



## **ECONOMICS**

# **IN FAVOUR OF TRUE TAX REFORM: LOWER TAXES, HIGHER RATES OF SAVING AND GREATER COMPETITIVENESS**

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*The tax changes proposed by the Socialist Government simply constitute a series of patching-up measures that fail to reduce taxes and will not solve the problems of inflation, the foreign deficit and the loss of competitiveness of the Spanish economy. Furthermore, they penalise many families with children\*. The Partido Popular proposes far-reaching tax reform that really reduces taxes, including both personal income tax (IRPF) and the business tax, that encourages saving and economic activity, that truly helps families and that boosts the competitiveness of Spanish companies.*

Spanish society calls for a change in our tax system that will tackle the challenges that face us and lay the foundations for another decade of growth and prosperity. At the last Partido Popular (PP) Convention, a number of proposals were approved that cater for these demands. The result is a determined and wide-ranging initiative that affects all forms of taxation and undertakes a series of truly structural changes. The PP reform package proposes lower taxes for Spain as a means of enabling the Spanish economy to recover its competitive edge, encouraging and rewarding saving, boosting productive investment and personal effort and providing strong support to families. These three policy directions seek to transform the economic and social map in order to help resolve the problems that are hindering Spain's growth, as well as to enhance well-being.

This approach seeks to engineer a far-reaching transformation of our productive fabric and offer a true form of support to families, whilst also correcting the country's drifting economic performance based on its loss of competitiveness. This constitutes a courageous and determined reform, one that is clearly based on a Liberal model of society, a model that places the emphasis on the individual. It benefits all tax-payers, but especially those whose family burdens are the heaviest. It also seeks to reward saving and personal effort. Those who save will not pay the same as those who fail to do so.

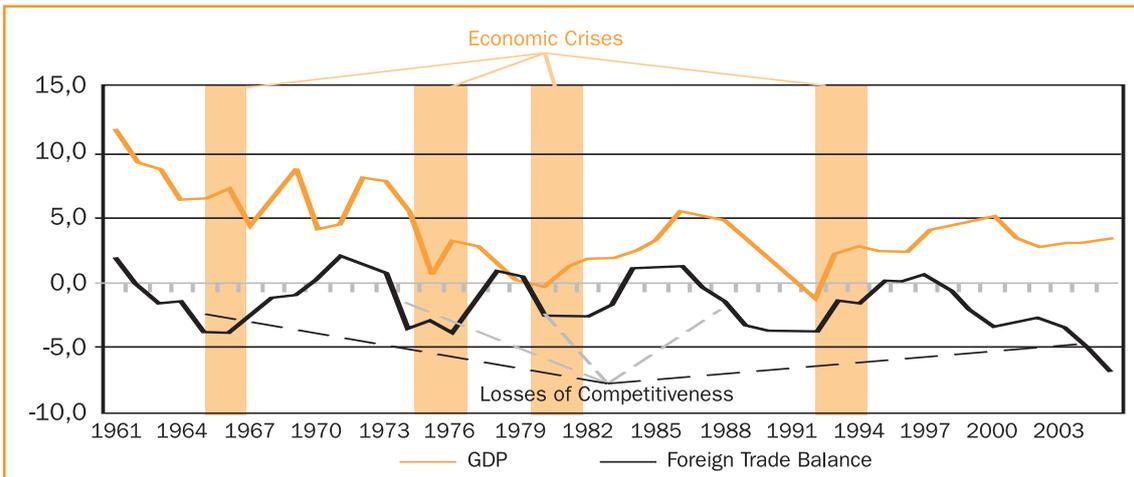
The Government's reform represents nothing more than a mere series of patching-up measures designed to cover current problems. It seeks to offer an approximate fulfilment of the PSOE electoral programme with a poor copy of the tax reforms undertaken by PP governments in recent years. In quantitative terms, the reform does not present any clear economic objectives. It has been proposed simply because the PP governments introduced tax reforms, but it lacks conviction and is not based on any kind of social or economic model. What is more, it will do nothing to boost competitiveness, it discriminates against medium incomes and, above all, it is prejudicial to households with the heaviest family burdens. Incomprehensibly, it constitutes a disincentive for saving, especially in its most popular forms: housing and pension plans.

\* See FAES papers number 28.

### Boosting Competitiveness

Spain is losing its competitive edge. And in the past, crises in terms of competitiveness have always announced the beginning of economic crisis. At the present time, Spain has the largest foreign deficit in its history, standing at 6.5% of GDP. This situation is not sustainable over time.

**GRAPH 1. LOSS OF COMPETITIVENESS HAS ALWAYS ANNOUNCED THE BEGINNING OF ECONOMIC CRISES IN THE PAST**



Since the spring of 2004, the foreign deficit has grown at a dizzying rate. It is essential to reverse this trend or we will be forced to take more extreme measures, something that nobody wants to see.

**GRAPH 2. THE FOREIGN DEFICIT HAS GROWN AT A DIZZYING RATE**



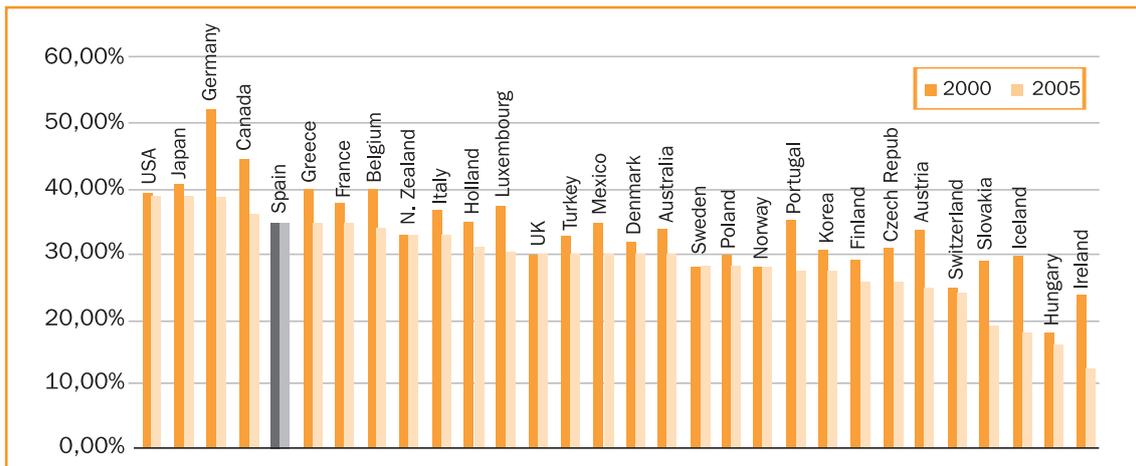
The measures proposed in our reform include the following:

**1. Personal Income Tax (IRPF).** We propose to lower the average and marginal rates imposed on tax-payers. This will help to reduce the “tax gap” (the difference between gross wages and net wages), which will favour collective bargaining, help to control inflation and provide a boost to company competitiveness, all of which will lead to greater and better employment. This decrease would encompass a *minimum* rate of 12% and a *maximum* rate of 40%.

The Partido Popular proposes to raise the deductions that can be made by working mothers, with a view to facilitating the necessary conciliation between family life and employment. Thus, the deduction to be made for the first child will increase to 1,500 euros a year (125 euros a month), the amount for mothers with a second child will be 1,800 euros a year (150 euros a month), and the deduction for mothers who have a third child and any subsequent children will be double the amount currently established, coming to 2,400 euros a year (200 euros a month). This doubling of the current deduction will also apply in cases of multiple births or mothers who have disabled children.

**2. The Business Tax.** We propose to reduce the *general rate* to 25% and the rate for small and medium-sized enterprises (SME's) to 20%, bringing them into line with current rates throughout the world. In general, Spain's neighbouring countries have lowered their general tax rates in recent years. Thus, between the years 2000 and 2005, the average rate throughout the OECD decreased from 33.6% to 29.2%, and the rate throughout the EU-15 fell from 35.1% to 30.1%, with the average throughout the EU-25 being just 25.01%.

**GRAPH 3. SPAIN'S BUSINESS TAX IS CURRENTLY THE FIFTH HIGHEST IN THE OECD**



The Partido Popular's reform also aims to improve the tax situation for productive investment through a new amortisation table and through free amortisation over a period of two years for certain assets that have a special impact on the modernisation of productive processes. The current deductions system would be improved, especially in the case of professional training and R+D and innovation and *the definition of an SME would be extended* to include all companies that have a turnover of less than 12 million euros, instead of the current limit of 8 million euros. The tax base for the lowest tax rate would be raised to 200,000 euros.

In terms of indirect taxation, Spain's Regional Governments must be given the regulatory capacity to reduce the current rate of tax on business operations. This would provide an incentive for companies to be set up operations in Spain and for business "holdings" to be established in Spain.

The use of taxation for environmental purposes is becoming increasingly important within a world in which it is becoming urgently necessary to protect air

and water standards, control CO<sub>2</sub> emissions and encourage the correct management of natural resources.

Any policy for supporting the environment in terms of taxation must take into account three aspects:

- No new forms of taxation should be created, since this will distort productive processes.
- European commitments deriving from the Directive on the Taxation of Energy and the Directive on Greenhouse Gas Emission Allowances must be complied with.
- It is not appropriate to modify the taxation of energy products when the economy is adapting to brusque changes in relative prices.

The Partido Popular's proposal contrasts with that of the Government. Thus:

- In the Socialist proposal, under the heading of personal income tax (IRPF), many tax-payers, especially those who have the heaviest family burdens, will find that their marginal rates have increased. This lessens any incentive to work harder and invest more. Instead of boosting economic activity, this measure contracts it.
- The Socialist reform proposal for the business tax increases the rate, instead of lowering it. It reduces the nominal rate by five points, but eliminates any allowances, thus effectively cancelling out the effect of any tax rate decrease. The effective amount of tax paid by companies will be the same or even higher.

**“The Socialist proposal represents a disincentive for saving and fails to boost competitiveness, whilst being prejudicial to tax-payers with the heaviest family burdens. The PP, however, has designed a proposal for a modern and dynamic Spain, promoting the conciliation of family life and employment, protecting the environment and ushering in a new period of growth”**

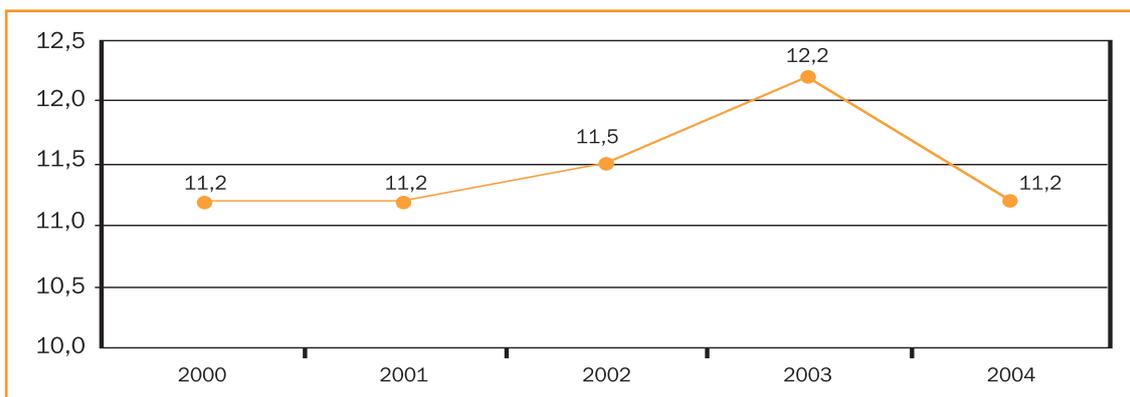
The Socialist reform will obviously have no effect on competitiveness or employment. What is more, the elimination of allowances will affect large companies the most, which will exacerbate delocalisation processes.

### **Fostering a Saving Culture**

Spain needs to save. The level of indebtedness of Spanish families and companies has increased considerably. Spain's entry into the Monetary Union, accompanied by world conditions of liquidity, increase the availability of credit to all Spaniards. This has facilitated investment, improved the country's economy and made it easy for members of society to gain access to loans for consumption purposes or to buy a home. However, in recent years, this liquidity has heated up the economy, producing inflationary tensions, forcing house prices up and increasing the country's foreign deficit. With interest rates being lower than the rate of inflation, there is little incentive to save: Who is going to save when what they receive as a reward for saving is less than the amount they lose as a result of inflation?

However, the country cannot finance growth without saving. If we do not save for the future, we will not be able to face the problem of paying pensions to future generations, due to the general ageing of the Spanish population. The rate of saving among Spanish households stands at its lowest level for 25 years. Families have gone from being the suppliers of savings to companies and Public Administration to being the recipients of savings.

**GRAPH 4. THE RATE OF SAVING IS NOT INCREASING**



In the year 2004, Spanish families indebted themselves in net terms to the tune of 6,000 million euros in order to finance their purchases. Companies are also becoming increasingly indebted. In order to finance business and finance households we must turn to the foreign debt.

**“Spain needs to save urgently. The PP proposes the creation of deductions for saving in the medium and the long term for income that arises from work. The idea is that those who save the most will also save the most in taxes”**

In order to encourage saving, the aim is to create a *deduction* similar to the deduction that can be made when saving for a first home, applying this formula to other forms of medium- and long-term saving, provided that this income derives from work. The rate would be 15%, and the *maximum deduction limit would be 9,015 euros*. When implementing this measure, the amount invested would have to correspond to long-term saving (at least five years) and the income must derive solely from current working activities. The idea would be to reduce average and marginal rates on job income which is set aside for long-term saving purposes. Thus, a tax-payer who presents the same income and conditions as another, but saves more, will pay less in taxes. At the same time, any differences in the fiscal treatment applied to this and to other forms of saving, such as home mortgages or pension plans, would be almost entirely removed. Furthermore, a *minimum exemption limit of 600 euros* would be established for profits from saving.

The Partido Popular proposal contrasts once again with the Government’s proposal, given that the latter:

- Worsens the tax regime for pension plans, especially when they are paid up in the form of a single lump sum, which reduces the appeal of this kind of saving.
- Worsens the tax regime for dividends, especially with regard to the lowest income levels.
- Raises the tax rate for capital gains from 15% to 18%, which represents a disincentive for saving.

### **Correcting Imbalances**

All of the tax measures proposed by the Partido Popular are designed to form part of an overall policy that will correct the imbalances within the economy and provide

a new boost for growth and employment. The most immediate measures need to provide incentives for saving and boost the competitive capacity of Spanish companies. Thus, reductions in the business tax will increase investment, as will the reduction in the tax gap resulting from the PP's income tax (IRPF) reform.

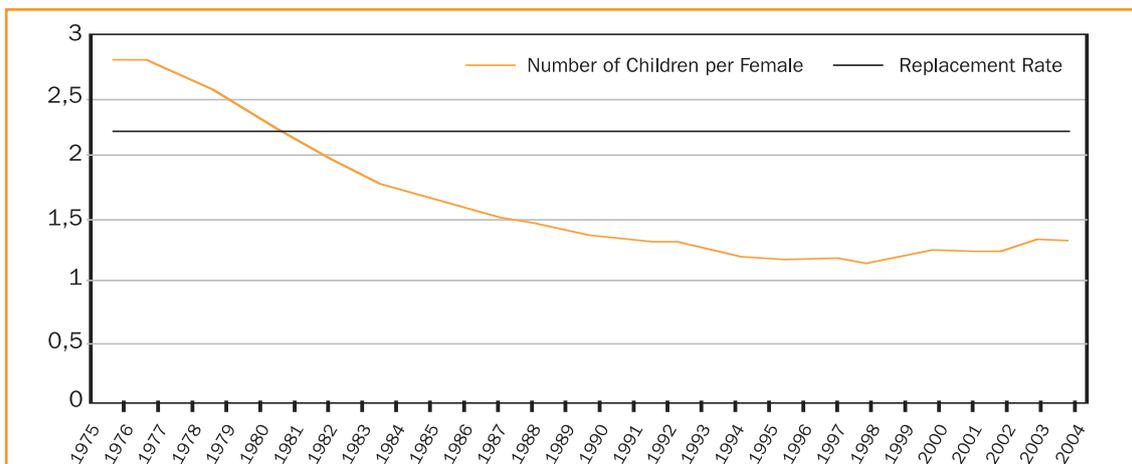
Rising investment will lead to an increase in productivity, which will enhance competitiveness and reduce inflation, which will ultimately lead to an improvement in the foreign deficit figures. At the same time, increasing levels of saving will help to moderate demand and inflation, correcting any excessive rises in price or the public deficit.

In short, implementation of this reform, in accordance with an appropriate calendar, will reduce inflation, correct the foreign deficit and provide a boost to growth and employment.

### Supporting the Family

Spain has the lowest birth-rate in Europe. The problem of ageing will hit Spain somewhat later than other European countries, but it will have a greater impact.

**GRAPH 5. OUR POPULATION IS NOT SUSTAINABLE BASED ON THE CURRENT BIRTH RATE**



The tax system must help families. In this respect, the PP policy proposes the following:

**1. Raising personal and family minimum limits** in order to support families: Reductions for children will double, with the amount corresponding to the first child increasing from 1,400 euros to 2,800 euros, the amount being paid to mothers with two children rising from 1,500 euros to 3,000 euros, and the amount being paid to mothers with three and successive children increasing from 2,200 euros to 4,400 euros. Reductions for caring for children under the age of three will also increase, from 1,200 euros to 2,400 euros. Reductions for the elderly will increase substantially, rising from 800 euros to 1,000 euros for tax-payers over sixty-five years of age, and from 1,000 euros to 2,000 euros for those over 75 years of age. Reductions for disabilities and dependency will rise to 2,000 euros, being applied in cases of both disability and to help defray assistance costs.

**2. Furthermore,** the business tax will establish a free amortisation regime for costs incurred by the creation of crèches at companies.

**3. Access to housing** is another aspect that has a strong influence on family life. In order to help families in this respect, the PP proposes to:

–Raise the deduction rates for young people under the age of 35 years, enabling them to deduct up to 30% of the amounts they invest in the purchase of a first home.

–Increase the duration period of the Home Savings Account Scheme (“Cuenta Vivienda”). The current period of 4 years is sometimes insufficient when it comes to building up the savings required to cover initial home purchase costs (deposit, processing costs, etc). In this respect, we propose to establish a new period of 10 years.

–To exclude insurance saving schemes that command an interest rate from calculations of the deduction limit, as an additional tax benefit.

**“The general effects of the reform proposed by the PP will boost annual investment by between 3% and 5%, and productivity by between 1.5% and 2% a year. The tax base will increase by some 2,975 million euros a year, and both employment and family welfare will increase”**

Furthermore, it is necessary to introduce a reform of the current Transfer Tax, providing the Spanish regions with a greater regulatory capacity, accompanied by a reduction in VAT on sites set aside for subsidised housing projects.

The Partido Popular policy also contrasts, under this heading, with the Government’s proposal, given that the latter:

- Modifies the current system of minimum income in favour of a deductions system, which is prejudicial to families on medium incomes with family burdens. Individuals earning between 18,000 and 60,000 euros a year will be hit the hardest by this reform, as will families with the largest number of children or single-parent families.

- Deductions for those trying to buy their first home will be reduced, these being precisely the ones who are forced to purchase at the highest prices.

### **Economic Effects of the Reform**

The income tax (IRPF) reduction proposed by the PP would entail a tax decrease equivalent to 3,500 million euros (10.83%). Some 129,000 jobs would be created, based on 100 million working hours a year, with economic activity also increasing by three tenths of GDP. The well-being of each household will increase by 676 euros, with progressive taxation increasing by 11.5% and tax elasticity by 7.5% throughout the cycle. Furthermore, the wage paid to working mothers would increase by 176 million euros.

With regard to the business tax, revenue would be reduced by 9,500 million euros. The induced effects of this measure would come to 19.9% of the tax. Annual investment would increase by between 3% and 5%, whilst productivity would increase by between 1.5% and 2% a year. The tax base would increase by some 2,975 million euros a year.

As a whole, this tax reform would entail a fixed-base cost similar to that of the reforms undertaken during the legislatures of 1996-2004: 1.4% of GDP

The PP's reform package once again contrasts with that of the Government in this respect:

- The Socialist income tax (IRPF) reform only reduces the tax by 2,000 million euros. The economic impact has not been calculated, although it would be very small in view of the very few economic incentives the measure provides.
- The business tax reform, as proposed by the Government in its current form, would maintain or even raise the tax burden on companies. Rate reductions would entail a saving of 4,000 million euros, which would be cancelled out by the figure of at least 4,000 million euros in lost allowances.

**“Our families are our greatest social asset. A tax system that fails to support families is not an appropriate tax system for Spaniards”**

### Conclusions

The current economic, social and demographic situation in Spain calls for change. Timid and superficial measures will not bring about any change in the current state of affairs. Current problems have worsened over the last two years and now it is important to act swiftly and firmly.

Spain must recover its image as a modern country that is prospering within Europe. Spaniards need a culture of competitiveness, a culture that allows us to spot new opportunities, instead of merely dwelling on the threats we face. We need a culture that will help us to face the future with optimism, an image that we must also project beyond our borders.

Spain must lead Europe in the sense that it provides a favourable environment for business activity. Business guides throughout the world must define Spain as an active and innovative country, one that nurtures an excellent business environment, one in which it is easy to do business. Companies must be able to carry out their activities wherever the conditions suit them best, but Spain must provide an attractive option. And, of course, neither taxes nor any other form of public intervention must be the cause of companies not wishing to set up business in Spain or of delocating to another country.

Our families are our greatest social asset. They constitute the form of social organisation in which Spaniards feel most at ease, representing our most highly valued institution. A tax system that fails to support families is not an appropriate tax system for Spaniards. Our families, our children and our relatives are all important. The tax system must favour those who have the heaviest family burdens.

In short, Spain needs reform along the lines proposed by the Partido Popular: lower taxes, higher rates of saving and greater competitiveness.