The fiscal reform proposed by the Government is a lost opportunity in terms of making further progress in correcting the imbalances in the Spanish economy, especially the foreign deficit, and fails to produce gains in productivity and competitiveness. The income tax reform (IRPF) is prejudicial to many families with children on average incomes, and also to young people who are hoping to buy their first home. The reform of the business tax is unsatisfactory and even counterproductive for many companies, given that the elimination of certain allowances will lead to an increase in the effective tax rate.

1. Introduction
The main developed countries are reliving the debate on the reform of their tax systems, within the context of a head-on battle against the public deficit and criticism of high levels of overall fiscal pressure. The latest developments in Public Taxation have delimited the generally accepted objectives and requirements that enable us to map out an “overall fiscal model”. Any debate on the reform of personal income tax must encompass four general objectives:

1. An expansion and extension of taxable income, maintaining the principle of capacity to pay as the basis for sharing the tax burden, founded on a distributive and equitable approach. In Spain, this approach is even enshrined in the Constitution.

2. Enhancement of the system’s neutrality, reducing its interference in the allocation of productive resources and in strategic decision-making on the part of consumers and businessmen.
3. Greater simplicity regarding the tax structure and a more efficient tax administration.

4. A design accepted by the main political parties, one that can be adapted to the economic and fiscal objectives of the governing party.

“The tax reform proposed by the Government is insufficient in terms of resolving the problems of our economy, which is sustained by an unsustainable resource: indebtedness. A unique opportunity has, thus, been lost in order to promote an essential change in the Spanish pattern of economic growth”

These objectives are hardly new, but in recent years we have witnessed something of a rearrangement of tax policy objectives:

- Priority of efficiency regarding the allocation of resources (fiscal neutrality) and subordination of re-distribution, without the progressive taxation principle being eroded to extremes that are incomprehensible to the public (linearisation of income tax/IRPF).
- Operative simplification, helping the public to understand their tax obligations. Taxpayers must understand the nature of their tax obligations. In this respect, the following aspects must be ensured:
  - Taxpayers must be able to distinguish between what is taxable and what is not, which is linked to a correct definition of the main components that make up taxable income and a clear definition of tax thresholds. In this sense, the Government’s project constitutes a considerable step backwards.
  - The amount to be paid for each taxable item must be true and problems relating to patrimonial assessments and the taxation of returns and costs must be eliminated.
  - The inspiring principle behind the system as a whole must be comprehensible; it must be viewed as a “system” and not as a superimposed mass of unconnected concepts and measures.
  - Administration of the system must be easy, bearing in mind that the costs of applying any tax system do not only encompass those of tax agency management and administration, but also the costs incurred by taxpayers when fulfilling their obligations.

Any solvent proposal for a “tax model” must take into account these premises.

2. The Economic Context and the Model Proposed by the Government

In view of the tax reform process that has been initiated following the approval of the Government’s fiscal reform project by the Cabinet, which will mainly affect the concepts of personal income tax (IRPF) and the business tax, we must be clear on a number of points. Based on the premise that the current model must necessarily enjoy a sense of continuity within a process of gradual tax reform, as opposed to radical proposals of a “linear tax”, it appears that the Socialist Government intends to continue adjusting aspects of the tax structure that may improve the excellent macro-economic, distributive and tax revenue results achieved by the governments of the Partido Popular. Here we come across the first disappointment: reform of direct taxation has always been one of the instruments employed by the Government to boost the productivity and competitiveness of the Spanish economy. However, the
pattern of economic growth (strong domestic demand and strong demand within the building sector) reveals a fundamental difference with respect to the past: growth is maintained by an anomalous, unhealthy and unsustainable resource, indebtedness. The “leverage ratio of the Spanish economy” is unsustainable in the medium term. It is essential to bring about a change in the pattern of growth by encouraging saving and investment, in particular, as key elements for boosting the productivity and competitiveness of the Spanish economy and as elements that will provide a counterweight to the worryingly high foreign deficit.

Spain has the most unbalanced economy in the developed world in terms of its foreign deficit. The trade deficit of the United States comes to 6% of GDP whilst the Spanish deficit in the year 2006 is likely to be more than 10% of GDP. The current Spanish deficit comes to 7.6% of GDP. International bodies (very recently, the IMF) have urged Spain to introduce a fiscal policy based on a restriction of public spending, increased public saving (not accompanied by a reduction in private saving) and increasing levels of productivity brought about through the promotion of business investment.

“Spain has the most unbalanced economy in the developed world in terms of its foreign deficit. The trade deficit of the United States comes to 6% of GDP, whilst the Spanish deficit in the year 2006 is likely to be more than 10% of GDP. International bodies have urged Spain to reduce spending, increase public and private saving and improve productivity through business investment.”

However, in the Government’s proposal we are faced with a somewhat “tight-fisted” reform, one that is clearly insufficient in terms of resolving the country’s growth problems. An opportunity has been lost to encourage saving and investment in the long term by means of a more generous reduction in tax rates. Furthermore, the reform presents limited tax incentives for encouraging savings for the future, when almost all solvent institutions have warned of the need to make provision for the ageing population and the financial burdens that will derive from this trend. Finally, lower tax revenue levels, that the tax authorities estimate at around 2,000 million euros in terms of income tax (IRPF), cannot have any significant effect on fundamental strategic economic behaviour, given that this “tax saving” for taxpayers does not compensate for the reductions in progressivity witnessed over the last two years, in spite of the false image conveyed to the public regarding successive rate deflations in the yearly National Budgets. Inflation is the most unjust tax of all, since it hits the smallest incomes the hardest. In this respect, the reforms of 1998 and 2002 did more to correct the effects of inflation on income tax than the “false deflations” of the last two years and the reform that is now proposed.

3. Reform of Income Tax (IRPF): Measures and Alternatives

In addition to macro-economic considerations, we must incorporate other ideas into the debate. The following are some of the other objectives that the reform should pursue:

- **Encouraging Participation in the Labour Market**
  The tax system should promote the participation of a greater number of people in the labour market and reduce the “tax gap”, which is to say, the difference between the
The Government’s reform presents limited tax incentives for encouraging savings for the future, when almost all solvent institutions have warned of the need to make provision for the ageing population and the financial burdens that will derive from this trend. What is more, the new structure means that tax-payers who exceed the threshold will pay 24%, instead of the current 15% rate.

With regard to the tax rate, the changes are minimal: the maximum marginal rate is reduced by two points (43%), a “zero” rate band is introduced and a rate made up of four bands is added, featuring intermediate rates of 24%, 28% and 37%. This structure means that tax-payers who exceed the threshold will pay 24%, instead of the current 15% rate.

- Encouraging Saving and the Neutrality of the Tax System

Saving finances physical capital, complements the training of human capital and enhances the economic stability of social partners. At the present moment, fostering savings constitutes a key objective: Spain has the lowest rate of saving in its history, featuring a very high level of indebtedness on the part of families and a record-high foreign deficit figure, caused, in good part, by a lack of national savings. Any measure that may, either directly or indirectly, adversely affect savings, must be strictly avoided.

Another key aspect is fiscal neutrality with regard to the different forms of saving, thus enabling the market to ultimately determine the appeal of a particular form of saving based on financial profitability. The Government’s proposal to apply a treatment similar to that which is applied to capital gains, namely a fixed rate of 18%, to all financial assets, seems to be formulated along these lines. However, this means that those who receive capital income, whose current rate stands at 15%, will now be taxed at 18%. Furthermore, capital gains generated within a period of under one year, which tend to have a high speculative element, would now also be taxed at 18%, instead of at the marginal tax rate.

This change penalises small savers and benefits speculators. Increasing the tax rate from 15% to 18% also contradicts the tendency to reduce tax on savings and goes against the general trend at a world level of reducing taxation applied to capital income. In this respect, this measures sends “negative signals” abroad regarding the tax implications of saving.

The new regime also entails the disappearance of mechanisms designed to avoid the double taxation of dividends. This change will benefit the highest incomes (all tax-payers within the highest marginal tax band) and those whose marginal rate is

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over 37%. However, it will be clearly prejudicial in the case of dividends paid on small incomes. The first 1,000 euros are exempt, but then a more serious problem arises: tax discrimination depending on whether the income proceeds from shares in the company’s own funds or derives from financial assets.

Furthermore, problems relating to this modification of the capital income tax model and the recognition of the rights that are acquired, will create a delay in implementation, generating adjustment costs and strategic forms of behaviour on the part of savers over a long transitional period, especially those who currently enjoy an exemption from real estate capital gains due to the disappearance of the transitory capital gains regime for income tax (IRPF).

“The reform penalises small savers and benefits speculators. Furthermore, increasing the tax rate from 15% to 18% goes against the general trend at a world level and sends negative signals abroad regarding the tax implications of saving in Spain”

● **Tax Regime for Qualified Pension Plans and Funds**
We can formulate numerous criticisms of the tax model that is proposed for future saving, which is to say, long-term saving designed to complement personal income once the active employment period has concluded. The change of course marked by the Government’s proposal is radical. The maximum annual deductible contribution will be less than 8,000 euros a year (10,000 euros if the taxpayer is over fifty years of age) or it will be equivalent to 30% of employment earnings, which will increase to 50% in the case of tax-payers over the age of fifty, adding the contributions, where appropriate, that are made by the employer.

This represents a radical modification of a form of saving that is highly sensitive to tax variations and could entail the complete disappearance of any kind of tax appeal for qualified pension funds as we know them today.

The possibility of claiming pension benefits as a temporary income or financial income must also be taken into account. Although the transitory regime aims to respect acquired rights, over the next few years a number of spurious strategies for contributing to these funds will emerge depending on the transitory conditions and periods (up to 2011), going against the principle of fiscal neutrality pursued by the reform.

Furthermore, a long-term saving product is introduced, the “Individual Systematic Saving Plan”, which consists of contributing amounts to the Plan without any tax reductions, whilst Plan pay-outs in the form of periodic income will not entail any tax implications. This is simply an inversion of the current pension fund tax regime (there is no reduction on contributions but a tax exemption on pension pay-outs). Although this may be of interest to some tax-payers, in general, as a means of saving for retirement and from the perspective of taxation throughout the life cycle, it is of little real interest, given that it renounces the idea of reducing taxable income during productive periods in which our marginal rates tend to be highest, applying the exemption during non-active periods when our tax rates tend to be lowest.

● **Supporting the Family As a Source of Social Vertebra ion and Stability**
Family burdens modify the financial situation of individuals, in which respect the size of the family, the number of dependent relatives and descendents, their state of...
incapacity and their age must all continue to be adjustment factors with regard to the tax system, based on the principles of equity and efficiency.

First, it is essential to adjust the minimum exemption and reduction limits, in view of the fact that inflation has eroded real values.

Second, in view of the ageing trend that is affecting the Spanish population and the foreseeable financial difficulties that the pension system will encounter, it would be a good idea to include tax incentives for what are known as “dependence situations and/or insurances” as a complement to contributions to tax-deductible pension plans and funds. However, these two instruments should not be encompassed within the same boundaries, given that this would diminish the financial possibilities they offer and, therefore, their effectiveness as incentives for long-term saving.

“The mechanism designed by the Government is extremely prejudicial to families on medium incomes with heavy family burdens. Furthermore, the regulation of pension funds and dependency insurances diminishes these instruments’ financial possibilities and appeal, which is not particularly rational in view of the ageing Spanish population and the foreseeable financial difficulties of the pension system”

Furthermore, a mechanism has been developed based on which deductions for descendents and similar concepts are maintained as reductions in taxable income, but through a mechanism in which each individual can reduce the amount allocated to his family circumstances depending on “his average tax rate”. This solution breaks away from the fiscal philosophy that exists in many of Spain’s neighbouring countries, and which has been applied by Spain’s tax model in recent years, which seeks to tax the “disposable income” of tax-payers once all essential personal and family needs have been covered. The Government’s reform represents an “old-fashioned” type of populism, which can be resumed by the false notion that under the current system “the child of a rich man is worth more (receives a larger deduction) than that of a poor man”. In order to avoid this, an “imaginative” solution has been found that consists of benefiting all income bands the same, without ceasing to visualise that part of income that is not taxed due to the fact that it is devoted to personal and family needs.

However, this mechanism is extremely prejudicial to families on medium incomes with heavy family burdens (large families, families with disabled members), a problem that the reform has sought to redress by raising the exemption limits for the third (3,600 euros) and fourth child (4,000 euros), without achieving this goal entirely.

● **Promoting Access to Housing**

Difficulties in gaining access to housing require fiscal mechanisms that encourage the creation of an empty housing market and help to moderate prices, both in terms of ownership and rent. However, although the deduction for home purchases is maintained, the changes that are introduced penalise those who purchase their habitual home for the first time; the increased rates are eradicated for purchases financed by mortgage loans and similar means (25% over the first two years on the
first 4,507 euros investment and 20% over subsequent years on the same amount). Young people, in particular, are penalised who are attempting to buy a home for the first time with outside funding.

**4. Reform of the Business Tax: Measures and Alternatives.**

The changes proposed regarding the Business Tax are also insufficient. First of all, without forgetting the importance of maintaining an appropriate correspondence between the accounting result and the taxable base, we might highlight the fact that, under the heading of amortizations, circumstances frequently require extra-accounting adjustments to be made, which facilitates the incorporation of measures to encourage investment. A general increase in the maximum coefficients established in the depreciation tables, justified by a reduction in the technical obsolescence periods witnessed in climates of rapid technological change, along with a reduction in fiscal amortization periods (even free amortization for certain assets associated with innovation), which constitute a way of deferring taxes, should certainly be considered. However, these possibilities have been forgotten for the time being.

Furthermore, it is necessary to update the balances that enable us to match amortization funds and latent appreciation to new circumstances deriving from the inflation differential vis-à-vis the EU, changes in asset assessment criteria as a consequence of New Community Instruments (NCI) and as a result of the long period of time that has elapsed since the last update. Postponing these changes to a second reform stage would be an error, since the reforming priorities would then fall more within the realm of business taxation than personal taxation.

“The reform of the business tax does not take into account new business environments. The need for companies to adapt to constant technological changes means that a reduction of technical obsolescence periods within the design of the tax regime must be contemplated”

With regard to tax rates, we can observe a general reduction in the nominal business tax rate that is applied in Spain’s neighbouring countries. Over five years, the nominal average business tax rate has fallen from 33.6% to 29.2%, whilst in the EU-15 it has fallen from 35.1% to 30.3%, with the EU-25 average being 25.01%. Nevertheless, when it comes to assessing the effective fiscal burden on a company, effective tax rates provide the most important barometer. In Spain, these rates have been substantially lower than nominal rates due to the important incentives that have been introduced for certain activities and investments.

The general reduction in the business tax burden advises that the general rate be lowered, bringing it down to around the level of the current average effective business tax rate at an international level, which is to say, 25%. Given that taxation represents a cost to companies, this would match the tax regime that is applied at an international level and reduce the business cost differential that hinders Spain’s competitiveness. In this respect, we should be audacious in terms of the tax cuts that are applied and avoid excessively long periods for reducing nominal rates, such as the period that is established in the proposed reform, where a reduction in the general nominal rate is implemented over a period of five years, to the tune of one percentage point a year, bringing us to a rate of 30% by the end of the process (25%...
for small-sized companies), which will already be outdated by that time. The tax cut should be instantaneous, or almost instantaneous, especially if we have a budget surplus to help us introduce the measure, given that the positive effects on business margins will generate financial returns in the form of greater tax revenue.

As far as incentive deductions are concerned, although it is true that the general reduction in rates must involve a reconsideration of the entire deductions regime for the tax quota, it is important to resist going to the extreme of bringing about the entire elimination of deductions in order to promote a poorly conceived fiscal neutrality (neutrality does not mean uniformity). It is very important not to launch erroneous messages regarding the priorities of fiscal policy in relation to incentives. In this respect, we believe it is essential to maintain a series of deductions aimed at achieving the following objectives:

1. To provide an incentive for productive investments that will generate employment. We believe fiscal benefits should be maintained that consist of a reduction in tax paid on appreciation due to reinvestment in productive assets and activities, perhaps featuring certain adjustments that avoid reinvestment in activities that are more financial (investment companies) than productive.

2. To maintain and even extend the scope of application of deductions regarding costs and investments arising from R+D activities, especially innovation, which provides the foundation for productivity in the long term. A fiscal incentive instrument of general application is exchanged for a policy defined by the authorities by means of discretionary public spending measures under the heading of R+D and innovation: pure budgetary interventionism regarding the selection of R+D and innovation measures.

3. To increase deductions regarding costs arising from professional training, which is essential for improving our human capital. Especially serious is the probable disappearance of deductions regarding costs arising from professional training and deductions for the creation of employment for the disabled.

The remaining incentives should be reconsidered in the light of their cost-effectiveness, as well as their compliance with Community regulations regarding State subsidies. They should be phased out within the framework of a transitory period that permits a readjustment of investment decisions linked to changes in the tax incentive regime.

In conclusion, the proposal for reforming personal income tax (IRPF) and the business tax, as it currently stands and pending parliamentary approval, enables us to state that this is simply a minor reform, involving a series of mere adjustments to the current model, adjustments that are of little import. In many cases, these changes represent a step backwards in terms of bringing our system into line with the predominant models today, and they will have little effect when it comes to tackling the problems of the Spanish economy.