons who must shall file a return jointly to both Administration shall make the instalment payment of the tax according to the turnover generated in each territory. For this purpose, the proportion determined shall be in accordance with the last tax return for the Tax.

The preceding paragraph notwithstanding, upon prior notice to the Coordination and Evaluation Committee pursuant to chapter III, Section 2 of the present Economic Agreement, a different proportion may be applied in the following cases:

- a) Mergers, divisions, transfer of assets and exchange of securities.
- b) Start-up, termination, increase or reduction of activity in common or basque territory entailing a significant variation in the proportion calculated according to the criterion specified in the first paragraph of number Two hereabove.

In all cases, the variation shall be considered significant when it entails a difference of 15 or more percentage points in the proportion applicable to any of the territories.

Three. Payments by instalment effectively paid to each Administration shall be reduced by the part of the tax owed thereto.

#### *Article 18.*—Administration of the Tax in cases of returns filed with both Administrations

In cases of returns filed to both Administrations, the following rules shall apply:

First. The result of the tax assessments shall be payable to the Administrations of the State and of the Basque Country according to the relative volume of operations performed in each territory during each tax period.



Second. Persons who must file returns with both Administrations shall present, within the deadlines and in due form, all the documents stating the applicable proportions and the tax owed to, or to be refunded by, each of the Administrations.

Third. Applicable refunds shall be made by the respective Administrations in the proportion that pertains to each of them.

#### *Article 19.—Inspection of the Tax*

One. Inspection shall be performed by the Territorial Government competent by virtue of the Historical Territory when the taxable person has his or her fiscal domicile in the Basque Country.

However, inspection of taxable persons whose total business turnover in the previous year exceeded seven million euros, and who performed 75 per cent or more of their total operations in the common territory, shall be performed by the Administration of the State.

Moreover, inspection of taxable persons with fiscal domicile in the common territory whose total business turnover in the previous year exceeded seven million euros and whose entire operations were performed in the Basque Country shall be performed by the Territorial Government competent by virtue of the Historical Territory.

Two. Tax inspections shall be performed pursuant to the legislation of the competent Administration, in accordance with the rules contained in the preceding paragraph, without prejudice to the collaboration of the rest of the Administrations.

Should the inspectors find that there is a tax liability due or an amount to be refunded corresponding to both Administrations, the collection or payment in question shall be made by the inspecting Administration, without prejudice to any compensations from each other to which the parties may be entitled. The inspection agencies of the competent Administrations shall communicate the results of their actions to the rest of the Administrations affected.

Three. The conditions laid down in the preceding rules are without prejudice to the faculties corresponding to the Territorial Governments of the Historical Territories within the scope of their territories in matters of verification and investigation, although their actions cannot have economic effects on taxpayers' final returns filed as a result of actions of the agencies of the competent Administrations.

Four. The proportions set in verifications by the competent Administration shall affect the subject's paid-in taxes, without prejudice to those taxes which, following said verifications, are definitively agreed between both Administrations.



*Article 20.*—Economic interest groupings, joint ventures and corporate groups

One. The tax system governing economic interest groupings, joint ventures and corporate groups shall correspond to the Basque Country when all of the entities which comprise the groups are subject to basque legislation.

These entities shall attribute to their partners their share of turnover from the operations performed in each territory, which they shall take into account in determining the proportion of operations.

Two. 1. Corporate groups shall be subject to the so-called Basque tax consolidation system when the dominant company and all of the dependent companies must file independent tax returns under Basque legislation, and shall be subject to the tax consolidation system of the common territory when the dominant company and all of the dependent companies must file independent tax returns under the tax system of the common territory. For these purposes, companies subject to the other legislation shall be considered excluded from the corporate group.

In any event, identical rules shall apply to those established at any given time by the State for defining corporate groups, dominant companies, dependent companies, degrees of control and internal transactions of the group.

2. To adopt the tax consolidation system for corporate groups, the following rules shall apply:

First. The companies comprising the group shall, in accordance with the general rules referred to herein, file the return established under the rules for filing independent tax returns.

Without prejudice to the preceding paragraph, the dominant company shall submit to each of the Administrations the consolidated accounts of the corporate group.

Second. The corporate group shall file returns with the State or Basque Administrations according to the volume of operations performed in each territory.

For these purposes, the relative volume of operations performed in each territory shall consist of the sum or aggregation of the operations, that each of the companies in the group effects therein, before any applicable inter-group elimination.

#### SECTION 4 TAX ON INCOME OF NON-RESIDENTS

*Article 21.*—Applicable legislation

One. The Tax on Income of Non-residents is agreed to be a tax subject to the same rules in terms of substance and form as those established at any given time by the State.

The above paragraph notwithstanding, the permanent establishments domiciled in the Basque Country of entities or persons resident abroad shall abide by Basque legislation on this Tax in accordance with the provisions contained in article 14.

When the taxpayer exercises the option to file a return for Personal Income Tax having complied with the requirements laid down in the rules governing Personal Income Tax, for the purposes of application of the optional system, the rules of the Territorial Government competent by virtue of the Historical Territory shall be considered provided a majority of the total income obtained in Spain comes from benefits of the work and economic activities obtained in basque territory. If the taxpayer is entitled to a refund, it shall be paid by said Territorial Government regardless of where the income was obtained within spanish territory.

Two. An individual taxpayer or entity shall be understood to operate by means of permanent establishment when by whatever title it makes continuous or habitual use of facilities or places of work of whatever kind, where all or part of its activity is conducted, or where it acts by means of an agent authorised to enter into contracts, on behalf of the non-resident taxpayer, and who habitually exercises such powers.

Particularly understood to be permanent establishments are management headquarters, branches, offices, factories, workshops, warehouses, shops or other establishments, mines, oil or gas wells, quarries, agricultural, forestry or fishing operations, or any other place of prospection or extraction of natural resources, and any construction, installation or assembly works of more than twelve months' duration.

#### *Article 22.—Levying of the Tax*

One. In the case of income obtained through a permanent establishment, the Tax shall be levied by either Administration or by both jointly, pursuant to the provisions contained in article 15 hereabove.

Two. In the case of income obtained without the involvement of a permanent establishment, the tax shall be levied by the competent Territorial Government in each Historical Territory when income is understood to have been obtained or produced in the Basque Country according to the following criteria:

- a) The income from economic transactions when produced in basque territory.
- b) The earnings arising from the provision of services, such as studies, designs or projects, technical assistance, management support services and professional services, when the service is performed or used in basque territory. Services shall be understood to be used in basque territory when they serve business or professional activities conducted in basque territory or are concerned with goods located therein. When the place of use and the place of rendering of the service are not the same, the former shall be taken for tax purposes.

- c) Income arising, directly or indirectly, from salaries and wages when the work is performed in basque territory.
- d) Income arising, directly or indirectly, from the personal performance, in basque territory, of artists, actors or athletes, or from any other activity related to the aforesaid performances, even when attributed to a person or entity other than the artist, actor or athlete.
- e) Dividends and other earnings from equity holdings in Basque public entities, as well as the yield from equity holdings in private entities, in the amount envisaged in Section three of this article.
- f) Interest, royalties and other earnings on investments:
  - a') paid by individuals with habitual residence in the Basque Country or Basque public entities, or paid by private entities or permanent establishments in the amount envisaged in Section four of this article
  - b') when generated in return for investments of capital used in basque territory.

When these criteria fail to coincide, the place of utilisation of the capital whose service is remunerated shall apply for tax purposes.

- g) Income earned, directly or indirectly, from real property located in basque territory or from rights on such real property.
- h) Income attributed to individual taxpayers from urban real property located in basque territory.
- i) Capital gains arising from securities issued by Basque public entities or persons, as well as from securities issued by private entities, in the amount envisaged in Section four of this article.
- j) Capital gains arising from real property located in basque territory or from rights on such real property. In particular, the following are considered included in this letter:
  - a') capital gains arising from rights or shares in a resident or non-resident entity whose assets are principally made up of real property located in basque territory;
  - b') capital gains arising from the transfer of rights or shares in a resident or non-resident entity attributing to their holder the right of enjoyment of real property located in basque territory.
- k) Capital gains arising from other assets located in basque territory or rights that must be met or are exercised in said territory.

Three. When, pursuant to the criteria set out in the previous section, income can be understood to be earned in both territories, the taxation thereof shall correspond to the Historical Territory when the taxable person, in the event of an individual, has his or her habitual domicile in the Basque Country; if the taxable person is a corporate body or permanent establishment, the rules laid down in section four of this article shall apply.

Four. In the cases referred to in letters e), f) and i) of section 2 hereabove, and in the case envisaged in paragraph three, the income paid by private entities or permanent establishments shall be understood to be obtained or produced in basque territory in the following amount:

- a) In the event of entities or permanent establishments that file tax declarations solely in the Basque Country, the total amount of the income paid.
- b) In the event of entities or permanent establishment that file declarations jointly to both Administrations, the portion of the income paid in proportion to the volume of transactions performed in the Basque Country. However, in the cases referred to in this letter the competent Administration for taxing the total amount of the earnings shall be the Administration of the territory wherein lies the habitual residence or fiscal domicile of the persons, entities or permanent establishments that file a return on behalf of the non-resident, without prejudice to the compensation to be made to the other Administration for the portion corresponding to the relative volume of operations performed in the territory of the latter. Moreover, any refunds payable to non-residents shall be paid by the Administration of the territory wherein lies the habitual residence or fiscal domicile of the persons, entities or permanent establishments that file a return on behalf of the non-resident, without prejudice to the compensation to be made to the other Administration for the portion corresponding to the relative volume of operations of the paying entity performed in the territory of the latter.

Five. The Special Charge on Property belonging to non-resident entities shall be levied by the Territorial Government deemed competent by virtue of the Historical Territory when the property is located in the Basque Country.

#### *Article 23.—Payments on account*

One. Payments in instalments made by permanent establishments, and tax withholdings and payments on account for income received shall be exacted in accordance with the rules laid down in Sections 2 and 3 hereabove.

Two. Withholdings and payments on account associated with income from taxpayers operating without a permanent establishment shall be exacted by the Administration of the territory in which the income is understood to have been obtained, pursuant to the provisions contained in the preceding article. Additionally, inspection shall be performed by the agencies of the competent Administrations under the same article.

The previous paragraph notwithstanding, in the cases referred to in number two, letters e), f) and i) of the preceding article, and in the case envisaged in paragraph three, said payments on account shall be exacted by the Territorial Governments according to the relative turnover performed by the taxpayer in the Basque Country, applying the rules laid down in Section 3 hereabove.

Three. The provisions laid down in article 12 on the efficiency of payments on account made in one of the other Administration shall apply.

## SECTION 5 WEALTH TAX

### *Article 24.*—Applicable legislation and levying of the Tax

The Wealth Tax is agreed to be a tax subject to autonomous legislation by the Basque authorities.

It shall be levied by the competent Territorial Government of the Historical Territories or by the State, according to whether the taxable person files his or her Income Tax return with the one Administration or the other, regardless of the territory wherein lie the assets liable to taxation.

In the case of taxable persons liable to taxation by real nature obligation, the Tax shall be levied by the Territorial Governments of the Historical Territories when the greatest value of the assets and rights lies in basque territory. For these purposes, assets and rights shall be deemed to lie in basque territory when they are located, may be exercised, or must be fulfilled in said territory.

When a non-resident whose last residence was in the Basque Country chooses to file in compliance with personal income, he or she may do so in common or basque territory pursuant to the respective legislation.

## SECTION 6 INHERITANCE AND GIFT TAX

### *Article 25.*—Applicable legislation and levying of the Tax

One. The Inheritance and Gift Tax is agreed to be a tax subject to autonomous legislation by the Basque authorities.

It shall be levied by the Territorial Government deemed competent by virtue of the Historical Territory in the following cases:

- a) Donations or gifts ‘mortis causa’ and income received by life insurance beneficiaries when the decedent’s place of habitual residence is in the Basque Country on the date of accrual of the tax.
- b) Donations of real property when such property is located in basque territory. For these purposes of the provisions contained in this letter, the transfer free of charge of securities referred to in article 108 of Law No. 24 of July 28, 1988 governing the Securities Market shall have the consideration of gifts of real property.
- c) In all other gifts, when the habitual residence of the transferee is in the Basque Country on the date of the accrual of the tax.
- d) In the event that the taxable person is a resident abroad, when all the assets or rights in question are located, may be exercised or must be fulfilled in basque territory, and in the case of receipt of sums from life insurance

policies when the contract was made with insurance entities residing in basque territory, or when the contract was concluded in the Basque Country with foreign entities operating therein.

Two. In the cases envisaged in letters a) and c) of the preceding point, the Territorial Governments of the Historical Territories shall apply the regulations of the common territory when the decedent or transferee acquired residence in the Basque Country less than 5 years prior to the date of accrual of the tax. This rule shall not apply to persons who have preserved the political consideration of Basque citizens pursuant to article 7<sup>o</sup>.2 of the Statute of Autonomy.

Three. When in a document a single transferor gratuitously transfers assets or rights to a single transferee, and by virtue of paragraph One hereabove, the income must be considered as produced in both common and basque territory, to each shall correspond the result of applying to the value of the transferred items whose income is attributed thereto, the average rate which, according to its rules, would correspond to the value of the totality of transferred items.

Four. In cases of accumulation of gratuitous transfers, to the Basque Country shall correspond the income resulting from applying to the assets and rights actually transferred, the average rate which, according to its rules, would correspond to the value of the totality of accumulated items.

For these purposes, totality of accumulated assets and rights shall be understood to mean those from prior gifts and those that are the object of the actual transfer.

## SECTION 7 VALUE ADDED TAX

### *Article 26.*—Applicable legislation

The Value Added Tax is agreed to be a tax subject to the same rules in terms of substance and form as those established at any given time by the State. Nevertheless, the competent Institutions of the Historical Territories may adopt their own filing and payment forms, which shall contain at least the same information as those of the common territory, and may set the payment deadlines for each settlement period, which shall not be substantially different from those set by the Administration of the State.

### *Article 27.*—Levying of the Tax

One. Value Added Tax shall be levied in accordance with the following rules:

First. Taxable persons operating solely in basque territory shall file exclusively with the relevant Territorial Government and those operating solely in the common territory shall do so with the Administration of the State.

Second. Taxable persons operating in both the common and basque territory shall file returns and pay taxes to both Administrations according to the relative volume of operations in each territory, determined in accordance with the points of connection set out in the following article.

Third. Taxable persons whose total turnover in the preceding year did not exceed seven million euros shall in all cases file a return, wherever their turnover is generated, with the Administration of the State when their fiscal domicile is located in the common territory, and with the relevant Territorial Government if their fiscal domicile is located in the Basque Country.

Two. For the purposes of this rule, total turnover shall be understood as the total consideration, net of Value Added Tax and the equivalency surcharge, where applicable, obtained for supplies of goods and of services performed in the course of the taxable person's business or professional activity.

In cases of the activity being started during the tax year, the seven million euro figure shall be computed on the basis of the business volume registered during the first calendar year.

Should the first year of the activity fail to coincide with the calendar year, a full year's turnover shall be calculated for computing the aforesaid figure.

Three. For the purposes of the provisions contained in the preceding article, a taxable person shall be deemed to operate in one territory or the other when, pursuant to the criteria laid down in article 28, said taxable person performs the supply of goods or services therein.

Four. The tax for operations related to the intra-community traffic of goods, with the exception of the cases specified in the following paragraphs contained in this article, shall be levied according to the terms laid down in point One hereabove.

Five. The tax on intra-community acquisitions of new means of transport purchased by private individuals or by persons or entities whose transactions are wholly exempt or not subject to Value Added Tax, shall be levied by the Administration of the common territory or basque territory in which said means of transport are definitively registered.

Six. The tax shall be levied by the Administration of the State or the competent Territorial Government of the Historical Territories or by the State, according to whether the taxable person has his or her domicile in common or basque territory, in the following cases:

- a) Intra-community acquisitions of taxable goods either by choice or due to having exceeded the quantitative limit set in the legislation regulating the tax, purchased by taxable persons who only perform transactions which do not carry the right to total or partial deduction for input tax, or by legal entities that do not act in their entrepreneurial capacity or by professionals.

- b) Intra-community acquisitions of goods under the simplified system, the special system for agriculture, livestock and fishing operations, and the equivalency surcharge system.

*Article 28.*—Determination of place of transactions

One. For the purposes of the present Economic Agreement, the following transactions subject to taxation shall be understood to be performed in the Historical Territories of the Basque Country:

A) Supplies of goods:

1. Supplies of movable tangible property when delivery to the purchaser is performed from basque territory. When the goods must be shipped in order to be delivered to the purchaser, the supplies shall be understood to have been performed in the place where the goods were located at the moment of initiating the dispatch or shipment. The following exceptions shall apply to this rule:
  - a) In the case of goods processed by the supplier, the supply shall be understood to be made in basque territory if the final processing of the goods in question was performed in that territory.
  - b) In the case of supplies involving the installation of industrial facilities outside the Basque Country, said supplies shall be deemed performed in basque territory if the preparation and manufacturing work is done in said territory and the cost of the installation or assembly does not account for over 15 per cent of the total remuneration. Conversely, supplies involving the installation of industrial facilities in the Basque Country shall not be deemed performed in basque territory if the preparation and manufacturing work is done in the common territory and the cost of the installation or assembly does not exceed 15 per cent of the total remuneration.
  - c) In the case of goods which must be dispatched or shipped from another EU Member State and which meet the requirements laid down in the legislation regulating Value Added Tax for application of the distance selling system, supplies shall be deemed performed in basque territory when the delivery finalises in said territory.
2. Supplies made by electric power producers when the power generation plants are located in basque territory.
3. The handing-over of real property, when the properties are located in basque territory.

B) Supplies of services:

1. Supplies of services shall be deemed performed in basque territory when they are effected from that territory.



2. Exceptions to the preceding paragraph are services directly related to real property, which shall be considered performed in the Basque Country when said assets lie in basque territory.
  3. Moreover, excepted from the provisions contained in the preceding paragraphs are insurance and capitalisation transactions, regarding which the rules laid down in article 32 of the present Economic Agreement shall apply.
- C) The provisions contained in the preceding letters notwithstanding, levying of the tax shall be the competence of the Administration of the State when the fiscal domicile of the taxable person is located in the common territory, and of the relevant Territorial Government when the taxable person's fiscal domicile is located in the Basque Country, for the following transactions:
- 1st. Supplies made by agricultural, forestry, livestock or fishing operations, and fishing boat owners, each harvesting directly from its own fields, forests or nets, of unprocessed natural products.
  - 2nd. Transport services, including removals, towing and crane operations.
  - 3rd. Lease or rental of means of transport.
- Two. Entities not performing the transactions set forth in this article shall file their returns with the Territorial Governments they have their fiscal domicile in basque territory.

#### *Article 29.—Tax administration and inspection*

One. Results of the assessment of the tax shall be attributed to the competent Administrations in proportion to the volume of consideration, net of Value Added Tax. Said consideration shall be the taxable supplies of goods, and services and exempt goods and services entitled to deduction, performed in the respective territories during each calendar year.

Two. The provisionally applicable proportions for each calendar year shall be those determined on the basis of the previous year's transactions. The provisional proportion applied to tax returns for the first calendar year of the activity shall be estimated by the taxable person on the basis of his or her estimate of the transactions to be performed in each territory, without prejudice to the final adjustments thereto.

The preceding paragraph notwithstanding, upon prior notice to the Coordination and Evaluation Committee pursuant to chapter III section 2 of the present Economic Agreement, a different proportion may be applied in the following cases:

- a) Mergers, divisions, exchange of securities and transfer of assets.
- b) Start-up, termination, increase or reduction of activity in common or basque territory entailing a significant variation in the proportion calculated

according to the criterion specified in the first paragraph of this number. In all cases, the variation shall be considered significant when it entails a difference of 15 or more percentage points in the proportion applicable to any of the territories.

Three. In the last tax return filed at the year-end, the taxable person shall calculate the definitive proportions according to the transactions actually performed in said period, and shall adjust as necessary the returns filed in the previous settlement periods with each of the Administrations.

Four. Persons liable to taxation shall file returns with the competent Administrations stating in all cases, the applicable proportions and the tax owed to, or to be refunded by, each of the Administrations.

Five. Applicable refunds shall be made by the respective Administrations in the proportion that pertains to each of them.

Six. Inspections shall be performed in accordance with the following criteria:

- a) Inspection of taxable persons that must file returns exclusively with the Territorial Governments of the Historical Territories or, as the case may be, with the Administration of the State, shall be performed by the Tax Inspection Bodies of each of said Administrations.
- b) Inspection of taxable persons that must pay taxes in proportion to the relative turnover generated in common and basque territory shall be carried out in accordance with the following rules:

First. Taxable persons having their fiscal domicile in the common territory: Verification and inspection shall be performed by the State Tax Inspection Bodies, who shall regularise the taxable person's tax situation with respect to all the competent Tax Authorities, including the proportion of the tax that corresponds to each of the different Administrations.

Second. Taxable persons having their fiscal domicile in basque territory: Verification and investigation shall be performed by the competent bodies of the Territorial Government of the Historical Territory in question without prejudice to the collaboration of the Administration of the State, and shall be deemed effective by all the competent Administrations, including as regards the proportion of the tax corresponding to each. In the event that the taxable person generates in the common territory 75 per cent or more of its total turnover, in accordance with the points of connection laid down herein, the competent authority shall be the Administration of the State, without prejudice to the collaboration of the Territorial Governments of the Historical Territories of the Basque Country.

Should the inspectors find that there is a tax liability due or an amount to be refunded corresponding to both Administrations, the collection or payment in question shall be made by the inspecting Administration, without prejudice to any compensations from each other to which the parties may be entitled. The inspection agencies of the competent Administrations shall

communicate the results of their actions to the rest of the Administrations affected.

Third. The conditions laid down in the preceding rules are without prejudice to the faculties corresponding to the Territorial Governments of the Historical Territories within the scope of their territories in matters of verification and investigation, although their actions cannot have economic effects on taxpayers' final returns filed as a result of actions of the agencies of the competent Administrations.

Fourth. The proportions set in verifications by the competent Administration shall affect the subject's paid-in taxes, without prejudice to those taxes which, following said verifications, are definitively agreed between both competent Administrations.

Seven. Entities making use of the special system for entity groupings shall file a return applying the rules laid down in Section 7, with the following particularities:

First. Dependent companies, whose inspection under the rules laid down in paragraph Six hereabove is performed by a body of the Territorial or common territory different from the dominant entity, shall be considered excluded from groups of entities.

Second. Entities comprising the entity grouping shall, in accordance with the general rules referred to herein, file the return established under the rules for filing independent tax returns, with the amounts arising from the individual application of the rules regulating the tax, including, as the case may be, the particular rules governing entity groupings.

Each entity in the entity grouping shall individually calculate the turnover attributable to each Administration, applying the rest of the rules laid down under Section 7 herein.

Third. The amounts computed in the aggregate tax returns of the entity grouping shall consist of the sum of the results calculated according to the above rule corresponding to each of the State or Basque Administrations, without the aggregation of the amounts corresponding to different tax administrations.

Fourth. The specific tax obligations of the dominant entities must be fulfilled with the tax Administrations of the territories in which the group entities have their operations.

Fifth. The special system for entity groupings shall in no case alter the rules under the present Economic Agreement, in particular those applicable to determine the turnover figures in each territory.

Eight. Recapitulative statements of intra-community supplies and acquisitions shall be filed with the Tax Authority empowered to inspect and investigate the relevant taxable persons.

## SECTION 8 CAPITAL TRANSFER TAX AND STAMP DUTY

### *Article 30.*—Applicable legislation

The Capital Transfer Tax and Stamp Duty is agreed to be a tax subject to Basque legislation, except in cases of certain company operations, bills of exchange and documents used in their stead or serving the purposes of a draft, which shall be regulated by the so-called common legislation. In such cases the competent institutions of the Historical Territories may adopt their own filing and payment forms, which shall contain at least the same information as those of the common territory, and may set the payment deadlines for each settlement period, which shall not be substantially different from those set by the Administration of the State.

### *Article 31.*—Levy of the Tax

The tax shall be levied by the respective Territorial Governments on the following:

1. On transfers for valuable consideration and leases of real property, and on the establishment and assignment for valuable consideration of real property rights, including guarantees, when the assets are located in basque territory.

In the cases referred to in article 108 of Law No. 24 of July 28, 1988 governing the Securities Market, when the real property comprising the assets of the entity whose securities are transferred is located in basque territory.

2. On transfers for valuable consideration of movable goods, stock and loans, as well as the establishment and assignment of rights thereon for valuable consideration, when the individual purchaser has his or her habitual residence in the Basque Country or the corporate purchaser has its fiscal domicile therein.

The above notwithstanding, two provisions are established:

- a) In transfers of shares, subscription rights, debentures and similar securities, as well as participation certificates, the place of formalisation of the transaction shall apply.
  - b) In the constitution of chattel mortgages or pledges without transfer of possession, or concerned with ships, vessels or aircraft, the territory where such acts are to be registered shall apply.
3. On the constitution of simple loans, guarantee deposits, nonproperty leases and pensions, when the borrower, lessee, receiver of guarantee or pensioner is a private individual and has his or her habitual residence in the Basque Country, or is a corporate body and has its fiscal domicile in that territory.

In cases of loans backed by guarantees, when the mortgaged real property is located in basque territory or when the corresponding mortgages or pledges without transfer of possession registerable therein.

If a single loan is guaranteed with a mortgage on real property located in the common and basque territory or with a chattel mortgage or pledge without transfer of possession registerable in both territories, taxes shall be paid in the proportion corresponding to each Administration, and in the absence of this specification in the deed, the proportion shall correspond to the verified value of the assets.

4. On administrative concessions of assets when located in the Basque Country, and on the execution of works or services when executed or rendered in the Basque Country. These same rules shall apply for administrative actions and transactions liable to taxation by government concession equalisation.

In cases of concessions on the exploitation of goods exceeding the territorial scope of the Basque Country, the tax levied shall be proportionate to the extension of such in the basque territory.

In cases of concessions on the execution of works exceeding the territorial scope of the Basque Country, the tax levied shall be proportionate to the estimated amount of the works to be realised in the basque territory.

In cases of concessions on service operations exceeding the territorial scope of the Basque Country, the tax levied shall be calculated according to the arithmetic mean of the percentages of population and area relative to the entirety of the Autonomous Communities involved.

In cases of joint concessions exceeding the territorial scope of the Basque Country, the tax levied shall be calculated by applying the criteria laid down in the three paragraphs hereabove to the corresponding share of the concession.

In the case of administrative concessions exceeding the territorial scope of the Basque Country, the inspection shall be performed by the competent bodies of the Territorial Government of the Historical Territory when the fiscal domicile of the concessionary entity is located therein.

5. On certain corporate operations, when any of the following circumstances apply:
  - a) The entity has its fiscal domicile in the Basque Country.
  - b) The entity has its corporate domicile in the Basque Country, provided that the effective seat of management is not located within the territorial scope of the Tax Authority of another EC Member State, or if so located, said State does not impose a similar tax on such corporate operations.

- c) The entity performs business transactions in the Basque Country when its effective seat of management and corporate domicile are not located within the territorial scope of the Tax Authority of another EC Member State, or if so located, said States do not impose a similar tax on such corporate operations.
- 6. On notarised statements, deeds and certificates, when they are authorised or issued in basque territory.  
  
The preceding paragraph notwithstanding, in cases subject to sliding scale stamp duty, when the Registry where the assets or transactions are to be inscribed or registered is located in the Basque Country.
- 7. On bills of exchange and documents used in their stead or for draft purposes, and on promissory notes, bonds, debentures and similar securities, when issued in the Basque Country; in the event that their issue occurs abroad, when their first holder has his or her habitual residence or fiscal domicile in said territory.
- 8. On caveats, when made in the public Registries of the Basque Country.

## SECTION 9 TAX ON INSURANCE PREMIUMS

### *Article 32.*—Applicable legislation and levying of the Tax

One. The Tax on Insurance Premiums is agreed to be a Tax subject to the same rules in terms of substance and form as those established at any given time by the State.

Nevertheless, the competent Institutions of the Historical Territories may adopt their own filing and payment forms, which shall contain at least the same information as those of the common territory, and may set the payment deadlines for each settlement period, which shall not be substantially different from those set by the Administration of the State.

Two. The Tax shall be levied by the respective Territorial Governments of the Historical Territories when the location of the risk or commitment, in insurance and capitalisation operations, arises in basque territory.

Three. For these purposes, location of risk shall be understood to be in basque territory in accordance with the following rules:

First. In cases of insurance on real property, when the assets are located in said territory. The same rule shall apply when the insurance refers to real property and its content, if the latter is covered by the same insurance policy. In the event that the insurance refers exclusively to movable goods located within premises, with the exception of goods in commercial transit, when the premises wherein the goods are contained lie in said territory.

If a single insurance covers the risk of real property located in both common and basque territory the location of risk shall be determined by the value of the properties situated in each of the territories.

Second. In the event that the insurance refers to vehicles of any kind, when the person or entity under whose name the vehicle is registered has his or her habitual residence or fiscal domicile in the Basque Country.

Third. In the event that the insurance refers to risks arising during travel or outside the habitual residence of the policyholder, for a period equal to or less than four months, when the policyholder has signed the contract in basque territory.

Fourth. In all cases not explicitly covered by the preceding rules, when the policyholder, if an individual, has his or her habitual residence in the Basque Country, or if otherwise, when the corporate or branch domicile referred to in the contract is located in said territory.

Four. The location of the commitment shall be understood to be in basque territory when the policyholder has his or her habitual residence therein, in the case of individuals, or its corporate or branch domicile, as the case may be, in this territory in the event of corporate bodies.

Five. In the absence of specific rules of location pursuant to the points hereabove, insurance and capitalisation transactions shall be understood to take place in basque territory when the contracting party is an entrepreneur or a professional who enters into such transactions in the course of his or her business or professional activities and has his or her effective seat of management in said territory or has a permanent establishment therein, or in lieu thereof, his or her place of residence.

## SECTION 10 EXCISE DUTIES

### *Article 33.*—Applicable legislation and levying of the taxes

One. Excises Duties are agreed to be taxes subject to the same rules in terms of substance and form as those established at any given time by the State. Nevertheless, the competent Institutions of the Historical Territories may adopt their own filing and payment forms, which shall contain at least the same information as those of the common territory, and may set the payment deadlines for each settlement period, which shall not be substantially different from those set by the Administration of the State.

Two. Excise Duties of Manufacturing shall be levied by the respective Territorial Governments of the Historical Territories when the liability arises in the Basque Country.

Refunds of *Excise Duties of Manufacturing* shall be paid by the Administration of the territory where the liability in question was paid in. Nevertheless, in cases where it is not possible to determine in which Administration the duty was paid

in, the refund shall be made by the Administration of the territory where entitlement to the refund is generated. Authority over the establishments located in the Basque Country, as well as the authorisation system of same, under any of its regimes, shall be exercised by the respective Territorial Governments of the Historical Territories. However, prior notice shall be given to the State Administration and the Coordination and Evaluation Committee.

Three. The Excise Duty on Certain Means of Transport shall be levied by the respective Territorial Governments, when the vehicles are definitively registered in basque territory.

The provisions pursuant to paragraph One hereabove notwithstanding, the competent institutions of the Historical Territories may increase the tax rate by up to 15 per cent of the rates laid down at any given time by the State.

Registration shall be performed according to the criteria laid down in the currently applicable legislation. In particular, individuals shall register vehicles in the province where their habitual residence is located.

Four. The Excise Duty on Coal shall be levied by the respective Territorial Governments of the Historical Territories when the liability arises in the Basque Country.

The duty shall become chargeable at the time of release for consumption or own consumption.

Release for consumption means the time of the first sale or delivery of coal following production, extraction, importation or intra-community acquisition.

First sale or delivery shall also mean any subsequent sales or deliveries of coal for meant for resale by business owners when the acquisition thereof is eligible for exemption for resale.

Own consumption shall mean the use or consumption of coal by producers or extractors, importers, intra-community purchasers, or business owners referred to in the paragraph above.

## SECTION 11

### EXCISE DUTY ON RETAIL SALES OF CERTAIN MINERAL OILS

#### *Artículo 34.*—Applicable legislation and levying of the Tax

One. The Excise Duty on Retail Sales of Certain Mineral Oils is agreed to be a tax subject to the same rules in terms of substance and form as those established at any given time by the State.

The above notwithstanding, the competent institutions of the Historical Territories may establish the tax rate within the limits in force at any given time in the common territory.

The competent Institutions of the Historical Territories may also adopt their own filing and payment forms, which shall contain at least the same information



as those of the common territory, and may set the payment deadlines for each settlement period, which shall not be substantially different from those set by the Administration of the State.

Two. The Excise Duty on Retail Sales of Certain Mineral Oils shall be levied by the respective Territorial Governments on the following:

- a) Sales or supplies of the products affected by this tax executed in public retail establishments located in basque territory, with the exception of supplies to end consumers who make use of the facilities necessary for the reception and consumption of said products outside of the basque territory. Conversely, the tax for supplies executed from common territory to end consumers who make use of the facilities necessary for the reception and consumption of said products in the Basque Country shall be levied by the Territorial Governments.
- b) Intra-community imports and acquisitions of the products affected by this tax when intended for direct consumption by the importer or purchaser at a service station located in the Basque Country.

## SECTION 12 OTHER INDIRECT TAXES

### *Article 35.*—Applicable legislation

Other taxes shall be regulated by the same basic principles, substantive rules, taxable events, exemptions, accruals, bases, rates, fees and deductions as those established at any given time by the State.

## SECTION 13 GAMING DUTIES

### *Article 36.*—Applicable legislation

Gaming Duties are agreed to be taxes subject to autonomous legislation when the authorisation is obtained in the Basque Country. The same rules in terms of taxable events and taxable persons shall apply as those established at any given time by the State.

### *Article 37.*—Levying of the tax

One. Duties on Games of Chance and Gambling shall be levied by the Territorial Government deemed competent by virtue of the Historical Territory when the taxable event is performed in the Basque Country.

Two. Duties on Raffles, Betting and Random Combinations shall be levied by the Territorial Government deemed competent by virtue of the Historical Territory when the authorisation thereof must be obtained in the Basque Country.

## SECTION 14 FEES

### *Article 38.*—Competence for levying

Fees collected for the special use or exploitation of Territorial Government public domain for services rendered or activities performed thereby under public Law shall be levied by the Territorial Governments.

## SECTION 15 MUNICIPAL TAX AUTHORITIES

### *Article 39.*—Tax on Immovable Property

The Tax on Immovable Property shall be regulated by the rules adopted by the competent Institutions of the Historical Territories and shall be levied on rural and urban assets located in the respective Historical Territory.

### *Article 40.*—Tax on Business and Professional Activities

One. The Tax on Business and Professional Activities shall be regulated by the rules adopted by the competent Institutions of the Historical Territories.

Two. The competent Institutions of the Historical Territories shall be responsible for levying the Tax on Business and Professional Activities exercised in their territory, in accordance with the following rules:

- a) In cases of minimum municipal rates, or raised rates as applicable, when payable in favour of the municipalities of the Historical Territory.
- b) In cases, where applicable, of provincial rates when the activity is exercised in the corresponding Historical Territory.
- c) In cases of rates entitling the taxpayer to perform his or her activity in more than one province when his or her habitual residence or fiscal domicile is in the Basque Country, as the case may be. Payment of said amounts to the corresponding Administration of the common or basque territory shall entitle the taxpayer to exercise his or her activity in both territories.

### *Article 41.*—Motor Vehicle Tax

The Motor Vehicle Tax shall be regulated by the rules laid down by the competent Institutions of the Historical Territories, when the domicile appearing on the driver's licence corresponds to a town or city in their territory.

### *Article 42.*—Other municipal taxes

The competent Institutions of the Historical Territories may maintain, establish and regulate, within their own territory, the system governing the remaining taxes peculiar to municipalities, pursuant to the criteria specified below:

- a) Attention to the general structure established for the system of municipal taxes under the common regime, and to the principles on which said structure is based, respecting any harmonisation rules envisaged in article 3 hereof that are applicable in this field.
- b) Non establishment of indirect taxes other than those of the common regime, the revenues from which might be transferred or passed on outside the territory of the Basque Country.

## SECTION 16 ADMINISTRATIVE AND PROCEDURAL RULES

### *Article 43.*—Habitual residence and fiscal domicile

One. For the purposes of the provisions contained in the present Economic Agreement, it shall be understood that resident individuals have their habitual residence in the Basque Country pursuant to the successive application of the following rules:

First. When they remain in said territory for more days of the tax period, for Personal Income Tax purposes; of the previous year counting up to the day prior to the date of accrual for the purposes of Inheritance and Gift Tax, Capital Transfer Tax, Stamp Duty and Excise Duty on Certain Means of Transport.

For the remaining taxes the habitual residence of taxable persons shall be the same as that used for Personal Income Tax at the date of accrual of said taxes.

To determine the period of stay, temporary absences shall be computed.

Unless there is evidence to the contrary, an individual shall be considered to remain in basque territory when this is the location of his or her habitual dwelling.

Second. When this is where they have their main centre of interests, considering as such the territory where they obtain most of their taxable income for Personal Income Tax purposes, excluding, for these purposes, income and capital gains arising from capital investments, and income allocated under the tax transparency system, except in the case of professionals.

Third. When this is the territory of their last declared residence for Personal Income Tax purposes.

Two. Individuals resident in Spanish territory who do not remain in said territory for more than 183 days of the calendar year shall be considered residents of the territory of the Basque Country when they have their main centre or base of business or professional activity, or of their economic interests, in said territory.

Three. When it is presumed that an individual resides in Spanish territory, s/he shall be considered to have her/his habitual residence in basque territory if her/his not legally separated spouse and dependent children of minor age have their habitual residence in the basque territory.

Four. For the purposes of the present Economic Agreement, the following shall be understood to have their fiscal domicile in the Basque Country:

- a) Individual taxpayers who have their habitual residence in the Basque Country.
- b) Corporate persons and other entities subject to Corporation Tax when their corporate domicile is in said territory, provided that the administrative management and direction of their business is effectively centralised therein.  
Otherwise, the place where said management or direction takes place shall apply. In cases where the place of domicile cannot be established by applying the aforesaid criterion, the place where the greatest fixed asset value is located shall apply.
- c) Permanent establishments whose administrative management and direction of their business takes place in the Basque Country. In cases where the place of domicile cannot be established by applying the aforesaid criterion, the place where the greatest fixed asset value is located shall apply.
- d) Civil societies and entities without independent legal status whose administrative management and direction takes place in the Basque Country. In cases where the place of fiscal domicile cannot be established by applying the aforesaid criterion, the place where the greatest fixed asset value is located shall apply.

Five. Persons liable for Corporation Tax and permanent establishments owned by non-residents shall be obliged to notify both Administrations of changes of address or fiscal domicile causing changes in competence for levying said taxes. For Personal Income Tax notification shall be understood to be completed upon filing a return for said tax.

Six. Any disputes between Administrations that may arise over the domicile of taxpayers shall be resolved, following a hearing, by the Arbitration Board provided for in chapter III, section 3 of the present Economic Agreement.

Seven. Individuals residing in common or basque territory who change their habitual residence from one to the other shall fulfil their tax obligations in the new place of residence, when the latter serves as the point of connection, as of that moment.

Moreover, when by virtue of the provisions contained in this point it is deemed that no change of residence has taken place, individuals must file the necessary supplementary returns, including late payment interest.

Changes of residence made for the purposes of achieving lower tax liability shall not be deemed effective.

It shall be presumed, unless the new residence extends continuously for a minimum of three years, that no change has taken place, for Personal Income Tax and Wealth Tax purposes, when the following circumstances occur:

- a) For the year in which the change of residence occurs, or the year thereafter, the taxpayer's Personal Income Tax tax base is at least 50 per 100 higher than the year prior to the change. If joint returns are filed, individualisation rules shall apply.
- b) For the year in which said situation occurs, the taxpayer's Personal Income Tax liability is lower than it would have been under the applicable legislation of the territory of residence prior to the change.
- c) The year after the event referred to in letter a), or the following year, the taxpayer again acquires habitual residence in said territory.

Eight. Unless there is evidence to the contrary, it shall be presumed that no change of fiscal domicile of corporate persons has taken place if in the year before or after the change no earnings are filed or the professional activity has been terminated.

Nine. Changes in taxpayer domicile may be promoted by any of the Administrations involved. The Administration shall transmit its proposal, together with the necessary antecedents, to the other Administration, which in two months' time shall announce its decision on the change of domicile and on the effective date. If the latter responds by endorsing the proposal, the competent Administration shall then inform the taxpayer.

Should the Administrations fail to reach an agreement, the procedure may continue in compliance with the provisions laid down in number six of the present article.

#### *Article 44.*—Fiscal offences

In cases where the Tax Authority considers that infractions could constitute an offence against the Public Treasury regulated under the Penal Code, the case shall be decided by the competent jurisdiction and the administrative procedure shall not be pursued until the court has handed down a firm ruling, whether the legal proceedings are dismissed or closed, or the case is returned by the Public Prosecutor.

#### *Article 45.*—Cooperation of financial institutions for tax administration and inspection purposes

One. The Territorial Governments of the Historical Territories of the Basque Country shall be responsible for the tax inspection of the accounts and loan and deposit operations both of financial institutions and of any individuals or corporate bodies that are engaged in banking or loan operations, in order to levy the taxes under their competence.

Regarding actions to obtain the information referred to in the preceding paragraph and performed outside the basque territory, the provisions contained in number two herebelow shall apply.

Two. Investigation and verification actions which are within the scope of competence attributed hereby to the Territorial Governments, but which must be performed outside their territory, shall be performed by the Tax Inspection services of the State, or by those of the competent Autonomous Communities when dealing with taxes governed by autonomous legislation, at the request of the competent body of the aforesaid Territorial Governments.

When the Tax Inspection Service of the State or of the Territorial Governments of the Historical Territories detect, as a result of their inspection and verification activities, findings of fiscal relevance for the other Administration, it shall notify the latter of same as specified in the pertinent regulations.

#### *Article 46.*—Obligation to provide information

One. Summaries of withholdings and payments on account shall be submitted, pursuant to their respective legislation, to the competent Administration for taxing withholdings and payments on account, which shall be included therein.

Entities that are depositaries or administrators of income on assets which, in accordance with the corresponding legislation, require annual summaries on withholdings and payments on account, shall submit said summaries, pursuant to their respective legislation, to the competent Administration for verification and investigation of said entities.

Entities liable to payment of the Corporation Tax levied by the State and by the Territorial Governments shall submit annual summaries on withholdings and payments on account corresponding to the income referred to in articles 7 (One, c) and 9 (One, First, a) of the present Economic Agreement pursuant to the rules on place, form and filing deadline determined by the competent Administration for levying the tax.

Two. Tax returns filed for the purpose of fulfilling the different legal obligations for providing general tax information shall be submitted, in accordance with their respective legislation, to the competent Administration of the State or the Territorial Governments of the Historical Territories, according to the following criteria:

- a) In the case of taxpayers who engage in business and professional activities, to the competent Administration for the verification and investigation of said activities.
- b) In the case of taxpayers who do not engage in business and professional activities, depending on whether their fiscal domicile is in the common or basque territory.

Three. Generally applicable tax returns shall be filed, in accordance with their respective legislation, with the competent Administration wherein lies the fiscal domicile of the liable taxpaying individual or entity, and also with the Administration to which said person or entity must submit, in accordance with the rules laid down in the present Economic Agreement, one or more of the following tax returns:

Tax return for withholdings and payments on account  
 Corporation Tax return  
 Value Added Tax return  
 Business and Professional Activities return

*Article 47.*—Corporate mergers and divisions

In merger and division operations of companies whose taxable income, as the case may be, must be recognised by both Administrations pursuant to the filing criteria contained in article 14 hereabove, the Territorial Governments of the Historical Territories shall apply identical regulations as those in effect at any given time in the common territory, and the corresponding administrative procedures of each Administration shall be complied with.

## CHAPTER II FINANCIAL RELATIONS

### SECTION 1 GENERAL REGULATIONS

*Article 48.*—General principles

The financial relations between the State and the Basque Country shall be governed by the following principles:

First. Fiscal and financial autonomy of the Institutions of the Basque Country in the development and implementing of its powers.

Second. Respect for the principle of solidarity in the terms laid down in the Constitution and in the Statute of Autonomy.

Third. Coordination and cooperation with the State in matters of budgetary stability.

Fourth. Contribution by the Basque Country to charges of the State not assumed by the Basque Autonomous Community, as determined by the present Economic Agreement.

Fifth. The faculties of financial supervision exercised by the State at any time in matters concerning municipalities shall correspond to the competent Institutions of the Basque Country, without this being construed to mean, in any way whatsoever, that the Basque Municipalities shall have a lower level of autonomy than that enjoyed by those under the common regime.

*Article 49.*—Concept of the quota

The contribution of the Basque Country to the State shall consist of an overall quota, comprising the quotas from each of the Historical Territories, as the Basque Country's share of all the charges of the State not assumed by the Autonomous Community of the Basque Country.

*Article 50.*—Periodicity and updating of the quota

One. Every five years, by means of a law passed by the Spanish Parliament, subject to the prior agreement of the Joint Committee on the Economic Agreement referred to in the following article, the methodology to be used in setting the quota, in the five-year period, shall be determined in accordance with the general principles laid down herein, and the quota for the first year of the five-year period shall be approved.

Two. In each of the years following the first, the Joint Committee on the Economic Agreement shall bring the quota up to date by applying the methodology approved in the Law referred to in the preceding paragraph.

Three. The principles underlying the methodology for determining the quota and contained herein may be amended in the Quota Act, when circumstances and the experience acquired in its application make this advisable.

*Article 51.*—Basque Municipalities' share in revenues from taxes not covered by the Economic Agreement

In cases of indirect contribution through a participation in such taxes, the Territorial Governments of the Historical Territories shall distribute the amounts which, pursuant to the general apportionment rules, correspond to the Municipalities in their respective Historical Territory.

SECTION 2  
METHODOLOGY FOR DETERMINING THE QUOTA

*Article 52.*—Charges of the State not assumed by the Autonomous Community

One. Charges of the State not assumed by the Autonomous Community are those which correspond to competences which have not been actually assumed by the latter.

Two. To determine the total amount of said charges, the entire State Budget allocation corresponding to the competences assumed by the Autonomous Community as of the entry into effect of the transfers established in the corresponding Decrees shall be deducted from the total State Budget expenditures.

Three. Among others, the following shall be considered charges not assumed by the Autonomous Community:

- a) The sums allocated in the General State Budget to the Inter-territorial Compensation Fund referred to in article 158.2 of the Spanish Constitution. The contribution to this burden shall be made by means of the procedure laid down in the Quota Act.



- b) Transfers or subsidies granted by the State to public entities, provided that the competences exercised thereby have not been assumed by the Autonomous Community of the Basque Country.
- c) The interest payments and repayments of principal on all State debts as determined in the Quota Act.

Four. Apportionment to the different Historical Territories of their share of non-assumed charges shall be made by applying the rates referred to in article 57 herebelow.

#### *Article 53.*—Adjustment to consumption for Value Added Tax

One. For the purpose of perfecting the attribution of Value Added Tax revenues, an adjustment mechanism is set up between the actual revenue capacity and the rate of consumption of the Basque Country.

Two. The result of applying the following mathematical equation shall be used as the adjustment mechanism:

$$RF_{PV} = RR_{PV} + a \times RR_{AD} + (a - b) \times H$$

Where:

$$H = \frac{RR_{PV}}{b} \text{ if } \frac{RR_{PV}}{RR_{TC}} \leq \frac{b}{1-b}$$

$$H = \frac{RR_{TC}}{1-b} \text{ if } \frac{RR_{PV}}{RR_{TC}} \geq \frac{b}{1-b}$$

$RF_{PV}$  = Final annual revenue for the Basque Country

$RR_{PV}$  = Real annual revenue of the Basque Country

$RR_{TC}$  = Real annual revenue of the common territory

$RR_{AD}$  = Real annual revenue from imports

$$a = \frac{\text{Consumption of residents of the Basque Country}}{\text{Consumption of residents of the State (minus Canary islands, Ceuta and Melilla)}}$$

$$b = \frac{v - f - e + i}{V - F - E + I}$$

$v$  = Gross added value of the Basque Country at factor cost

$V$  = Gross added value of the State (minus Canary Islands, Ceuta and Melilla)

$f$  = Gross capital formation of the Basque Country

$F$  = Gross added value of the State (minus Canary Islands, Ceuta and Melilla)

$e$  = Exports from the Basque Country

$E$  = Exports from the State (minus Canary Islands, Ceuta and Melilla)

$i$  = Intra-community acquisitions of goods in the Basque Country

$I$  = Intra-community acquisitions of goods in the State (minus Canary Islands, Ceuta and Melilla)

Three. The value of the rates referred to the paragraph One hereabove shall be determined in accordance with the Quota Act.

Four. The provisional attribution of the aforesaid adjustment for each of the excise duties and the definitive regularisation thereof in the immediately subsequent year shall be carried out in accordance with the procedure in force at the time and approved by the Joint Committee on the Economic Agreement.

*Article 54.*—Adjustment to consumption for Excise Duties

One. For the purpose of perfecting the attribution of revenues from Excise Duties on Alcohol and Alcoholic Beverages, Intermediate Products, Beer, Mineral Oils and Manufactured Tobacco, an adjustment mechanism is set up between the actual revenue capacity and the rate of consumption of the Basque Country for each of these taxes.

Two. The result of applying the following mathematical equation shall be used as the adjustment mechanism for each of the taxes listed hereabove:

$$RF_{PV} = RR_{PV} + c \times RR_{AD} + (c - d) \times H$$

Where:

$$H = \frac{RR_{PV}}{d} \text{ if } \frac{RR_{PV}}{RR_{TC}} \leq \frac{d}{1 - d}$$

$$H = \frac{RR_{TC}}{1 - d} \text{ if } \frac{RR_{PV}}{RR_{TC}} \geq \frac{d}{1 - d}$$

$RF_{PV}$  = Final annual revenue of the Basque Country from Excise Duties on Alcohol and Alcoholic Beverages, Intermediate Products, Beer, Mineral Oils and Tobacco

$RR_{PV}$  = Real annual revenue of the Basque Country from Excise Duties on Alcohol and Alcoholic Beverages, Intermediate Products, Beer, Mineral Oils and Tobacco

$RR_{TC}$  = Real annual revenue of the common territory from Excise Duties on Alcohol and Alcoholic Beverages, Intermediate Products, Beer, Mineral Oils and Tobacco

$RR_{AD}$  = Real annual revenue from Excise Duties from imports of Alcohol and Alcoholic Beverages, Intermediate Products, Beer, Mineral Oils and Tobacco

$$c = \frac{\text{Consumption of residents of the Basque Country}}{\text{Consumption of residents of the State (scope of application of the tax)}}$$

$$d = \frac{\text{Revenue capacity of the Basque Country}}{\text{Revenue capacity of the State} \\ \text{(scope of application of the tax)}}$$

Three. The value of the rates referred to the paragraph One hereabove shall be determined in accordance with the Quota Act.

Four. The provisional attribution of the aforesaid adjustment for each of the excise duties and the definitive regularisation thereof in the immediately subsequent year shall be carried out in accordance with the procedure in force at the time and approved by the Joint Committee on the Economic Agreement.

#### *Article 55.–Other adjustments*

One. For the purpose of perfecting direct taxation, an adjustment shall be made for the amounts arising from the cases laid down in articles 9.one.first.b) and 7.two herein.

Two. Similarly, in the Quota Act, other adjustment mechanisms can be established, as the case may be, which may improve the system for estimating the public revenue attributable to the Basque Country and to the rest of the State.

Three. The amounts resulting from application of the pertinent adjustments shall constitute the quota for each Historical Territory.

#### *Article 56.–Compensations*

One. From the quota corresponding to each Historical Territory the following items shall be subtracted for compensation purposes:

- a) The attributable portion of non-transferred taxes.
- b) The attributable portion of budgetary income not from taxes.
- c) The attributable portion of the deficit figuring in the General State Budget, as determined by the Quota Act. In the event of a surplus, the opposite would apply.

Two. Also subject to compensation of the quota corresponding to each Historical Territory is the portion attributable to the Basque Country for revenues utilised in the financing of Social Security functions and services related to health and social services devolved to the Basque Country which prior to the entering in effect of this Law were paid to the Basque Country by transfers from the Social Security General Treasury, as provided for in the budgetary regime laid down in Royal Decrees 1536/1987 of 6 November, 1476/1987, of 2 October, 1946/1996, of 23 August and 558/1998, of 2 April.

Three. Attribution of the items stipulated in the points above shall be made by applying the attribution rate referred to in article 57 herebelow.

*Article 57.–Attribution rates*

One. The attribution rates referred to in articles 52, 55.two and 56 hereabove, shall be determined basically in accordance with the income of the Historical Territories relative to that of the State.

Two. The rates shall be set out in the Quota Act and shall be applied during the validity period thereof.

*Article 58.–Effects on the provisional quota due to variations in transferred competences*

One. If, during the annual validity period of the quota, set in accordance with the preceding rules, the Autonomous Community of the Basque Country assumes competences whose annual cost at State level had been included in the charges of the State used as the basis for determining the provisional amount of the quota, said annual cost shall be reduced proportionally to the portion of the year during which the Basque Country has assumed said competences, with the quota being reduced accordingly.

The aforesaid proportional reduction shall take into account the actual periodicity of operating costs, as well as the actual extent to which the State's investments have been undertaken.

Two. The same procedure would be followed if the Autonomous Community stopped exercising competences already assumed at the time of setting the provisional quota, increasing the latter by the appropriate amount.

*Article 59.–Provisional and final settlements*

The quota and the appropriate compensations shall be set initially and provisionally using for this purpose the figures contained in the State Budget passed for the year in question.

Once the accounting year has ended and the State Budget has been settled, any necessary corrections shall be made to the amounts referred to in articles 52, 55 and 56 of the present Economic Agreement.

The positive or negative differences resulting from said corrections shall be added algebraically to the provisional quota for the year subsequent to that in which the corrections were made.

*Article 60.–Payment of the quota*

The amount payable by the Autonomous Community of the Basque Country shall be paid to the State Treasury in three identical instalments, during the months of May, September and December of each year.

### CHAPTER III ECONOMIC AGREEMENT COMMITTEES AND BOARD OF ARBITRATION

#### SECTION 1 JOINT COMMITTEE ON THE ECONOMIC AGREEMENT

##### *Article 61.*—Composition and agreements

The Joint Committee on the Economic Agreement shall be made up of one representative from each Territorial Government plus the same number from the Basque Government, on the one hand, and on the other, by the same number of representatives from the Administration of the State.

The agreements of the Joint Economic Agreement Committee must be adopted unanimously by all of its members.

##### *Article 62.*—Functions

The Joint Committee on the Economic Agreement shall exercise the following functions:

- a) Agree on modifications to the Economic Agreement
- b) Agree on coordination and cooperation commitments in matters of budgetary stability.
- c) Agree on the methodology to be used in setting the quota for each five-year period.
- d) Agree on the system and appointment of the Members of the Board of Arbitration described in section 3 of this chapter, and on operations, summons to and details of meetings, and the system for adopting agreements.
- e) Any and all agreements involving matters of tax and finance deemed necessary at any given time for the correct application and development of the provisions contained in the present Economic Agreement.

#### SECTION 2 COORDINATION AND EVALUATION COMMITTEE

##### *Article 63.*—Composition

The Coordination and Evaluation Committee shall be made up of:

- a) Four representatives of the Administration of the State.
- b) Four representatives of the Autonomous Community appointed by the Basque Government, three of which shall be at the proposal of each of the respective Territorial Governments.

*Article 64.–Functions*

The Coordination and Evaluation Committee shall exercise the following functions:

- a) Evaluate the adaptation of the tax legislation to the Economic Agreement prior to the publication thereof.

For this purpose, if as a result of the exchange of information on draft bills specified in article 4, paragraph one of the present Economic Agreement, observations should arise relative to the proposals contained therein, any of the Institutions and Administrations represented may request, in writing and with good cause, the Committee to assemble. The Committee shall then convene within fifteen days from the date of request to analyse the appropriateness of the proposed regulation for the Economic Agreement and shall make all efforts, prior to the publication of the corresponding regulations, to see that the Institutions and Administrations represented reach an agreement on any discrepancies in the tax legislation.

- b) Resolve any concerns put forward on the application of points of connection laid down in the present Economic Agreement. Concerns shall be transferred for their analysis, together with a proposed resolution, within two months from reception thereof, to the rest of the Administrations concerned. If no observations are formulated on the proposal for resolution in two months' time, said proposal shall be deemed approved. If observations are submitted, the Coordination and Evaluation Committee shall convene; if an agreement is not reached, the decision will then be transferred to the Board of Arbitration.
- c) Make whatever studies they deem necessary for the adequate structural and functional organisation of the autonomous regime within the fiscal framework of the State.
- d) Provide the competent Administrations with uniform action criteria, computer plans and programmes, and to organise the instruments, resources, procedures or methods for the effective materialisation of cooperation principles and information exchange.
- e) Analyse the cases and questions that have arisen over inspection matters between the Administration of the State and the respective Territorial Governments, and to examine valuation problems for tax purposes.
- f) Issue reports requested by the Spanish Ministry of Finance, the different Finance Departments of the Basque Government and the Territorial Governments, and the Board of Arbitration.
- g) Any other functions related, in particular, to the application and execution of the present Economic Agreement.

### SECTION 3 BOARD OF ARBITRATION

#### *Article 65.–Composition*

One. The Board of Arbitration is made up of three members appointed and formalised by the Spanish Minister of Finance and the Basque Minister of Finance and Public Administration.

Two. The arbitrators are appointed for a period of six months and may not be reelected unless they have served on the Board for less than three years.

Three. Should there be a vacancy it shall be filled according to the same procedure as for appointments. The new member shall serve for the amount of time the substituted person had remaining to fulfil his or her term.

Four. Members of the Board of Arbitration shall be appointed by experts of renown prestige with over fifteen years of professional experience in tax and finance matters.

#### *Article 66.–Functions*

One. The Board of Arbitrators shall exercise the following functions:

- a) Resolve all disputes arising between the Administration of the State and the Territorial Governments of the Historical Territories, or between the latter and the Administration of any other Autonomous Community, over the application of the points of connection for the taxes transferred hereunder and over the determination of the proportion corresponding to each Administration in cases of joint filing of Corporation Tax or Value Added Tax returns.
- b) Hear disputes arising between the interested Administrations over the interpretation and application of the present Economic Agreement in specific cases concerning individual tax relations.
- c) Resolve any disputes that may arise over the domicile of taxpayers.

Two. In disputes over competence, the Administrations affected shall inform the interested parties, implying the abeyance of prescription, and shall refrain from taking any other action.

Conflicts shall be resolved by regulatory procedure and interested parties shall be given due hearing.

#### *Article 67.–Agreements of the Board of Arbitrators*

The Board of Arbitration shall resolve, according to law and to the principles of economy, celerity and efficiency, all matters affecting the proceedings, whether or not they are presented by the parties involved in the conflict, including formulas for enforcement.

The resolutions of this Board of Arbitration shall, without prejudice to their executive nature, be subject only to appeals raised through judicial review to the relevant Chamber of the High Court.

## ADDITIONAL PROVISIONS

*First.* Until the provisions necessary for the application of this Economic Agreement are enacted by the competent Institutions of the Historical Territories, the regulations in force in the common tax system shall be applied, which, in all cases, shall have the character of supplementary law.

*Second.* One. Any amendments to this Economic Agreement shall be made by the same procedure followed for its enactment.

Two. In the event of a reform of the State tax legal system affecting the taxes object of agreement, or an alteration in the distribution of the regulatory competences affecting the scope of indirect taxation, or new tax figures or payments on account, both Administrations shall by mutual agreement proceed to adapt the present Economic Agreement to any modifications made in the aforementioned legal system.

The corresponding adaptation of the Economic Agreement shall specify the financial effects thereof.

*Third.* The Territorial Governments of the Historical Territories of Alava, Guipuzcoa and Vizcaya shall have the powers which in economic and administrative matters were recognised in article 15 of the Royal Decree of December 13, 1906 and which, by virtue of the general updating process of the traditional Basque regime envisaged in the First Additional Provision of the Spanish Constitution, are considered to subsist, without prejudice to the basic legislation to which reference is made in article 149.1.18 of the Spanish Constitution.

*Fourth.* The State and the Autonomous Community may agree on the joint financing of investments to be undertaken in the Basque Country and which, due to their cost, strategic value, general interest, impact on territories other than the Basque Autonomous Community, or due to other special circumstances, make such means of financing advisable.

Similarly, the State and the Autonomous Community may agree on the participation of the latter in the financing of investments which, having the characteristics referred to in the previous paragraph, are undertaken in territories other than that of the Community.

In both cases, the contributions made shall affect the Economic Agreement as agreed in each case.

*Fifth.* For the administration, inspection, revision and collection of the taxes transferred hereunder, the competent Institutions of the Historical Territories shall enjoy the same powers and prerogatives as those enjoyed by the State Treasury.

*Sixth.* The turnover figure referred to in articles 14, 15, 19 and 27 of the present Economic Agreement shall be updated, by resolution of the Joint Committee on the Economic Agreement, at least every five years.



## TRANSITIONAL PROVISIONS

*First.* The determinant turnover figure set forth in the present Economic Agreement shall apply to the tax or tax return period, depending on the type of tax, as of January 1st 2008.

*Second.* Taxes accrued prior to the entry into force of the present Economic Agreement shall be governed by the points of connection in force at the time of their accrual.

The same rule shall apply to withholdings, payments on account and payments in instalments when the accrual of the obligation to withhold, pay on account or make an instalment payment has taken place prior to the entry into force of the present Economic Agreement.

Procedures not finalised prior to the entry into force of the present Economic Agreement shall be governed by the regulations in force at the time of their initiation.

*Third.* Notwithstanding the provisions contained in the transitional provision hereabove, the bodies laid down in chapter III of the present Economic Agreement shall have knowledge, in accordance with the procedures and powers attributed thereto, of all of the cases pending decision between the two Administrations at the time of its entry into force.

*Fourth.* Moreover, a Joint Committee with equal numbers of representatives from the State Treasury and from the Government of the Historical Territory of Alava shall determine the compensation to be paid to the Government of this Historical Territory for as long as the latter continues to exercise competences and render services not assumed by the Autonomous Community of the Basque Country, and which in provinces under the common regime correspond to the State, as well as the rules for the annual revision of this compensation on the basis of the schedule for the transfer of competences to the Basque Country.

The determination and application of these compensations shall not affect the rules for determining the quota laid down in this Agreement, although they shall be made effective through reduction of the quota figure corresponding to Alava by virtue of article 41.two.e) of the Statute of Autonomy.

*Fifth.* The tax system applicable to economic interest groupings and joint ventures constituted prior to the entry into force of the present Economic Agreement shall be that of the Basque Country when said groupings do not exceed the territorial scope thereof.

*Sixth.* Tax groups which prior to January 1st 2002 filed returns with the State or Basque Administrations under the tax consolidation system pursuant to article 25 of the present Economic Agreement, approved by virtue of Law No. 12 of May 13th 1981, may maintain said tax system until December 31st 2006, provided that they satisfy the requirements provided for in the regulations on tax consolidation in force at December 31 2001.

*Seventh.* As long as no amendments are made to the current system of manufacture and sale of tobacco products, the following mathematical equation shall be used as an adjustment for the Excise Duty on the Manufactured Tobacco pursuant to article 54 of the present Economic Agreement:

$$RF_{PV} = RR_{PV} + c' * RR_{TC} [(1-c') * RR_{PV}]$$

Where:

$RF_{PV}$  = Final annual revenue for the Basque Country from Manufactured Tobacco

$RR_{PV}$  = Real annual revenue of the Basque Country from Manufactured Tobacco

$RR_{TC}$  = Real annual revenue of the Common Territory from Manufactured Tobacco

$$c' = \frac{\text{Manufactured Tobacco supplied to Tobacco and Stamp outlets in the Basque Country}}{\text{Manufactured Tobacco supplied to Tobacco and Stamp outlets located in the territory application of the Excise duty}}$$

*Eighth.* Partial refunds on the Tax on Mineral Oils from the establishment of the special reduced rate on diesel oil used as a fuel for professional purposes, authorised under Council Directive 2003/96/EC of 27 October 2003 restructuring the Community framework for the taxation of energy products and electricity, shall be made by the Administration corresponding to the fiscal domicile of the beneficiary of said refunds.

*Ninth.* Extraordinary refunds on the Tax on Mineral Oils for farmers and stockbreeders from the application of measures to offset the increase in production costs plaguing the agricultural sector shall be made by the Administration corresponding to the fiscal domicile of the beneficiary of said refunds.

*Tenth.* Pursuant to the fifth additional provision of the state Agencies Act 28/2006 of 18 July concerning the improvement of public services, when an autonomous body or public business enterprise is transformed to an agency, the system of competences set forth in article 7 for autonomous bodies and public business enterprises shall apply.

## FINAL PROVISION

Repeals or amendments, as the case may be, of the Economic Agreement rules applicable to the different taxes shall be understood without prejudice to the right of the respective Administrations to claim, pursuant to the points of connection previously in effect, any tax liabilities due prior to that date.

## ANNEX 4

### Five-Year Quota Act 2007-20111

#### CHAPTER I

#### LEGAL REGIME AND VALIDITY OF THE METHOD

##### *Article 1.*—Legal regime and validity of the method

The Quotas for the Basque Country for the fiscal years 2007 to 2011 inclusive will be determined by the method regulated by the following articles. This method adheres to the regulatory scheme laid down in Section 2, Chapter II of the Economic Agreement with the Autonomous Community of the Basque Country approved by Law 12/2002.

##### *Article 2.*—System

For the purposes of the provisions of the previous article, the net quota for the base year of the five year period shall be determined. This figure shall be updated for the subsequent years.

#### CHAPTER II

#### DETERMINATION OF THE NET QUOTA FOR THE BASE YEAR

##### *Article 3.*—Determination of the net quota for the base year

The net quota for the base year of the five year period from 2007 to 2011 shall be determined by applying the attribution rate to the total amount of the charges not assumed by the Autonomous Community and by making the relevant adjustments and compensations, all as provided for in the terms of the following articles.

##### *Article 4.*—Charges of the State not assumed by the Autonomous Community

One. Charges of the State not assumed by the Autonomous Community are those which correspond to competences which have not been actually assumed by the latter.

<sup>1</sup> As translated in web page of the Basque Government  
[http://www.ogasun.ejgv.euskadi.net/r51-341/es/contenidos/informacion/concierto\\_quinquenal/es\\_4177/adjuntos/Kuporen\\_legea\\_es.pdf](http://www.ogasun.ejgv.euskadi.net/r51-341/es/contenidos/informacion/concierto_quinquenal/es_4177/adjuntos/Kuporen_legea_es.pdf)

Two. To determine the total amount of said charges, the entire State Budget allocation corresponding to the competences assumed by the Autonomous Community as of the entry into effect of the transfers established in the corresponding Royal Decrees shall be deducted from the total State Budget expenditures.

Three. Among others, the following shall be considered charges not assumed by the Autonomous Community:

- a) The sums allocated in the General State Budget to the Inter-territorial Compensation Fund.
- b) Transfers or subsidies granted by the State to public entities, provided that the competences exercised thereby have not been assumed by the Autonomous Community of the Basque Country.
- c) The interest payments and repayments of principal on all State debts.

Four. Attribution to the different Historical Territories of their share of non-assumed charges shall be made by applying the attribution rate referred to in article 7 herebelow.

#### *Article 5.–Adjustments*

One. Without prejudice to the provisions of articles 14 and 15 herebelow, the figures resulting from the attribution referred to in point four of the preceding article shall be adjusted to improve the accuracy of the estimated income from direct tax attributable to the Basque Country and to the rest of the State pursuant to article 55 of the Economic Agreement.

Two. The amounts resulting from application of the adjustment regulated by point one above shall constitute the Quota for each Historical Territory.

#### *Article 6.–Compensations*

One. From the quota corresponding to each Historical Territory the following items shall be subtracted for compensation purposes:

- a) The attributable portion of non-transferred taxes.
- b) The attributable portion of budgetary income not from taxes.
- c) The attributable portion of the deficit figuring in the General State Budget.

Two. Also subject to compensation of the quota corresponding to each Historical Territory is the portion attributable to the Basque Country for revenues utilised in the financing of Social Security functions and services related to health and social services devolved to the Basque Country which prior to the entering in effect of Act 12/2002 of 23 May were paid to the Basque Country by transfers from the Social Security General Treasury, as provided for in the budgetary regime laid down in Royal Decrees 1536/1987 of 6 November, 1476/1987 of 2 October, 1946/1996 of 23 August and 558/1998 of 2 April.

Three. Attribution of the items stipulated in the points above shall be made by applying the attribution rate referred to in article 7 herebelow.

#### Article 7.–Attribution rate

The attribution rate referred to in articles 4 and 6 hereabove, set basically in accordance with the income of the Historical Territories relative to that of the State, is 6.24 per cent for the current five year period.

#### Article 8.–Net quota

The sum resulting from the adjustment performed as per article 5 and the compensations stipulated in article 6 (One) hereabove shall constitute the net quota for the Basque Country for tax year 2007, which is the base year of the five year period.

After the Net Quota is determined, the sum of compensations as per in article 6 (Two) hereabove, and the amount resulting from the application of the Fourth Transitional Provision of the Economic Agreement shall be subtracted.

### CHAPTER III

#### DETERMINATION OF THE NET QUOTA FOR THE SUBSEQUENT YEARS OF THE FIVE YEAR PERIOD AND FINAL SETTLEMENT OF THE QUOTAS

#### Article 9.–Method of determination

The net quota for the subsequent years after the base year of the five year period shall be determined provisionally by applying an updating index to the net quota.

In the years following the base year compensation shall be performed according to article 6 (Two) of this Act.

#### Article 10.–Updating index

The updating index is the quotient between expected revenues from taxes covered by the Economic Agreement, excluding those transferred in their entirety to the Autonomous Communities, as stated in Chapters I and II of the State Budget for the tax year to which the net quota refers and the duly adjusted revenues expected by the State for the same tax items in the base year of the five year period.

#### Article 11.–Effects of variations in the competences assumed

One. If during any of the years following the base year of the five year period the Autonomous Community of the Basque Country assumes further competences whose annual cost at State level had been included in the charges of the State used as the basis for determining the net quota for the base year of the five year period as per article 8, said annual cost at State level associated with the transfer in the year in which the transfer takes place shall be calculated as deduced from the General State Budget for the year in question.

Should the new transfer not take effect on January 1st, the total annual cost at State level associated with the transfer for the year in question shall be considered on a prorata basis in proportion to the portion of the year during which the Basque Country has enjoyed said competences, with effect exclusively for the determination of the net quota for the year in which the transfer takes place.

The aforesaid proportional reduction shall take into account the actual periodicity of operating costs, as well as the actual extent to which the State's investments have been undertaken.

Two. If the circumstance indicated in the preceding paragraph arises, the net quota for the base year of the five year period shall be reduced by the amount resulting from the application of the attribution rate regulated by article 7 to the total annual cost at State level in the year of the transfer divided by the updating index regulated by article 10.

The net quota for the base year of the five year period thus revised shall be used to determine the quota for the year in which the transfer takes place and for the subsequent years.

Three. The mechanism described above shall be applied inversely if the Autonomous Community of the Basque Country ceases to exercise competences which it had previously assumed.

Four. If during any of the years of the five year period, the State should reserve for itself or assume new funding commitments, as a result of legislative measures, general interest or interinstitutional agreements, in matters whose implementation corresponds to the Autonomous Communities, the Joint Committee on the Economic Agreement shall meet to analyze and determine the financial contribution, as the case may be, which corresponds to the Basque Country.

#### *Article 12.–Final settlement*

One. The provisionally set quotas, as provided for in the articles hereabove, shall be settled definitively by applying the actual value of the updating index described in article 10, and inferred from the net revenue actually obtained by the State both in the year to which the quota refers and its equivalent in the base year of the five year period, to the final net quota for the base year.

Definitive settlement of compensation shall be performed according to article 6 (Two) of this Act.

Two. Exceptionally, the final settlement of the net quota for the base year of the five year period shall be made taking into account the actual value of the updating index described in article 10, which is inferred from the net revenue actually obtained by the State in the base year of the five year period, with respect to the equivalent revenue forecast shown in the State Budget for that year.

Definitive settlement of the compensation for the base year of the five year period shall be performed according to article 6 (Two) of this Act.

Three. The net revenue obtained by the State in each tax year shall be that stated in the certificate issued by the General Audit Inspectorate of the State Administration to this effect. As such shall be taken the revenue obtained in the year to which the certificate refers, whatever the year of accrual.

Four. Final settlement shall be made in May of the year following the year to which the net quota to be settled refers, and any differences with the net quota set provisionally for the said year shall be regularized in that month, being calculated, as the case may be, with the payment to be made in that month as provided for in the following article.

## CHAPTER IV COMMON RULES

### *Article 13.*—Payment of the quota

The sum to be paid by the Autonomous Community of the Basque Country in each tax year shall be paid to the State Revenue Department in three equal instalments in the months of May, September and December of the year in question.

### *Article 14.*—Adjustment for Value Added Tax

One. The following shall be added to the actual revenues of the Basque Country from Value Added Tax:

- a) 6.875 per cent of the Value Added Tax revenues from Customs Duties.
- b) 1.110 per cent of the actual tax revenues of the common territory divided by 94.235 per cent, or of the actual tax revenues of the Basque Country divided by 5.765 percent, according to whether the percentage of tax revenues of the Basque Country, with respect to the State total, minus the revenue obtained through Customs, is greater or less, respectively, than 5.765 per cent.

Two. The provisional attribution of the aforesaid adjustment and the definitive regularization thereof in the immediately subsequent year shall be carried out in accordance with the procedure in force at the time and approved by the Joint Committee on the Economic Agreement.

### *Article 15.*—Adjustment for Excise Duties

One. The following shall be added to the actual revenue of the Basque Country from Excise Duties on Alcohol and Alcoholic Beverages, Intermediate Products, Beer, Mineral Oils and Manufactured Tobacco:

- a) 1. 7.130 per cent of the revenues from Duties on Alcohol and Alcoholic Beverages, and on Intermediate Products from Customs Duties.
2. 5.198 per cent of the actual revenue from the Duty on Alcohol and Alcoholic Beverages and on Intermediate Products of the common territory

divided by 98.068 per cent, or the actual revenue of the Basque Country from the same excise duty divided by 1.932 per cent, according to whether the percentage of revenue of the Basque Country with respect to the State total, less the amount from Customs Duties, is greater or less, respectively, than 1.932 per cent.

- b) 1. 7.130 per cent of the revenues from Customs Duty on Beer.
- 2. 5.399 per cent of the actual revenue from the Excise Duty on Beer of the common territory divided by 98.269 per cent, or the actual revenue of the Basque Country from the same excise duty divided by 1.731 per cent, according to whether the percentage of revenue of the Basque Country with respect to the State total, less the amount from Customs Duties, is greater or less, respectively, than 1.731 per cent.
- c) 1. 6.560 per cent of the revenues from customs duty on mineral oils.
- 2. When negative, 1.700 per cent of the actual revenue from the Excise Duty on Mineral Oils of the common territory divided by 91.740 per cent, or the actual revenue of the Basque Country from the same Excise Duty divided by 8.260 per cent, according to whether the percentage of revenue of the Basque Country with respect to the State total, minus the revenue obtained by Customs, is greater or less, respectively, than 8.260 per cent.
- d) The difference between the result of applying to the common territory's actual revenue from the Excise Duty on Manufactured Tobacco the percentage corresponding annually to the value of the products supplied to the tobacco and stamp outlets located in the Basque Country with respect to the value of the products supplied to said establishments in the territory where the excise duty is applied, and the result of applying a supplement up to a hundred of the percentage defined above to the actual revenue from the same excise duty in the Basque Country.

Two. Should the actual revenue obtained by the Basque Country differ by more than 7 per cent for the Excise Duty on Mineral Oils, or by more than 10 per cent for the Excise Duty on Alcohol and Alcoholic Beverages, Intermediate Products and Beer from the figure resulting from the application of the rates indicated in the last part of sub-sections a)2, b)2 and c)2 of point One of this article, to the actual revenue of the State as a whole for the said items, those rates shall be corrected to carryout adjustments for the year in which such differences arise.

This correction shall be made by applying the percentage of variation, be it positive or negative, above the limits set in the preceding paragraph, to the corresponding rates referred to in the last part of sub-sections a)2, b)2 and c)2 of point one above.

Three. The provisional attribution of the aforesaid adjustment for each of the excise duties and the definitive regularization thereof in the immediately subsequent year shall be carried out in accordance with the procedure in force at the time and approved by the Joint Quota Committee.



## ADDITIONAL PROVISION

*First.* The First Additional Provision laid down in Law 37/97 of 4 August shall remain in force for the five year period 2007-2011.

*Second.* The provisional net quota for the Basque Country for the base year of the five year period from 2007 to 2011 indicated in Appendix 1 to the present document is approved.

*Third.* The financial provisions applying to the Basque Country for the implementation of the System for Personal Autonomy and Attention to Dependent Persons, the development of the Organic Law on Education, and the provisions agreed upon at the Conference of Presidents of 10 September 2005 for health care funding will be determined by the Joint Committee on the Economic Agreement.

*Fourth.* In the event of a reform of the State tax legal system affecting the taxes object of agreement, or an alteration in the distribution of the regulatory competences affecting the scope of indirect taxation, or new tax figures or payments on account, both Administrations shall by mutual agreement, proceed to adapt the net quota for the base year of the five year period and the updating index in such a way and to such an amount as may be pertinent. Such adaptations shall take effect as from the year in which the reform is made.

Both Administrations shall, as the case may be, make the pertinent adjustments or compensations, given the nature of the tax figure object of the agreement.

*Fifth.* In the event of a reform of the State tax transfer system or a substantial modification to the General State Budget as a result of amendment to the finance system of the Autonomous Communities or Local Bodies, the Joint Quota Committee shall meet to analyse and determine, if applicable, the revision of the net quota for the base year of the five year period and/or revision of the updating index to the net quota. Where applicable, adaptations shall take effect as from the year in which the reform is made.

*Sixth.* In the event of a reform of the actual regime of manufacturing and commerce of Manufactured Tobacco both Administrations shall by mutual agreement, proceed to adapt sub section d) of Article 15 One.

*Seventh.* The cost for the Autonomous Police Force set forth in Appendix 1 reflects the funding corresponding to the number of staff with active service administrative status pursuant to the deployment agreements adopted prior to 1 January 2007.

The Joint Economic Agreement Committee shall agree on the funding for any increase in the current staff of the Autonomous Police Force.

## TRANSITIONAL PROVISION

*Sole.* Exceptionally, for the 2007 fiscal year, the provisional Quota will be increased by the amount corresponding to the part of the year in which the officers of the 20th graduating class of the Autonomous Police Force were in the training period, in compliance with the agreements adopted by the Joint Quota Committee in this area.

## FINAL PROVISION

*First.* Exceptionally, should the term of this Act elapse without a new law being enacted to regulate the method for determining the quota for the following years, the method laid down in this Act shall apply in all its terms for the provisional determination of the net quotas and the compensations referred to in article 6 (Two) and the First additional provision of this document and in the Fourth transitional provision of the Economic Agreement for the year 2012 and subsequent years.

The quotas and compensations thus determined shall be replaced by those applicable under the law indicated in the previous paragraph once it is enacted.

*Second.* The provisions of this document are understood to be without prejudice to the regulations contained in the additional, transitional and final provisions of the Economic Agreement with the Basque Country, which remain in force insofar as they are applicable on their own terms.

## APPENDIX 1

### Provisional Quota for the Autonomous Community of the Basque Country for Base Year 2007

	Thousands of Euros	Thousands of Euros
State Budget Expenditure	–	188,417,352.98
Charges assumed by the Autonomous Community <sup>1</sup>	–	102,664,732.79
Total non assumed charges	–	85,752,620.19
Application of the attribution rate to non assumed charges:		
6.24 % of 85,752,620.63	–	5,350,963.50
Compensation and adjustments to be deducted	–	–3,702,794.41
For taxes not covered by the Economic Agreement (3,942,605.41 at 6.24 %)	–246,018.58	–
For other non tax income (7,589,293.77 at 6.24 %)	–473,571.93	–
For budget deficit (40,872,263.17 at 6.24 %)	–2,550,429.22	–
For direct taxes covered by the Economic Agreement	–432,774.68	–
Net quota	–	1,648,169.09
Compensations article 6 (Two), Quota Act	–	–82,088.07
Sole transitional provision, Quota Act	–	2,980.31
Alava Compensations	–	–3,823.80
Net amount payable	–	1,565,237.53

<sup>1</sup> This figure includes an assumed charge on the State level for the Autonomous Police Force of 10,189,126 thousand Euros.

Without prejudice to the third additional provision of the Method for the 2007-2011 Quota.

## ANNEX 5

### Glossary, Abbreviations and Translation of Terms

#### GLOSSARY

**Agreed Taxes:** Taxes assigned to the Historical Territories in the Economic Agreement. Almost all the taxes have been agreed except the Social Security Contributions. The Foral Deputations of the Historical Territories collect and, subject to some harmonization conditions, regulate the agreed taxes.

**Araba:** Name in Basque for Alava.

**Bizkaia:** Name in Basque for Vizcaya.

**Common Regime Autonomous Communities:** This term refers to the Autonomous Communities of Spain within the Common System of Financing. The Common Regime Autonomous Communities includes all the Autonomous Communities, except for the Basque Autonomous Community and the Foral Community of Navarre. The Canary Islands, although formally under the Common Regime, have some fiscal singularities that give them significant tax autonomy.

**Common System of Financing:** The financing system of the Autonomous Communities, except for the Basque Country and Navarre. The main taxes are collected by the Central Government. The Autonomous Communities receive a share of what is collected in its territory plus an equalizing transfer.

**Common Territory:** Spain, excluding the Basque Country and Navarre.

**Contributions:** Transfers made by the Foral Deputations to the Basque Government to finance its expenditures.

**Contributions Acts:** Five-year Laws regulating the distribution of the revenue from agreed taxes between the Basque Government and the Foral Deputations

(vertical model of distribution). The Contributions Acts also establish the method to calculate the percentage of the Quota and of the agreed resources that belong to the Basque Government that each Foral Deputation has to pay (horizontal model).

**Economic Agreement Law:** Law regulating the fiscal and financial relations between the Basque Country and the State. It establishes that all taxes (except Social Security Contributions) belong to the Basque Country (strictly speaking to the Historical Territories) which, in return, pays a Quota to the State

**Ertzaintza:** Regional Police of the Basque Country.

**Euskadi/Basque Country** (in the sense used in this book): Refers to the political region formed by the provinces of Alava, Biscay and Guipuzcoa.

**Euskal-Herria/Basque Country** (literally Basque people and Basque Territory): Refers to the seven Territories with Basque language, culture and legal traditions. These regions are Alava, Biscay, Guipuzcoa and Navarre in Spain, and Basse Navarre, Labourd and Soule in the South of France.

**Foral Deputation:** Provincial Council ruling a Historical Territory (former province) elected by the Assembly of the Territory. It regulates and collects the agreed taxes in the Territory. Foral Deputations spend, basically, in Social Services and public works (mainly territorial roads).

**Foral System of Financing:** The financing system of the Basque Country and Navarre. The Foral Autonomous Community regulates and collects all taxes within its region and transfers a given amount of money (Quota in the Basque Country or Contribution in Navarre) to the State as payment for the services it provides.

**Fueros/Foral Rights and Law:** Collections of local laws and customs together with special economic and political immunities underwritten by the kings of Castile (and later Spain) in return for political allegiance to the monarchy. The Basque Country had *Fueros* or *Foral Constitutional Law* until 1876.

**General Deputy:** The General Deputy is the President of the Government of a Historical Territory. The head of each Department (for instance, the Treasury or Agriculture) is called Foral Deputy.

**Gipuzkoa:** Name in Basque for Guipuzcoa.

**Historical Territories:** The name used in many legal texts to denominate the three provinces of the Basque Country. Historically the Territories were the basic political units and each of them had its own *Fueros*, Assembly and Regional Government.

**Historical Territories Law:** Law that distributes the expenditure competences between the Basque Government and the Historical Territories. The Law also establishes the principles to divide the revenue from agreed taxes between the Basque Government and the Historical Territories.

**Institutional Obligations:** Is what each Foral Deputation has to transfer to higher levels of government (contribution to the Basque Government plus Quota to the State).

**Juntas Generales/Assemblies:** Historically this was the name of the assembly of representatives of the towns and districts of a Territory. Nowadays it is the name given to the representative assembly of a Historical Territory. Each Territory has its own Juntas Generales, which are responsible for approving the budget and the taxes of each Territory. The Juntas also elect the President of the Territory (General Deputy).

**Lehendakari:** President of the Basque Government.

**Non Assumed Charges (expenditures):** State expenditures in competences that have not been assumed by the Basque Country

**Points of Connection:** The criteria to determine who has to pay taxes to the *HTs*, what percentage of their economic activity (consumption, income, etc.) is subject to the taxation in the *HTs* and which Tax Law applies.

**Quota:** The amount the Basque Country pays the State every year as payment for the expenditures made by the State on behalf of the residents in the Basque Country and as a contribution to the solidarity among Autonomous Communities.

**Quota Law:** A five-year Law regulating the determination of the Quota.

**State:** The Central Government of Spain

**Statute of Autonomy:** A Statute Law specifying the economic and political competences of an Autonomous Community. On the expenditure side, the Statutes of all the Autonomous Communities are very similar (although not identical). On the revenue side the Statutes of Navarre and the Basque Country say that these Autonomous Communities will have a Foral System of financing. The other Autonomous Communities have a Common System of financing.

**Tax Coordination Body of the Basque Country:** It is a body made up of six representatives (three of the Basque Government and one of each Foral Deputation) whose function is to encourage fiscal harmonization, cooperation and collaboration among the Foral Deputations.

**TRANSLATIONS**

<b>Spanish Term</b>	<b>Translation Used</b>
Aportaciones	Contributions
Bizkaia	Biscay
Consejero	Minister of the Basque Government
Cupo	Quota
Cargas No Asumidas	Non Assumed Charges
Diputación Foral	Foral Deputation
Diputado Foral	Foral Deputy
Diputado General	General Deputy
Hacienda Foral	Foral Treasury
Ley del Concierto Económico	Economic Agreement Law
Ley Orgánica de Financiación de las Comunidades Autónomas (LOFCA)	Organic Law on the Financing the Autonomous Communities
Norma Foral	Tax Regulation
Órgano de Coordinación Tributaria de Euskadi	Tax Coordination Body of the Basque Country
Territorio Histórico	Historical Territory

**ABBREVIATIONS**

<i>AC</i>	Autonomous Community
<i>HT</i>	Historical Territory
<i>EU</i>	European Union
<i>GDP</i>	Gross Domestic Product
<i>VAT</i>	Value Added Tax
<i>BC</i>	Basque Country
<i>GVA</i>	Gross Value Added
<i>BCAC</i>	Basque Country Autonomous Community
<i>BPS</i>	Basque Public Sector
<i>FGT</i>	First-Generation Theory of Fiscal Federalism
<i>SGT</i>	Second-Generation Theory of Fiscal Federalism
<i>EC</i>	European Community

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