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Fiscal Reform in Spain

Accomplishments and Challenges

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STUDIES IN FISCAL FEDERALISM AND STATE-LOCAL FINANCE

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1. Introduction

Jorge Martinez-Vazquez and José Félix Sanz-Sanz

The Spanish tax system started an extensive period of reform from 1977 onward, two years after the death of General Francisco Franco. This reform process, ongoing for the last three decades, has put Spain's public finances on a sound footing and it represents the most identifiable key factor behind the "Spanish economic miracle." In 1975 total tax revenues as a percent of GDP in Spain stood at less than 20 percent. By comparison, the OECD average country was collecting in tax revenues 31 percent of GDP. By 2002 Spain had converged to the OECD average with total tax revenues representing over 25 percent of GDP. This improved fiscal performance allowed Spain to close significant deficits in capital infrastructure and social programs, without risking any significant macroeconomic imbalances. Even though the budget deficit was in the neighbourhood of 7 percent in the middle 1980s and again in the middle 1990s following international macroeconomic shocks, by 2002 Spain was operating with a balanced budget. This significant increase in tax effort was largely accompanied by a fairer distribution of tax burdens and the elimination of large tax distortions that had affected the efficient operation of the economic system. But not everything worked well. Despite the rapid process of reform, Spain's tax system has continuously played catch-up with that of its European neighbours and it may still be lagging in international competitiveness.

However, we believe that the largely successful tax reform in Spain contains valuable lessons for other countries, such as Argentina and Mexico, which in recent times have struggled with bouts of economic crisis. These crises can be largely traced to tax systems that have failed to either yield adequate revenues for the desired expenditure programs or do so in an efficient and equitable manner.

This volume is a collection of original essays that attempt to shed light on the fiscal reform process in Spain in the last thirty years. Although some of

the topics covered in this volume have been analysed elsewhere, most of the previous work has been written in Spanish and has been unevenly disseminated. In addition, this volume provides an overview of the whole reform process up to the most recent times and in all its dimensions: tax policy reform, the modernisation of tax administration, and a deep decentralisation process.

The volume focuses on four major themes. The first theme is the political economy of tax reform in Spain; a fundamental part of the success story is that political forces and economic interests were able to form alliances at some key junctures of the process to keep the reform moving forward. The second theme is an in-depth look at the main instruments of the tax system including the evolution of income taxation, the big role played initially by wealth taxes, and the introduction of a VAT upon Spain's accession to the European Common Market. The third theme focuses on the interaction between tax reform and another major institutional transformation of Spain's fiscal systems over the last 30 years: the rapid fiscal decentralisation process that led Spain from being one of the most centralised countries in the world to being one of the most decentralised. The fourth theme is the modernisation of the tax administration system in Spain. A more effective and efficient tax collection and enforcement system has been the critical ingredient for the overall success of fiscal reform in Spain. The volume closes with some reflections and lessons that one can extract from the experiences in Spain for successful fiscal reform in other countries. In the following paragraphs we describe in more detail the contributions of the different chapters in the volume.

Chapter two, written by Francisco Comín, analyses the political environment surrounding Spanish tax reform from the early seventies, during the last years of Franco's dictatorship, to the present, with the peaceful democratic succession of government coalitions from the right and the left. In the mid seventies, after Franco's death, Spain faced two fundamental challenges: the transition from a dictatorship to a democracy and the modernisation of the economic institutions. Addressing both issues required a high degree of social and political consensus. Despite the fact that almost 35 years had passed since the end of the Spanish civil war, Spain was still a deeply divided country in ideological terms where for many generations the deep wounds brought by the civil war had not healed. A significant part of this chapter is dedicated to analyzing how the necessary political consensus was generated. The chapter gives particular attention to the *Moncloa Pacts*, where very early in the transition to democracy the main parties form the entire political spectrum, from those aspiring to a continuation of Franco's legacy to the communist party and others on the left which had been illegal and persecuted for decades.

Remarkably, they sat together and came up with the key political principles that permitted the introduction of a democratic Constitution and the radical transformation of Spanish institutions, not the least of which was the transformation of its fiscal system. The rest of Comín's chapter takes us on a journey through the main political milestones up to recent times highlighting the symbiosis between political change and fiscal reform.

Chapter three, by Emilio Albi, focuses on the role played by one economic group which, surprisingly, is normally forgotten when analyzing the reform of the Spanish fiscal system: the business community. Albi, as a first-class witness due to his double role as academician and tax advisor, describes the major reform issues during the last thirty years from the viewpoint of entrepreneurs and investors. He highlights, as one of his main conclusions, the social benefits derived from the cooperation during practically the entire period between policy makers and business organisations. However, his chapter stresses some important problems still pending in the tax reform agenda, such as the complete elimination of double taxation of dividends and international regulations regarding corporate income.

Chapter four by José Manuel González-Páramo and Pablo Hernández de Cos, takes a comprehensive view of the fundamental role played by the European integration process in the evolution of the Spanish tax and budget policies. Their point of departure is the early 1960s when Spain formally applied to join the European Common Market until its definitive accession on January 1, 1986. González-Páramo and Hernández de Cos also examine the impact on Spain's fiscal policies of the European Union expanding agreements, including the creation of a Single European Market in 1993 and the reinforcement of the European convergence as a first step towards the creation of the Economic and Monetary Union (EMU), now in operation. There is little doubt that the developments taking place in Brussels at the European supranational level have had clear and strong influences on the economic and fiscal reforms undertaken in modern Spain over the last three decades. Their chapter concludes with an exploration of the important challenges that the participation of Spain in the EMU still poses for the future of its fiscal and budgetary policy.

The next six chapters pay close attention to the reform process of each of the main taxes in Spain's tax system. Chapter five, by Desiderio Romero Jordán and José Félix Sanz-Sanz, studies the important role played by the Personal Income Tax (PIT) in the modernisation of the Spanish tax system. This chapter describes the introduction of the modern PIT in 1978 (prior to that, under Franco, personal income taxation had been fragmented with a variety of scheduler approaches) and its major reforms implemented in 1991, 1998 and 2002. As is the case in other countries, the PIT is definitely

among the most relevant taxes in the Spanish tax system, both in terms of revenue power as well as in terms of the number of taxpayers it affects. In addition, as the PIT is self-assessed and filed regularly on an annual basis, it is clearly perceived by taxpayers. As a result, the design and structure of the PIT has remained one of the main concerns of policy-makers, both at a national and at a regional level. This visibility was confirmed when in 1989 Spain's Supreme Court ruled as unconstitutional the use of the "household" as the unit of taxation prompting quite a radical reform of this tax in 1991. Personal income taxation in Spain has followed—with some lags—international trends, from highly progressive and narrower bases in the earlier years to simpler and flatter rate structures and wider bases in more recent times.

In chapter six, Raquel Paredes Gómez analyses the role and evolution of the Corporate Income Tax (CIT). This tax, together with the personal income tax, burst onto the Spanish tax scene for the very first time in 1978 and rapidly became one of the most important taxes in the Spanish fiscal system. The continuous fine tuning of the CIT has been a process of making good on the tax principles behind the 1978 reform. These principles included: competitiveness, international tax coordination, neutrality and coordination with accounting rules and with the personal income tax. Paredes Gómez' analysis highlights the increasing importance played by open economies, globalisation and international competition in informing the most recent reforms of this tax.

Taxing personal wealth was a fashionable public policy in the decades of the sixties and seventies of the last century. As a result, the Spanish tax reform initiated in 1978 was strongly imbued with this principle. Chapter seven, by Laura de Pablos Escobar, aims at analyzing the role played by wealth taxation in Spain's tax system. Her analysis focuses in particular on three different tax instruments levied on personal wealth: the net wealth tax, and the taxes on inheritance and gifts. These taxes were advocated mainly on the grounds of improving vertical equity, and, also important for the case of the net wealth tax, on the grounds of enhanced administrative control and enforcement of other taxes, especially the PIT. Although the net wealth tax was indeed instrumental in getting a sharp increase in taxpayer compliance in the PIT, Laura de Pablos Escobar concludes that the Spanish experience on the redistribution side has been clearly unsuccessful. De Pablos Escobar strongly advocates for a more prominent role of wealth taxes in modern tax schemes but, extrapolating from the recent Spanish experience and international trends, she conveys a feeling of hopelessness about their future. The decline of their role and importance in Spain was signalled by the re-assignment of wealth taxes at the sub-national

government level, where although initially they represented key financing instruments, their use has also been in decline.

Chapter eight, by José Sánchez Maldonado and J. Salvador Gómez Sala, studies the reform and evolution of consumption taxes in Spain over recent decades. Their paper pays special attention to the introduction of the value added tax (VAT) adopted upon accession of Spain to the European Common Market in 1986. This represents one of the most important, if not the single most important, development in Spain's tax system over the last thirty years. The VAT substituted for a system of turnover taxes that had been highly distortionary and with low revenue yield and quickly became the workhorse of Spain's tax system. The accession of Spain to the European Community also demanded further harmonisation of the indirect taxes. Sánchez Maldonado and Salvador Gómez Sala further study the reform of excise taxes during the 1990s to bring the Spanish tax system into compliance with European legislation in this area. Their chapter carefully studies the comparative performance of indirect taxation in Spain in an international context.

Social security taxes and the system of social protection are analysed by Ignacio Zubiri in chapter nine. By practically all measures the system of social protection in Spain at the beginning of the democratic transition was quite defective. This "social deficit" was one that the central government moved quickly to close. The chapter carefully evaluates the rapid development of social protection in Spain in the last thirty years. During this period, the Spanish social protection system became one of the more advanced ones in the world. At present, the Spanish Pension system is, in terms of replacement rate, one of the most generous, health services are free for everyone, and unemployment benefits are substantial in comparison with other countries in the same economic area. The evolution of social expenditures and the way they have been financed is described in detail in this chapter. The achievement of a welfare state in Spain did not come without costs in terms of labour market rigidities and unemployment and it came late, at a time when Spain's European neighbours and international trends had already turned in the other direction emphasizing competitiveness and labour market flexibility.

The role of environmental taxes in Spain's tax system is analysed by Alberto Gago, Xavier Lavandeira, Fidel Picos and Miguel Rodríguez in chapter ten. These authors conclude that environmental taxes have not been used much in Spain, and this has been a clearly wrong policy. However, a certain interest in this type of taxation does now exist at the regional government level, although that interest so far has been focused more on the revenue capacity of these taxes than on the environmental impact they may have. The authors provide a careful analysis of the existing "green"

taxes in Spanish regions and their potential. For the near future, these authors forecast an increased use of environmental taxes in the areas of transport, tourism and solid waste.

Chapters 11 and 12 are dedicated to the study of fiscal federalism in Spain and the important role fiscal decentralisation has played all along in the reform of Spain's tax system. Decentralisation still remains one of the fundamental issues in current tax debate in Spain.

In chapter 11, Julio López Laborda and Carlos Monasterio Escudero provide a comprehensive overview of the fundamental issues arising from the process of territorial decentralisation that has been taking place in Spain since the restoration of democracy in 1978. This process resulted in the emergence of the so-called "Autonomous State". They describe in depth the asymmetric approach to fiscal decentralisation adopted in the 1978 Constitution with two radically different systems established to finance regional expenditure: the "common system" which applies to all Spanish regions but two, and the "special or 'foral' system", which applies exclusively to the Basque Country and to Navarre. This system of intergovernmental finance is of critical importance for understanding the essence of the Spanish Public Finance in the last thirty years and, probably, for those interested in what will happen in the next thirty as well. López Laborda and Monasterio Escudero focus their attention on the assignment mechanisms, for both revenues and expenditure competences, between central and regional governments. In this respect, they dedicate special attention to assess the use of the "effective (historical) cost" criterion employed throughout the intergovernmental finance system to evaluate vertical and horizontal imbalances. The chapter also analyses the current system of transfers and sub-national borrowing. Some initially fiscally irresponsible behaviour has been followed by strict limits and discipline partly imposed by European Union rules on allowed deficits and debt levels at the overall national level.

The system of local government public finance is analysed in chapter 12 by Francisco Pedraja-Chaparro, Javier Salinas-Jiménez, and Javier Suárez-Pandiello. The most important message in this chapter is the confirmation that local government decentralisation is clearly the "forgotten child" in the vigorous process of fiscal decentralisation initiated in the late seventies. The focus on decentralisation reform in expenditure assignments and tax revenue autonomy has been almost exclusively focused on the intermediate level of government, the regions or "Comunidades Autonomas," as they are known in Spain. A very telling figure provided by Pedraja, Suarez, and Salinas is that in 1978, prior to any decentralisation and as a result of the centralist Franco regime, Spanish local authorities managed around 13 percent of total public expenditure. Currently, this figure remains under 15

percent of total public expenditure. This is a clear indication that the intense fiscal decentralisation process that has been carried out in Spain during the last thirty years has been driven by political considerations, in large part trying to manage centrifugal political forces, and much less by economic efficiency considerations traditionally associated with decentralisation reform. The chapter provides a clear picture of where local communities stand in the recent Spanish public finance experience and proposes options and mechanisms to improve decentralisation at this local government level.

Jorge Onrubia in chapter 13 provides an in-depth look at the state and evolution of the Spanish Tax Administration from 1977 until the present. The regaining of democracy in Spain together with the need for considerably increased revenues for developing Spain's infrastructure and improving its welfare system not only led to the tax policy reforms initiated in 1977 but also acted as a trigger for a new way to understand the relationship between taxpayers and the tax administration. Not only did taxpayers see that government now was on their side but there was strong political consensus for criminalizing tax offences, a first in Spanish history, and early achieved out of the Moncloa Pacts. In addition, successive governments invested heavily in human and capital resources, especially in information technology, which led to the rapid and effective modernisation of the tax administration system. Added flexibility for employment and compensation policies was provided by making the Spanish tax administration a semi-autonomous agency. Some other events that influenced the development of a more modern tax administration were the fiscal decentralisation process and the adoption of modern taxes such as a global PIT and the VAT. However, not everything has gone according to plan. Onrubia concludes by reviewing the lights and also the shadows of the tax administration reform in Spain and provides recommendations for improving tax enforcement and taxpayer services in Spain. The last chapter of the book, by Jorge Martinez-Vazquez, takes a retrospective view of Spain's experience with successful fiscal reform in the context of overall budgetary and economic policy in the country. Martinez-Vazquez reflects on the changes in tax morale in the country, with citizens becoming more approving of their government policies. The chapter also reviews the process of convergence in the performance of the Spanish tax system to that in OECD countries and it draws lessons for fiscal reform in other countries.