

**TAX SYSTEM AND REFORMS IN EUROPE:
SPAIN**

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TAX SYSTEMS AND TAX REFORMS IN EUROPE: SPAIN

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Abstract

This paper aims at discussing the main features of Spain's tax system, its recent reforms and those underway. It is part of a wider research on European taxation, carried on at this Department, under the direction of L. Bernardi and P. Profeta, and the supervision of V. Tanzi. The current state of the main taxes, their future reforms are studied starting from 1975, when Spain shifted to democracy. Direct taxes, indirect taxes and social security contributions are compared with the European average, trying to focus on the major changes from 1975 to 1999. The structure of the main taxes is surveyed, showing the recent reforms and the differences with the previous system. The analysis goes on observing the evolution of the tax burden from 1975 to 1997, looking at progressivity of the tax system, at the redistributive implications. Moreover, in this paper we analyse the process of fiscal decentralisation and the tax wedge in corporate and labour taxation. Finally, after a brief overview of the macroeconomic and budget framework, the paper assesses the fiscal reforms that have taken place during 1990s. The aim of these reforms was a more neutrality of the tax system and a reduction of disincentives to labour force participation, in tandem with an offset increase in VAT rates. Actually, the main tax reforms guidelines are a further reducing of the tax burden on labour, a promotion of tax neutrality across saving instruments and corporate tax regimes, and an improvement of decentralisation.

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1. Introduction, content and main conclusions

In this paper we will analyse the fiscal system in Spain. We start half way through the 1970s from a historical viewpoint. In these years, Spain, if compared with the other European Countries, was a backward country, with an economic and a social situation similar to other Mediterranean countries (i.e. Portugal and Greece). Since 1975, when Spain shifted to democracy, the country has crossed a period of strong reforms. In a first time, the aim of reforms was to modernise the economic structure of the country and to guarantee expenditure level higher than in the past. During the 1980s, reforms concerned the adaptation of the revenues and expenditures to the European standard, in view of the entrance in the European Community. Finally, in the 1990s, Spanish policy makers choices has been concentrated to the aim of the monetary union (EMU) and to improve the employment rate.

We then analyse the main features of the Spanish tax system and the composition of revenues, in comparison with other European Countries. At the end we discuss the economic impact of the more recent reforms of the tax system.

Part. 2 includes an analysis of the tax system, showing the behaviour, over the last two decades, of the most important variables, related to the performance of GDP, underlining the main characteristics of the revenue structure, direct taxes, indirect taxes and social contributions and comparing the performance with the European average. In this section we examine how, the shift to democracy and the entrance in the European Community contributed to raise, above all during 1980s, the expenditure and in so doing, the revenue. The total revenue, in fact, grew from 1980 to 1999 by 11 per cent, but the growth rate of expenditure has decreased in the 1990s, caused by efforts to respect the Maastricht Treaty. In the same years, the composition of revenue has also been modified, aimed at a greater convergence with European standards. Harmonisation of VAT caused a strong increase in revenue for this tax, while, on the side of direct taxation, a constant growth of corporate and personal taxation has been observed. Social contribution has increased, particularly the amount charged to employees', with the aim of increasing the social protection system.

Section 3 shows an overview of the main taxes of the Spanish system, such as corporate and personal income tax, VAT and excise duties. For each of these, analysis summarises economic characteristics and tax rates. It can be observed how some characteristics distinguish the Spanish tax system by European standards. Interestingly, for example, the taxation of savings and financial activities are included in personal taxation (with a starting account, whose rate depends on the type of financial activity). Moreover, some Autonomous Communities have a special regime that allows them to collect an additional personal income revenues. These Autonomous Communities, due to various special laws caused by ethnic tensions, also collect some other taxes, such as VAT or excise

duties. With regards to corporate taxation, it's important to underline that, over the rate of 35 per cent of taxation, a lot of special laws come in to play, in order to make corporate tax more user friendly causing large deductions in some cases or tax rates to be lower than the statutory rate.

The consequence of this, is explained in Section 4, is an effective corporate tax rate 11 per cent lower than the statutory rate. This is close to the average tax relief provided in the European Union. Section 4 shows the economic impact of the tax system, analysing implicit tax rates, the tax wedge, and the division of the tax burden by economic or territorial criteria. This section is an overview of tax effects on labour supply, wages, investment and production choice and it is necessary to understand the guidelines of recent reforms in Spain and the aim of the more recent policies. This analysis uncovers what is the lowest tax wedge on labour in the European Union (the EU average is 51.3 percent) although it is still higher than the OECD average. However there is an obvious trend toward lower taxation of capital and the implicit tax rate on labour, which has usually shown increase in the past has remained constant in the last year.

The reduction of progressivity, in the 1990s, caused a reduction of the redistributive effect of the tax system. In fact, in the European context, Spain shows a higher degree of inequality in income distribution pre and post taxation.

Concerning decentralisation, it must be emphasised how, the Spanish system devolves 29 per cent of revenues to Local Governments, against a European Average of 18 per cent.

An historical view of the reform process of the tax system is included in section 5. In this section the main reforms in the 90s are explored, in conjunction with the main macroeconomic indicators (i.e. public balance and unemployment) observing the general process of convergence towards the EMU and the constraints of the Growth and Stability Pact.

From this analysis the more important guidelines of the reform become apparent. Convergence with the EMU and the constraints of the Maastricht Treaty obliged Spanish policy makers to reduce net borrowing and public debt. Although the high growth rate of GDP, and a lower level of public expenditure than in other Countries, could help Spain to stay within the parameters requested by EU, high rates of unemployment (although implicit rates and tax wedge are lower than European average) have driven the Government towards strong taxation reform. The aim of the reform was to increase the neutrality of the system, reducing the distortion of taxation, and to build a less progressive personal income taxation system, thus increasing labour supply and investments. In the same way the taxation of some unemployment benefits was linked to major labour market reform.

In 1991 and 1998, a reform of the brackets and of the tax rates strongly reduced the progressivity of the system. The cost of the reforms is secondary to the redistributive effect of

taxation. These reforms were balanced by an increase of the taxation on consumption, caused by harmonisation with European laws on VAT, and an increase in some excise duties.

In the same years the process of decentralisation continued, increasing the revenues and the fiscal liability of Local Governments.

Future reforms, will have the same aim of those carried out in the 1990s important economic and demographic data indicates the need for further reform of the social security system, in order to provide for the large ageing population. This implies a set of policies aimed at improving the labour supply and able to insure a sustainability of the social security system. So, next reforms must work towards further neutrality of the system, a reduction of taxation on labour, financed by a growth of taxation on consumption. A reduction of social contributions of low-paid employment will be necessary to improve the supply of low-skilled jobs, and, consequently, move resources from unemployment assistance to the ageing population. Income tax should be drastically changed in its structure, with the result of attributing relevant advantages to the low-middle and the highest incomes

Moreover, the decentralisation process must be further pushed in order to achieve higher liability of Local Government in the expenditure process.

2. A broad outline of the system and its development from the '70s

2.1 The current structure of taxation and social security contributions

In 2000, the general Government expenditure (Banca d'Italia, 2001) reached the level of 40,0 per cent of GDP, decreasing by 5 per cent from 1995. From this aggregate, we can extract the current expenditure, which is 35.2 per cent of GDP. It may be divided in four parts: final consumption (17.1 per cent of GDP and 48.5 per cent of total current expenditure), transfer and subsidies (14.8 per cent of GDP and 42 per cent total current expenditure), interest and, finally, investment (both 3.3 per cent and 9.4 per cent respectively).

Spanish expenditure decreased, during the second half of 1990s, according to a general European trend, caused by the constraints imposed by the Maastricht Treaty. However, current expenditure is lower than the EU average. The largest difference concerns lower interest expenditure and social transfer, compensated by higher expenditure in investment.

Using the time series of Banca d'Italia, fiscal pressure, excluding capital taxes is 35.5 per cent of GDP. Including capital tax this number grows to 35.9 per cent.

Comparing details of expenditure and current revenue (38.6 per cent of GDP), we can observe, over the last years, a growth in balance surplus. From 1995 to 2000, huge primary surplus increased from a deficit of 1.4 per cent of GDP to a lending of 2.9 per cent (Banca d'Italia, 2001). This growth used to modify the national balance. In fact, the net borrowing, reached in 2000 the level of 0.4 per cent of the GDP (in 1995, this data was 6,6 per cent of GDP).

The actual Spanish tax system provides for the following main taxes: a personal income tax, called *Impuesto sobre la renta de las personas físicas (IRPF)*, a tax on the income of non residents (*Impuesto sobre la renta de No Residentes*), a corporation tax (*Impuesto sobre sociedades*), a wealth tax (*Impuesto sobre el patrimonio*), succession and gift duty (*Impuesto sobre sucesiones y donaciones*) and, in addition to VAT, some taxes on special goods (tobacco, beer, alcoholic beverages) and other less important taxes. In Section 3 we will analyse some of these taxes making up the Spanish tax system.

European statistics (Eurostat, 2000) show how in 1999 direct taxes (11.7 per cent), indirect taxes (12 per cent) and social contribution (12.8 per cent) contribute to total revenue by about one third each. The taxation of income (personal and corporate income) and VAT are the main ways of financing expenditure. In 1999, these categories constituted 10.1 per cent and 6.5 per cent respectively of GDP.

Looking at the internal composition of the three loudest voices in revenue, the main source is VAT, which provides for more than half of the indirect taxes, while with regards to direct taxes, the main source is the tax on income, with a majority of revenue due to personal income taxation.

2.2 The developments of the system from 1970 to 2000

Tab.1 shows development of the structure of taxation in Spain since 1980.

According to a general trend, common to all industrialised Countries, total tax revenue rose strongly (from 13.7 per cent in 1980 to the current 23.7 per cent). In Spain this is due to the shift to democracy after 1975. In fact, after this, Government expenditure in Spain was fairly low by international comparison, keeping tax pressure considerably below the OECD average.

The social contribution has also increased according to the aim of improving the social protection system. However, the trend shows a growth in the percentage contribution charged to employers, with the aim of reducing the labour cost and unemployment.

In Spain, the harmonisation of VAT in the European Union caused a strong increase in the revenue of this tax, until recently valued at 6.5 per cent of GDP. In the field of indirect taxes, we can also notice a growth in the excise duties.

Regarding direct taxes, the constant growth of revenue was due to the constant growth of the principal taxes (corporation and income tax). However, in the 1990s, there was a decrease in the revenue of corporation tax, caused by a more friendly policy for enterprises, and a slower growth of increase in personal income tax than in the 1980s.

To sum up, during the last 20 years, the Spanish tax system has aimed at catching up with European standards. This is due mainly to two reasons: the shift to democracy and the entry, in 1986, into the European Community. More recently, the policies implemented aimed at reducing the fiscal burden and supporting economic growth.

TAB. 1 *Structure and development of fiscal revenues in Spain and European average as per cent of GDP, 1980-2000*

	1980		1985		1990		1995		1999	
	<i>Spain</i>	<i>Europe</i>	<i>Spain</i>	<i>Europe</i>	<i>Spain</i>	<i>Europe</i>	<i>Spain</i>	<i>Europe</i>	<i>Spain</i>	<i>Europe</i>
Direct Taxes	7.1	12.7	8.6	13.1	11.9	13.2	11.4	13.3	11.7	14.5
Personal income	4.8	9.3	5.8	9	7.6	8.9	8.1	9.6	10.1*	9.9
Corporation income	1.2	2.2	1.6	2.8	3.1	2.9	2	2.4		2.8
Other	1.1	1.2	1.2	1.4	1.2	1.4	1.3	1.3	1.6	1.8
Indirect taxes*, of wich	6.6	13.2	9.4	13	10.4	13	10.5	13.6	12.0	14.6
VAT	0	6.6	0	6.1	5.4	6.6	5.4	6.9	6.5	7.3
Excise duties	1.5	3.2	1.7	3.2	2.0	3.1	2.9	3.4	5.5**	2.5
<i>TOTAL TAXES REVENUES</i>	<i>13.7</i>	<i>25.9</i>	<i>18</i>	<i>26.1</i>	<i>22.3</i>	<i>26.2</i>	<i>21.9</i>	<i>26.9</i>	<i>23.7</i>	<i>29.1</i>
Social contributions	11.8	13.4	11.9	13.8	12.2	13.7	12.4	15	12.8	14.0
Employers	9.3	7.8	8.4	7.9	8.8	7.8	8.6	8.0	8.9	7.8
Employees	1.9	4.3	2	4.5	1.9	4.5	2.1	5.1	2.1	4.5
Self Employed	0.7	1.3	1.5	1.5	1.4	1.4	1.7	1.8	1.8	1.7
<i>TOTAL FISCAL REVENUES</i>	<i>25.5</i>	<i>39.3</i>	<i>29.9</i>	<i>39.9</i>	<i>34.5</i>	<i>39.9</i>	<i>34.3</i>	<i>41.9</i>	<i>36.5</i>	<i>43.1</i>
Administrative level										
Central Government	11.3	22.3	13.9	22.1	17.3	22.2	16.7	22.5	17.0	23.7
Local Government	2.4	2.9	4.1	3.1	4.4	3.8	4.6	4.0	5.7	4.3

* Minor items are omitted. ** Aggregate data caused by the lack of further disaggregation in New Cronos database.

Sources: 1980-1995, Eurostat, 2000; 1999, Eurostat New Cronos Databank 2002 (data equalised with Eurostat, 2000).

2.3 A comparative view with the European average

In 1999, the estimated aggregate level of taxation in Spain was 36.5 per cent of GDP, 6.6 per cent less than the EU average. This lower value is constant during the 80s and 90s. However during the 1980s the differential between European and Spanish average decreased from 13.8 per cent in 1980 to 10 per cent in 1985 and then to 5.4 per cent in 1990, while, from 1995 the value of the differential has increased to 7.6 per cent (1995). This is a consequence of new policies implemented during the last year and is already mentioned at the end of the previous paragraph.

A natural consequence of this trend is lower revenue for the single voices of Tab.1, except for the social contribution charged to employers that are always higher than European average. This means a lower charge for employees that pay a lower sum than in other Countries.

However, during the last 20 years, there has been a general adjustment of the composition of the revenue, which is now more similar to the European structure, than in the early 1980s. In 1980 the weight of social contributions on the total fiscal revenue, was very high, while in Europe a more balanced fiscal revenue composition existed (with direct taxes, indirect taxes and social contribution each making up one third). In 1999 the composition of fiscal revenues was similar to the European average. The weight of social contribution (although this is 3 per cent higher than in the EU) decreased by more than 11 percentage points, compensated by a strong growth in indirect taxes (7 per cent of the total) and in direct taxes (4.3 per cent of the total).

To summarise, although the fiscal revenues of Spain are always lower than the average of EU Countries, the current structure of the tax burden is similar in its composition of direct/indirect taxes and social contributions.

Another point of interest is the administration of the tax burden. While in other EU Countries about 55 per cent of the fiscal revenue is managed by Central Government, in Spain this percentage is only 46.5 per cent. In 1980 this percentage was 56.7 per cent for EU and 44.3 per cent for Spain. This means that in Spain, like in the rest of the European Union, there has been an increase of resources devolved to Local Government. However a high rate of fiscal centralisation, is still present in Spain only partially compensated for by more favourable treatments reserved for some local communities, among the most important are the Basque Country and Navarra.

3. Some quantitative and institutional features of main taxes

3.1 The Personal Income Tax and the taxation of financial activities

The last reform of the personal income tax in Spain goes back to 1998. An important characteristic of the Spanish system is that the beneficiaries of the tax are not only central Government but also two autonomous communities: the Basque Country and Navarra. In these communities, to calculate the amount of the tax due, citizens must consider the specific autonomous community tax rate plan.

The imposition unit, by decree of the Constitutional Court of 1989 is not the family but the individual.

The basis of assessment is the amount of the taxpayer's disposable income. This includes income from employment, capital, business, capital gain and losses and imputed income as laid down by law.

In particular, the composition of the single income voice is as follows:

- employment income: job wage, fringe benefits, compensations, travel expenses, if higher than the sum provided for by law, pensions and supplementary pension received by the consort, insurance premium and social security contributions paid by the employer;
- land rent: rent by real properties and 2 per cent of the cadastral income of the properties;
- capital gains or losses: interests, capital gains, dividends.

The law on income allows certain deductions. The most important concerns the salary. In fact people that have a yearly wage lower than 8,113.6 euro have a deduction of 3,005 euro, while people that earn between 8,113.6 and 12,020.2 euro can have a deduction of 3,005 euro less the difference between the income earned and 8,113.6 euro, multiplied by 0,1923. So, if the income is higher than 12,020.2 euro, the annual deduction is 2,253.8 euro.

The deduction increases in case of invalidity, while the system allows deduction of a percentage of medical care expenses.

Other deductions concern insurance premium against death or invalidity, the purchase or the building of a house, the purchase of cultural goods and the gift for association non-profit.

Family deductions are structured as follows:

- euro 601 for each parents in charge aged over 65
- 1202 euro for each son aged under 25 living with the taxpayer
- 1803 euro for the third and others sons under 25 that live with the passive subject.

There exists a personal deduction of 3,305 euro, increased to 3,906 euro for people aged over 65, and 5,108 euro in the case of a percentage of invalidity from 33 to 65 per cent. If this percentage is over 65 per cent, the amount of the personal deduction is 6,911 euro.

This sum is increased by 300 euro if the son is less than 3 or by 150 euro if he is less than 16.
Other forms of deduction are provided for invalidity and for contribution to pension plans.
No deduction for the spouse is provided for the law. Tab.2 summarises the list of deductions.

TAB. 2 *Deduction on personal income tax*

	Quantities	Limit (euro)
DESCENDANTS		
First and second (each one)	1,202	
Third and other	1,803	
Physically and mentally handicapped (33-65%), blind	1,803	
Physically and mentally handicapped (over 65%), blind	3,606	
Passive subject aged over 65	601	
Physically and mentally handicapped (33-65%), blind	1,803	
Physically and mentally handicapped (over 65%), blind	3,606	
INSURANCE		
Life, death, incapacity	10%	601
Mixed, contract over 10 years	10%	300
HOUSING LOAN		
<i>For the first 2 year</i>		
Under 4,508 euro	25%	4,508
From 4,508 to 9,016 euro	15%	9,016
<i>Following years</i>		
Under 4,508 euro	20%	4,508
From 4,508 to 9,016 euro	15%	9,016
GIFT		
For non-profit associations	20%	
Other associations of public interests	10%	
PROFESSIONAL ACTIVITIES		
Dividends (in general)	40%	
Dividends from general insurance company, social security institutes, etc.	25%	
Tax on the increase of the land value	75%	
Dependent work	162	
OTHER		
House purchasing or modernisation	15%	9,015
Medical expenditure	15%	
Children care	20%	

There is a long list of incomes exempt from personal taxation. The most important are public scholarships, child allowance and unemployment benefit.

The rates given in Tab.3 are applied to the net general taxable basis. This is obtained by making deductions from the general taxable basis for contributions to pension plan or provident mutual societies. Tab.4, instead, presents the additional rates adopted, in the autonomous communities.

TAB. 3 *General rates for personal income tax, year 2000.*

Net taxable basis (euro)	Rate applicable (Percentage)	Basque Country and Navarra (Percentage)
Less than 3,678.19	15.00	3.00
From 3,678.19 to 12,873.68	20.17	3.83
From 12,873.68 to 25,134.32	23.57	4.73
From 25,134.32 to 40,460.13	31.48	5.72
From 40,460.13 to 67,433.55	38.07	6.93
Over 67,433.55	39.60	8.40

Source: Agencia Estatal de Administracion Tributaria

Concerning financial activities, in general, the Spanish tax system provides for a withholding rate of 18 or 20 per cent for some activities (see Tab.4) or for an exemption in other cases, plus taxation based on the marginal personal income tax rate of any taxpayer. It must be underlined that some financial products held for more than two years offer a more favourable personal income rate than the tax rates provided for the normal brackets of income.

TAB. 4 *Withholding rate on financial savings, year 2000.*

<i>Financial products / income</i>	<i>Withholding rate</i>			
	<i>Held for less than 2 years</i>	<i>Held for more than 2 years</i>	<i>Held for more than 5 years</i>	<i>Held for more than 8 years</i>
Bank account, life insurance contracts, dividends	18			
Capital gains on mutual funds	20	20		
Treasury bill, private bonds, capital gains on shares	0	0		
Bank account, housing savings schemes, pension funds (lump-sum payments), life insurance contracts (lump-sum payments)		18		
life insurance contracts (lump-sum payments)			18	
life insurance contracts (lump-sum payments)				18

3.2 Corporation Tax

The *Impuesto sobre sociedades* is regulated by a law in force since 1 January 1996. As for the personal income tax, the beneficiary of the revenue is central Government and the autonomous communities of Navarra and the Basque Country.

The taxpayers of this tax are all resident legal persons except for partnership and other entities without legal status, such as investment funds, joint ventures, risk capital funds, etc.

The basis of assessment is the amount of income generated during the tax year in question less any negative tax bases carried over from previous years. The basis of assessment is calculated by making certain tax adjustments to the results reported in the accounts.

There are two cases of automatic exemption:

- a complete exemption for central Government, the autonomous communities, certain public bodies and the Bank of Spain
- a partial exemption for some incomes accruing to political parties, trade unions, associations, common agricultural policy subsidies.

Moreover, company-restructuring operations (merger, divisions, and transfer of assets and exchange of shares) enjoy tax neutrality.

The deductions are as follows:

- to avoid domestic double taxation, dividends or shares of profits received from other business resident in Spain qualify for a 50 per cent deduction or for a 100 per cent deduction if the receiving company has owned, directly or indirectly, 5 per cent of the capital of the distributing company for at least one year prior to distribution
- to avoid direct or indirect double taxation at international level an exemption system based on a 100 per cent deduction for income received from abroad was introduced in 1996
- to provide permanent incentives for certain activities such as research and development, exporting (for 25 per cent of foreign investment), investment in cultural goods, film production and book publishing, investments for environmental improvement and pollution control, employment of disabled worker.

All these deductions may not exceed 35 per cent of the full tax liability less the deduction allowed to avoid domestic and international double taxation and any applicable allowances.

The standard rate is 35 per cent, but the law provides reduced rates for small businesses (30 per cent for profit up to 90,152 euro) and for mutual insurance companies, social welfare organisations, mutual guarantee schemes, credit cooperatives and non-profit making organisations (all these categories pay a rate of 25 per cent).

Other reduced rates are provided for cooperatives (20 per cent for the result of their activities), foundations and public associations (10 per cent), pension funds (0 per cent), enterprises extracting hydrocarbons and related activities (40 per cent).

Negative tax bases may be carried forward to offset positive tax bases generated over the following 10 tax years. Newly founded companies may begin counting the carry-over period from the tax year in which their tax base first became positive.

3.3 Value Added Tax

The legal base of *Impuesto sobre al valor anadido* was approved in 1992, but has been frequently amended. The beneficiary is central Government and the autonomous communities of the Basque Country and Navarra, where tax is collected in accordance with central Government legislation, except using different tax declaration forms. Part of the revenue accrues to the communities.

The tax is payable by:

- natural or legal persons who exercise business or professional activities and make taxable supplies of goods or services
- traders or professional persons for whom taxable transactions are carried out by persons or entities not established in Spain
- importers, whether or not traders or members of the professions
- undivided estates, persons owning goods in community and other economic units without legal status carrying out taxable transactions.

The tax is payable on supplies of goods made by traders or professional persons, habitually or occasionally, in the course of their business or professional activity. People that import goods, irrespective of the destination of the goods imported and the status of the importer, are also subject to VAT, and the same rule applies to intra-Community acquisitions¹ and for the supplies of goods and services made by traders or professional persons in the course of business in mainland Spain or the Balearic Islands.

The exemptions concern several categories. The most important of these are the exports and the transaction of goods sent definitively to the Canary Islands, Ceuta or Mellila, the supplies of goods intended for another Member State, if the purchaser is an entrepreneur and some transactions in accordance with international treaties regarding Spain.

The basis of the assessment consists of the total value of the consideration for the taxable transactions, excluding discounts allowed after transaction. The amount of VAT paid on the acquisition of goods or services directly linked to the business or professional activity of the taxable

¹ I.e. supplies of goods and similar transactions carried out in accordance with the Communities transitional arrangements for VAT, between operators in two or more Member States of the European Union.

person is generally deductible from the amount due in respect of that person's activity. The exemptions also concern some domestic transactions, such as health, social security, education, welfare work, insurance and reinsurance, finance, supplies of non-building land and the public postal service, etc.

There are three tax rates:

- 4 per cent, applicable to certain basic necessities (i.e. bread, milk, medicines)
- 7 per cent, applicable to certain goods and services regarded as basic necessities such as food for human consumption, water, medical equipment, air and sea transport of passengers
- 16 per cent, applicable to all other transactions.

3.4 Excise duties

The Spanish tax system includes several excise duties. The most important concerns hydrocarbons, tobacco, beer, wine and certain means of transport. For all excise duties, the beneficiary is central Government, the Basque Country and Navarra.

The *Impuesto sobre hidrocarburos* is payable on the manufacture and import of hydrocarbons. The basis of assessment is the volume of dutiable product or, in some cases, the unit of weight or gigajoules (GJ). Tab.5 explains the tax rate for hydrocarbons.

TAB. 5 *Tax rate for hydrocarbons*

Leaded motor fuels	404.7 euro / 1000 litres
Unleaded motor fuels	402.9 euro / 1000 litres (97 octane and above)
Other	371.7 euro / 1000 litres
Diesel oil for general use	269.8 euro / 1000 litres
Diesel oil for use as motor fuel	83.6 euro / 1000 litres
Fuels oil	13.4 euro / tonne
LPG for general use	795.2 euro / tonne
LPG for PSVs	57.5 euro / tonne
LPG not used a fuel	7.4euro / tonne
Methane for general use	16.8 euro / GJ
Methane not used a fuel	0.16 euro / GJ
Kerosene for general use	404.7 euro / 1000 litres
Kerosene not used as fuel	404.7 euro / 1000 litres

The excise duty on tobacco (*Impuesto sobre las labores del tabacco*) concerns the manufacture and import of several tobacco products such as cigar and cigarillos, cigarettes, cut tobacco for rolling, other tobacco for smoking.

The basis of assessment could be *ad valorem* or in number of units; the tax rate for this tax are in Tab.6.

TAB. 6 *Excise duty on manufactured tobacco*

Cigar and cigarillos	12.5 % on the maximum retail price
Cigarettes <i>ad valorem</i>	54 % on the maximum retail price
Cigarettes (specific)	3 euro per 1,000 units
Cut tobacco for rolling	37.5 %
Other tobacco products	22.5 per cent

The *Impuesto sobre la cerveza* is paid by the manufacture and import of dutiable products. The basis of assessment is the volume of beer, and the tax is payable when the goods leave the brewery or authorised warehouse. The tax rate is calculated dividing the type of goods into classes of alcoholic strength and calculating tax per hectolitre. Other excise duties similar to this one concern wine (*Impuesto sobre el vino y bebidas fermentadas*), other spirits and alcoholic beverages. In the last case the rate is calculated according to the quantities of pure alcohol.

The excise duties on certain means of transport concern the first definitive registration or entry into Spain of new or used self-propelled vehicles powered by an engine, for use on the road or on public land, small vessels, boats for pleasure or water sports, mechanically powered aircraft and light aircraft. The tax is payable by the person or entity in whose name the means of transport is initially and definitively registered.

The tax rate depends on the capacity of the vehicle and if the vehicle is powered by petrol engine or diesel engine. Special tax rates, cheaper than in the rest of Spain, concern the Canary Islands, while there's no taxation in Ceuta and Melilla.

4. The fiscal burden

4.1 The distribution of taxation charge

The statistical sources (Eurostat, 2000), show that in 1997, more than 54 per cent of total fiscal revenue originated from labour, while slightly less than 18 per cent originated from capital factors. The residual quota of revenues is imputable to the consumption (Tab.7).

The structure of total revenues according to the economic function shows how, during the 1980s and 1990s, the fiscal burden rose in all sector, although it's observable a rising weight of the taxation of the consumption and the aim, in the 1990s, of decrease the burden on capital. This has been compensated by a increase in the pressure on labour. From tab. 7 it can observable, how, recently there has been also a deceleration of labour revenues growth, caused by aim of employment policy.

TAB. 7 *Structure of total revenues by economic function, as a percentage of GDP*

	1980	1985	1990	1995	1997*
Consumption	5.3	8.4	9.2	9.3	9.8
Labour	15.5	16.4	17.8	18.9	19.2
<i>Employed</i>	14.7	14.7	16.1	16.8	17.2
<i>Self-employed</i>	0.8	1.7	1.8	2.1	2.0
Capital	4.8	5.1	7.5	6.1	6.5
TOTAL	25.6	29.9	34.5	34.2	35.5

* estimated data

Source: Eurostat (2000)

The implicit tax rate on consumption (13.8 per cent) is very low, because of the low overall level of taxation. Taxes on consumption produce about 27 per cent of total tax revenue. The trend indicates a strong growth of this implicit rate during 1980s and then stabilisation above 13 per cent.

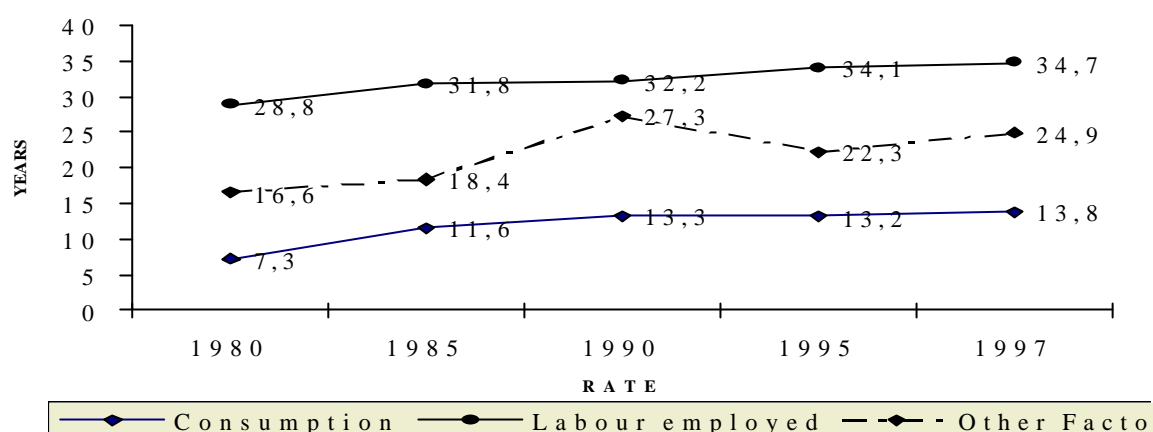
The implicit tax rate on labour is 34.7 per cent and it shows a constant increase. In the second half of the 1980s and in the early 1990s the implicit tax rate on other factors of production (i.e. self-employed labour and capital) increased significantly and then fell again by several percentage points. In 1997 it stands at 24.9 per cent. The main factor behind these evolutions may be found in the development of corporation tax revenues, which account for a third of taxes on capital.

TAB. 8 *Implicit tax rate in Spain and Europe from 1980 to 1997*

		<i>Consumption</i>	<i>Labour employed</i>	<i>Other Factor</i>
1980	<i>Spain</i>	7.3	28.8	16.6
	<i>EU-15</i>	16.0	35.1	36.6
1985	<i>Spain</i>	11.6	31.8	18.4
	<i>EU-15</i>	15.6	37.1	32.3
1990	<i>Spain</i>	13.3	32.2	27.3
	<i>EU-15</i>	16.2	37.5	31.5
1995	<i>Spain</i>	13.2	34.1	22.3
	<i>EU-15</i>	16.7	41.7	29.4
1997	<i>Spain</i>	13.8	34.7	24.9
	<i>EU-15</i>	16.8	41.9	31.1

Source: Eurostat (2000).

Graph 1. *Implicit tax rates in Spain from 1980 to 1997.*



The standard approach to measuring the impact of a tax on the distribution of income is to take the difference between pre-tax and post-tax Gini coefficients. The factors that influence the redistribution so measured, are summarised in a short index, proposed by Aronson, Johnson and Lambert (1994).

Using this approach, Wagstaff et al. (1999) calculated the redistributive effect of income tax for twelve Countries².

Spain has a strongly unequal pre-tax income distribution (Gini index pre-tax is 40.83 per cent). The post-tax Gini index is 39.64 per cent, so, the *RE*, that is the redistributive effort of taxation is 0.0329, thus the redistribution operated by income taxation reduces the Gini index of 3.29 per cent. This figures very high, but insufficient to converge to European inequality standard levels. The average tax rate is 13.97 per cent, while Kakwani's progressivity index assumes the value of 0.2545, underlining a high value of progressivity. However, this calculation dates back too many years. Many reforms have since taken place, like that concerning personal tax rates, which imply a lower progressivity, and can thus strongly modify these figures. However, the European statistics on redistribution indicate that Spain and the Mediterranean Countries have, over the last years, a high degree of inequality.

4.2 Tax wedges on labour and corporate taxation

² In the case of Spain, they used a sample of 21,233 families drawn from income tax files of the Institute for Fiscal Studies (IEF) for the year of 1990.

The tax wedge is an indicator to measure the distortion caused by taxation on the factors and production choices of economic agents.

Taxes on labour income account for almost to 60 per cent of general Government revenues. The tax wedge is currently estimated at about 43 per cent of total labour costs in industry in 2000 (Joumard, 2001). A decomposition of the wedge into the three main ‘voices’ of personal taxation explain how the highest percentage of the Spanish wedge is imputable to employer’s and employees’ social security contributions, that together accounted for three quarters of the tax wedge.

Although in the early ‘80s and ‘90s the Spanish tax wedge rose strongly, affected by an increase of total fiscal revenues in this period, over the last years the growth of the tax wedge has diminished. In the same period employment policies have contributed, to reduce the wedge on labour in the rest of Europe.

The regressivity of tax wedge on labour³ and the provision for a minimum social security contribution cause the high tax wedge rates that low paid workers must face. This is likely to adversely affect employment of the low skilled.

The marginal tax wedge on labour, which is an important indicator for work incentive⁴s, is significantly below the EU average, with a data for an average production worker of 44 per cent in 1998 (Joumard and Varoudakis, 2001).

The 1994 labour market reform largely redressed tax distortions related to unemployment benefits because most of them became taxed and severance payments, received in connection to employment security provisions, still enjoy a partial tax relief.⁵

While Spain has a relatively low tax wedge by European standards, some studies (Joumard and Varoudakis, 2001) indicate that its adverse impact on employment may have been exacerbated by some rigidities that reduced firms’ incentives to resist upward pressure on wages, and thereby facilitated forward shifting of taxation into labour cost.

³ This is due to minimum payments and contribution ceilings, which apply to both employees’ and employers’ social security contributions.

⁴ If the system contains some elements of family taxation (either because income taxes are levied on households rather than individuals or because there are familyrelated tax allowances or credits), high marginal tax wedges on labour may discourage a potential second earner from taking on a job.

⁵ The *Marginal effective tax rates* (METRs = 1 - net income in work - net income out work / change in gross income on household) extra income take into account the influence of both the social benefit and tax system. They indicate the share of extra earned income of the family that is “taxed away” because of withdrawal of unemployment benefits, cancellation of means tested social benefits or higher income taxes.

In 1997, METRs ranged from 78 per cent in case of a household with a single full time earner and a non-working member, not entitled to benefits based on previous earnings, to 19 per cent in case of household with an unemployed person and a person employed part-time, without benefit entitlements. In the case of a single eamer household where part-time work is taken up after a long period of unemployment, the METR is 159 per cent, with a high probability of these workers falling into the unemployment trap.

Statutory corporate tax in Spain is 35 per cent. In the period 1990-96, the effective corporate tax was 11 percentage points lower than the statutory rate. Major corporate tax incentives are economy wide and take the form of investment tax credits. Moreover a number of special sector based and geographic corporate tax regimes exist. In 1996 (see Tab.9) total tax expenditures amounted to 24 per cent of total gross corporate income tax liabilities (0.7 per cent of GDP), with half of them accounted for by the various tax incentives to investment.

TAB. 9 *Breakdown of gross corporate income tax liabilities (1996)*

The gross corporate tax liabilities	
Net corporate income tax liabilities	76 %
Tax allowance for double taxation of dividends	12 %
Tax Incentives to investment	11 %
Other corporate income tax exemptions	2 %
The structure of tax relief	
Carry over of tax exemptions	34 %
Transitory 1995 5% tax credit on investment	29 %
General tax incentives to investment	14 %
Canary Island special regime	7 %
Transitory 3-years tax relief for business start-ups in 1994 and 1997	6 %
Tax relief for exporters of educational and cultural goods	3 %
Other corporate tax incentives	3 %
Tax relief for employment creation	2 %
Cooperative societies	1 %
Tax credit applying in Ceuta and Melilla	1 %

Source: Spanish Ministry of Economy and Finance

The analysis of effective taxation on corporate profits (Giannini and Maggiulli, 2001) shows that the effective marginal tax rate (less than 25 per cent) is lower than the effective average tax rate calculated considering a real return equal to 20 per cent (about 30 per cent) and than the statutory rate. The gap between marginal and average effective rate is higher if consider a case of debt finance of investment. In this case the effective marginal tax rate is negative. This depends on the interaction between interest payments deducibility and tax allowancesfro depreciation in excess to economic depreciation.⁶

4.3 Taxation by levels of government and fiscal federalism

Over the last two decades, Spain has undertaken an important decentralisation process involving large areas of public sector management.

Until 1978⁷, the Spanish public administration was essentially characterised by centralism, with central Government assuming control of practically all public expenditure. The Constitution OF 1978 introduced a second level of Government (17 Autonomous Communities or Regions, two of them with special regime) and a third level (50 country councils or Local Governments) provided for a division of the competencies over the three levels.

International sources (Eurostat, 2000) explain that, in the early '80s revenues to central Government were a bit more than 82 per cent (86 per cent in the European Union). At the end of the '90s, the same indicators are something more than 71 per cent to Central Government and less than 29 per cent to Local Government. From 1980 the process of decentralisation of levels of expenditure has grown. This is due to an important process of devolution of function and expenditure to the 17 regional Governments, each with significant differences between them.

At one extreme are the Basque Country and Navarra regions. These two regions have their own personal and corporate income tax systems and collect most taxes. Most power of expenditure has been devolved, excluding social security transfers, which are implemented by Spain's unitary social security system. For other spending programmes, carried out exclusively at the State level, these two regions pay a share to the state, the *cupo*.

The revenue raising powers of the other regional Governments are more limited. In 1997, these so-called *common regime* regions were granted revenue-raising power on a share of the personal income tax and on the "cede taxes" (mainly on property). Taxes over which the common regime regions have revenue raising powers account, respectively, for about one fifth and one half of their total and unconditional resources. The remaining tax receipts are pooled at central Government level and redistributed across the regions in order to guarantee to each region the ability to provide a given standard of public services.

Through this redistribution of tax receipts, rich regions contribute to finance the poorest regions.

The implementation of the 1997-2001 financing system for the common regime regions implies that a large proportion of a region's financial resource depends directly upon that region's economic performance. Specifically, for the regions that accepted the agreement, the share of unconditional financial resources that depends on its own personal income tax doubled. However, Tab.10 shows that it varies significantly from one region to another.

⁶ For countries characterised by narrow tax bases and relatively high statutory rates the information provided by effective marginal tax rate are limited and might be highly confusing, if used as the unique measure to study the impact of taxation on investment and their location decision.

⁷ The date when the current Spanish Constitution was approved.

TAB. 10 *Unconditional resources in some regions under the common regime, percentage 1996.*

	<i>Cataluna</i>	<i>Andalucia</i>	<i>Galicia</i>	<i>Castilla - La Mancha</i>
State transfer	16	61	61	32
Ceded taxes and fees	32	16	15	25
PIT regional part	26	11	12	21
PIT participation in State revenues	26	11	12	21

Source: Bank of Spain, Agencia Tributaria

The participation to the State revenues from personal income tax (PIT), which correspond to the additional share (for most regions, 15 per cent) of PIT revenues collected in their jurisdiction, this percentage is 26 per cent of unconditional resources in Cataluna but only 11 per cent in Andalucia. On the other side the state transfers are 16 per cent of unconditional resources in Cataluna and 61 per cent in Andalucia and Galicia.

Moreover, Tab.11 shows the difference between regions under the common regime and the Basque Country and Navarra, with respect to the financing of their regional Government. The unconditional resources, i.e. the sum of the regional part of PIT, ceded taxes and fees and other transfers, in the common regions are 41 per cent of total financial resources, while in Autonomous Community this percentage is 58 per cent.

TAB. 11 *The financing of the regional Governments, percentages for 1996*

	<i>Regions under the common regime</i>	<i>Basque Country and Navarra</i>
Borrowing	16	12
Conditional transfer	43	30
Unconditional resources	41	58

Source: Bank of Spain, Agencia Tributaria

The implicit tax competition across regions allowed by the new financing system could also induce a further increase in the variability of the regions' resources. However, to prevent tax-induced migration flows across regions, measures were introduced to limit the taxing powers of regional Governments (imposing bands of tax rates) and a stricter definition of tax residence was implemented.

To protect the regions against temporary revenue shortfalls, a guarantee scheme was designed in 1996 and modified in 1998. Regional Governments no longer face any downside risk on their core financial resources: actually the state is committed to granting matching transfers to each individual region if the 30 per cent share of personal income tax revenues collected in its jurisdiction grows less than nominal GDP.

This guarantee scheme poses three big problems:

- it is asymmetric since the central Government has to pay in the event of bad outcomes while regional Governments do not fund an insurance system in the event of good outcomes. It may thus imply a significant cost for the state budget
- guarantees do not provide regional Governments with the right incentives to contain expenditures
- the guarantee scheme also constrains efforts to reduce the overall tax burden since the cost would have to be borne exclusively by central Government.

4.4 A comparative view with the European average

Now we compare the indicators of fiscal burden that we have seen for Spain with the same figures corresponding to the European average.

The most general indicators of the incidence of the fiscal burden are certainly the implicit rates (See tab. 8). During the 1980s, the Spanish trends of implicit tax rates on consumption converged to the European average, but now the Spanish figure (13.8 per cent in 1997) is still the lower than European figure (16.8 per cent). The gap between the Spanish and the European implicit rates on labour employed remained constant during the 1980s. Since 1995 this gap has increased and in 1997 the Spanish average was 7.2 per cent lower than the European average. The third kind of implicit tax rate, that is on other factors, is 6 per cent lower than the European average: in 1997 it was 24.9 per cent in Spain and 31 per cent at the EU level.

From the point of view of efficiency, taxes on labour create a tax wedge in France which in 2000 occupies the fourteenth place in OECD list (Joumard, 2001). The tax wedge is close to the OECD average, and thus well below the European average. During the 1990s, the tax wedge increased by two and half percentage points, nearly as much as on average in the European Union. Concerning marginal tax rates, Spain is significantly below the EU average, with a marginal tax wedge for an average production worker of 44 per cent in 1998 (Joumard and Varoudakis, 2000).

How observed in many OECD countries, the rising tax wedges on labour income may partly account for the increase in structural unemployment because a higher tax wedge raises labour costs and can lead to a reduced demand for labour.

Spain has a statutory corporate tax rate (35 per cent) very close to the EU average, though, as elsewhere in Europe, it displays a lower effective rate of corporate taxation as a result of a number of tax incentives.

The effective corporate tax (11 per cent lower than statutory rate) is close to the average tax relief provided in the European Union (Buijink, Janssen and Schols, 1999).

Due to relatively high marginal tax rates for higher-income taxpayers, the overall tax wedge on physical investment is rather high by international comparison. This is due to the taxation of dividends that is added to the overall tax wedge on investment and to the more favourable tax treatment of capital gains on assets held for at least two years (see section 3.2). For these reasons, the overall tax wedge on investment falls by a third. It stands close to the average for the OECD Countries.

Concerning the division of fiscal burden by economic function criteria, a comparison with the European average indicates that Spanish figures are a bit lower than EU concerning work and, consequently, higher concerning capital.

The redistributive effects of taxation indicate that together with Ireland, the UK and the US, Spain has the most unequal pre-tax income distribution. These four Countries also have the same ranking in post-tax income distribution. For Spain the redistributive effort of the taxation (*RE* is 0.0329), is lower than Ireland, Sweden and Finland. Kakwani's progressivity index assumes the value of 0.2545, underlining a higher value of progressivity compared with the majority of the other Countries examined, although the reduction of the brackets in the 1990s has lowered this value. Although Kakwani's progressivity index indicates a high progressivity, the re-ranking effect and horizontal inequality assume low values, insuring high levels of redistribution, but they are not sufficient to obtain a degree of post-tax inequality similar to the European average.

The degree of decentralisation in Spain is higher than the European average, being that 29 per cent of revenue is devolved to Local Government against about 18 per cent of the European average.

To sum up, in Spain the implicit tax rates and the tax wedge are lower than the European average. Moreover, like in other Countries, taxation is more favourable, according to the capital and the degree of decentralisation, which is higher than in other Countries, caused by partly ethnic tensions. However, this structure isn't sufficient to prevent two important characteristics of Spanish economic system. The first is inequality in the primary distribution of income: high rates of progressivity (although limited by reforms) appears not sufficient to reduce the post-tax inequality to EU standards. The second is the high structural unemployment rate: a taxation more favourable than in other countries isn't enough efficient in growing the employment rate.

5. Tax reforms in the '90s and those currently planned

5.1 A quick glance at the budget and general economic environment

The Spanish public finance situation, during the 1990s was not particularly negative. In 1996, when all European Countries started big financial adjustments of public finance to converge with EMU, the ratio of public debt / GDP was 68.1 per cent, against a European guideline of 60 per cent and a European average of 72.3 per cent. In the same year net borrowing was more worrying. Being 7.8 per cent of GDP, with a European average of 4.2 per cent and a catch up parameter of 3 per cent. But the moderate level of interest expenditure compared with other Countries, (5.2 per cent in the same year), added to a high rate of GDP (more than 4 per cent per year) and a low level of public expenditure, This allowed entry in the EMU with the first group of Countries and pursuit of public finance, reforms in order to respect the Stability and Growth Pact signed in Amsterdam.

In 2001, the Spanish economy grew by 2.8 per cent after four consecutive years at little more than 4 per cent. This slowdown was due to the more muted expansion of domestic demand and weakening exports, under pressure of an adverse international climate.

GDP growth in Spain stood at 1.3 percent higher than the Eurozone average, while its employment growth lead was around 1.5 points. This conduct marks a significant break with the pattern of the past, when the Spanish economy paid a higher downcycle toll in production and job losses because of lags in adjusting to external and supply shocks, the rigidity of markets and the use of policies to bolster income and demand, which ended up raising prices and undermining international competitiveness.

The progressive slowdown in Spanish and international economic growth was echoed in the yearlong performance of labour markets. Employment and unemployment figures both continued to improve but did so at an appreciably slower pace than in previous years. This loss of steam was not met by a similar moderation trend in labour cost indicators.

Labour Force Survey (LFS) estimates put the year-on-year increase in the employed population at 1.8 per cent in the last three quarters of 2001, while the year-on-year rise in *Social Security enrolments* was 3.4 per cent in January 2002, close to the outcome of the two preceding quarters. Conversely, unemployment indicators showed further deterioration. LFS estimates an unemployment rate at 13 per cent at the end of 2001.

On the side of public finance indicators, in 2000, the net borrowing of General Government in Spain (Banca d'Italia, 2001) reached the level of 0.4 per cent of the GDP. In 1995, this data was 6,6 per cent of GDP. The decrease was due to the effort to conform to the constraints of the Maastricht Treaty and the Stability and Growth Pact.

In the same period, huge primary surplus increased from a deficit of 1.4 per cent of GDP to a lending of 2.9 per cent, while the current account balance reached a lending of 3.4 per cent of GDP.

The low level of public debt (60.9 per cent of GDP in 2000) produced interest payments of 3.3 per cent.

5.2 Tax reforms in the '90s

Tax reforms during the 1990s aimed at raising potential output by improving labour market performance and raising capital formation. In 1991, the income tax reform included provisions to raise incentives for women to join the labour force by assessing taxes individually rather than as the family unit. The main objectives of the 1991 personal income tax reform can be summarised in three points (Joumard and Varoudakis, 2000):

1. the tax treatment of families became more neutral: married couples were given the option of filing separate returns, while the previous system aggregated incomes. The reform reduces disincentives to labour force participation of household partners;
2. the tax base was broadened including new sources of income;
3. long-term savings were given tax incentives. The taxation of undistributed profits of private investment funds was brought more into line with tax existing in other EU Countries.

Moreover, the structure of the brackets of income, that, since 1987 provided for 37 brackets with tax rates from 8 to 65.13 per cent, was simplified during the '90s through several new laws.

A small shift in the tax mix, away from labour income was carried out in 1995 to improve labour market performance by reducing labour cost; social security contributions were reduced by 1 percentage point, in tandem with an offset increase in VAT rates. In addition, targeted temporary reductions in social security contributions were implemented as part of the 1997 labour market reform, with the aim of improving employment prospects of workers at the margin of the labour market. Finally, in order to rebalance the tax mix from direct to indirect taxes and to better reflect the costs and benefits of Government-provided services, substantial increases in excise taxes and user fees were introduced in 1997.

The more recent far-reaching reform dates back to 1998. The importance of this law can be summarised in the following points:

1. marginal rates of income tax were lowered, from 56 to 48 per cent for the top income bracket and from 20 to 18 for the lowest. Moreover, the number of the brackets was reduced from 10 to 6, with the tax rates shown in Tab.3;
2. neutrality across various types of incomes has been improved. Labour and capital income have been put on a more equal footing. Capital income, except long-term capital gains, has

been integrated into the tax base. Most partial exemptions on capital gains and income have been removed;

3. the reform also made progress in harmonising tax rates and withholding rates on income from different financial assets held during the same period;
4. an exempted living standard minimum has replaced a vast range of tax relief. Before reform, personal income tax included a large amount of tax relief, which reduced its productivity, created horizontal inequities and provided broad scope for tax avoidance. In 1998, the reform introduced a tax-exempt living standard minimum which takes into account the characteristics of the tax unit;
5. compliance and collection costs have been lowered, thus freeing resources to fight tax evasion. Withholding payments were redesigned to take into account individuals' characteristics, and thus fit better with effective tax liabilities. In 1998, the threshold below which individuals are not required to fill a tax return was raised to 21,035 euro.

Reforms have also aimed to ease constraints on corporate financing and investment, to promote risk-taking, and to enhance firms' competitiveness. In 1995 the corporate income tax reform improved the neutrality of the tax system toward different financing instruments and investments, and reduced discrimination against foreign direct investments by Spanish firms.

In fact, the 1995 reform abandoned the distinction between types of income (operating income, net capital gains and net increases in assets), identifying the balance of the profit and loss account as the unique tax base. Concerning discrimination against foreign investments, the correction for international double taxation of dividends and capital gains was applied to corporation owning 5 per cent of the capital of foreign companies instead of the previous limit, 25 per cent, for at least two years (one year from June 1996). In addition, in June 1996, a set of tax measures was adopted to facilitate firms' access to capital markets. These measures included a change in the taxation of capital gains through personal income tax⁸ and the increase of the period during which firms can carry forward losses and offset them against future profits was raised (from 5 to 7 years). The maximum period was raised to 10 years by 1999 budget law.

Moreover, distortions on investment decisions were reduced: the reform of Corporate Income tax (1995) has allowed firms to value inventories adopting the LIFO method, as in many other OECD Countries, avoiding that the taxation of changes in values reflecting inflation developments. The same reform gave more freedom to small and medium sized enterprises in spreading capital depreciation expenses over time and also introduced tax incentives for investment. Finally, the 1997

⁸ Moreover, in 1997, the corporate income tax was cut from 35 to 30 per cent for small enterprises.

budget law introduced a lower tax rate that applies to them, from 35 to 30 per cent up to the first 90,152 euro of taxable income.

During the 1990s a decentralisation process took place, characterised since 1997 by an imbalance between tax assignments and expenditure functions. Until 1997, in fact, fiscal devolution to the regions was confined to the so-called *ceded taxes*, mainly on property⁹. Since 1997, regional Governments are able to modify the base and the rates of the ceded taxes, though with some limitation. Limited powers to set marginal personal income tax rates and tax credits have also been granted. In addition, the principles of financial solidarity across regions and of resource sufficiency for the provision of public services act as a limit to a rapid and more ambitious devolution of tax competition.

5.3 Planned tax reforms and the debate on fiscal system

The tax system has been designed to achieve a large number of objectives, which may conflict with each other. Reforming the tax system thus requires the decision of which objectives are most important and how far they should be pursued by the tax system or by other policies.

Actually, the main tax reforms options appear follow three fundamental guidelines (Joumard and Varoudakis, 2000; OECD, 2001):

- a) a further reducing of the tax burden on labour, with priority given to the low-paid, by shifting towards taxation of consumption;
- b) a promotion of tax neutrality across saving instruments and corporate tax regimes, and enhancing the effectiveness of tax incentives to investment ;
- c) an improvement of decentralisation tax, in order to effectively comply with the Stability and Growth Pact, with a reinforcement of incentives to match regional spending by locally raised tax revenues and provision of the right incentives for sound management of public finance at regional and central level;
- d) an improving of efficiency standards concerning tax collection and administration.

The reduction of the tax burden on labour, aimed at improving labour market outcomes would need to be carried out in tandem with labour market reforms. A priority in this field is the cutting of social security contributions at the low-end of the pay scale, improving employment prospects of low-skilled workers. These is measures could be implemented together with cash transfer to active workers whose earnings are below a certain threshold, in order to prevent increase of the *working-poor*. Reduction of tax burden on labour can be implemented (although Spain were already working

in this direction during 1990s reform) as well as reduction of the marginal tax rate of top-income earners, who are more disposed to income mobility toward countries where top income taxation is lower. High marginal tax rates, under such conditions, frustrates the efficiency of the system without any gain in terms of equity. Raising the employment rate by reducing the tax rate is also needed to enhance the sustainability of the social security system in view of ageing population prospects.

The reduction of the tax burden can be financed by a reduction in primary expenditure and a rise in consumption-based taxes, that are now lower than the European and OECD average. So, this is a solution that may harmonise the Spanish VAT system with European standards.

Macroeconomic simulations (Leibfritz, Thornton and Bibbee, 1997) broadly assess the relative pay-off, in terms of growth and employment, of changes in tax mix.

TAB. 13 *Long-run effects of tax changes: model-based estimates*

		GDP	Employment
<i>1 per cent of GDP reduction in (*)</i>			
Labour taxes	Spain	0.91	0.76
	EU	2.08	1.83
Corporate income taxes	Spain	2.02	0.39
	EU	3.09	1.06
Consumption-based taxes	Spain	0.66	0.54
	EU	1.46	1.28
<i>1 per cent of GDP shift from</i>			
Labour to consumption-based taxes	Spain	0.26	0.23
	EU	0.64	0.57
Labour to corporate income taxes	Spain	-1.12	0.38
	EU	-1.04	0.76
Corporate income to consumption-based taxes	Spain	1.35	-0.15
	EU	1.60	0.22
<i>Tax changes to match projected rise in social security cost resulting from ageing(**)</i>			
Increase in labour taxes	Spain	-2.84	-2.48
	EU	-6.89	-6.00
Increase in consumption-based taxes	Spain	-0.90	-0.73
	EU	-2.03	-1.72

(*): offset by a reduction in government transfer payments to household

(**): projected social security expenditures over the period up to 2030.

Source: European Commission, DG II and OECD Secretariat.

A reduction in labour taxes, financed by a cut in unemployment benefits, has a much stronger employment and output impact than cuts in labour taxes offset by an increase in other taxes

⁹ Tax revenues retained by the regions accounted for only 7 per cent of the central Government total tax revenues

(especially consumption taxes), while the big increase in GDP and in employment rate concerns a hypothetical reduction of the corporate tax.

The table also shows the financial consequence of the ageing of the population, from now to 2030, that must be addressed to avoid a big decrease of output and employment consequent to the rise of costs to finance bigger social security programs.

Moreover, to remove tax-induced distortions in the labour market and enhance incentives to workers on replacement income, severance payments should be included in taxable income, as in the case of unemployment benefits in 1994.

Further Improving neutrality of taxation on financial assets would increase the liquidity of the Spanish stock market and the efficiency of resource allocation. In this direction, maybe it's opportune to reduce preferential tax rates for some types of investments (i.e. pension funds) in order to reduce the distortion of taxation in investment choice.

Progress to remove the preferential tax treatment on long-term capital gains, by taxing all capital gains at the current flat rate, placing the taxation of dividends and retained earning on a more equal footing, would work in the same direction. At the same time, this would lessen the need to rely on overgenerous tax incentives for business start-ups.

Aiming to improve neutrality of corporate taxation and further enhance business investment would involve removing the reduction in corporate tax rate for smaller companies. Typically these reductions are intended to target market failure, or to contribute to social policy or equity objectives. Effective targeting is often undermined by arbitrage opportunities, which erode the tax base and cause distortions in the allocation of resources¹⁰. Non-tax measures that lower the overall cost of doing business in a certain region, such as infrastructure development, or the provision of training facilities are more transparent and may create more durable positive effects.

Moreover, it suggests further extension of the provision of inheritance tax, aiming to prevent the break-up of family businesses, to a wider range of descendants. Streamlining inheritance tax and associated exemptions would help to improve horizontal equity in the transmission of small business.

The 1997-2001 financing agreement is a step in the direction of progress towards balanced and efficient fiscal decentralisation and closing the gap between sub-national government' spending and revenue-raising powers, providing them with the ability to tailor taxes devolved to them to local specific conditions.

(excluding social security contributions) in 1995.

¹⁰ For example, special tax regimes designed to lower the taxes paid by certain companies alone can lead to a serious distortion of competition.

Additional reforms are necessary to improve the degree of decentralisation. Thus, in granting tax powers to the regions, it would be important to avoid a rise in collection and compliance costs and in tax avoidance. Further devolution of taxes that are also designed to achieve redistributive objectives is difficult since different rates could entail incentives for migration, and virtuous or vicious cycles. Additional resources for the regions could come from consumption taxes that have the advantage of generating less volatile revenues than income taxes.

A particular problem is the efficiency of the tax system in reducing administrative cost and preventing illegal tax abuse. The resources absorbed by tax administrators for the collection and filling of a tax reform are yet another element of the cost of taxation. Measures that could be envisaged to improve cost-effectiveness include the reduction of overlap between local and central Government tax administrations, with regard to collection and processing and the introduction or extension of information technology. In this field there are also all the problems concerning cross-border taxation of the operations, i.e. consumption tax regimes. In fact, in some circumstances, the basic principle of taxation in the place of consumption can prove either problematic or give rise some complexities¹¹. In the absence of frontier-based fiscal controls since the completion of the single market in 1993 The VAT regime for transactions within the European Union, necessitates specific rules for transaction between the Member States, in order to prevent complicated procedures that generate additional compliance costs to business.

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¹¹ Is the case of some elements of VAT regimes applicable within the European Union.

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