

## Tax Administration and Tax Autonomy\*

Tax administration is a key institution in any tax system. Although there is a consolidated literature on the determinants, size and outcomes of administrative strategies, the possibility of externalities in this policies in a federal country or in an international context has received limited attention in the literature. In such frameworks analysing the determinants of the tax administration acquires great relevance. Indeed the existence of potential interactions between sub-central tax authorities, resulting from the mobility of tax bases, and, more generally, the existence of other tax externalities, potentially impacting the efficient functioning of such institutions, need to be taken into account when setting policies. By employing the Spanish framework, the three papers that constitute the study have examined the incentives that lead to the existence of three different forms of externalities in tax administration and their corresponding consequences.

The first study<sup>1</sup> analyses the presence of horizontal competition in tax enforcement for the case of the Inheritance and Gift Tax (IGT). There is evidence that the decentralization of the IGT in federal countries can induce a race to the bottom in statutory tax parameters due to the threat of mobility of tax bases. Similarly, we hypothesize that the same type of competition between regions occurred in Spain even before the decentralization

of legal power, in the form of opaque competition on tax enforcement since it is the effective tax rate that conditions mobility. The data shows a reduction in the dispersion and mean of audit rate across regions during the analysed period (see Graph 1). By employing spatial econometrics techniques the paper confirms the presence of mobility-based competition in tax enforcement. We also prove that after the decentralization of the normative power a partial switch occurs from a more opaque competition in tax audit rates to a more transparent competition in statutory tax rates, partially circumventing the problem of sub-optimal tax enforcement. Nevertheless, decentralizing both the tax and the audit rates might not be optimal as it could provoke a race to the bottom in both instruments with consequent inefficient outcomes.

Before concluding that a decentralized tax administration will only result inefficiency, we sought to investigate whether there is room for potential cooperation between sub-central tax administrations. The second paper<sup>2</sup> aims at analysing this issue by examining the potential presence of cooperation in managing the application of the different tax allocation principles corresponding to the whole set of wealth taxes administered by Spain's common-regime regions. Our results show that the essential condition for cooperation

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is the existence of a reciprocity linkage between regions. We also find that there is sluggishness in this process, which is partly the result of the short-sighted behaviour of tax authorities influenced by budget constraints. This is, in part, good news for the functioning of Spain's decentralized tax administration, as in the medium-long run the gains to be made from cooperation are achieved.

Thus these studies analyse the tax externalities that might arise when sub-central tax administrations set their policies, by highlighting how the strategies of these institutions are mutually interdependent. The third paper<sup>3</sup> takes this analysis one step further by identifying the existence of externalities in tax administration policies caused by the specific external shock of terrorism. We analyse the case of the Basque Country where terrorism represents a permanent threat. In this context, economic

\* This Info IEB is based on the content of a the PhD thesis of the IEB associate researcher Luca Salvadori, titled "Essays on Tax Administration" and in particular on the three contributing papers.

<sup>1</sup> This paper has been published as: Durán-Cabré, J.M., Esteller-Moré, A. and L. Salvadori (2015): "Empirical Evidence On Horizontal Competition In Tax Enforcement", *International Tax and Public Finance*, in press. (DOI: 10.1007/s10797-014-9333-0).

<sup>2</sup> Durán-Cabré, J.M., Esteller-Moré, A. and L. Salvadori (2015): "Empirical Evidence On Tax Cooperation Among Sub-Central Administrations", Working Papers of the IEB 2015/07, submitted.  
<sup>3</sup> Salvadori, L. (2015): "Does Tax Enforcement Counteract The Negative Effects Of Terrorism? A Case Study Of The Basque Country", Working Papers of the IEB 2015/09.

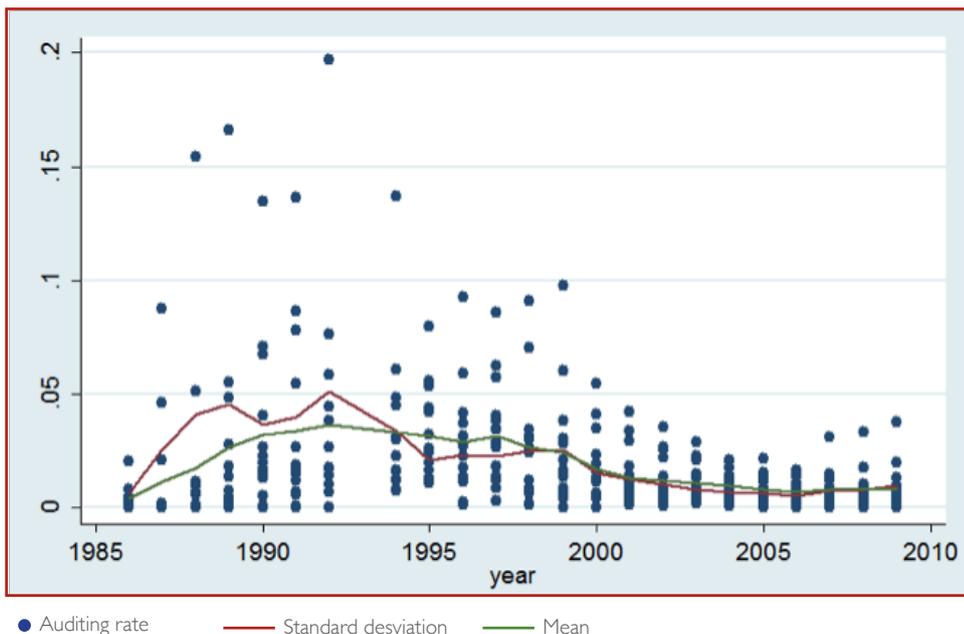
“Terrorism constrains the tax authority’s ability to set tax enforcement policies in the affected region”

agents, and in particular self-employed workers, threatened by extortion as well as by other targeted terrorist attacks, have the incentive to shift their residence in order to avoid the costs of terrorism. Moreover the level of private investment in the area is negatively affected by terrorism (see Graph 2). By altering individuals’ incentives to reside in their home region, terrorism constrains the tax authority’s ability to set tax enforcement policies in the affected region. This study provides evidence of the fact that the tax administrations of the Basque Country and Navarre employ tax enforcement as an instrument to counter the negative impact that ETA’s terrorist activity has on tax bases, tax revenues and, in short, on the economy as a whole. Our results suggest that the impact of terrorism on the Basque economy estimated by previous literature<sup>4</sup> is implicitly calculated net of the impact of terrorism on tax administration and, thus, it could be considered as a lower bound of the impact of terrorism on the Basque economy.

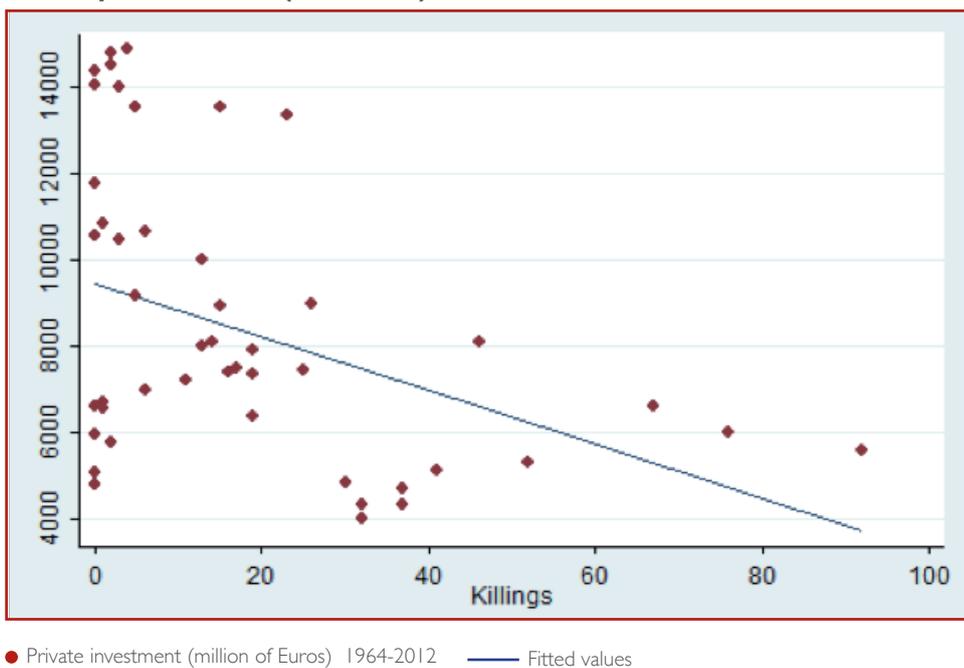
The whole research line shows that in a federal framework tax administrations employ their policies as strategic instruments, demonstrating that decentralizing tax administration gives regional governments additional degrees of tax autonomy and, thus, this process needs to be designed by identifying and circumventing all potential inefficiencies.

Luca Salvadori, IEB researcher

Graph 1: Dispersion of the IGT audit rate



Graph 2: Relationship between investments and terrorist activity in the Basque Country and Navarre (1964-2012)



Source: own calculations from IVIE and BBVA stock capital database (available at <http://goo.gl/fbmGmG>) and the Interior Ministry’s database on terrorism.

<sup>4</sup> See Abadie, A. and J. Gardeazabal (2003), “The Economic Costs of Conflict: A Case Study of the Basque Country,” *American Economic Review*, vol. 93 (1), pp. 113-131.