

THE ECONOMIC SITUATION IN THE BASQUE COUNTRY

A powerful financial tool: The economic agreement State Government-Basque authorities

José Ignacio Martínez Churiaque

Professor in Financial Economy and Accounting, University of the Basque Country

Summary

The Basque Country has its own and privileged tax system, not to be found in any region of any other federal or centralized state. The design, management and control of the main taxes belong to the regional tax authorities of the Basque Country. “Global effective tax pressure” is slightly below to that of the rest of Spanish regions. Moreover there is a contribution to be paid to the Central State Institutions for additional services provided by the State. This contribution is determined solely by the Basque executive, without the intervention of the Central State Government. It has been considered that this contribution is under evaluated amounting in around 2,000 million euros. This entails a number of economic privileges which contravene the principle of equality established in the Spanish Constitution. Regional resources per capita in the Basque Country are 60% higher than the average of the rest of the regions in Spain.

The Basque Country and its economy

The Basque Country (or Euskadi, in Basque) is a small region in northern Spain, almost insignificant in the European Union (it has an area of only 7,234 square kilometres). The region is currently lacking in natural resources and is therefore very dependent upon resources from outside the region, particularly regarding energy, food, etc. In 2006, the population of the Basque Country totalled 2,133,684 people, with a population density of 295 persons per sq km, and its GDP at current prices amounted to 61,764 million euros, distributed as follows: Agriculture and Fisheries, 1%; Industry, 29.3%; Construction, 8.9% and Services, 60.8%. GDP per capita is 136.2% of the European Union average, higher than that of France (111.1%), Italy (103.3%), Germany (114.4%) and Spain (105.2%).

Since the end of the 19th century, the Basque Country has been one of the main centres of industrialisation in Spain, thanks to the efforts of a group of people who knew how to take advantage of the demands of a developing market (with strong protectionist measures which they knew how to profit from), to attract private capital, create a modern education system and rely on individual values such as effort and personal talent. This position was maintained until the 20th century. Thus, from 1950 to 1975, despite Spain's lack of liberal institutions and markets at that time, the region's GDP at current prices grew at an annual cumulative rate of 6.63%, whereas the Spanish average stood at 6.1% (the Basque Country thus being the third Spanish region with the highest GDP, only behind Madrid and the Balearic Islands).

When the nationalists took power in the Basque Government in the first years of the Spanish democracy, there was a situation of high political instability, replacement of individual values by group values, industry conversion, continued terrorist activity, etc. For this reason, the GDP of the Basque Country grew at a rate of 1.64% from 1975 to 1995, considerably below the national average of Spain (2.54%), also faced with the same kind of problems. After that date, there was a combination of ebullient nationalism in politics (attempts at destroying the existing political pluralism, setting of filters to limit access to public employment, etc.) and economic pragmatism, which brought more interesting results: from 1995 to 2002, Basque GDP grew at an annual cumulative rate of 3.8%, almost equal to Spain's average (4%). The annual average rate of GDP growth in real terms between 2000 and 2006 was 3.08%, still below the Spanish national average (3.34%).

As a final conclusion, it could be said that the weight of the Basque Country's economy in the economy of Spain as a whole has experienced a decrease, as shown in Table 1. This loss of relative position experienced during the last 25 years, as pointed out by all statistical sources available, indicates that the Basque public sector has been less efficient than the Spanish public sector, in each case with reference to their overall economy. It is necessary to point out, however, that the Basque Country has witnessed certain specific phenomena not experienced

by the rest of Spain: massive industrial restructuring and subsequent relocation of decision-making centres, higher labour costs than in the rest of the country, and a terrorist activity which, according to the perpetrators themselves, has negatively affected between 10% and 20% of the region's wealth-generating capacity, which explains why the growth of private capital has been considerably lower than in the rest of Spain: around 20% respectively 70% for the period.

Table 1. GDP at current prices for Spain and the Basque Country

	1960		1975		1980		2005	
SPAIN	19,253	100.00	47,428	100.00	50,229	100.00	905,455	100.00
BASQUE COUNTRY	1,287	6.68	3,400	7.17	3,209	6.39	55,620	6.14

In billions of pesetas. 2005 in millions of euros.

A Rich Population: per capita GDP

Per capita GDP is the most widely used measure both in welfare surveys and in economic convergence surveys. This indicator of the standard of living has to be completed with other indicators related to issues such as education and health, as is the case of, for example, the UN's Human Development Index or HDI. The arithmetic average of the income index (per capita GDP), the health index (life expectancy at birth) and the education index (adult literacy and schooling rate) places the Basque Country among the most developed regions in Europe.

Per capita GDP in the Basque Country (see Table 2) has always been above the Spanish national average, although its relative position has worsened. This is due to the process of real convergence between regions recently undergone in Spain. In 1955, per capita GDP in the Basque Country stood at 190% of the Spanish average, while it is currently below 130%.

Table 2. GDP per capita (in current Euros)

	1980		1995		2005		Crecimiento Interanual 1980-2005
SPAIN	2,429.20	100.00	11,114.70	100.00	20,863.90	100.00	9.00%
BASQUE COUNTRY	3,178.30	130.84	13,292.50	119.59	26,399.60	126.53	8.80%

Demographic Problems

Demographic variation is the clue to understand why the relative weight of the Basque economy in the Spanish economy is decreasing (smaller percentage of GDP and of capital accumulation), while it still keeps a high level of GDP per capita. The Basque population has not experienced significant growth since 1981, while the Spanish population has increased from 37 million in 1981 to 45 million (see Table 3).

Table 3. Demographic evolution of the Basque Country, and percentage of Basque population to total population in Spain

Population	1981	1991	1996	2001	2006
Basque Country	2,134,763	2,109,009	2,098,055	2,101,478	2,133,684
% of Spanish population	5.66%	5.35%	5.29%	5.11%	4.77%

In the last 25 years, the relative weight of the Basque population in the total population of Spain has decreased due to three main reasons:

a) Drastic decline in fertility rate. Decrease in the birth rate is explained by the change in living habits (lower number of children per woman), women's increased participation in the labour market (increase in average age of mothers at first birth) and decreasing confidence in the future.

b) Ageing in the population, which results in higher death rates

c) Change in migration flows. Traditionally a region of immigration receiving immigrants in search of work, the Basque Country's labour market has in the last 25 years become less attractive for people born in other regions of Spain. The prevailing excess of localism and ebullient nationalism impose identity criteria which are contrary to free individual choice. At the same time, language policies have been used as a filter which denies equal opportunities in the access to public employment. At the same time, the relocation of the decision-making centres of large companies has resulted in an emigration of qualified workers caused a decrease in quality jobs. A significant part of the Basque Country's human capital has had to emigrate due to a lack of job opportunities in accordance with their level of university education. This decrease is now being compensated by the arrival of foreign immigrants who perform unqualified jobs, although the percentage is still low compared to the local population (and 4% below the Spanish average). Special mention should be made to the loss of population resulting from terrorist activities. People who have been threatened or extorted by ETA and have emigrated as a result are spread across all economic sectors, including liberal

professionals, company executives, university teachers, etc. According to some sources, they amount to around 200,000 people.

A Powerful Financial Tool: the Economic Agreement between the State Government and the Basque Authorities. The Autonomous Tax System

The Basque Country has its own separate tax system. This means that Spain waives levying most of the taxes of a part of its territory because the regulatory capacity regarding the design, management and control of the main taxes has been devolved to the regional tax authorities of the Basque Country.

Taxes transferred or devolved to the Basque Country include the main taxes levied in any tax system. Thus, Basque tax authorities are fully empowered to levy the following taxes and to pass all relevant tax regulations in connection therewith: direct income tax, company tax (for companies resident in the Basque Country for tax purposes, with an annual turnover of less than 6 million euros; for all other companies, the regional tax authorities participate in the collection of taxes to the extent of the amount of revenue income generated in the region), including the tax consolidation system for Basque company groups; wealth taxes, inheritance tax and gift tax. Powers have also been transferred to the regional authorities in connection with indirect taxes, including VAT (on goods and services provided within the Basque Country), property transfer taxes and special taxes (on alcohol, tobacco, vehicle registration, etc.). Local taxes (levied by city councils) are also regulated by the Basque regional tax authorities.

Since the Basque Country has its own regulatory power over tax issues, it is necessary for the State Government to reach an agreement with the Basque tax authorities before establishing new taxes in order for such taxes to be incorporated into the tax system. This happened, for instance, in 1986, when Spain joined the European Union and the determination of VAT was established in the accession agreement. The limits of the Basque Country's regulatory powers are not clearly defined. On the one hand, Basque tax authorities have the obligation to respect the system, terminology and definitions set forth in the Spanish General Tax Law. On the other hand, they are subject to certain harmonization rules: they are not entitled to establish tax privileges, nor to impede Spain's single market or hinder free competition and the free movement of persons and capital. Finally, "global effective tax pressure" shall be at least equal to that of the rest of Spain.

However, exercise by the regional tax authorities of such advantageous fiscal powers does not seem to have been based on loyalty to the abovementioned obligation of tax harmonization. Taxes collected under regional tax policies regarding corporate profits have amounted to approximately 2% of Basque GDP,

slightly below the amount of taxes collected in the rest of Spain. This is not only due to a difference in the tax rate (28% vs. 30%), but is also related to the fact that the rate of tax effectively applied is significantly lower, as a result of higher deductions, increased tax reliefs and more tax-exempt corporate activities. This advantageous situation has also been evidenced in relation to inheritance taxes, gift taxes, property transfer taxes, etc. As for other taxes, such as VAT, which is subject to harmonization under international treaties, there has been almost no real regulatory autonomy at all.

This privileged tax system, not to be found in any region of any other federal or centralized state, has been managed in a context of continuous confrontation, sometimes with the neighbouring Spanish regions, sometimes with the Spanish State Government and sometimes with the European Union authorities, all of which have initiated judicial actions against certain tax regulations approved by the regional government, arguing that said regulations favoured relocation of companies from other regions, provided for disguised subsidies contravening the single market and hindered competition.

According to the applicable law, there is a limit to the Basque Country's tax autonomy: the so-called "global effective tax pressure" has to be similar to that of the rest of Spain. But this tax harmonization has not been achieved. According to Basque sources, tax pressure in 2005 equalled 32.6% of the GDP, notably below the Spanish average (which equalled 35.6% of the GDP) and significantly below the 27-nation European Union's average (amounting to 39.6%). All of this explains why the management of the Basque tax system, and not its actual existence, is the current subject of discussion.

The Dubious Method of Calculating the Basque Tax Contribution to the State

The Spanish State, which scarcely collects any taxes at all in the Basque Country (other than custom duties and other similar taxes) nevertheless provides the citizens of the Basque Country with all the services expected from a modern state. Some of these services are provided through the peripheral or regional administration of the Basque Country, such as health services, education, etc. (cf. II of Table 4). Such public services are determined solely by the Basque executive, without the intervention of the central State Government. Financial resources for such services are obtained from the tax revenue raised by the Basque tax system, as described above.

However, the Spanish State Government provides some other services through the central administration, which are related to powers not transferred to the Basque Country, the costs of which are not borne by the regional government (cf. III of Table

4). These services include international relations, defence and security, the armed forces, customs and tariffs arrangements, transport services of general interest, common institutions (the Parliament, the Royal Household, the Constitutional Court, the General Council for the Judiciary, etc.) and other similar services. The amount to be paid in connection with said central services, not provided by the regional government, is determined through a complex method of calculation. According to the procedure set forth in Spanish Law 29/2007 (which is shown in Table 4), services directly provided by the Basque government (II) are to be deducted from the total State expenditure. The resulting figure corresponds to the central State expenditure on indivisible services, or services not provided by the regional administration (III). This amount is multiplied by a coefficient which supposedly represents the relative weight of the Basque economy and the Basque population in Spain as a whole (IV), and which coefficient has remained unchanged since 1981 due to the nationalists' unwillingness to accept any changes thereto).

Table 4. Calculation of the amount payable to the Spanish State Government

	Million €
(I) State Budget. Expenditure	188,417
(II) Expenses borne by the regional government of the B.C.	102,665
(III = I – II) Expenses not borne by the regional government	85,752
(IV) Imputation rate (6,24%)	6.24%
(V = III x IV) Tax contribution	5,351
(VI) Adjustments and offsets	
Others (taxes levied directly by the State, non-tax revenue, etc.)	-1,153
Budget deficit	-2,550
(VII = (V – VI) Net Tax Contribution	1,648
(VIII) Other adjustments	-83
(IX = VII – VIII) DUE NET	1,565

As can be seen from the table above, the amount payable by the Basque Country to the whole of Spain for services provided by the central State Government should be 5,351 million euros (approximately 8.5% of the GDP), in accordance

with the relative weight of the Basque economy and population. However, the application of certain adjustments, some of which are of a clear technical nature and some of which are the result of political agreements, reduce the payable amount to only 1,565 million euros.

The most politically negotiated adjustment is related to the budget deficit. The revenue in the Spanish State Budget amounts to 198,454 million euros. This means that Spanish public finances have a budget surplus of approximately 10,000 million euros. However, certain revenues transferred from the central government to the regional governments of other Spanish regions are deducted when calculating the Basque tax contribution. This agreement between the central government and the rest of Spanish regions turns the actual surplus into a deficit for the purposes of calculation of the Basque tax contribution. Said deficit, estimated at 40,872 million euros, gives the amount of 2,550 million euros shown in VI above when multiplied by the abovementioned rate of 6.24%. In other words, the Basque regional authorities “purchase” the services not directly provided at regional level for an amount close to 2.5% of the region’s GDP.

This complex method for calculation of the final amount to be contributed to the State by the Basque Country is what is raising doubts about the Basque tax autonomy, since the discount applied to the final amount may disguise state subsidies. These financial flows (in the form of lower payments) obtained from another tax system, increase the resources of the region and, therefore, the region’s spending capacity is above the national average. All of this gives rise to a number of economic privileges (the regional resources per capita in the Basque Country are 60% higher than the average of the rest of the regions) which contravene the principle of equality established in the Spanish Constitution.

Outside the Basque Country, the most widely extended conclusion is that the method of calculation of the Basque tax contribution should be revised, since the costs related to powers not transferred to the region are erroneously valued. The lawyers of the European Union, in the various judicial proceedings being conducted, always refer to the undervaluation of the services provided to the Basque Country by the State Government. According to these lawyers, the contribution is “much lower than it would be if the Basque tax contribution was correctly calculated”. According to most of the sources available, this undervaluation amounts to an estimated 2,000 million euros.