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Editorial

European Guidelines for Federal Member States Granting Fiscal Competences c.q. Tax Autonomy to Sub-national Authorities

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In federal Member States, the question has, in recent years, become more and more up for discussion about which European legal limitations are valid when applied to the repartition of tax competences between the federal level and the infra-State level. From the jurisprudence of the European Court of Justice (ECJ), a number of guidelines can be derived, which the federal states should take into account at the moment of transmission of fiscal competences to their federated entities.

A first important point of attention concerns the scope of Article 87 of EC dealing with national state aid measures. In this context, two judgments of the ECJ are crucial, namely, ECJ, 6 September 2006, Case No. C-88/03, *Portugal v. Commission* and ECJ, 11 September 2008, Case Nos C-428/06 through C-434/04, *UGT-Rioja*. Both cases raised the question on which circumstances do variations in the national tax rate adopted solely for a designated geographical area of a Member State fall under the definition of State aid. In the first case, the legislative body of the Azores Region had adopted by decree arrangements for adapting the national tax system to the region's specific characteristics under the powers devolved to it in the matter. This decree included, in particular, a section concerning reductions in the rates of income and corporation tax. The second (joined) case(s) concerned a number of authorities active within the Spanish Basque country that have been assigned far-reaching autonomous powers. Under those powers, they had set the corporation tax rate for companies established in their territory at 32.5%, whereas a corporation tax rate of 35% was generally applicable in Spain.

In tackling the question when geographically limited national tax rate variations are *state aid measures*, Advocate General L.A. Geelhoed, in his opinion for the *Azores Region* case (paragraphs 48 to 49), primarily made the distinction between an increase in national tax rate for a defined geographic area of a Member State and a decrease in such a state. An increase in national tax rate for such a geographic area does not fall under state aid rules. This constitutes an 'exceptional burden' imposed within that area, rather than the grant of aid to taxpayers falling under the general regime who are subject to a lower tax rate. To avoid problems concerning the selective state aid, it seems, as a consequence, to be preferable within the federal state structure to allow federated entities to raise low federal tax rates instead of giving them the competence to lower high federal tax rates (*first guideline*).

With regard to the assessment of the condition of *selectivity*, which is also a constituent factor in the concept of State aid, the Court in the *Azores Region* case considered that it is appropriate to examine whether, within the context of a particular legal system, that measure constitutes an advantage for certain undertakings in comparison with others, which are in a comparable legal and factual situation. The determination of the reference framework has a particular importance in the case of tax measures, since the very existence of an advantage may be established only when compared with 'normal' taxation (paragraph 56). This reference framework, however, does not necessarily need to be defined within the limits of the Member State concerned. It is possible that an infra-State body enjoys a legal and factual status, which makes it sufficiently autonomous in relation to the central government of a Member State. In other words, whereas deviation from a uniform national tax on a regional basis would normally lead to regional aid, such deviation is not considered present if the region involved has a sufficient degree of autonomy allowing to set its own tax framework independent of the Member State (paragraphs 57 to 58).

In its opinion, for the *Azores Region* case, Advocate General Geelhoed made a distinction between three situations, two of which concern situations where fiscal powers are transferred to sub-national authorities (paragraph 45). In one of these two situations, fiscal sovereignty is transferred by the central state to all local authorities at a certain level (regions, districts, or others), which have the autonomous power to decide, within the limit of the powers conferred to them, the tax rate applicable in the territory within their competence. In that situation, there is no 'normal taxation' applying to the national territory as a whole from which the rules of the individual local or regional authorities depart in an advantageous manner. The relevant local rules therefore stand in isolation and are not selective (paragraph 53, see also Opinion of Advocate General Kokott for the *UGT-Rioja* case, paragraph 47). Therefore, a *symmetrical* transfer of fiscal powers to all the concerned sub-national authorities could prevent federal states having difficulties with the state aid rules of Article 87 et seq. (*second guideline*).

In the opposite situation – such as in the *Azores Region* case and the *UGT-Rioja* case – characterized by an *asymmetrical* division of fiscal competences, some local or regional authorities have certain rule-making fiscal powers that are held by the central authorities in the rest of the national territory. In order to prevent difficulties in that context with the aforementioned state aid rules, a sufficient degree of autonomy ought to be present. Therefore, autonomy must be established at three different levels (*third guideline*):

(1) Institutional autonomy: the rule-making regional or local authority must have, from a constitutional point of view, a political and administrative status separate from that of the central government.
(2) Procedural autonomy: the rules must have been adopted without the central government being able to intervene directly with regard to their content; such autonomy does not preclude the establishment of a conciliation procedure in order to avoid conflicts, provided that the final decision taken at the conclusion of that procedure is adopted by the infra-State body and not by the central government (*UGT-Rioja* case, paragraph 96). Procedural autonomy does not preclude a (constitutional) system of solidarity as for instance laid down in Article 138 of the Spanish Constitution according to which the State is to 'guarantee the effective implementation of the principle of solidarity laid down in Article 2 of the Constitution by endeavouring to establish a fair and adequate economic balance between the different parts of Spanish territory'. The requirement for an infra-State body to take into account the economic balance between the different parts of the national territory when adopting tax legislation defines the limits of that body's powers, even if the concepts used to define those limits, such as that of economic balance, may be developed in the context of interpretation as part of judicial review (*UGT-Rioja* case, paragraphs 102 to 103).
(3) Economic and financial autonomy: if tax incentives are introduced, the local authorities should not be compensated out of national resources in order to assume full financial responsibility for their decision (see *Azores Region* case, paragraph 67, and *UGT-Rioja* case, paragraph 51).

The circumstance that the infra-State body ought to assume responsibility for the political and financial consequences of a tax reduction measure requires that the body is responsible for the management of a budget. It ought to have control of both revenue and expenditure (*UGT-Rioja* case, paragraph 67) (*fourth guideline*).

The mere fact that there are financial transfers between the central State and its infra-State bodies cannot, however, in itself suffice to demonstrate that those bodies do not assume the financial consequences of the tax measures that they adopt and, accordingly, that they do not enjoy financial autonomy. Such transfers may indeed take place for reasons unconnected with the tax measures. On the other hand, the mere fact that there are no open compensation mechanisms between the central State and its infra-State bodies is in itself not sufficient to prove an economic and financial autonomy. One has also to take into account hidden compensations in sectors such as, for instance, social security, the guarantee of minimum public services by the central State or in the functioning of an inter-territorial compensation fund (see *UGT-Rioja* case, paragraph 137). To avoid rendering the evaluation of the economical and financial autonomy of infra-State bodies unnecessarily difficult, it seems to be preferable that, within the federal state structures, the financial streams are made sufficiently transparent, on the one hand, between the central State and its infra-States and, on the other hand, between the infra-states among themselves (*fifth guideline*).

It appears from the foregoing that federal states where fiscal competences are attributed symmetrically to the federated entities experience no (particular) problems indeed as far as 'selective' state aid is concerned. This does not mean, however, that they do not have to take into account other European legal limitations. These limitations affect mainly the *exercise* of the fiscal competences attributed to them. More particularly, the federated entities will also have to respect the fundamental freedoms and the non-discrimination principle upon the implementation of their fiscal competences (*sixth guideline)*. See, for instance, recent cases ECJ Case No. C-11/07, 11 September 2008, *Eckelkamp e.a. v. Belgium* and ECJ Case No. C-464/05, 25 October 2007, *Geurts, Vogten v. Belgium*, both judgments concern the inheritance tax legislation as applicable in the Flemish Region.

This second point of attention was recently, however indirectly, also under discussion at the Court of Justice in the non-fiscal case Government of the *French Community and Walloon Government v. Flemish Government*, dated 1 April 2008 (Case No. C-212/06). The Court was asked whether, on a proper construction of Articles 18, 39, and 43 of EC, legislation of a federated entity of a Member State (i.e., the Flemish Community) is contrary to those provisions when limiting affiliation to a specific care insurance scheme and entitlement to the benefits provided by that scheme to persons residing in the territory coming within that entity's competence and to persons pursuing an activity in that territory and residing in another Member State, with the result that persons are excluded who work in that territory but reside in the territory of another federated entity of the same State. The Court considered that, in the case at hand, the exclusion from the care insurance scheme of Belgian nationals working in the territory of the Dutch-speaking region or in that of the bilingual region of Brussels Capital but living in the French- or German-speaking region and have never exercised their freedom to move within the European Community is a purely internal situation on which community law cannot be applied (paragraphs 37 to 39). The situation is, however, totally different inasmuch as the exclusion also applies to nationals of Member States other than the Kingdom of Belgium or to Belgian nationals who have exercised their freedom to move within the European Community. Federated entities that wish to attribute specific fiscal advantages and wish to reserve them only to citizens who have their residence on their territory will certainly have to take the abovementioned jurisprudence into account (*seventh guideline*). For example, the lump sum decrease on the federal personal income tax, recently introduced in the Flemish Region (Decree 30th of June 2006), is, from that previous point of view, problematic. To be able to enjoy this tax reduction, the taxpayer has to be taxable in the framework of the personal income tax in a municipality that is part of the Flemish Region. An inhabitant of the Brussels or Walloon Region working but not living in the Flemish Region cannot be beneficiary of the reduction, even if he is a national of a Member State other than the Kingdom of Belgium, who has exercised his freedom to move within the European Community.

The aforementioned should make clear that Europe sets important bounds to the manner whereupon, in federal states, the fiscal competences can be transmitted to the federated entities, as well as to the manner whereupon these federated entities can make use of these competences.