

## WEALTH TAXATION AND DECENTRALIZATION: THE SPANISH CASE

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**Abstract:** The future of personal wealth taxation, that is, the inheritance and gift tax (IT) and the annual wealth tax (AWT), and their possible elimination is one of the topics currently discussed in the field of tax reform. In Spain, one of the few countries that currently levies both taxes, the debate is moreover affected by a decentralization process. In this paper, on the one hand, we analyse what is currently happening among Spanish regions, which once received legal power to modify taxes, started a competition race that may take to the abolition of IT. On the other hand, an analysis of AWT permits to observe a very poor development of tax bases, with declared values of important assets (estates, equity shares or money and banking deposits) among rich taxpayers that clearly vary along time well far away from their respective market price evolution.

**Keywords:** wealth tax, decentralization

**JEL Codes:** H24, H71, H73

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# 1. Introduction

The future of wealth taxation is one of the topics currently discussed in the field of tax reform, and more particularly the future of personal wealth taxes, that is, the inheritance and gift tax and the annual net wealth tax (Dalsgaard, 2005; Blattmachr and Gans, 2001). Thus, a distinctive feature of the personal wealth taxation debate lies on the discussion about the very existence of both taxes. Countries like the United Kingdom or the United States have never levied an annual wealth tax. Other countries like Germany or Italy eliminated the tax in the nineties, and Iceland and the Netherlands have done it more recently. In fact, nowadays only eight OECD members levy it and only five EU (25) state members. As far as the inheritance and gift tax is concerned, although most OECD countries apply it, Italy and Portugal eliminated the tax at the beginning of the new century, which had already happened in Australia and Canada in the eighties. Therefore, the discussion does not usually deal with how to reform these taxes, but rather with their possible elimination.

What are the main reasons behind this process of tax reform in the field of wealth taxation? Opponents to the inheritance and gift tax argue that disincentives work and saving and, therefore, reduces economic growth (Joint Economic Committee, 2003). In addition, the tax unfairly discriminates against savers, hurts family-owned businesses and is easy to avoid, which creates high avoidance and compliance costs. In relation to the annual wealth tax, its opponents consider the tax is unfair because of unequal treatment of different assets and administrative problems (Smith, 2001). Likewise, combined with the income tax, the wealth tax is blamed for negatively impacting economic efficiency, through lifetime behavioural responses in anticipation to paying taxes (Holtz-Eakin and Marples, 2001). Furthermore, different treatments may encourage investment based on tax differentials rather than market forces, which foster social unproductive activities, such a tax planning (Hansson, 2002), and disincentives capital accumulation (Kopczuk and Slemrod, 2000).

Currently, Spain levies both taxes, that is, a personal net wealth tax and an inheritance and gift tax. They are levied by the central government and administered by each regional government (so-called "Comunidad Autónoma", that is, *Autonomous Community*, AC from now on). All revenue corresponds to the AC's, which since 1997, and even more since 2002, also have some legal power to introduce changes in the basic national regulation, due to a decentralization process carried out in the last years (see Durán and Esteller, 2005). Nonetheless, this process has raised an additional

issue in the debate about their reform, since if a region reduces the tax burden or eliminates the tax, it may attract taxpayers from other regions starting a process of tax competition among regions. Up to now, there is only casual evidence about it, especially in the case of inheritance taxation, so it is not possible to ascertain its real empirical importance. Thus, in Spain, the debate about wealth taxation is affected by a decentralization process, which in other countries, such as Australia and Canada, provoked the elimination of the inheritance and gift tax. Precisely, in this paper, we will abstract from the rest of issues mentioned before that are also included in the debate about the reform of wealth taxation (i.e., distortions regarding saving decisions, dubious pattern of the distribution of the tax burden,...), and will just focus on how decentralization might affect wealth taxation.

Firstly, we will deal with tax competition, since as we mentioned before there is not any empirical analysis about it for the Spanish case; and secondly, we will analyze whether the current legal structure achieves taxing the *real* personal wealth, or evasion and/or a wrong assessment of each asset included in the tax base impede it. As we will argue, this latter situation might be provoked by the peculiar process of decentralization. On the one hand, the legal definition and the criteria of assessment of each item included in the tax base are established by the central government, which does not have any direct interest in considering the adoption of changes in the legislation, since does not have any participation in the amount of revenue collected in the wealth tax. On the other hand, regional governments do not probably have either the technical means or the right incentives to properly administer that tax. For instance, it has been recently shown that the excessive dependence on unconditional grants has provoked a disincentive to exert an adequate level of effort to guarantee compliance in the taxes administered by regional governments (Esteller, 2005). On the whole, given incentives are not properly aligned in the right direction, it is easily presumable that the level of tax compliance in the wealth tax is low and the assets included in its tax base are not properly assessed.

In this paper, we will test empirically these two issues for the Spanish case: tax competition in the inheritance and gift tax and incentives to adequately promote tax compliance in the wealth tax. Given these two different but complementary analysis, we aim to shed some light on the debate about the reform of wealth taxation in Spain. Our first results, regarding the AWT, show that tax bases declared in the wealth tax vary well below market price evolution, and in the case of real estate property, even below the most common value legally accepted to value those assets (so-called “Valor

catastral”). The discrepancy between declared values and market values is more or less equal for all groups of rich taxpayers.

The rest of the paper is organized as follows. In the next section, we briefly describe the legal structures of the Spanish personal net wealth tax and the inheritance and gift tax, making especial emphasis in comparing them with other international experiences. In the third section, we empirically test the tax competition process in the inheritance and gift tax. In the fourth section, we analyze how the incentives created by the institutional decentralization process affect the personal net wealth tax. Finally, we conclude.

## **2. Wealth taxation in Spain**

### ***2.1. The national regulation***

Spain is one of the few industrialized countries that currently levies both an annual net wealth tax (AWT) and an inheritance and gift tax (IT). They are both national taxes, that is, taxes levied by the central government, although all tax revenue collected corresponds to regional governments, which are responsible for their administration, and since 1997 also have some legal power to introduce changes in the basic national regulation<sup>1</sup>. Regions can vary tax rates and introduce new allowances and tax credits, without any limitation, but they have to respect any other basic regulation. Therefore, although the basic regulation is common, effective tax burden from both wealth tax and inheritance and gift tax can be very different among regions. The basic parameters of the national regulation are shown in Table 1.

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<sup>1</sup> This is the common system, because two Spanish regions, so-called “foral communities”, have a completely different fiscal system. These two regions, Navarra and Basque Country, have their own annual wealth tax and inheritance and gift tax, and so have been able to modify all the legal elements of those taxes since the approval of the 1978 Constitution.

**Table 1. National parameters of annual wealth tax (AWT) and inheritance and gift tax (IT), Spain. Year 2005**

	<b>AWT</b>	<b>IT</b>
<b>- Rebates for businesses</b>	Exemption, subject to certain conditions	95% rebate, subject to certain conditions
<b>- Threshold</b>	108.181,18 €	- 15.956.87 €, for spouse and children ≥ 21 years - no threshold for gifts
<b>- Min. marginal tax rate</b>	0,2%	7,65% (*)
<b>- Max. marginal tax rate</b>	2,5%	34% (*)
<b>- Number of tax brackets</b>	8	16

(\*) Tax rates can be increased up to 240% depending on the relationship with the decease/donor and the previous wealth of the heir/donee.

Regarding the international experience and the annual wealth tax, the first issue to point out is a decreasing number of countries in the industrialized world levies the tax. Apart from Spain, only four other EU (25) state members levy it: Finland, France, Luxemburg and Sweden. In what seems to be a common trend, countries such as Iceland (2004) the Netherlands (2000), Italy (1998), Germany and Denmark (1997) or Austria (1994), have abolished the annual wealth tax in the near past. Furthermore, the Finnish and Luxemburg's governments have announced the future elimination of the tax from their tax systems. However, this trend does not seem to affect Spain for the time being.

Compared to international standards (see

Table 2), the Spanish tax schedule is characterized by a high number of tax brackets, with the lowest minimum marginal tax rate, 0.2%, and the highest marginal rate, 2.5%. Spain, as most other countries, gives special treatment to family business assets (including incorporated business), which since 1994 are exempt subject to certain conditions<sup>2</sup>. Owner-occupied dwellings are also exempt since 2001, although up to a maximum amount of 150,253.03 euros. Real estate properties are usually assessed according to a registered value (so-called "Valor Catastral"), which is usually below half their market value. Since the introduction of the wealth tax in the late seventies, its tax revenue has only accounted for about 1.08% of total tax revenue and about 2.5% of total tax revenue of regional governments. The weigh of AWT revenues is also small in other European countries, except in Luxemburg where, for instance, in 2002 it accounted for 6% of total tax revenue.

<sup>2</sup> Business or professional activities performed by a taxpayer whose business earnings constitute his main source of income. For incorporated business, the taxpayer has to individually hold at least 5% of capital (or 20% within his family group) and to manage the business and receive a pay which constitute his main source of income.

**Table 2. Annual net wealth tax in other EU (25) countries. Year 2004**

	<b>Finland</b>	<b>France</b>	<b>Luxemburg</b>	<b>Sweden</b>
Threshold (€)	250.000	732.000	2.500 + 2.500 per child	164.470
Min. marginal tax rate	0.8%	0.55%	0.5%	1.5%
Max. marginal tax rate	0.8%	1.8%	0.5%	1.5%
Number of tax brackets	1	6	1	1
Special rebates	<u>Family business</u> : 70% <u>Owner- occupied dwellings</u> : 10.000 €	<u>Family business</u> : exempt <u>Owner- occupied dwellings</u> : 20%	Exemptions up to certain amount for some goods	<u>Family business</u> : exempt <u>Owner- occupied dwellings</u> : 75% market value

As far as the inheritance and gift tax is concerned, Spain, as most other countries (Table 3), taxes more lenient close relatives and spouses than other taxpayers. The statutory tax rate is also progressive, with a tax schedule with sixteen brackets whose rates vary from 7.65% to 34%. Nonetheless, the final tax rate can be increased by a multiplier coefficient that takes into account the previous wealth of the heir/donee and his relationship with the deceased/donor. This coefficient goes from 1 to 1.2 for descendants and spouses, but for other beneficiaries varies between 1.5882 and 2.4. The aim of the multiplier is to increase the redistributive effect of the tax and to our knowledge is a peculiarity of the Spanish tax. Apart from allowances based on the relationship of the heir with the deceased, since 1996 a specific 95% rebate is given to family business transfers subject to certain conditions<sup>3</sup>. A 95% rebate is also offered to owner-occupied dwellings, although up to 122,606.47 euros.

Compared to other countries (Table 3), the final maximum marginal rate for descendants and spouses, 40.8%, is well over the mean 27%. Nonetheless, its weight over total tax revenue has remained stable for the last years, about 0.6% in Spain, similar to the average weight within the OECD and EU countries, while for Spanish regional governments represents approximately the 4% of their total amount of tax revenue.

<sup>3</sup> Basically, business assets have to be exempt from the wealth tax of the deceased/donor, and heirs/donnees must keep acquisition for 10 years.

**Table 3. Inheritance and gift taxes in OECD countries. Year 2004**

	Austria	Belgium (varies among regions)	Finland	France	Germany	Netherlands	Ireland	Luxemburg	Norway	Portugal	Sweden	United Kingdom*	United States (only federal)*
<b>Rebate for spouse (€)</b>	2.200	Between 12.500 and 50.000	6.800	76.000	307.000	496.324	456.438	Exempt, if any child	31.250	Exempt	Exempt	Exempt	Tax allowance: \$1.500.000
<b>Rebate for descendants (€)</b>	2.200	Between 12.500 and 50.000	3.400	46.000	205.000	8.483 subject to inheritance	456.438	Exempt, up to succession law	31.250	Exempt	7.800	375.980	Tax allowance: \$1.500.000
<b>Rebate for no relatives (€)</b>	110	-	3.400	1.500	5.200	-	22.822	-	31.250	-	2.300	375.980	Tax allowance: \$1.500.000
<b>Tax schedule: number of tax brackets</b>	14	3, 6 & 9	3	7	-	7	1	-	2	-	3	1	-
<b>Min. marginal rate close relatives</b>	2%	3%	10%	5%	7%	5%	20%	2,2%	8%	-	10%	40%	45%
<b>Max. marginal rate close relatives</b>	13%	30%	16%	40%	30%	27%	20%	6,4%	20%	-	30%	40%	48%
<b>Min. marginal rate no relatives</b>	14%	30%	30%	60%	17%	41%	20%	16,5%	10%	Transmissions tax: 10% (10,8% for real estate)	10% (but to minor brackets)	40%	45%
<b>Max. marginal rate no relatives</b>	54%	90%	48%	60%	50%	68%	20%	48%	30%		30% (but to minor brackets)	40%	48%

(\*): The United Kingdom and the United States have an estate tax, that is, a transferor based tax, rather than an inheritance tax, based on recipient, as all other countries.

## **2.2. Regional changes in the regulation**

Since 1997 all Spanish regions - except the “foral communities”, Navarra and Basque Country (see fn. 1) - have legal power to modify the basic regulation of both wealth taxes. But, has this legal power been widely used by regions? For the time being the answer varies with the tax, because regional governments have only carried out minor changes in the annual wealth tax, while they have been much more active in the inheritance and gift tax (see again Durán and Esteller, 2005).

Apart from small changes in the net wealth – slight varying of the tax threshold (in Catalonia €108,200 and Madrid €112,000) and the introduction of a particular and more generous threshold for disables (€250,000 in Andalusia, €216,400 in Catalonia and Galicia, €224,000 in Madrid and €200,000 in Valencia) - no region has enacted significant legal changes. Therefore, the tax burden for a given taxpayer remains the same among regions. However, many regions have introduced important variations in the inheritance and gift tax. Regions have to respect national allowances established in the basic regulation, but they can improve them, that is, relax the conditions. In fact, all regional governments have relaxed those requirements for national allowances or have introduced other rebates, which in some cases imply paying nothing. For instance, two regions, Cantabria and La Rioja, do almost not tax transfers to spouses or to direct descendants. It should be borne in mind that those two regions are neighbours of the “foral communities”, where this kind of transfers had already been exempt a few years ago. Furthermore, seven other regions (Asturias, Balearic Islands, Castilla-León, Galicia, Madrid, Murcia and Valencia) do not tax descendants who are under 21 years old, and some of them - those currently under a conservative government - have announced that they will not tax spouses and descendants in the near future. Three other regions, Andalusia, Aragon and Catalonia, have already increased, or they will do it in the near future, the allowance for close relatives and spouses and slightly reduce the tax rates, since they are not willing to eliminate the tax. Especially with respect to these latter cases, it is interesting to analyze to what extent they will be able to retain the tax bases within their territory.

Hence, on the one hand, Spanish regions have been very active making use of their legal power in the IT. It seems a competition race to the bottom has started for some regions, where most transfers are, or will be near, exempt. On the other hand, regions have only introduced minor changes in the annual wealth tax, which seems to get rid of

the competition process and does not enter the race. An analysis of the evolution of the annual wealth tax may help to understand this different development. We carry out this analysis in the next section, and will go back to the tax competition process in the IT in section 4.

### **3. Incentives: Annual Wealth Tax**

#### ***3.1. Preliminary analysis***

As we previously mentioned, two issues related with the process of Spanish fiscal decentralization might affect the annual wealth tax: the predicted low levels of tax compliance, and the underassessment of some of the items included in the tax base with respect to their market value (that is, the real tax capacity of the owner that should be taxed). The aim of this section is precisely to detect to what extent those two issues are really important. Regional tax administrations do not probably have the right incentives to properly administer this tax. That is, to exert the proper efforts to guarantee tax compliance, which is already especially difficult in a world where capital movements (in part, to escape taxation) are promoted by the extremely low levels of mobility costs and the easy access to worldwide financial information (Zee, 2002).

Among the issues regarding the decentralization process that might affect the incentives to properly administer this tax, we can cite the disincentives provoked by the generous unconditional grant system (Esteller, 2005) – in 1991, the unconditional transfers from the central government accounted for 80% (approx.) of total regional income, although this percentage has been progressively reduced up to 45% in 2002 (see Bosch and Durán, 2005) - or the lack of technical means at disposal of the regional tax administrations (including in some cases access to relevant information to carry out tax audits). Also, up to 1985, there was a clear disincentive caused by the fact that the unconditional grant system was designed in such a way that any increase in the amount of tax revenue collected was taxed at 100%, that is, implied an automatic decrease of 100% in the amount of unconditional grants received<sup>4</sup>. These facts and the relatively high costs of administration (partly caused by the high degree of mobility of tax bases) are the most reasonable causes of the presumably low levels of tax

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<sup>4</sup> See Baretto *et al.* (2002), who empirically show that the current German equalization grant system disincentives the effort of the rich Länder to guarantee tax compliance given that a big share of the tax revenue collected (in some case, above 80%) is distributed among the poor Länder. That is what the authors call a “tax on tax revenue”.

compliance in this tax.

However, the central government, which is responsible for the design of the tax base, has not varied since the inception of this tax the criteria to assess some of the items included in the tax base. For instance, regarding real estate property, the legislator establishes that its value in fiscal terms is the highest of the three following ones: the acquisition value, the value used in other taxes (basically, inheritance and gift tax) and the value calculated by a national agency (so-called “Dirección General del Catastro”) which, as we said before, is about half the market value. As we already know, this value is so-called “Valor Catastral” (from now on, VC). In contrast, other assets are valued at market prices<sup>5</sup>. As long as the regional tax administration does not check to what extent the taxpayer has declared the right value out of the three possibilities, either because it does not have the proper incentives, or because it does not have the right piece of information to compare among the cited three values, or even if it does have the information, it does not have the technical means to process it, there will be an underassessment of that type of assets, which will implicitly provoke a lower level of tax compliance.

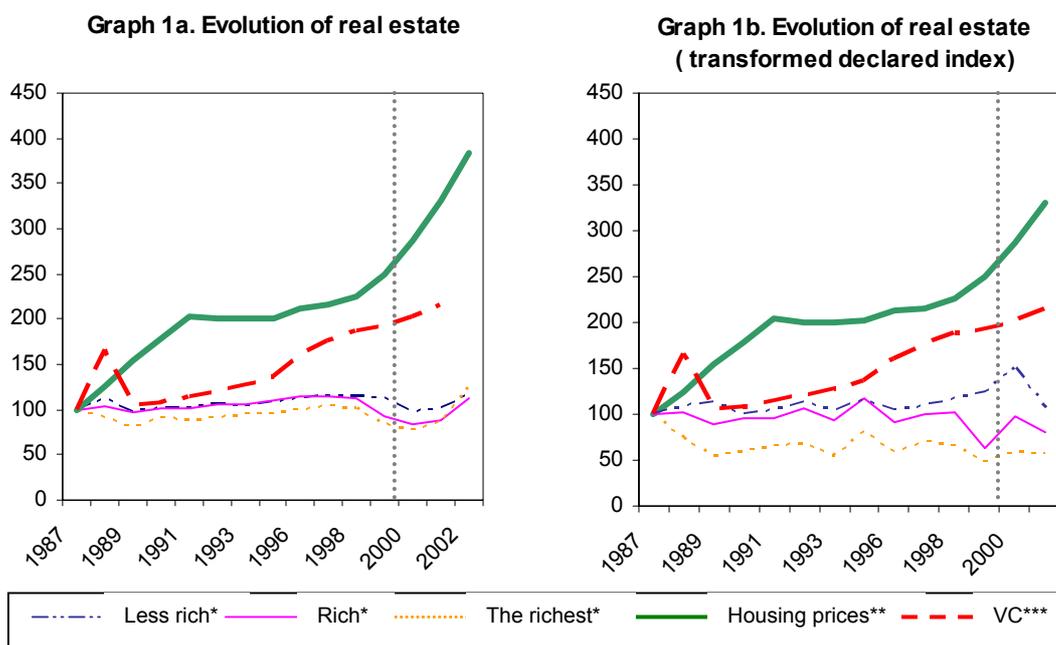
Precisely, in Graph 1a, we can ascertain the impact of this fact. The wide line reflects the evolution of housing prices during the period 1987-2002 (we will name this index “external”). Housing prices are measured as an index (1987=100), so given that the index has a value of 385% in 2002, we can conclude that the nominal growth of housing prices has been 285% between 1987 and 2002. The thin lines pick up the same kind of index, but with respect to the monetary values declared per tax return of diverse groups of rich taxpayers (“the richest”, “rich” and “less rich”). Again, the base year is 1987, so both lines start in 1987 from the same starting point (100). Hence, the graph is able to show to what extent the nominal growth rates of each index differ, abstracting from the differences in the values of the base year. From Graph 1a, as expected, it is clear for the three groups of taxpayers that the rate of growth of the values declared are extremely below the market values, especially for the group of taxpayers named “the richest”<sup>6</sup>. However, note that both indexes (the “external” one

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<sup>5</sup> Thus, note that there is a clear discrimination among taxpayers with the same real level of wealth: those whose assets are, for example, materialized in shares are more taxed than those other taxpayers which have a greater proportion of wealth materialized in real estate property (see, e.g., Smith, 2001).

<sup>6</sup> As we have suggested before, during this period of analysis, there have not been important changes in the legislation of the annual wealth tax. Thus, the variation in the index picking up

and that obtained from the tax returns) are not exactly measuring the same, since the index obtained from the tax returns is mixing the increase declared in the housing prices and the increase declared in the number of dwellings. In Graph 1b, we correct the index obtained from tax returns in order to just picking up the increase in the price declared per dwelling (see Appendix). In this way, all indexes are (almost) perfectly comparable. Despite this correction, the general picture that emerges is the same than the one that emerges from Graph 1a. However, from now on, we will only comment Graph 1b, given the greater technical accuracy in the methodology of comparison.



\* Data for these three groups of taxpayers have been obtained from the Institute of Fiscal Studies and the Spanish National Tax Administration (so-called "Agencia Estatal de la Administración Tributaria").  
 \*\*Market price, obtained from the Spanish Ministry responsible for Public Works.  
 \*\*\* "Valor Catastral" obtained from the "Dirección General del Catastro".  
 The vertical dotted line reflects the structural change produced in 2000 due to the introduction of the dwelling exemption.

Up to now, from this simple analysis, we have been able to detect a great discrepancy between the declared values of real estate properties in the AWT and an external index that reflects the evolution of the market price of housing. Besides, the greater the wealth of taxpayers, the greater the discrepancy. In any case, note that tax declared values do not react to market prices at all. However, we still do not know whether this discrepancy is due to an underassessment of real estate properties subject to taxation due to the criteria of assessment established in the legislation and/or to tax evasion.

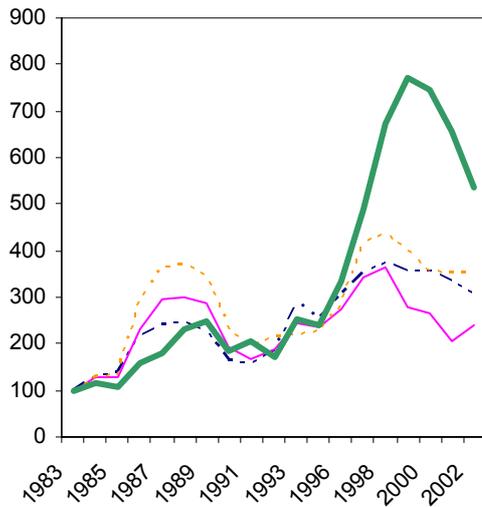
the declared values should only be influenced by the behavior of the taxpayer and the efforts of the regional tax administration to properly assess the tax bases and force tax compliance.

But we know that the most likely assessment criterion of the housing asset is the VC. Thus, describing its evolution along the same period of time, we will be able to know to what extent the discrepancy between the “external” index and the index of declared tax values is only caused by its underassessment or it is also caused by tax evasion. For example, in 2000, from Graph 1b, we can infer that the importance of underassessment is able to measure up to 52.8%, while tax evasion is able to explain the rest of the difference (47.2%). In fact, while the extent of underassessment (i.e., the distance between the index of VC and the external index) is more or less constant along time, the extent of tax evasion (i.e., the distance between the index of declared values and the index of VC) increases along the same period of time.

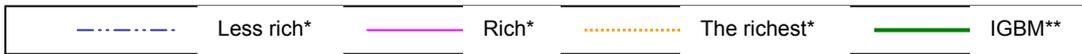
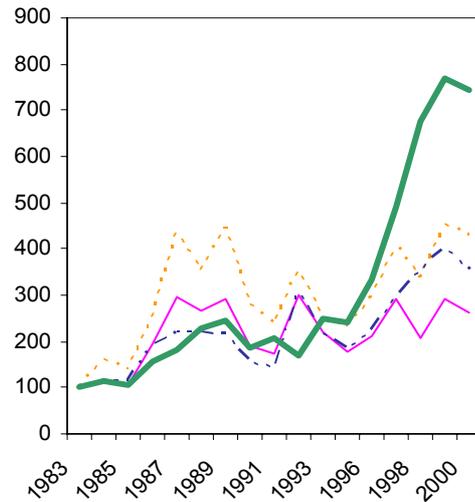
Next, we repeat the same exercise with two types of assets which fiscal valuation cannot cause any discrepancy with market values unless there is tax evasion, since in the tax return they must be included according to their market value. We are referring to shares traded in organized capital markets (i.e., in the stock exchange) (Graph 2) and to the amount of liquid money and bank deposits declared by taxpayers (Graph 3). In particular, the legal criterion used to assess stock shares is the average value of its market price during the last three months of the fiscal year, while for bank deposits is the higher bank balance either on average for the last three months of the year or the 31 of December. Thus, any discrepancy with respect to the external index should only be due to tax evasion.

Related to stock market shares and in contrast to real estate properties, in the eighties and the beginning of the nineties, the index of declared values evolves slightly above the external index. However, from the mid nineties, just when there is a boom in the Spanish stock exchange, the trend dramatically reverses. From then on, as in the case of real estate, the declared values in the tax returns are well below the external index, especially for the “rich” taxpayers. Thus, tax evasion has increased in a period of boom in the stock exchange. Regarding the amount of money and bank deposits declared per tax return (so-called M1), again as in the case of real estate property, declared values do not respond at all to changes in the amount of liquid money in the economy. This pattern is quite similar for all three groups of rich taxpayers.

**Graph 2a. Evolution of equity shares on the stock market**



**Graph 2b. Evolution of equity shares on the stock market (transformed declared index)**

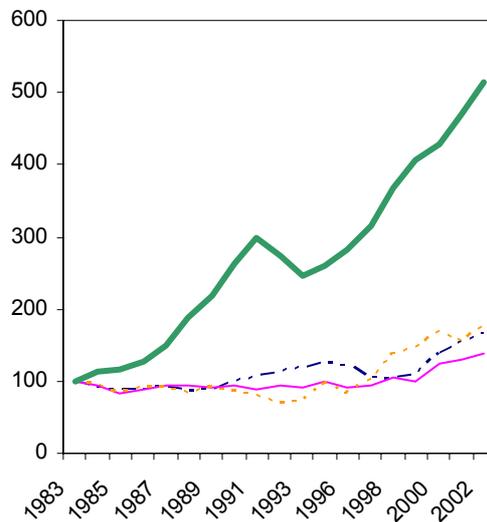


\* Data obtained from the Institute of Fiscal Studies and the Spanish National Tax Administration.

\*\*General Index of the Stock Market of Madrid. Source: Stock Market of Madrid.

This index is the only one available for all the period we have considered (1983-2002). It has been compared with IBEX35 (1990-2002), which is much more representative of the Spanish Stock Market, and we can conclude that both have the same evolution.

**Graph 3. Evolution of money and banking deposits**



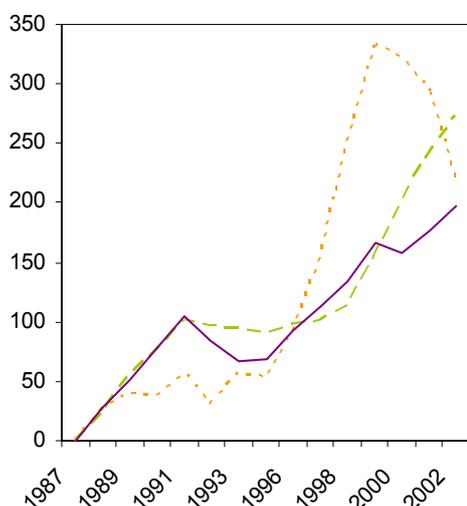
\* Data obtained from the Institute of Fiscal Studies and the Spanish National Tax Administration.

\*\*Money and banking deposits. Source: Bank of Spain.

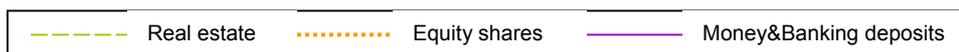
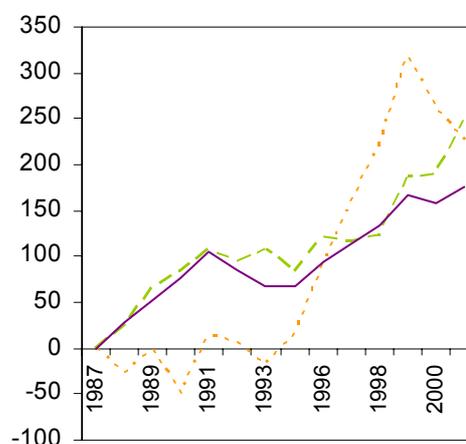
To sum up, in Graph 4 we try to reflect, for the three assets we have considered, the difference between the external index and the one obtained from the tax returns.

Regarding real estate property and money and bank deposits, the discrepancy is clearly increasing throughout the period, although it is slightly greater in the case of real estate. Recall that in this latter case, the discrepancy is not only caused due to tax evasion, but also to underassessment of the tax base. In contrast, the discrepancy regarding equity shares seems to be dependent on the phase of the cycle of the stock exchange. In booming periods, the discrepancy increases more strongly than in the other two types of assets, while under stable or recession periods, the situation is just the reverse.

**Graph 4a. Discrepancy between external index and declared index**



**Graph 4b. Discrepancy between external index and transformed declared index**



Data of external indexes have been obtained from the Spanish Ministry responsible for Public Works, Stock Market of Madrid and bank of Spain.  
 Data of declared indexes have been obtained from the Institute of Fiscal Studies and the Spanish National Tax Administration.

### 3.2. Empirical analysis

The previous analysis has confirmed our guesses concerning the low levels of tax compliance in the AWT both due to underassessment of the assets subject to taxation and to the very presence of tax evasion. In this section, we will try to confirm those results by means of a multivariate analysis, and will also try to find out what are the causes behind this result. Thus, in order to carry out this analysis, we will simply estimate an equation explaining the amount of tax base declared by type of asset.

That is, for instance, in the case of real estate property, the value declared ( $SP$ ) can be explained by means of the following equation:

$$SP_t = \alpha_0 + \alpha_1 VC_t + \alpha_2 EP_t + \mu_t \quad [1]$$

During this period, there have not been changes in the statutory tax parameters, so the amount of tax base declared in the AWT should just been a linear combination of the two most common indexes of tax capacity used regarding real estate property. That is, the registered value so-called “valor catastral” (VC) and the market price (EP). The constant ( $\alpha_0$ ) is picking up any other factors that remain constant along time (e.g., the statutory tax parameters), while  $\mu_t$  is the random error of the regression with the traditional statistical properties. In principle, we will estimate such kind of equation for each type of asset and for each group of taxpayers (i.e., a time series analysis), although we will also estimate a panel of date for each type of asset for the three group of tax payers (i.e., fixed effects model). We will also try to add other explanatory variables to expression [1], for instance, the level of income p.c. in order to try controlling for tax evasion. In any case, according to our intuition, and the preliminary results of section 3.1, we expect  $\hat{\alpha}_1 = \hat{\alpha}_2 = 0$ .

However, the estimation of expression [1] will not provide any empirical evidence about which are the causes behind those supposedly low estimates of  $\hat{\alpha}_1$  and  $\hat{\alpha}_2$ . In order to try to ascertain the likely causes, we will estimate a new version of expression [1]:

$$SP_t = \alpha_0 + \alpha_1 VC_t + \alpha_2 EP_t + \alpha_3 (VC_t \times system_{t+5}) + \alpha_4 (EP_t \times system_{t+5}) + \mu_t \quad [2]$$

Till 2002, the regional financing system was renegotiated every five years. At the moment of renegotiation, a new assessment of the vertical fiscal balance between the State and the AC's was carried out, and as a consequence new financial instruments or simply more resources were ceded to the AC's. Since 1997, the AC's depend slightly more on their own tax revenues, since they have been ceded more tax power. We would expect that a greater level of tax autonomy provoked greater levels of fiscal responsibility, and so the incentives to guarantee tax compliance and/or to assess more properly assets subject to taxation were greater. Thus, again we would expect that  $\hat{\alpha}_1 = \hat{\alpha}_2 = 0$ , but  $\hat{\alpha}_3 = \hat{\alpha}_4 = 0$ , where *system* is a dummy variable indicating each new financing system starting from 1992, and which changes since then every five years.

We have previously identified an institutional cause that might incentive regions to exert greater efforts to guarantee compliance in the AWT. However, there might also exist budgetary reasons that force the AC's to exert greater efforts in administering this tax. For example, it is reasonable to postulate that, given a level of fiscal responsibility, the greater the financial pressures of the AC (i.e., either caused by an increase in the expenditure needs and/or by a decrease in the level of revenues), the greater the level of effort in administering the AWT. That is,

$$SP_t = \alpha_0 + \alpha_1 VC_t + \alpha_2 EP_t + \alpha_3 (VC_t \times Def_t) + \alpha_4 (EP_t \times Def_t) + \mu_t \quad [3]$$

We expect that  $\hat{\alpha}_1 = \hat{\alpha}_2 = 0$ , but  $\hat{\alpha}_3 = \hat{\alpha}_4 = 0$ ; where the financial pressures are picked up by the variable *Def*, which measures the expected deficit at the beginning of the fiscal year.

#### 4. Competition: Inheritance and Gift Tax

Since the restoration of democracy in Spain, the “foral communities” have had the legal power to establish an IT completely different from the tax of the rest of AC's. Only from 1997, the latter AC's have also been able to change the statutory parameters of the tax. Thus, for example, “foral communities” have exempt inheritances to children and spouse, which presumably has provoked that certain taxpayers change their location in order to take advantage of the lower level of taxation. However, this presumption of mobility, and more interesting, its degree has never been tested empirically. In part, this situation might be caused by the lack of statistical information about this tax.

In this paper, we will try to deal with this issue by means of an empirical analysis in the vein of the paper by Bakija and Slemrod (2004). In Spain, the place of residence of the taxpayer determines what region collects a share of the personal income tax (about a 33% correspond to the regions), and all revenues from AWT. As far as inheritance tax is concerned, the nexus is the residence of the deceased. Therefore, any legal change approved by a region will have to be taken into account to determine tax liabilities from its taxpayers. Hence, when a person relocates to another region in order to reduce the burden of his future heirs in the IT, he pays his personal income tax and his AWT to the new region. Precisely, given the lack of fiscal information (number of tax returns,

amount of tax base, and so on) by tax brackets of the IT, we will indirectly test the tax competition process in the IT by looking at how the number of tax returns of the AWT respond to the relative differences of tax pressure among the “foral communities” and the rest, before 1997, and since then among all AC’s.

Navarra and the Basque Country, the two foral regions with a specific financing system, do not tax transfers to spouses and descendants (see Map 1). Once the rest of AC’s had legal power to exempt transfers to certain heirs, Cantabria in 2003 and La Rioja in 2004 - both neighbours from the foral regions - were the first regions to nearly exempt spouses and descendants from taxation. Or Asturias, the only Spanish region where a centre-left government introduced the nearly exemption for descendants under 21 years old since 2004, probably because all the neighbour regions under centre-right governments had already done it (see Map 2).

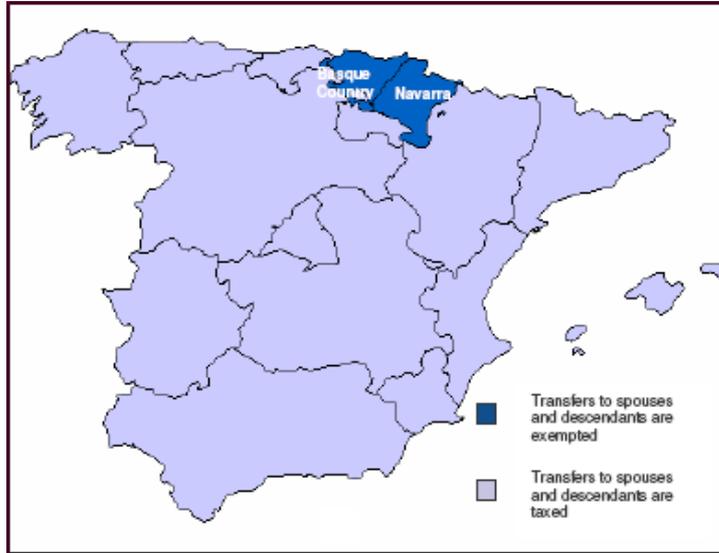
Maps 1 and 2 attempt to reflect the degree of activity of the AC’s since they have been able to enact legal changes regarding the Inheritance and Gift Tax. Thus, for the time being, apart from other minor changes, four regions do not tax inheritances to spouses and descendants any more. Seven other regions do not tax descendants who are under 21 years old, while some of them have announced they will not tax spouses and any descendants in the future (see section 2.2). Therefore, it seems the tax competition race has started, and we will have to observe how it evolves in the near future and which its consequences are.

In fact, a tax competition process already happened in the case of Australia and Canada with respect to inheritance taxation. Previously to that situation, there were two inheritance taxes, one at the federal level and another one at the state or province level. But, when the federation removed its inheritance tax (in 1978 and in 1972, respectively), a fast process of competition among regions took to the final elimination of the tax (in 1983 in Australia, and in 1986 in Canada)<sup>7</sup>. A recent empirical paper by Bakija and Slemrod (2004) shows for the US that changes in state tax policy (particularly in inheritance and estate taxes and sales taxes) affect the number of federal estate tax returns filed in each state. A one percentage point increase in the effective inheritance and estate tax rate is associated with a 1.4% to 2.7% decline in the number of federal estate tax returns. Estates over \$5 million are found to be particularly sensitive.

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<sup>7</sup> See Duff (forthcoming), for a further explanation.

**Map 1. Is There Tax Competition in the Inheritance and Gift Tax? Situation before 2003**



**Map 2. Is There Tax Competition in the Inheritance and Gift Tax? Situation since 2003**



## 5. Conclusions

An analysis of the recent legal changes adopted in the IT by the Spanish regions permits to suggest that a competitive race to reduce or eliminate the tax has already started. However, further empirical research is needed to be able to confirm this intuitive idea.

The competitive race does not affect AWT, although a first empirical study shows an increasing difference between what is declared and what should be declared for the three most important items of personal wealth: real estate, stock shares and bank deposits. Tax evasion and underassessment of real estate seem to be the origin of those differences, which have also been strengthened by the decentralisation of the tax. This topic also requires more empirical research.

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## **Appendix: Correction of declared values of assets included in the Net Wealth Tax**

In order to make comparable the index of declared values and the external one in the case of housing and shares, we have to transform the declared index in order to abstract either from a greater level of tax compliance in "quantities" (i.e., number of dwellings declared or number of shares declared) and/or a new composition of individual savings in favor of one or another type of asset. Obviously, this is not a problem for the liquid money. For instance, take the case of shares. The index for  $t=1$  ( $IND_1$ ) is

$$IND_1 = \frac{\# shares_1(d) \times p_1(d)}{\# shares_0(d) \times p_0(d)} \quad [A1]$$

where (d) means declared values. In order to disregard the increases in the number of shares from  $t=0$  to  $t=1$  (due to an increase in tax compliance and/or a new savings composition), we transform the previous index as follows. From official statistics (Bank of Spain), we know that the percentage of savings materialized in shares, for example, for  $t=1$ , is

$$\alpha_1 = \frac{\# shares_1 \times p_1}{S_1} \quad [A2]$$

where  $S_1$  is the total amount of savings. Then, we have  $\# \text{ shares}_1 = \frac{S_1 \times \alpha_1}{p_1}$ . If we

multiplied the numerator of [A1] by  $\frac{\# \text{ shares}_0(d)}{\# \text{ shares}_1(d)}$ ,  $IND_1$  would only depend on the ratio

of prices. However, note that in [A1], we have the number of shares declared, while we have obtained the number of shares from an external statistical source. But, if we suppose that  $\# \text{ shares}_1(d) = \beta \times \# \text{ shares}_1$ , where  $\beta < 1$ , and assume that this value does not change very much from year to year<sup>8</sup>, we can now rectify the numerator of

expression [A1], since we are assuming that  $\frac{\# \text{ shares}_0(d)}{\# \text{ shares}_1(d)} \cong \frac{\# \text{ shares}_0}{\# \text{ shares}_1}$ . Therefore,

the correction factor for  $t=1$  ( $cf_1$ ) that we will use is  $cf_1 = \frac{S_0 \times \alpha_0}{S_1 \times \alpha_1} \times \frac{p_1}{p_0}$ . All the variables

that appear ( $S$  and  $\alpha$ ) can be easily obtained from statistical sources external to the fiscal information, while the ratio of prices is precisely the “external” index we use to measure the evolution of the market price of the corresponding asset subject to taxation.

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<sup>8</sup> For example, this is a usual assumption in the recent literature measuring tax wealth concentration (see, e.g., Alvaredo and Saez, 2005).