

The role of tax competition in internal territorial tax regimes: Federal States and the European Union*

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Abstract

This paper carries out a reflection, from a comparative perspective, on tax competition within the federal states, especially in the countries of America and Europe. For this, the authors explain the different aspects of the problem: fiscal competition; the decentralization and federalism and its fiscal effect; the fiscal federalism; and the tax competition in federal states. The authors seek to explain these phenomena and evaluate the positive and negative arguments that have been given about tax competition in this context. The authors describe how fiscal decentralization and fiscal competition are phenomena that have overpassed the Federal States and has been extended to countries with other forms of State.

Key words. Tax Competition, Fiscal Federalism, Decentralization

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1. Introduction

The competitiveness of the economy allows attracting investments (of various kinds, such as productive, financial, speculative, etc.) and thereby increasing the possibilities of economic growth. Now, this competitiveness is a matter that depends on multiple factors (quality and efficiency of the institutions, macroeconomic environment, higher education and training, efficiency of the markets of goods and services, development of the financial market, size of the market, sophistication of the business, technological capacity and innovation, etc.).²

The competitiveness of national economies should not be based on measures that violate common rules and fair market rules.

Internationally, fair competition is made possible by the homogenization of regulatory schemes (including taxation) for investment and establishment of companies, in such a way as to constitute a neutral factor against economic decisions.

On the contrary, some specific competitive policies are not admissible in a context of free and fair markets, such as the reduction of standards of protection of workers (labour dumping) or the environment (environmental dumping) or aid for investments (via infrastructure or direct subsidies, etc.).

2. Tax competition

The countries can use their fiscal structures to compete in the economic sphere.³ This subject has been the object of study by the specialists⁴. Tax

² MATTHEWS, Stephen, "What is a "Competitive" Tax System?", *OECD Taxation Working Papers*, N°2, 2011, OECD Publishing [<http://dx.doi.org/10.1787/5kg3h0vmd4kj-en>].

³ The relativity of the matter is set out in the report of 1998 of OECD "*Tax competition and the interaction of tax systems can have effects that some countries may view as negative or harmful but others may not. For example, one country may view investment incentives as a policy instrument to stimulate new investment, while another may view investment incentives as diverting real investment from one country to another. In the context of this last effect, countries with specific structural disadvantages, such as poor geographical location, lack of natural resources, etc., frequently consider that special tax incentives or tax regimes are necessary to offset non-tax disadvantages, including any additional cost from locating in such areas. Similarly, within countries, peripheral regions often experience*

competition can have a double dimension, benign or harmful, depending on their effects, but there is no clear distinction between what could be considered beneficial and acceptable fiscal competition as opposed to harmful⁵.

In some cases, the tax competition would be beneficial and loyal if it is based on administrative efficiency and simplification of tax processes and management of public resources, always considering the need of the State to provide a minimum of public services with a minimum acceptable of quality for the normal life of its inhabitants.

At the same time, it can presents a harmful dimension if it is only based on the reduction of the tax burden, because this situation generates as a consequence the decrease in tax revenues for the countries and the consequent instability of public finances in the frame of the need to provide public services of a minimum required quality.

This damage caused to the public accounts, and especially to those of other countries, with the deployment of contrary policies to international conventions or agreements of multilateral organizations, is considered as unlawful, harmful or damaging tax competition.

There are clear situations regarding when tax competition is lawful or unlawful, but there are others in which there is no clarity, which requires specific criteria to identify it. For example:

(1^o) Fiscal competition could be considered lawful if it attracts capital for effective investments in real businesses, and to the extent that the fiscal

difficulties in promoting their development and may, at certain stages in this development, benefit from more attractive tax regimes or tax incentives for certain activities. This outcome, in itself, recognises that many factors affect the overall competitive position of a country. Although the international community may have concerns about potential spillover effects, these decisions may be justifiable from the point of view of the country in question.". OECD (1998), *Harmful Tax Competition, An Emerging Global Issue*, Paris, p. 15.

⁴ WILSON, John Douglas, "Theories of Tax Competition", *National Tax Journal*, Vol 52 N^o2,1999, pp. 269-304

⁵ MORENO NÚÑEZ, Héctor, La fiscalidad internacional (amenazas y oportunidades en un entorno competitivo), Páginas: 103-138. ID vLex: 54898972 [<http://doctrina.vlex.com.mx/vid/fiscalidad-amenazas-oportunidades-competitivo-54898972>], p. 122

factor is not determining for investment decisions. Fiscal competition is not lawful if the mobility of the taxable base is only due to fiscal reasons and does not derive from the efficiency to develop economic activities, and in that sense, it breaks the neutrality that the tax system should have.

(2°) It may result in the existence or non-existence of a balance between the financial needs of a State to generate public goods, with a level of tax burden acceptable to a taxpayer concerning the economic activities he or she performs.

(3°) Tax competition always causes a reduction in the tax burden for the taxpayer but can erode the tax bases in profound terms, putting public finances at risk, especially in the case of "tax wars", which it can generate a "race to the bottom", producing an impoverishment of public finances.

(4°) The harmful tax competition means an aggression for the jurisdiction that suffers it because it generates a decrease in its economic activity and instability of its public finances. The aggressor jurisdiction grows at the expense of the victim.

(5°) The aggressor jurisdiction establishes a scheme that allows by taxpayers the abuse of the legal system or tax regulations of the violated jurisdiction; what also attacks the political system because it limits the exercise of the sovereign public powers by democratic bodies.

(6°) In the national scope, in the federal States, in addition to the above mentioned, it generates several negative effects.

Then, tax competition is a public policy, deployed in the field of taxation, which seeks to achieve the attraction of tax bases, through the establishment of certain conditions. The limits of the licit or illicit (harmful) tax competition are usually discussed, and in general, it constitutes a way of under-fund the States victims of the aggressive policies of other States.⁶

Harmful tax competition has been a concern for a long time. The OECD highlighted, for example, in 1998, in a document in which it mentioned some key characteristics: *No or low effective tax rates; Ring-Fencing of*

⁶ AVI-YONAH, Reuven, Globalization, Tax Competition, and the Fiscal Crisis of the Welfare State, Harvard Law Review, Vol. 113, N°7 (May, 2000), pp. 1573-1676

*Regimes; Lack of transparency; Lack of effective exchange of information. Furthermore, this international organization, remarked other additional characteristics: An artificial definition of the tax base; Failure to adhere to international transfer pricing principles; Foreign source income exempt from residence country tax; Negotiable tax rate or tax base; Existence of secrecy provisions; Access to a wide network of tax treaties; Regimes which are promoted as tax minimisation vehicles; The regime encourages purely tax-driven operations or arrangements.*⁷

A decade later, AVI-YONAH⁸ reflects on it: "The OECD Report and its progeny represented a useful beginning. To complete the work, two steps are needed, both of which can be taken by the OECD countries if the political will exists: eliminate the ability of non-OECD countries to offer preferential tax regimes by eliminating deferral for all CFCs, and eliminate tax evasion by OECD residents by imposing a refundable withholding tax on payments to nontreaty countries while requiring real exchange of information by treaty countries". This concern of the OECD has continued, which is possible to observe, without going any further, with the BEPS plan⁹. In general, tax competition is a term used to refer to the efforts of certain States to attract taxpayers and specifically, tax bases, through the different mechanisms of connection with its jurisdiction (connection factors) granting a more favourable tax treatment (in detriment of other jurisdictions), even without capturing the economic activity that the taxpayer performs, but in any case, achieving the capture of financial resources on the part of the taxpayer who pursues to carry out his fiscal planning. In other cases,

⁷ OECD (1998), *Harmful Tax Competition, An Emerging Global Issue*, Paris.

⁸ AVI-YONAH, Reuven, (2009), "The OECD Harmful Tax Competition Report: A Retrospective After a Decade", *Brooklyn Journal of International Law*, V. 34 I. 3 Article 7, p. 795.

⁹ OECD (2017), "BEPS Action 5 on Harmful Tax Practices", Terms of Reference and Methodology for the Conduct of the Peer Reviews of the Action 5 Transparency Framework, OECD/G20 Base Erosion and Profit Shifting Project, Paris, [www.oecd.org/tax/beps/beps-action-5-harmful-tax-practices-peer-review-transparency-framework.pdf]; ARRIBAS, Diego et al., "Acción 5: Combatir las prácticas tributarias perniciosas, teniendo en cuenta la transparencia y la sustancia", en AAVV, *Plan de acción BEPS: Una reflexión obligada*, Fundación Impuestos y Competitividad, Madrid, 2017, pp. 135 y ss.

through fiscal competition, it is possible to capture all the physical and financial investment, all productive economic activity, through a more favourable tax treatment.

Likewise, harmful tax competition undermines the principles of tax justice on which the tax system should be sustained by overloading the less mobile tax bases (real estate income and income derived from personal work, and charges for public services that are divisible), and undermines the equity of treatment among taxpayers of similar tax capacity. The mentioned differences of treatment imply arbitrary discrimination, which in many cases generate litigation that need be resolved by the highest national courts.

One question is about how to quantify and verify harmful competition.

First of all, it is necessary to analyse whether tax competition is related to the total financial burden that an investor must meet, deriving from mandatory norms of Public Law (including parafiscality or quasi-taxation, referred to all special charges establishes by rules of Public or Regulatory Law) or only the taxes or some types of taxes.

In fact, in our opinion, the analysis of the financial burden requires a broad understanding of the concept of taxation, such as taxes, parafiscal levies or quasi-taxation¹⁰, public prices, regulatory charges, and in some cases even private prices (for example, the prices of goods and services necessary to satisfy the basic public needs of those that must be supplied by the State, but that are supplied by private companies). This should be analysed on a case-by-case basis and not by purely theoretical structures.

Second, according to our view, tax competition involves the entire tax system, not just some aspects of it. Indeed, competitiveness can occur in various fields (which makes it hardly comparable), as the OECD (1998) has stated: cases of low effective taxes, special low taxation regimes for companies operating abroad or not be residents; lack of transparency or

¹⁰ "Parafiscalité: Prélèvements obligatoires, institués par voie d'autorité et affectés à des organismes distincts de l'État ou des collectivités locales, dans un but économique ou social (Bern.-Colli Extr. 1976)."

"Parafiscal charges or Parafiscal levies (or Parafiscal taxes) affected to a beneficiary, which is not the State".

lack of effective exchange of information; artificial definition of tax base; non-adherence to international principles regarding transfer pricing or undercapitalization; sources of foreign income exempt from taxes typically for residents; negotiable taxation; rules that guarantee secrets of taxpayer operations; access to a wide network of treaties or conventions on taxes; tax regimes that are promoted as tax minimization vehicles; legal regime that stimulates operations that are based only on tax incentives; etc.¹¹

To a great extent, the considerations of international tax competition can be adapted to the fiscal competition that can be generated between constituent units of Federal States (states or provinces), i.e., subnational levels.

Now, the aggressive fiscal competition damages the unity of the market and produces economic inefficiencies because the tax bases are transferred towards the constituent units of the Federal State (they be states or provinces) that have low taxation essentially for fiscal concerns and not for considerations of an economic nature (attack on fiscal neutrality). The effects of these schemes deteriorate the performance and growth of the economy.

It is possible to disaggregate these ideas and add others, maintaining that it is possible that there is aggressive tax competition through mechanisms such as the following: determination of the elements of the tax or of the tax obligation such as more restrictive taxable events (extension of the tax exemptions); favourable rules to determine the taxable bases (referred to legal norms, such as the credits against utilities or certain mechanisms of accelerated depreciation; or through administrative processes, such as the negotiated determination of the taxable base); reduced tax rates; regulatory structures that allow the integration of personal taxes with corporate taxes; legal rules regarding administrative procedures for the inspection or collection of taxes that establish a wide variety of restrictions for the Tax Administration and in turn that provides ample possibilities for the taxpayer to delay or suspend them beyond what is reasonable -v.g., through the multiplication of administrative appeals and the possibilities of

¹¹ OECD (1998), *Harmful Tax Competition, An Emerging Global Issue*, Paris.

suspensions of administrative procedures-; existence of alternative conflict resolution means in the administrative or judicial fields, that reflects a systematic administrative and judicial practice inclined to favour the reduction of the tax burden; any kind of systematic policies that implies the permissiveness of the Administration that favour the non-compliance of taxpayers; legal norms that are comparatively more favourable for the taxpayer in terms of suspension, prescription or extinction of the principal and accessory tax obligations; reduced quantity and quality of formal obligations for taxpayers; more restrictive procedural rules for the prosecution of tax obligations (on terms, means of evidence or evaluation of evidence, procedurals remedies, etc.); extensive or beneficial legal rules of cancellation of tax obligations of payment or suspension of the requirement of formal obligations; lack of transparency or access to taxpayers' information or restrictions on the exchange of information; subscription of few international agreements on the exchange of information and collaboration between tax administrations; complex legal rules that transform into ineffective the special or general anti-avoidance legal clauses; etc.

3. Decentralization and federalism and its fiscal effect

Fiscal decentralization is a process by which the distribution of fiscal competences between public entities at different territorial levels takes place, which is linked to the distribution of competences related to the provision of public services, and to the development of government autonomy¹². These processes of distribution of competences (functions or capacities) are not always well planned, and often suffer of multiple inconsistencies.¹³

In this way, there is usually greater fiscal competition to the extent that there is more political autonomy of the territorially decentralized entities.

¹² A general theory in: Santiago LAGO PEÑAS & Alberto VAQUERO GARCÍA, *Descentralización y Sistema Tributario: Lecciones de la Experiencia Comparada*, Fundación Impuestos y Competitividad, Madrid, 2016.

¹³ Christopher BERRY, *Imperfect Union: Representation and Taxation in Multilevel Governments*, Cambridge University Press, New York, 2009, especialmente pp. 89 y ss.

Centralized or regionalized countries usually consider a local or municipal taxation¹⁴, and a regional taxation¹⁵. Fiscal decentralization is a phenomenon that accompanies territorial decentralization (territorial distribution of public responsibilities).¹⁶

To understand the phenomenon of fiscal federalism, we must understand the phenomenon of federalism as a form of the State.

It is possible to observe in a specific way the widespread phenomenon of local entities, local corporations, local governments, municipalities or town halls. Unlike to the federalism, which is developed only in some countries, the expansion of the municipalities is global.

The federalism refers to a form of State, and implies the existence of two constitutional levels of self-government: national or federal and state, provincial, etc. encompassed in the term of "constituent units", that each jurisdiction denominates them of different way (provinces, autonomies, states, etc.).

Fiscal federalism is linked, basically, with the fiscal and financial phenomenon in the context of the Federal State¹⁷. It refers to the way in

¹⁴ This is the case of Chile, in Latin America. See: VALENZUELA BARROS, Juan Pablo, "Descentralización fiscal: los ingresos municipales y regionales en Chile", *Proyecto Regional de Descentralización Fiscal*, Comisión Económica Para América Latina y el Caribe, Naciones Unidas, CEPAL/GTZ, Serie Política Fiscal 101, 1997 [<https://repositorio.cepal.org/handle/11362/7397>].

¹⁵ Also in Chile, the possibility of incorporating regional taxes has been proposed for some time, which will probably happen in the reforms proposed in 2018. GRANADOS, Sergio & RODRÍGUEZ, Jorge, "Propuestas para avanzar en descentralización fiscal en Chile", *Programa Cohesión Territorial para el Desarrollo, Documento de Trabajo N°7*, Serie Estudios Territoriales, Junio de 2013, RIMISP, Santiago de Chile. This document, like what the National Congress currently proposes, refers to establishing a specific tax for the benefit of municipalities and regional governments (shared in a proportion to be determined), on those business activities and investment projects that their nature generates negative externalities in the territory where they are located.

¹⁶ ROPERT, María Angélica, "Evolución de la Descentralización Fiscal y Administrativa en Chile", *Documento de Trabajo*, CIEPLAN, Santiago de Chile, Junio de 2011.

¹⁷ "The theory of fiscal federalism constitutes a section of public finances that studies the way in which responsibilities are assigned among the different levels of governments for the provision of public services and for the generation of their financing. The reason for being of this discipline is that the vertical structure of government presents juxtaposed forms, which raises the need to establish and coordinate the functions of expenditure and tax powers and, therefore, the definition of intergovernmental transfers." (p. 12). Consejo Federal de

which public income and expenditure are controlled (that is, who decides on) the fiscal matters of the constituent units. This issue affects the budgetary management of the federal government and the constituent units.

There are a series of powers of the Federation or the Union (understood as the political power of the National State), other specific powers of the Federal Government (the executive power of the Union or the Federation) and the political power in general or the governments in particular of the constituent units.

The federal system is established on the basis of the dual model or the integrated model, defined in one way or another according to the greater or lesser extent of the legislative powers of the Federation or of the constituent units, whether they have exclusive, shared or concurrent responsibilities, between both levels of government.

In the dual system, it is understood that the states came together to form the Union, but maintaining their sovereignty, so that the central power is a product of the states. The functions and powers of the federal government (Union) and the functions and powers of state governments (subnational level) are clearly and strictly defined and separated so that any mutual invasion of powers to the state or federal sphere are unconstitutional.¹⁸

The integrated model implies that the Federation or Union maintains a series of competences on the constituent units. In some way, this model can be understood from a State that is divided into constituent units to which are gradually granted greater powers.

The federal system can be symmetric or asymmetric, according to whether the relationship between the Federal Government and the constituent units, or between the constituent units, are equivalent or not.

Inversiones, Provincia de Buenos Aires, "Luces y sombras del federalismo fiscal. Argentina y el mundo", Informe Final, Mayo 2014 (hereafter, INFORME 2014).

¹⁸ CÁRDENAS GRACIA, Jaime, (2004), "México a la luz de los modelos federales", en *Boletín Mexicano de Derecho Comparado*, nueva serie, año XXXVII, pp. 479-510. núm. 110, México, mayo-agosto de 2004, p. 483.

On the other hand, federal systems can present a competitive or cooperative model.

The cooperative model establishes relationships of solidarity between the constituent units, focused on the processes of financing, design, provision and administration of public services, being the co-participation of all the public powers the dominant rule in the provision of such services¹⁹.

It is competitive if each constituent unit of the State pursues only its ends and interests.²⁰

As we have noted, in the context of the Federal State, capacities (public functions) can be exclusive, shared and concurrent²¹. The exclusive capacities are those that correspond only to the Federation or only to the constituent units in an exclusive manner. The concurrent capacities are those that correspond to the Federation as well as to the constituent units, they overlap and therefore should be harmonized and coordinated the exercise of them. Shared competences are to be exercised jointly by the Federation and each (or all) of the constituent units (subnational governments), in some cases in a single action or in other cases by two decision acts that are integrated (a "double integrative decision").

¹⁹ LÓPEZ-ARANGUREN, Eduardo, "Modelos de relaciones entre poderes", *Revista de Estudios Políticos* (Nueva Época) N°104. Abril-Junio 1999, 9-34, p. 17.

²⁰ "The elements of the model are: 1) There are states and autonomous local governments that are independently responsible for each other for the welfare of the people who live in their territories; 2) In each territory, the costs of public goods and services are equal to the revenues collected from taxpayers. Costs are not outsourced or transferred to the central government or to taxpayers throughout the country; 3) The externalities or overflows of costs or benefits from one jurisdiction to another are very limited, and there is no collaboration between state or local powers to restrict competition; 4) There is good information available to consumer-taxpayers about the services and costs provided by all state and local governments throughout the country; 5) There is consumer-taxpayer mobility, and a propensity to consider public services and what they cost as important criteria in decisions about residence establishment. The competition between powers obliges local governments to be more efficient, to improve the quality of the services they are responsible for and to reduce costs. The model also fosters the search for innovative public policies." CÁRDENAS GRACIA (2004), op. cit., p 486.

²¹ BAZAN, Víctor "El federalismo argentino: situación actual, cuestiones conflictivas y perspectivas", *Estudios constitucionales*, Santiago, v. 11, n. 1, p. 37-88, 2013 .

Now, these capacities present a political character, for that reason should be described the way in which they are generated and executed. Some capacities are described in the Political Constitutions, are derivatives from the federal state form, others are derivatives from legislative decisions or mutable policies over time, where the largest number of rules are negotiated in a cooperative and competitive manner in agreements that imply greater flexibility than constitutional agreements.

In this matter, it can be distinguished the normative structure and the use of this normative structure, because the last is basically a contingent political issue, that is, of the groups that govern the federal States and the constituent units (subnational governments). In other words, the complex reality of the federal states demands constant negotiation regarding to the state and federal decisions that affect how are understood the extensions of each jurisdiction.

Finally, federalism implies a set of analytical difficulties, given that they represent a myriad of phenomena, a countless number of different national experiences. In effect, the countries with a federal system constitute a heterogeneous group in their histories, institutions and institutional practices, in which they are usually cited: EEU, Canada, Mexico, Venezuela, Argentina, Germany, Russia, Switzerland, Austria, Spain, United Kingdom, Bosnia and Herzegovina, Australia, Micronesia, India, Pakistan, Malaysia, United Arab Emirates, Ethiopia, Nigeria, Sudan, etc. Obviously, the reality of Western Europe²² is far from the reality of North America, Latin America²³ and other countries of the world.

4. Fiscal federalism

In the same way that there is no single model of federalism, neither is there an unique pattern of fiscal federalism. Decentralized systems can be by

²² SWENDEN, Wilfried, *Federalism and Regionalism in Western Europe, A Comparative and Thematic Analysis*, Palgrave MacMillan, New York, 2006; Scott L. GREER, *Territory, Democracy and Justice, Regionalism and Federalism in Western Democracies*, Palgrave MacMillan, New York, 2006.

²³ ESCOBAR-LEMMON, Maria, "Fiscal Decentralization and Federalism in Latin America", *Publius*, Vol. 31, No. 4 (Autumn, 2001), pp. 23-41, Oxford University Press.

separation of taxes or by separation of tax systems (e.g., Australia) or overlapping or shared taxes (e.g., Spain, USA, Germany or Canada)²⁴.

For example, American fiscal federalism is recognized by the freedom of the governments of the states²⁵; Canadian fiscal federalism is highlighted by the significant degree of financial autonomy of subnational governments²⁶; Mexican fiscal federalism is a system marked by the growing decentralization of spending that is combined with a great centralization of tax collection in the level of federal government²⁷; in Germany, the Constitution establishes a jointly manage for a series of taxes that are

²⁴ VILA MAIOR, Paulo, "Is Fiscal Federalism Different in the European Union? A Comparative Analysis Through the Allocation Function" (November 3, 2008). *Paper for the Second Conference on the Political Economy of International Organizations, January 29-31, 2009 at the University of Geneva and the Graduate Institute of International Studies, Switzerland*. Available at SSRN: <https://ssrn.com/abstract=1294667> or <http://dx.doi.org/10.2139/ssrn.1294667>

²⁵ A broad explanation in: KHRAICHE, Maroula & FLAHERTY, Patrick, "Federalismo fiscal: el caso de Estados Unidos", *Clm.economía: Revista económica de Castilla - La Mancha*, Nº8, 2006, págs. 325-354.

The Informe (2014) explains "This assertion is based on the broad tax powers granted to subnational governments, in addition to assuming responsibility for the implementation of the main public policies, such as those related to the provision of health, education and social assistance services. However, in practice, the judgment on the autonomy of subnational governments is not univocal. First, it must be remembered that the process of fiscal decentralization that was strengthened in the 1990s implied the asymmetric delegation of revenue and expenditure competencies. Consequently, vertical imbalances deepened, which ended up being compensated with greater transfers from the central government. And on the other hand, it is important to clarify that the bulk of the transfers are of a conditioned nature and, some of them, have a ceiling of the maximum annual amount, which reduces the margin for manoeuvre of subnational governments. Despite presenting certain horizontal imbalances, which emerge from the territorial diversity of the United States, the prevailing fiscal federalism does not contemplate a specific fiscal leveling mechanism. Finally, interregional inequalities are expected to be attenuated indirectly by the application of current transfers."

²⁶ The Informe (2014) explains "Unlike what happens in other countries, in Canada it is observed that the process of fiscal decentralization consisted not only of assigning greater responsibilities to subnational governments but also of granting tax powers for the generation of own resources."

²⁷ The Informe (2014) sustains: "The unequal allocation of income and expenditure competencies among the different levels of government consolidates a scheme in which vertical fiscal imbalances predominate. In this framework, transfers constitute a vital tool for financing subnational governments, which are applied to reduce both horizontal and vertical imbalances."

particularly important for the Federation, the Länder and, to a certain extent, as the municipalities²⁸; in Australia is implemented a model of cooperative federalism which is characterized by the joint action of the different levels of government in various areas of intervention²⁹; etc.

The federal countries are different in relation to factors such as: levels of governments (although three federal state levels are usually observable: intermediate level -autonomous communities, regions, territories, states, etc.-, local level); responsibilities over expenses; public responsibilities over the management of public services (health, education, etc.); competences assigned or shared in different percentages over different taxes (taxes on incomes of natural persons, corporate taxes, special taxes, social security, etc.); tax revenues sharing; transfers between subnational entities; the ways of collecting taxes within different levels of governments; use of different taxes in each level of governments; use of differentiated surcharges over subnational or national tax; the ways of imputing the payment of taxes between national and subnational taxes; etc.

LAGO y VAQUERO³⁰ distinguish three families of fiscal decentralization models:

(a) Models of fiscal autonomy, in which there are ample freedom in legislation and management (USA and Canada). The central or federal treasury and the sub-centres usually share taxable objects, there being no harmonized tax bases at the beginning. In this model there are great

²⁸ Informe (2014) maintains: "Income tax, corporation tax and VAT are divided between the Federation and the Länder as a whole. The municipalities are entitled to a part of the income tax and VAT. Therefore, these taxes are called 'joint taxes' ". The report adds that "Although Germany is a strongly federal country, in which the tax powers of each subnational state are relatively strong, the scheme implemented to reduce the disparities implies strong transfers of funds from the richest states to the most disadvantaged states".

²⁹ The Informe (2014) explain the Australian system: "Another aspect that stands out of the Australian system is the scarce delegation of tax policy decisions in state governments; therefore, the central government concentrates a significant portion of the collection of taxes". And he adds that "Australian fiscal federalism is characterized by the presence of certain asymmetry in the delegation of obligations and powers in subnational governments."

³⁰ A general theory in: LAGO PEÑAS, Santiago & VAQUERO GARCÍA, Alberto, *Descentralización y Sistema Tributario: Lecciones de la Experiencia Comparada*, Fundación Impuestos y Competitividad, Madrid, 2016, p. 21.

autonomy and self-government, greater fiscal co-responsibility is guaranteed, the comparison of results and fiscal measures is encouraged. Nevertheless, it has important limitations, e.g. boosts negative horizontal externalities caused by cross-border purchases and harmful tax competition, in addition to complicating the control of fraud and tax compliance.³¹

(b) Performance sharing models (Germany and Australia): Low fiscal autonomy and a predominant role of transfers. This model allows for better tax management, but potentially reduces tax liability and accountability.³²

(c) Surcharge models (Denmark, Norway and Sweden): Tax surcharges from the federal treasury, with a highly centralized administration. This model concentrates on personal taxes and makes it possible to share the tax power without additional management costs or problems arising from lack of harmonization of the taxes in reason of the basic elements that they comprise are established by the central administration (taxable event, tax base, tax rate, etc.). The sub-central administrations only have to set a surcharge and the central administration manages and collects the tax, transferring to the territorial administrations the amounts of their respective surcharges.³³

Now, the core of the problem of fiscal federalism is found on tax collection, non-tax revenues, transfers, spending in the federation, and relations between the federation and the constituent units that support the system. Then, fiscal federalism deals with a very complex issue, which generally implies the structure and expenses of the Federation and the constituent units, and all the relations derived from it, including transfers and indebtedness.

It would be possible to draw up an outline of matters included in fiscal federalism:

³¹ LAGO PEÑAS & VAQUERO GARCÍA, *Descentralización y Sistema Tributario*, op. cit., p. 21.

³² LAGO PEÑAS & VAQUERO GARCÍA, *Descentralización y Sistema Tributario*, op. cit., p. 21.

³³ LAGO PEÑAS & VAQUERO GARCÍA, *Descentralización y Sistema Tributario*, op. cit., p. 21.

(a) Revenue in general. (i) In a federal system, public revenues are of four kinds: income from own resources (generated through the exercise of own capacities whether or not managed by the owner of the public powers); shared income; non-owned income (produced as a result of the exercise of delegated or assigned powers); those financial transfers coming from the federal government. (ii) It is possible to distinguish between tax and non-tax revenues. Non-tax revenues are constituted by indebtedness or transfers from the federal government to the constituent units, or between them from the richest to the most economically depressed. (iii) The ownership of the public powers over income can be either exclusive or concurrent. In turn of, the exclusive powers can be managed by the owner or managed by delegation or assignment. In tax matters, they can be: exclusive taxes (national or sub-national); tax in concurrence (shared tax powers); subnational tax rates on national taxes; tax participation or co-participation on national taxes, with criteria for assignation tax yield on tax type (tax sharing) or redistributive (revenue sharing); assignation of funds (contributions or federal transfers) through non-conditional contributions (block grants) or conditioned contributions under the modality of federal matching (matching grants) or for specific purposes (categorical grants)

(b) The responsibility for the public expenses. Public expenditures may be the responsibility of the central government or belong to the constituent units, or they are decentralized (expenses transferred) by the Federal Government to the subnational units. Expenditures oriented to the production of public goods constitute the essential action of the State, and they normal and generally belong to the federal government (external defence or internal security, administration of justice, large infrastructures, etc.). Another area of less intense public goods can be decentralized (health, education, social security, local infrastructures, etc.). Again, there are two possibilities about the ownership of the public responsibilities over expenses: exclusive or concurrent. There are two possibilities regarding the exercise of the exclusive powers: managed by the owner or managed by delegation or transfer.

(c) *The structure of tax regimes and the attributions of taxes.* Taxes can be structured at the Federation, constituent units or municipal levels. Each can have exclusive or concurrent responsibilities to establish the taxes or to configure the essential elements of them. In both cases, the authority may have or not a regulatory duty or political will to harmonize these taxes. Likewise, it is possible that there is an enabling legal rule to configure all or part of the taxes subject exclusive competence. It is possible that the collection of taxes is shared or delegated.

(d) *The distribution of tax revenues and intergovernmental transfers.* It is possible that the collection of taxes is delegated and that part of them are destined to the constituent unit, or that it is directly the Federation that collects the tax throughout the national territory and derives part of those resources to the constituent units.

(e) *The economic management of the federation.* This refers to the management of economic policies, such as exchange and monetary policies, which are relevant for tax purposes. Usually, these are policies determined centrally by the Federation.

(f) *The agreements and institutional relations.* It refers to existing agreements between the Federation with one or more constituent units, and that relate to specific tax or economic aspects that affect the tax area.

On the other hand, in the study of fiscal federalism there is necessary a consideration for the regulations with economic implications and the capacity to impose them³⁴. One of the concerns of the federal systems is in the conservation of the market unit, and the control of the barriers that imply the market distortion (protectionist policies, against the free market

³⁴ This is observed in Europe: "Las disparidades en el tratamiento fiscal provocan las mayores distorsiones en el Mercado Único: Rebajas en los impuestos", ID vLex: 216970, [<http://libros-revistas-derecho.vlex.es/vid/disparidades-provocan-distorsiones-216970>]; "La UE trata de acabar con todos los incentivos fiscales desleales", ID vLex: 16533000 [<http://el-pais.vlex.es/vid/acabar-incentivos-fiscales-desleales-16533000>]; "Alemania, Francia e Italia exigen a la UE que elimine la ingeniería fiscal", ID vLex: 547066910 [<http://el-pais.vlex.es/vid/alemania-francia-italia-exigen-547066910>]; Comisión de las Comunidades Europeas, "2004/C 33 E/003E-1638/02 de Bart Staes a la Comisión Asunto: Postura del Comisario Busquin sobre la competencia en materia fiscal en el mercado interior europeo", ID vLex: 24874683. [<http://eu.vlex.com/vid/bart-postura-comisario-busquin-fiscal-24874683>]; etc.

competition, establishment of incentives and discriminations to favour of local companies or to attract investments, etc.). Fiscal competition within a Federal State attempts against both the market unit and the efficiency of the economy. It also undermines equity and non-discrimination (impartiality), which are essential values within the framework of the fiscal order in a federal system.

Evaluatively, the negative face of fiscal federalism is that the more tax powers are created, the more taxes will be created, which will result in a greater fiscal burden, and a big state creativity in the creation of tax figures under various *nomen iuris* and legal regimes (including under mixing of Private-Public Law statute), under the excuse of the needs for new resources for new public functions, all declared as necessary and justified from the public and political perspective. This would be a "first trap".

The fiscal competition between the states or provinces in the Federal States constitutes a "trap over the trap" (or "double trap"), in terms of seeking more quantity of financial resources, because the distribution of tax powers does not always end with tax competition but with the permanent increase in the tax burden.

5. Tax competition in federal states

In the context of non-federal countries but with levels of decentralization, aggressive tax competition can occur, either in a planned or spontaneous manner. For example, it is spontaneous if the territorial entities can apply certain taxes or vary tax rates or vary the composition of the tax bases; and it is planned when better fiscal conditions (normally exceptional) are designed for more economically depressed areas, including the system of preferential zones of taxes or of customs duties.

CHERNICK & TENNANT explain *"in a federal system, the level and structure of subnational taxation depends on both the assignment of tax bases to the various levels of government as well as the interdependent decisions of national and subnational governments regarding rates of taxation. In principle, federal taxation may be competitive or substitutive of subnational taxation -higher federal tax rates associated with lower state or provincial rates-, complementary -higher federal rates associated with higher*

provincial rates- or neutral, with little systematic relationship between the two".³⁵

Along with cooperative fiscal federalism, there is a competitive fiscal federalism³⁶. This other model has some theoretical foundations, as described by SUELT-COCK, identifiable in at least three elements³⁷:

(a) The autonomy of regional and local governments is essential for the well-being of the inhabitants who live in their territorial areas, since the preferences of taxpayers are better developed in a system of several levels of government, and not in a government which only has one level of the monopoly of public goods;

(b) The costs of public services and goods must be equal to the revenues collected by taxpayers in each jurisdiction, and

(c) There should be the possibility of mobility of both taxpayers and productive activities. Therefore, the taxpayers may better satisfy their demands or necessities, to the extent that there exist a greater number of governments and variations in public policies, as well as in tax benefits, costs and tax burdens. In such diverse systems, taxpayers choose the public goods and services they prefer, as well as the cost they pay for them. De MELLO explains that there are two fields of tax competition in federal states, one horizontal and one vertical.³⁸

³⁵ CHERNICK, Howard & TENNANT, Jennifer, "Federal-State Tax Interactions in the United States and Canada", *Publius*, Vol. 40, No. 3, Canadian and U.S. Federalism (Summer 2010), Oxford University Press, p. 508

³⁶ "Competitive federalism was developed by Thomas R. Dye from analogies between the functioning of the market and relations in a Federal State. Thus, it describes that in a State there is a market of public goods in which states and local governments compete to satisfy the demand of their taxpayers and attract others to their territorial areas. Unlike the theories of dual and cooperative federalism, which focused on the relations present in a Nation-State, competitive federalism focuses on the existence of competition among the various levels of government, that is, it emphasizes the horizontal relationships". SUELT-COCK, Vanessa, "La influencia del federalismo competitivo en el nuevo régimen local español", *Revista Estudios Socio-Jurídicos*, 2010, 12,(1), pp. 202.

³⁷ SUELT-COCK, Vanessa, "La influencia del federalismo...", op. cit., p. pp. 204.

³⁸ De MELLO, Luiz. "La 'guerra de impuestos brasileña': el caso de la competencia del impuesto al valor agregado entre los estados", *Revista Internacional de Presupuesto Público* – ASIP, 2008, Nº 66.

Horizontal competition is verified among subnational units. At the same time, there are at least three variants: in terms of indirect taxes or consumption, fuels and tobacco, and the like; in the matter of taxes on the income of natural persons; on income tax for companies. Vertical competition occurs between the Federal or National Government and the subnational State Government when they share the tax bases.³⁹ It also presents at least three variants: on indirect taxes or on consumption, fuels and tobacco, and the like; in the matter of taxes on the income of natural persons; on income tax for companies or companies.

Looking at some cases, it is possible to mention that tax competition can occur with different taxes and at different levels of territorial decentralization, that is, at the subnational level and at the local level.

In a decentralized country through local governments (municipalities) such as Chile, tax competition occurs through local taxes on business activities, because many municipalities take advantage of the wide margin to set tax rates to reduce them as much as possible for attracting companies.

In Spain, the autonomous communities have certain powers to determine some elements of taxes ceded in whole or in part, presenting disparities between the communities in the matter of the Tax on Property Transfers and Certified Legal Documented and the Tax on Inheritances and Donations. The latter has been widely used in tax competition. On the other hand, the Personal Income Tax incorporates a regional tranche susceptible to be altered by the subnational government, in addition to some deductions.⁴⁰

³⁹ WILSON (289) maintains with respect to vertical competition that: "*The basic problem is that each level of government imposes a tax on the same tax base. Whereas one state's tax increases the tax base available to another state under horizontal competition, now the tax imposed by one level of government diminishes the size of the tax base available to the other level of government. In the case of capital taxation, for example, a rise in the federal government's tax rate reduces national savings, thereby lowering the amount of capital available to each state government. A rise in a single state's tax rate has a similar, but smaller, effect, reducing the tax base available to the federal government.*" WILSON, John Douglas, "Theories of Tax Competition", National Tax Journal, Vol 52 no. 2 (June 1999) pp. 269-304. The interesting thing is that this can generate an excess of taxes, with the objective of the states to increase the benefits of social rights (welfare).

⁴⁰ LAGO PEÑAS & VAQUERO GARCÍA comment that *the Basque Country and the Autonomous Community of Navarre are unique cases in the EU in terms of the scope of tax decentralization, which ends up generating a set of problems, among which are the harmful*

LAGO & VAQUERO explain that Switzerland is organized as a federal state composed of 26 cantons and 2,991 local administrations, and has a tax scheme based on multiple levels of tax administration and has opted for tax competition between different administrations. This country is one of the most decentralized federations, but it presents several negative aspects, given that there are problems of coordination, harmonization and horizontal tax competition (between cantonal and local governments) and vertical (between the three levels of government that share tax bases). The result is a complex and non-transparent tax system, with significant differences between regions in tax rates. But also in the taxable bases.⁴¹

In a federal country, such as Brazil⁴², aggressive tax competition ("tax war"⁴³) occurs on the occasion of a tax similar to VAT called ICMS, Tax on the Circulation of Merchandise and Services, which is required in the various phases of the circulation of merchandise, from production to its sale to the final consumer.

De MELLO explains that tax competition between states has been predatory, resulting in an erosion of the tax base over time. He adds that tax legislation is complex because there are multiple tax rates within the same subnational state that are fragmented, and the 27 (subnational) states

*tax competition, and difficulties for the control and management tax in the case of persons subject to the taxes or the supra-regional taxable events. These specialists add that the problem generated by the "tax holidays" in the Basque Country, which meant the exemption of corporate tax payments for 10 years to companies and entities located in this territory and that ended with a sanction to Spain of 30 million euros for a judgment of the Court of Justice of the European Union in 2014. LAGO PEÑAS & VAQUERO GARCÍA, *Descentralización y Sistema Tributario*, op. cit., p. 65.*

⁴¹ LAGO PEÑAS & VAQUERO GARCÍA, *Descentralización y Sistema Tributario*, op. cit., p. 31.

⁴² SERRA, José & AFONSO, José, El federalismo fiscal en Brasil: una visión panorámica, *Revista de la Cepal* 91, Abril 2007, 29-52.

⁴³ De MELLO explains that "the ICMS is a tax charged by the states on selected goods and services. The mechanism of credit invoice is used. The services that are exempt from taxing the ICMS, such as inter-municipal transportation, are taxed by the municipalities. The municipal tax on services is the ISS, which is not creditable against state or federal tax obligations. The ISS paid on tickets is also not creditable. Income from ICMS accounted for approximately 7.5% of GDP in 2000-01, or almost two-thirds of total state income (including mandatory participation in revenues with the federal government)" de MELLO, Luiz, "La 'guerra de impuestos brasileña':...", op. cit.

(including the Federal District) are free to set their own tax rates and tax bases. Taxes are collected on a source basis, and interstate commerce is taxed at different tax rates to compensate, albeit imperfectly, to net importers for the resulting revenue losses. According to this specialist, despite this level of institutional complexity, the data reported suggest that: first, states react to changes in the tax policy of their peers, being particularly sensitive to the political changes of neighbouring states, especially those that belong to the same geo-economic region; and, second, there seems to be a leader among the states, while the other regions respond strongly to their political movements.⁴⁴

6. Final words

There is not a general model of fiscal federalism, in the rules or in practice. Anyway, the political culture is essential for its success or its failure.⁴⁵

There is no doubt that fiscal competition generates distortions, especially of a harmful nature, given that in general it is not neutral from the economic point of view. Now, at the level of Federal States, it can correct economic

⁴⁴ "The ICMS is collected at source, so that the income accrues to the state in which the good or service is produced. Therefore, the poorest states, in general net importers of goods and services subject to the ICMS, have requested that the collection to destination be changed, which would result in a redistribution of the income received by ICMS in their favor. A compromise has been reached by applying different rates to interstate commerce. Consequently, trade between a rich state and a poor state is taxed at 7%; otherwise, interstate commerce is taxed at 12%, the lowest rate applicable in principle to interstate commerce in any state. Registered merchants in an importing state are allowed to credit their taxes paid on interstate imports against their ICMS obligations in the importing state. As a result, the lower rate charged on trade with the less prosperous states allows these states to collect more revenue by taxing their own interstate rates on shipments from more prosperous states, and to return registered ICMS paid on these operations to registered merchants lowest rate. Although these differentiated rates for interstate commerce resulting in a certain horizontal share in revenues between net importers and exporters while maintaining collection at source, they have encouraged "invoice tourism" and, to a lesser extent, across borders, increasing compliance costs and hampering the harmonization of taxes. Efforts to reduce predatory tax competition have not been successful." De MELLO, Luiz "La 'guerra de impuestos brasileña'...", op. cit.

⁴⁵ "Ultimately federalism requires a pragmatic approach and represents a dynamic political technique for accommodating the circumstances and needs of the particular society in question. Thus, while we can learn from the varied experience of federations such as Canada, the United States and Germany, the most important lesson to be drawn is the need to adapt the federal financial arrangements to the particular situation." BOADWAY, Robin & WATTS, Ronald L., "Fiscal Federalism in Canada, the USA, and Germany", Working Paper 2004 (6), IIGR, Queen's University

inequalities (fiscal levelling), in that sense be corrective, that is, obey extrafiscal purposes or finalities of justice.

On the other hand, there are those who argue that tax competition is positive given that it leads to greater efficiency in the public sector, both because public providers are more sensitive to consumer tastes and because the quality is increased and is reduced the costs of services financed with public funds.⁴⁶

Likewise, it has been argued that the tax rates of sub-central government levels tend to increase instead of decrease, and tend to converge over time, regardless of the type of tax (this is what we have called the "double trap" or the "trap over the trap").⁴⁷

It seems that tax competition at the subnational level would not be totally negative, and the negative effects would be caused by poor design of the federal system and the legal structure of taxes, due to contingent politic problems and institutional disorders. The solution to avoid or solve the negative effects would be increasing fiscal institutional coordination and fiscal harmonization⁴⁸, but this political will is not easy to accomplish, especially if there exists a wide political autonomy of each sub-level of government.

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⁴⁶ BLÖCHLIGER, Hansjörg y PIÑERO-CAMPOS, José, "Competencia tributaria entre niveles subcentrales de gobierno", *Red de relaciones fiscales entre niveles de gobierno de la OCDE*, OECD, Paris, 2011, p. 45.

⁴⁷ BLÖCHLIGER, Hansjörg y PIÑERO-CAMPOS, José, op. cit., p. 31.

⁴⁸ "Harmonization refers to any situation where differences in taxation between the states (or provinces) are reduced either by cooperation among the states or by a federal government policy. Tax harmonization can be implemented in differing degrees of intervention. The most extreme is a uniform state tax system, so that all states would have identical tax bases and tax rates." ROUNDS, Taryn A., "Tax Harmonization and Tax Competition: Contrasting Views and Policy Issues in Three Federal Countries", *Publius*, Vol. 22, No. 4 (Autumn, 1992), pp. 91-120, Oxford University Press, p. 93.