Options for Reforming the Spanish Tax System

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OPTIONS FOR REFORMING THE SPANISH TAX SYSTEM

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by
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ABSTRACT/RÉSUMÉ

The recent tax reforms have improved incentives to work and removed barriers to the internationalisation of Spanish firms, and have helped to make the tax system simpler and more neutral, especially as regards saving. However, the structure of tax wedges, combined with significant labour market rigidities, continues to inhibit job creation, and particularly job creation for the unskilled. Furthermore, certain tax privileges, in particular incentives favouring owner-occupied housing, and the multiplicity of tax rates and systems applying to business profits, hamper economic efficiency and/or weaken income redistribution. Also, while the territorial authorities' taxing powers have been increased considerably since 1997, they remain modest by comparison with their prerogatives as regards spending. The absence of adequate mechanism for controlling expenditure at the territorial level, plus the tax revenue guarantees extended to the regions by central government, could jeopardize further progress on fiscal consolidation. This working paper recommends certain reforms aimed at correcting these shortcomings.

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Les réformes fiscales récentes ont renforcé les incitations à travailler, levé les barrières à l'internationalisation des entreprises espagnoles, et ont contribué à la simplification et une plus grande neutralité du système fiscal, en particulier vis-à-vis de l'épargne. Cependant, la répartition de la charge fiscale, associée à d'importantes rigidités sur le marché du travail, pénalise encore la création d'emploi, et en particulier l'emploi peu qualifié. De plus, certains privilèges fiscaux, en particulier les incitations à l'acquisition d'un logement ou la multiplicité des taux et régimes d'imposition des bénéfices industriels et commerciaux, ont des effets critiquables sur l'efficience économique et/ou la distribution des revenus. Par ailleurs, les pouvoirs des autorités territoriales en matière d'impôt, s'ils ont été considérablement augmentés depuis 1997, restent faibles au regard de leurs prérogatives en matière de dépenses. De fait, l'absence de mécanisme approprié de contrôle des dépenses au niveau territorial, ainsi que les garanties de recettes fiscales accordées aux régions par l'état central, pourraient nuire à la poursuite de l'assainissement des finances publiques. Ce document de travail préconise des voies de réformes pour pallier ces déficiences.

TABLE OF CONTENTS

Boxes

Tables

Text
1. Changes in general government expenditures and revenues
2. Marginal effective tax rates on additional income for one- and two-earner households
3. Tax rates on financial saving
4. Marginal effective tax wedges on physical investment, R&D and human capital
5. Cut in the burden: estimated impact of the 1998 personal income tax reform
6. Volatility of tax bases and revenues at national and regional levels
7. Share of taxes in energy prices
8. Long-run effects of tax changes: model-based estimates

Figures

Text
1. The tax burden
2. Tax receipts and expenditures by regional and local governments
3. Tax wedge on labour
4. The total marginal tax wedge
5. Owner-occupied housing in selected OECD countries
6. Composition of households' financial portfolio
7. Effective corporate taxation in the European Union
8. Breakdown of gross corporate income tax liabilities
9. Combined corporate and personal income tax wedge on distributed profits
10. International comparisons of average personal income tax rates and total tax wedges
11. Progressivity of the personal income tax
12. Debt of regional administrations
13. The financing of the regional governments

OPTIONS FOR REFORMING THE SPANISH TAX SYSTEM

Isabelle Joumard and Aristomène Varoudakis[1]

1.   Until the mid-1970s government spending in Spain was fairly low by international comparison, keeping tax pressure considerably below the OECD average. However, after the 1975 shift to democracy and up until the late 1980s, taxation rose sharply to finance escalating government expenditure. Tax reforms implemented until the beginning of the 1990s aimed mainly at endowing Spain with a modern tax system, and to raise funds to meet increasing demand for public services. Major steps in this process were the 1978 personal and corporate income tax reforms, the introduction of VAT after the accession to the European Union in 1986, and the 1991 reform of the personal income tax. At the same time, the tax system was subject to a number of pressures: coping with a political commitment to decentralise spending functions and taxation; pursuing distributional objectives; and providing aid to activities and constituencies in distress. Second-generation tax reforms, comprising the 1995 corporate and the 1998 personal income tax reforms, aimed at tax simplification, promoting tax neutrality and enhancing incentives for work, saving, risk-taking and investment.

2.   Recent changes in the tax system have achieved progress in streamlining taxation, reducing compliance costs and redressing previous distortions resulting from tax progressivity and lack of neutrality. Despite improvements, the tax system still contains imbalances, reflected in a relative strong tax pressure on labour income, lack of neutrality in the taxation of savings, preferential corporate tax regimes of questionable efficiency, and weaknesses in tax decentralisation. The first section of the chapter reviews the economic and social context in which tax policy has been designed and will need to evolve in the future. The second section discusses the interactions of the tax system with main markets and institutions and then provides an assessment of its effectiveness in promoting growth, equity and cost-efficient tax collection. The third section weighs the resulting trade-offs in tax policy design and draws out the main options for further tax reform.

Forces shaping tax policy

Spending pressures were subdued in the 1990s, but will rise again

3.   Between 1975 and the early 1990s total government expenditure — driven by spending on welfare programmes and on public investment — rose by more than one percentage point of GDP annually (Table 1), reaching 45 per cent of GDP in 1992. The rise in government outlays was initially matched by a significant increase in social security contributions and in personal income tax revenue. Subsequently,

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increasing public spending was covered by a rise in consumption taxes, with a considerable tax hike due to the introduction of VAT. Owing to the rapid rise in spending, Spain had, in 1990, a tax ratio only somewhat below the European average, starting from a level almost twice as low in 1975, and considerably higher than in non-European OECD countries (Figure 1). Over the 1990s, policy aimed at fiscal consolidation to fulfil the Maastricht treaty criteria. This was achieved largely by reining in government expenditure — especially on investment — rather than by raising the tax burden. Hence, in contrast to many other OECD countries, Spain's tax ratio stabilised.

4.   However, the tax system could come under strain again in the future. As in most other OECD countries, population ageing could threaten the sustainability of the social security system. Thanks to a still young age structure of the population — owing to the comparatively later arrival of the "baby boom" generation in Spain — sustainability of the social security system is ensured in the short run. Starting from around 2005, however, the liabilities of the system are projected to increase steadily, up to the middle of the century.[2] The pressures will become much stronger from 2025 onwards, when the "baby boom" generation retires. Holding the current contribution rates constant, the system is projected to generate a rising deficit, reaching 6 per cent of GDP in 2030 and a peak of nearly 9 per cent of GDP around 2050. Adjusting the parameters of the pension system as early as possible would help to smooth the fiscal cost of population ageing. As a complement to pension reform, the existing form of tax sheltering of saving for retirement could be preserved while tax incentives for other forms of saving instruments should be reconsidered. Some pressure on the tax system could also stem from the need to step up public investment to further upgrade infrastructure closer to the European Union standards — though increased private-sector participation could ease the budgetary impact.[3]

Tax reforms have aimed at boosting growth

5.   Tax reforms during the 1990s have aimed at raising potential output by improving labour market performance and raising capital formation. The Spanish tax mix has a different balance compared with other European Union countries, with a relatively strong reliance on labour taxes, largely to finance social security expenditures,[4] and a relatively low share of consumption-based taxes. The comparatively large total share of personal income and labour taxes, as well as the bias towards employers' social security contributions, will need to be addressed in designing tax policy, given that unemployment is still pervasive. Several tax measures have been already implemented in the 1990s. The 1991 income tax reform included provisions to raise incentives for women to join the labour force by assessing taxes individually rather than at the family unit. To improve labour market performance by reducing labour costs, a small shift in the tax mix away from labour income was carried out in 1995. Social security contributions were reduced by 1 percentage point, in tandem with an offsetting increase in VAT rates. In addition, targeted temporary

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2.   The future trends of the social security system are examined in OECD (1996).

3.   As proxy indicators of infrastructure endowment in Spain, paved roads and railroad tracks per square km amounted to 0.48 and 0.04 kms respectively at the beginning of the 1990s. The corresponding indicators for France, Germany and Italy were: for paved roads, 1.35, 1.42, 1.03, and for railroad tracks, 0.06, 0.12, 0.09. Calculations are based on World Bank (1994).

4.   In 1995, social security expenditure (excluding unemployment benefits) were funded up to two-thirds by employers' and employees' social security contributions and for the rest by government transfers (that is, by general taxation). As it is unlikely that wage earners perceive social security payments as part of their income (which could be the case if contributions were set on an actuarially fair insurance basis), the wedge is likely to be adverse for employment. This could be so either in terms of reduced labour supply if net wages are reduced, or in terms of labour demand if they are not. This is likely to be the case in pay-as-you-go systems where increases in contributions are often not linked to a marginal improvement in expected benefits.

Table 1. **Changes in general government expenditure and revenues[1]**

As a per cent of GDP

	1975 level	1975-80	1980-85	1985-92	1992-98
Total expenditure	**22.8**	**6.8**	**6.3**	**7.2**	**-2.8**
Consumption	11.3	2.9	1.5	2.6	-1.0
Transfers	8.0	3.9	1.3	1.8	-0.9
Subsidies	0.7	0.4	0.3	-0.2	0.2
Interest	0.3	0.2	1.8	2.0	0.1
Investment	2.6	-0.5	1.4	1.0	-1.2
Total revenues	**22.8**	**5.3**	**4.0**	**5.8**	**-0.6**
Personal income tax	1.9	2.6	1.2	2.8	-0.9
Social security	9.9	2.9	-0.3	1.3	-0.5
Corporate income taxes	2.0	-0.4	0.2	0.6	0.4
Consumption taxes	6.9	-0.1	2.9	0.3	1.1
Other revenues	2.1	0.4	0.0	0.8	-0.7

1. Changes are calculated from 3-year moving averages centered at the end points of each sub-period.

Source: OECD Secretariat.

Figure 1. The tax burden
As a per cent of GDP (1)
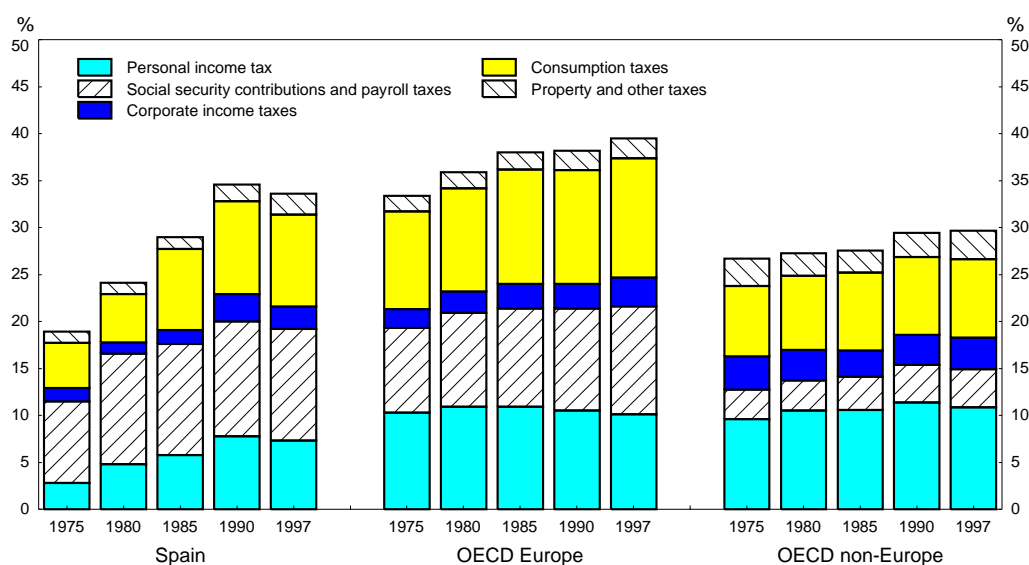
1. Three year centered moving average.
Source: OECD, Revenue Statistics.

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 (see OECD 2000, *Economic Survey of Spain,* Paris, Chapter II). Finally, with a view 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. These measures, combined with the recent boom in private consumption have led to an increase in the share of indirect taxes in general government tax revenues from 30 per cent in 1994, to almost 34 per cent in 1999.

6.   Reforms have also aimed to ease constraints on corporate financing and investment, to promote risk-taking, and to enhance firms' competitiveness (Box 1). The 1995 corporate income tax reform improved the neutrality of the tax system towards different financing instruments and investments. It also reduced the discrimination against foreign direct investment by Spanish firms by limiting the double taxation of dividends for inter-company share-holdings. Partly as a result, FDI assets have risen by more than three-fold between 1995 and 1999. 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 the personal income tax, so as to limit financial "lock-in"[5] and enhance financial market deepening. A possibility was also given to companies to revalue their productive assets in line with inflation to bring depreciation expenses for tax purposes more into line with the true cost of capital, and thereby to boost investment. In 1997, the corporate income tax rate was cut from 35 to 30 per cent for small enterprises.

The devolution of revenue raising powers has lagged the rapid decentralisation of spending competencies

7.   Until 1997, the decentralisation process was rapid but was characterised by an imbalance between tax assignments and expenditure functions. Since the establishment of regional governments by the 1978 constitution, regional governments' share in general government expenditure has risen steeply, from 3 per cent in 1981 to 25.7 per cent in 1997.[6] As a result, while Spain was a highly centralised country in the early 1980s, it stood close to the OECD average in 1997 when judged on the basis of regional and local governments' share in total expenditure (Figure 2). However, the devolution in revenue raising powers did not follow suit. Until 1997, fiscal devolution to the regions was confined to the so-called "ceded taxes", mainly on property. Tax revenues retained by the regions accounted for only 7 per cent of the central government total tax revenues (excluding social security contributions) in 1995. Fiscal discretion of regional governments was further limited by the fact that they could determine tax base or rates on only 22 per cent of their tax revenues, compared with around 90 per cent for Belgium, Denmark, Japan and Switzerland (OECD, 1999*c*). Some incentives for improving tax collection by the regions existed insofar as they could retain any positive deviation from the budgeted increase in receipts.[7] Overall, however, the bulk of regional financial resources continued to be provided by central government transfers, half of which were conditional — *i.e.* directed to specific purposes, such as the financing of social services or infrastructure investment.

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5.   Before June 1996, capital gains were not taxed once the legally established period, generally 10 years, had elapsed. From June 1996, a 20 per cent flat rate was established on capital gains obtained on assets held more than two years.

6.   These data on expenditures exclude interest payments. In 1998, regional and local governments accounted for 74 per cent of general government investment (Ministerio de Administraciones Públicas, 1999).

7.   The budgeted increase in ceded taxes was tied to the growth of a basket of taxes (including the personal and corporate income taxes as well as the VAT).

Box 1. **Main features of the 1995 corporate income tax reform and other measures affecting entrepreneurial activities**

- *Tax neutrality towards different sources of income was increased and compliance costs were reduced.* The 1995 reform abandoned the distinction between three types of incomes over which different tax rules were applying (operating income, net capital gains and net increases in assets). The 1995 law has identified the balance of the profit and loss account as the unique tax base. This measure also has the advantage of making the tax base easier to observe and verify.[1]

- *Distortions on investment decisions were reduced.* The 1995 Corporate Income Tax (CIT) reform has allowed firms to value inventories adopting the LIFO (last in, first out) method, used in many other OECD countries. This method allows inventories to be valued at their historical costs, thus avoiding the taxation of changes in values reflecting inflation developments. Another step in this direction was taken in June 1996 when a voluntary revaluation of fixed assets (to account for inflation) was proposed to companies. This measure has allowed them to set more realistic depreciation expenditures, thus lowering their tax liabilities, and has facilitated their financing.[2] The 1995 law also allowed intangible assets (goodwill, trademarks) to be depreciated.

- *The neutrality of the tax system vis-à-vis financing instruments was increased.* The 1995 reform lessened the double taxation of dividends for inter-company shareholdings. The participation threshold to benefit from a tax exemption on dividends accruing from a participation in another company was brought down from 25 per cent to 5 per cent, if the participation was held for at least two years. In June 1996, the required holding period to benefit from an exemption of double taxation was reduced from 2 years to 1 year.

- *Tax constraints on the internationalisation of Spanish firms were eased.* The correction for international double taxation of dividends and capital gains was applied to corporations owning 5 per cent of the capital of foreign companies — instead of the 25 per cent limit contained in the 1978 law — during at least two years. The required holding period was reduced to one year in June 1996. Also, there were some legal changes to avoid the double taxation of revenues.

- *Measures to promote small and medium-sized enterprises were implemented.* The 1995 CIT law gave more freedom to small and medium enterprises (SMEs) in spreading capital depreciation expenses over time and also introduced tax incentives for investment. The 1997 budget law introduced another measure in favour of SMEs, lowering the tax rate which applies to them from 35 to 30 per cent — up to the first ESP 15 million of taxable income.[3]

- *Risk-taking and enterprise creation was encouraged.* 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 in the 1999 budget law.

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1. See Serrano Leal (1996).
2. The previous revaluations took place in 1983. The 1997 voluntary revaluation was accompanied by a 3 per cent tax onthe revaluation of companies' assets.
3. Firms with a turnover below ESP 250 million per year.

Figure 2. Tax receipts and expenditure by regional and local governments
1997 (1)
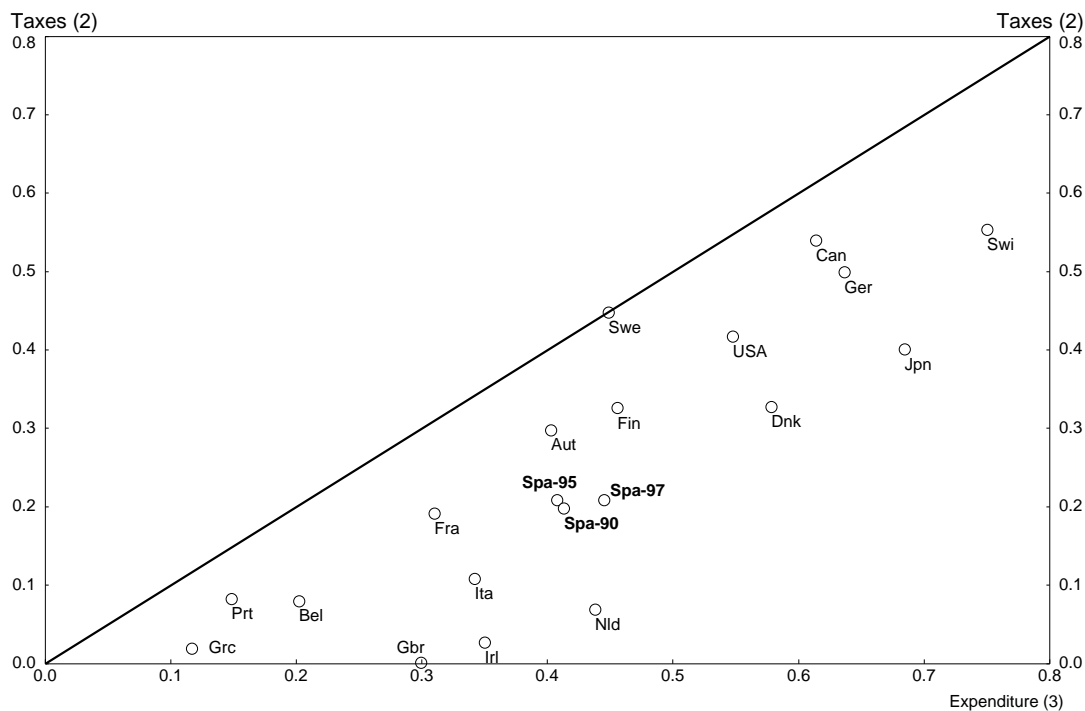
1. For Austria, Finland, Ireland, Netherlands, Sweden, Switzerland and United Kingdom: 1996. For Denmark, Greece, Italy and Portugal: 1995.
2. Direct and indirect taxes received by regional and local governments as a share of taxes received by the general government (excluding social security).
3. Total expenditure by regional and local governments as a share of general government expenditure (excluding social security and capital transfers).

Source: OECD, National Accounts and Bank of Spain, Financial accounts.

8.   The commitment to transfer further expenditure powers to the regions and to comply with the Spanish Stability Programme has given an impetus to enhance fiscal co-responsibility. The 1997-2001 financing system for the regions, which substituted lump-sum State transfers by locally-raised tax revenues, has been an important step towards improving incentives for sound management of public finance at the sub-national level. Incentives to trim expenditure result from the political costs of raising taxes now borne by regional governments. Specifically, since 1997, regional governments are able to modify the base and rates of the ceded taxes, though with some limitations. Moreover, limited powers to set marginal personal income tax rates and tax credits have been granted. However, the fear that tax competition could unduly undermine tax revenues of the regions has motivated the introduction of limits on the regions' taxing powers. Granting regional governments extensive powers to modify the base, rates and reliefs for more taxes would also make the tax system more complex and could widen tax loopholes. In addition, the principles of financial solidarity across regions and of resource sufficiency for the provision of public services — embodied in the Constitution — act as a limit to a rapid and more ambitious devolution of tax competencies. Overall, revenue-raising powers of the regions remain limited while further transfers in spending powers are planned. These concern the devolution of two main spending items, health and non-university education, which should be completed by 2004 for those regions where

devolution has not yet happened.[8] In addition, regionalist parties are pushing for more devolution, both on the spending side — *e.g.* on social transfers or the management of airports — and for revenue raising and tax collection powers.

Main issues for strengthening the tax system

The complexity of tax laws: tax administration and compliance

9.   Although much of the equipment and personnel endowment appears to be in place for an adequate functioning of the tax administration, in some respects effective enforcement of the tax laws could be strengthened. Reflecting an extensive use of computer technology and third party reporting requirements, collection costs are rather low by international standards — 1 per cent of tax revenues at the State level.[9] Compliance is also facilitated by an extensive reliance on withholding payments on wages and financial income. However, existing information on individuals' wealth (*e.g.* data from investment funds and bank accounts) is hardly used to verify income data, and the general feeling is that tax evasion — though difficult to estimate — is important.[10] As a matter of fact, tax fraud discovered over the two-year period 1996-98 amounted to ESP 2.2 billion (*i.e.* 7.6 per cent of the State's tax revenues).[11] Nevertheless, resources dedicated to the detection of undeclared activities are reported to be low compared to those devoted to the cross-checking of information on declared income flows. Furthermore, while the legal provisions call for severe penalties for tax evasion, these are applied only after a long delay, partly reflecting the lack of swift action by the judicial system.[12]

10.   Enforcement problems also partly reflect the complexity of the tax law, which embodies many exemptions, deductions and special regimes.[13] It multiplies the opportunities for overstating expenditures and misrepresenting the characteristics of the tax unit, thus exacerbating tax evasion.[14] It also raises compliance costs and generates uncertainty. A survey revealed that in 1998 only 16 per cent of taxpayers filed their personal income tax return themselves and, because of the difficulties to adjust withholding payments to final tax liabilities in the presence of a plethora of deductions and exemptions, 73 per cent of

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8.   Competences transferred include: education, social services, active labour market policies, some infrastructure investment, and health. In January 2000, the transfer of health responsibilities will not have been completed in 9 regions, while the process of decentralisation of primary and secondary education will be still pending in two regions.

9.   Ministerio de Economía y Hacienda (1998*d*).

10.   See Instituto de Estudios Fiscales (1998). According to a survey realised by the *Centro de Investigaciones Sociológicas* in 1998, 92 per cent of people interviewed considered that personal income tax fraud was significant.

11   See Ministerio de Economía y Hacienda (1998*e*).

12.   Sanctions vary between 35 and 150 per cent of the tax due. The period required to resolve a conflict can last up to 7 years.

13.   See Instituto de Estudios Fiscales (1998), p. 158, and Instituto de Estudios Fiscales (1994).

14.   Presumptions of a large overstatement of expenditures and misrepresentation of the characteristics of the tax unit concern the report of expenses related to the acquisition of a secondary residence as those for a main residence, overstating health expenditures, and considering a person as disabled. See Ministerio de Economía y Hacienda (1998*a*); Ministerio de Economía y Hacienda (1998*b*); Ministerio de Economía y Hacienda (1998*c*). See also Confederación Sindical de Comisiones Obreras (1998).

taxpayers were entitled to tax refunds in 1998.[15] In addition, frequent changes in the tax law, in particular on capital income, may have undermined the predictability of the tax system.

11.   The 1998 personal income tax reform was a significant step towards the simplification of the tax system. It streamlined deductions, reduced the number of tax brackets, and raised the income threshold below which an individual is no longer required to file a tax return (Box 2). The government expects that this will reduce compliance and administrative costs as well as tax evasion. Resources freed within the tax administration will be largely reallocated towards further enhancing assistance to taxpayers. Continued improvements of the *Agencia*'s communication technology will also help to reduce compliance costs and achieve further progress in reducing the processing delays of tax returns.[16] Furthermore, the creation of the *Consejo de Defensa del Contribuyente* in 1996 and of the *Estatuto del Contribuyente* in March 1998 should help to reduce taxpayers' uncertainty by introducing maximum time limits on tax inspections, prescriptions and refunds.[17] Efforts to fight against tax evasion have also been intensified, in particular by regrouping the existing resources within the tax administration into a single unit (ONIF) and by better co-ordinating tax collection and tax inspection activities, in line with the *Plan de Control Tributario Coordinado*. Stricter limits to the change in tax residence (within and outside the country) and on financial transactions with non residents, aimed at reducing tax liabilities (in particular to avoid "coupon washing"), have also been introduced.[18] Enhanced tax responsibility of territorial governments could also help to improve tax compliance, by bringing the tax administration closer to taxpayers.

12.   The corporate income tax, social security contributions and the value-added tax still embody multiple rates and tax reliefs which broaden the scope for tax avoidance. Progressivity in the corporate income tax (30 per cent for small firms, 35 for large ones) could lead to under-invoicing in order to be eligible for the lower rates and the self-employed are still taxed under the personal income tax, according to objective criteria rather than the realised income. In addition, both for the personal and the corporate taxes, rules applied in the Basque Country and the Navarra region differ from the rest of Spain, thus increasing the complexity of the tax system. While the value added tax rules are the same for the whole Spanish territory, a large number of goods are taxed at reduced or super-reduced rates. For small enterprises with poor book-keeping, VAT on differentially taxed products cannot be accounted for separately. The tax liability must thus be determined by applying presumptive methods, an approach that increases the difficulty of monitoring compliance. The social security system is also characterised by a proliferation of partial exemptions or reduced rates and different ceilings on contributions according to the situation of the worker (age, qualification, etc).

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15.   See Martín and García Lopez (1999). According to the *Memoria Económica del Anteproyecto de Ley de Reforma del IRPF*, the average taxpayer devoted one and a half hours to file tax returns and spent ESP 8 000 (opportunity costs and fees paid to tax advisers).

16.   Delays to process tax returns were cut for the personal income tax: from 110 days in 1995 to 66 in 1998, and a further reduction to 55 days is envisaged for 1999. Assistance to taxpayers has been developed, in particular through tax filing assistance by telephone. The *Programa de ayuda a la declaración de la renta* concerned 11 million tax declarations (15 million declarations were sent to the tax administration in 1998). From 1999, taxpayers have been able to file tax returns through the Internet.

17.   Maximum 12 months for tax inspections, 4 years for tax prescriptions and 6 months for tax refunds (after this 6-month period, interest is paid by the administration).

18.   From 1999, a taxpayer moving to a tax haven will continue to pay taxes in Spain during four years. To limit coupon-washing operations (which consist of selling and repurchasing domestic shares on international stock markets to reduce residents' tax burden), tax credits for dividends will no longer be granted for shares bought less than two months before, and sold less than two months after, the dividend disbursement.

Box 2. **Main objectives of the 1991 and 1998 personal income tax reforms**

The 1991 personal income tax reform

- *The tax treatment of families became more neutral.* Married couples were given the option of filing separate returns, while the previous system aggregated incomes and filing was jointly. The new system reduces disincentives to labour force participation of household partners.

- *The tax base was broadened.* New sources of income were brought into the tax base (*e.g.* in-kind benefits).

- *Long-term savings were given tax incentives.* The taxation of undistributed profits of private investment funds was brought more into line with that existing in other EU countries. In particular, the legislation exempted investors from all withholding taxes on undistributed profits earned in the fund and only applied the capital gains tax when the resources were withdrawn from the fund. Long-term capital gains concerning investment held for more than 10 years were in general exempted.

The 1998 personal income tax reform

- *The tax burden has been reduced, and incentives to work enhanced.* Marginal rates were lowered, from 56 to 48 per cent for the top income bracket and from 20 to 18 for the lowest. The number of tax brackets was also reduced, from 10 to 6. Taxpayers with income up to ESP 3 million (accounting for 80 per cent of total taxpayers) should see their tax liabilities reduced by 15 to 30 per cent.

- *Neutrality across various types of incomes has been improved.* Labour and capital income have been put on a more equal footing, as most partial exemptions and credits on financial saving income were curtailed. Capital income, except long-term capital gains, has been integrated into the tax base, with possibilities of cross-compensation between losses and gains. Most partial exemptions on capital gains and income have been removed.

- *Neutrality across different saving instruments has been improved.* The reform also made significant progress in harmonising tax rates and withholding rates on income from different financial assets held during the same period.[*] The reform maintained, however, preferential treatment of long-term financial saving instruments and owner-occupied housing.

- *An exempted living standard minimum has replaced a vast set of tax reliefs.* The personal income tax previously included an extensive set of tax reliefs, which reduced its productivity, created horizontal inequities, and provided broad scope for tax avoidance. The 1998 reform introduced a tax-exempt living standard minimum — *minimo exento* — which takes into account the characteristics of the tax unit. It substituted for most existing tax breaks (*e.g.* health and education expenditure, renting charges, care for the handicapped, child-care expenses).

- *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. The threshold below which individuals are not required to fill a tax return was raised from ESP 1.2 million in 1998 to 3.5 million. These two measures are expected to allow for a 5 million decrease in the number of tax returns to be filed (*i.e.* by about one third of total personal income tax returns), and tax refunds. The assessment of taxable income was also made more easily verifiable by the suppression of the imputed income of owner-occupied housing. Freed resources will be reallocated to activities of advising and assisting taxpayers, and to more effectively fight against tax fraud.

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* A 20 per cent rate is applied on capital gains on assets held for at least two years.

Taxation and labour market performance

13.   Taxes on labour income account at present for close to 60 per cent of general government revenues. In 1998, the overall tax wedge (personal income tax and social security contributions) of a single average production worker (APW) was 39 per cent of gross labour costs. Employers' and employees' social security contributions accounted together for almost three quarters of the tax wedge (Figure 3, panel A), with the major part (60 per cent) corresponding to employers' contributions. 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 (Figure 3, panel B). Concerning marginal tax rates, Spain is again significantly below the EU average, with a marginal tax wedge for an average production worker of 44 per cent in 1998 (Figure 3, panel C).

14.   Cross-country empirical studies have confirmed that rising tax wedges on labour income may partly account for the increase in structural unemployment observed in many OECD countries. A higher tax wedge raises labour costs and can lead to a reduced demand for labour. Unless labour supply is fully wage-inelastic and wages are fully flexible, the increasing tax burden will be in part shifted into higher pre-tax wages and lead to a lower level of employment. A panel data estimate for 19 OECD countries suggests that a 10 percentage point difference in the labour tax wedge could account for a difference in structural unemployment rates of up to as much as 1.5 percentage points (Elmeskov *et al.*, 1999).

Low-paid workers face a high tax wedge

15.   Owing to minimum payments and to contribution ceilings, which apply to both employees' and employers' social security contributions, the tax wedge on labour income is regressive (Figure 4, panel A).[19] In addition, because of a minimum social security contribution payment, low-paid workers face a higher-than-average marginal tax wedge.[20] This is likely to affect adversely employment of the low skilled. Though only 3 per cent of employees receive the minimum wage, many more workers could be excluded from the formal labour market due to the high initial threshold of the tax wedge. High taxation of low-paid workers may thus encourage participation in the untaxed underground economy. This is of particular concern in Spain, because the size of the informal sector appears to be substantial.

16.   Owing to a high real-wage elasticity of the demand for low-skilled workers, employment of this group could be quite responsive to targeted cuts in taxes or rates of social security contributions.[21] An illustration has been the boom in new permanent contracts, introduced in 1997, with lower firing costs and social security contributions for the recruitment of those most exposed to unemployment or those with a weak employment record (youth, workers above 45, long-term unemployed. However, these social security tax incentives are still of a temporary nature and they exclude core worker groups. Enhancing across-the-board progressivity of the tax wedge on labour income in a revenue-neutral way might call for a

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19.   The Spanish social security system includes a general regime and many special regimes applying to various professional categories. Following measures introduced in 1998, these special regimes are to be progressively harmonised with the general regime. The general regime and each category have a minimum (which is independent of the wage) and a maximum monthly basis for determining the amount of contributions.

20.   This is not shown in Figure 4 as the income corresponding to the minimum wage is less than half an average production worker's income.

21.   Low-skilled labour tends to be a good substitute for other production inputs (*e.g.* capital, energy). As a result, the high elasticity of substitution of low-skilled labour with these factors is reflected in a high own-wage elasticity. For discussion of available evidence see OECD (1995).

Figure 3. Tax wedge on labour (1)
As a percentage of gross labour costs (2)
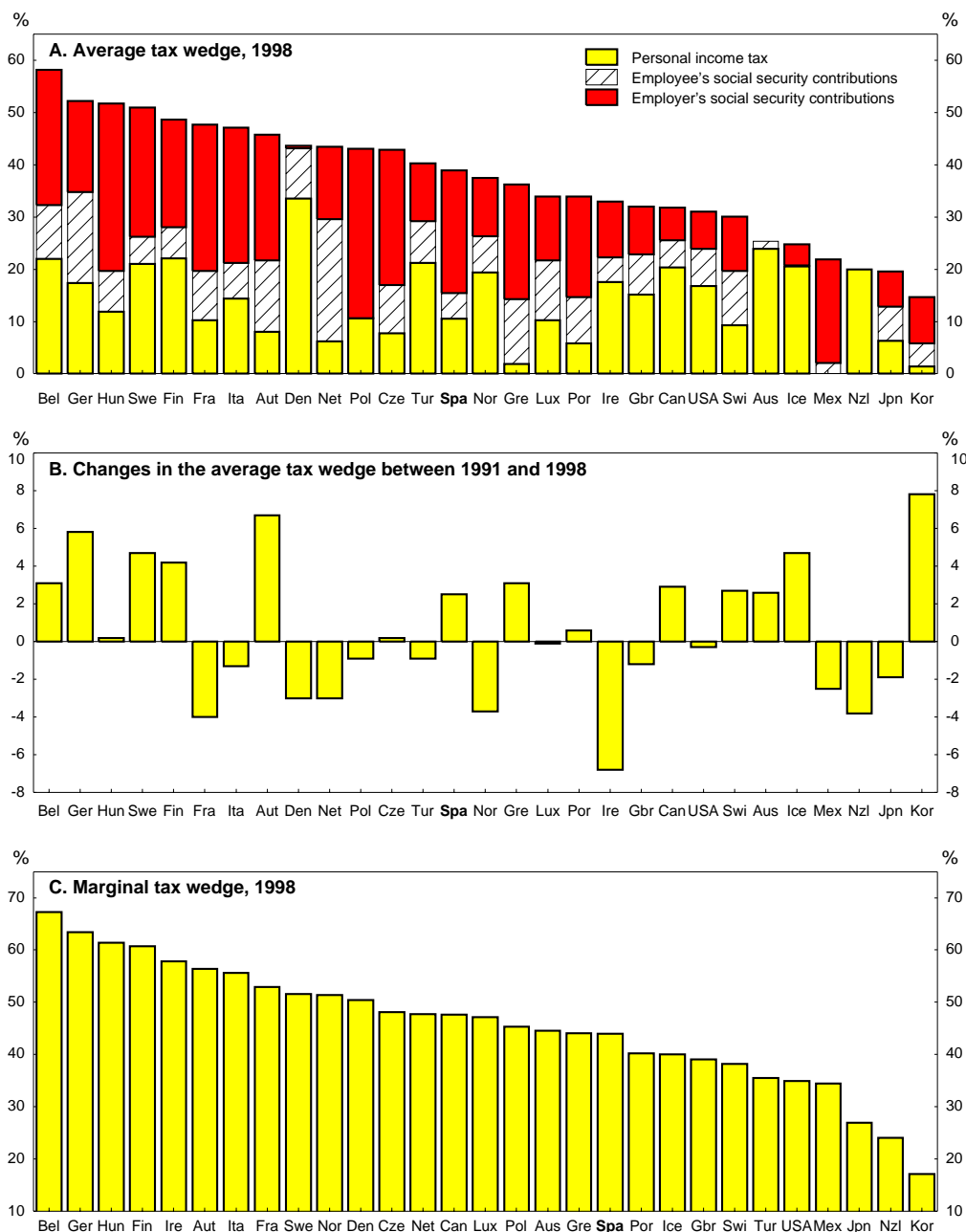
1. For a single individual at the income level of the average production worker.
2. Gross wage plus employers' contributions.
Source: OECD, The tax/benefit position of employees.

quite substantial increase in social security contributions for higher income earners. Countries with a progressive tax wedge, like Portugal and the United Kingdom, display a *higher* marginal tax wedge than Spain at beyond 1.5 to 2 times an APW's income, though their average tax wedge is lower at the APW level (Figure 4, panel B and Figure 3 panel A). If the real-wage elasticity of the demand for labour declines for workers with higher-level skills, building some progressivity into social security contributions (and hence in the average tax wedge) would also be advisable on economic efficiency grounds. Cutting taxes at the low-income/low-skill end of the pay scale, where workers face an elastic demand, and offsetting tax cuts by steeper effective tax rates at income/skill levels where workers face an inelastic demand, would bring about a decrease in the overall excess burden of labour taxation.[22]

Tax wedges interact with labour and product market rigidities

17.   While Spain has a relatively low tax wedge by European standards, its adverse impact on employment may have been exacerbated by a number of rigidities that reduced firms' incentives to resist upward pressure on wages and thereby facilitated forward shifting of taxation into labour costs. These rigidities include: *i)* a low level of product-market competition in sheltered sectors — that was prevalent until at least Spain's accession to the European Union; *ii)* restrictive employment protection legislation — and more specifically the generous severance payments for workers on permanent contracts — that considerably strengthened "insiders' power" in wage agreements; *iii)* collective wage agreements that are settled at the sector level, and are binding for all enterprises, thus putting a floor to negotiated wage increases for most companies in the sector; *iv)* the exclusion of unemployment benefits from taxable income until 1994, thereby stiffening wage resistance partly because of the resulting weakening of job search incentives.[23]

18.   The 1994 labour market reform has largely redressed tax distortions related to unemployment benefits because most of them became taxed.[24] However, severance payments received in connection with employment security provisions still enjoy a partial tax relief.[25] Disincentives can be portrayed by "marginal effective tax rates" (METRs) on household extra income, taking into account the influence of both the social benefit and the tax system. They indicate the share of extra earned income of the family that is "taxed away", either because of withdrawal of unemployment benefits, cancellation of means-tested

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22.   This follows as an application of the "Ramsey rule" for optimal taxation. The excess burden of a tax is an additional cost to society, over the amount of tax collected by the state. It arises when a price-distorting tax prevents markets from attaining efficient output levels, owing to the price of taxed goods being different from marginal private benefits and costs. Taxes with minimum excess burden are those levied on goods and services that are in inelastic supply, demand, or both — as in those cases market responses to distortions are subdued.

23.   In some cases, after-tax labour earnings were reportedly even lower than out-of-work transfer income. This had been reflected in *effective* marginal tax rates of close to 100 per cent at low-income levels that might have been at the origin of unemployment traps. See OECD (1994*a*).

24.   Unemployment benefits became taxed after the 1994 labour market reform with the exception of those received as lump-sum payments, to be used for the creation of a new business; to participate in a worker-owned limited company (*Sociedad Laboral*) or in a cooperative company; and for handicapped people who want to set up a business. In these four cases, unemployment benefits are tax-exempt up to ESP 1 000 000 (this treshold was increased in May 1999 from ESP 500 000).

25.   Mandatory compensation received as severance pay or for termination of employment is tax exempt up to the maximum legal amount as defined in the Labour Code.

Figure 4. The total marginal tax wedge
1998, per cent

A. Spain

Single - no children
Married - 2 children
Married - no children

Multiples of APW taxable income

B. An international comparison : Single - no children

Spain
Germany
Netherlands
Portugal
Sweden
United Kingdom

Multiples of APW taxable income
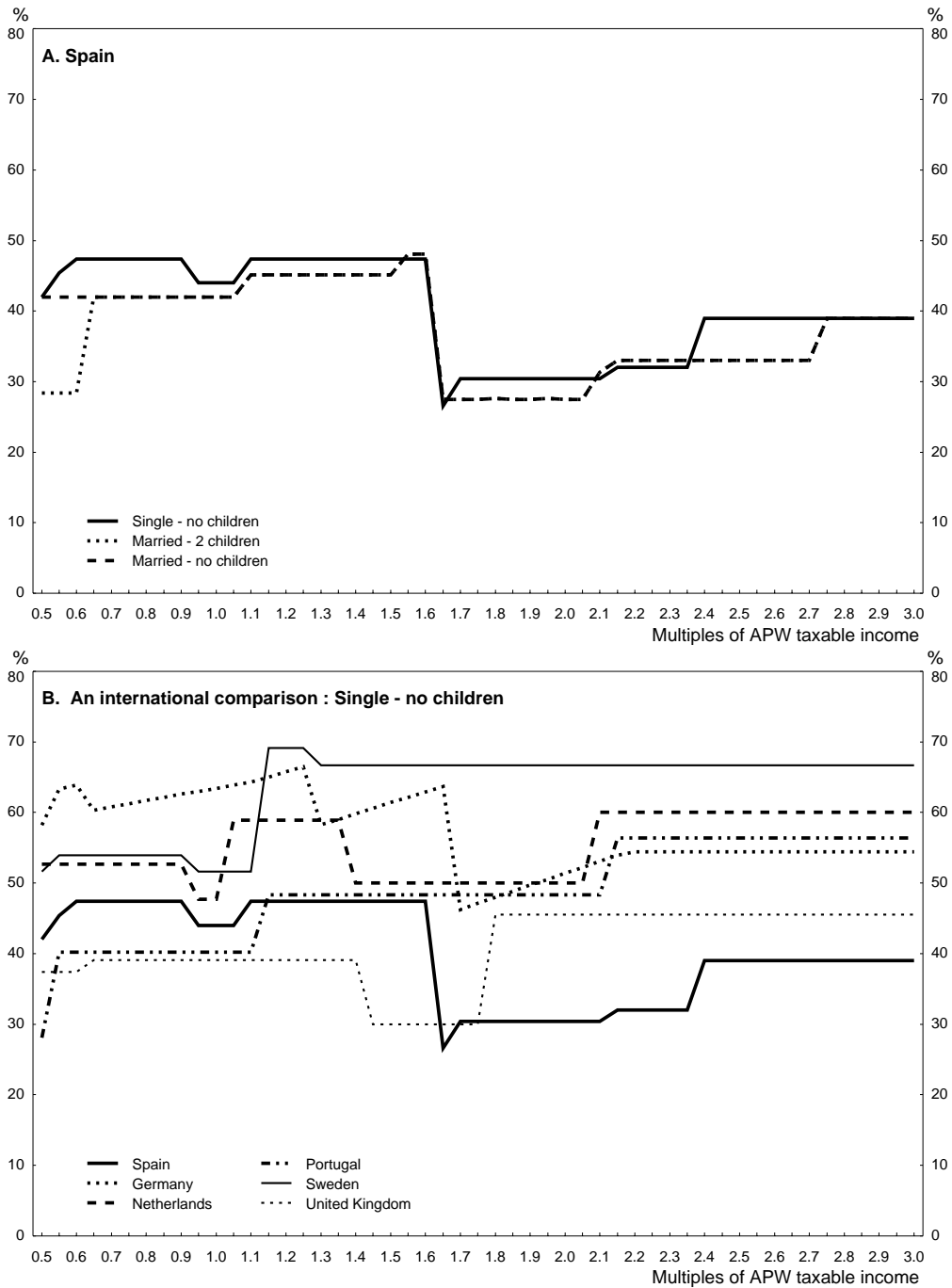
Source: OECD, The tax/benefit position of employees.

social benefits, or higher income taxes (Table 2). In the standard case of a single-earner (full-time or part-time) household, where the non-working member is not entitled to benefits based on previous earnings, the METRs are somewhat below 80 per cent. Although very high, these levels have been brought down to the OECD average, and stand currently at the low end for part-time work. METRs are also comparatively low for the second earner of two-earner households, where the principal earner either has a full-time job or is entitled to unemployment compensation. Nevertheless, in the case of single-earner households where part-time work is taken up after a long-run unemployment spell (Table 2, last column), the METR is still above 100 per cent, indicating a high probability that these workers could be caught in an unemployment trap. This reflects both withdrawal of means-tested unemployment assistance for long-run unemployed, and the structure of the personal income tax system that allows long-run unemployment assistance to remain tax-free.

19.   Across-the-board income tax cuts that have come into effect as a result of the 1998 personal income tax reform will lead to a somewhat lower tax wedge on labour income. At the APW income level, the personal income tax amounts to one-third of the overall tax wedge, corresponding to approximately 13 per cent of gross labour costs. According to preliminary estimates, personal income tax relief under the 1998 reform would allow a 1.5 percentage point drop in the income tax component of the tax wedge, bringing the overall tax burden to 37.5 per cent of gross labour costs.[26] However, the interaction with labour-market rigidities might restrict the responsiveness of labour demand and supply to incentives created by reduced tax rates. To enhance the employment impact of tax cuts, an increase in after-tax income from work should not be reflected in increased after-tax replacement income for those out of work and receiving severance payments.[27]

Real estate taxes and tax preferences to owner-occupied housing limit labour mobility

20.   Owing to restrictive urban land development regulations, which significantly restrict housing supply, home prices in Spain are among the highest in the OECD. Excessive reliance of local authorities on real estate taxes may reduce housing investment further, and raises home prices and market rents. With an average ratio of home value to median family income of 5.3, Spain is next only to Japan and the Netherlands (with ratios of 6.6 and 5.5 respectively), which suffer housing price pressures mainly due to high population density — as well as to restrictive planning in Japan. In addition, as a result of generous tax preferences granted to owner-occupied housing, the rental market for housing comprises less than 15 per cent of the existing residential housing stock. Poor development of the housing rental market, high home prices which vary significantly across regions, weak job search incentives, are factors that jointly hamper the geographic mobility of labour and impede labour market adjustment. The low geographic mobility of workers prevents regional labour markets from absorbing labour market imbalances and raises the overall rate of unemployment.

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26.   Personal income tax relief is estimated at 11.7 per cent of tax liabilities of the taxpayer with labour earnings at the APW level — that is, around 2 000 000 pesetas. The estimated impact of the personal income tax reform on individual tax liabilities are provided in "Memoria Económica del Anteproyecto de Ley de Reforma del IRPF", p. 31.

27.   See also OECD (1995). An analysis of these points can also be found in Pissarides (1998).

Table 2. **Marginal effective tax rates[1] on additional income for one- and two-earner households**
1997

	Full-time employed[2] / non-employed	Part-time employed[3] / non-employed	Full-time employed[4]	Full-time employed / part-time employed	Unemployed / full-time employed	Unemployed[5] / part-time employed without benefit entitlements	Part-time employed after 5 years of unemployment / non-employed
Spain	**78**	**77**	**23**	**19**	**23**	**19**	**159**
Netherlands	89	90	39	37	45	52	134
Finland	88	117	36	23	48	23	152
Sweden	88	79	37	42	43	42	154
Luxembourg	87	198	30	14	26	12	198
Switzerland	85	96	30	27	20	15	184
Czech Republic	85	162	19	2	22	15	162
Denmark	84	84	50	48	55	61	118
Germany	80	115	51	50	31	19	115
Portugal	79	174	21	13	14	11	174
Australia	78	60	29	15	78	60	60
Norway	77	77	47	43	42	35	142
France	76	69	28	38	29	30	133
Austria	76	135	30	21	32	43	135
Canada	75	105	37	33	34	29	131
Hungary	73	106	29	12	34	23	106
United Kingdom	72	93	28	20	60	55	93
Belgium	68	109	57	61	43	25	109
Ireland	68	83	32	25	20	38	60
United States	68	102	19	11	20	0	102
Italy	63	84	33	25	37	19	84
Iceland	63	139	44	56	27	49	139
Japan	60	133	12	10	10	7	133
Korea	55	129	13	9	2	1	129
Greece	54	104	30	30	66	118	104
Poland	48	58	19	17	19	17	91

1. Marginal effective tax rate = 1 - (net income in work - net income out of work) / change in gross income.
2. Earnings from full-time employment correspond to APW earnings.
3. Part-time employment corresponds to 16 hours or two days each week, and total earnings are 40 per cent of the APW level of earnings.
4. Applies to both earners.
5. Receiving a full-time unemployment benefit.
Source: OECD, Benefit systems and Work Incentives.

Non-neutralities still exist in the taxation of savings

21.		While the relationship between after-tax returns and the level of saving cannot easily be determined because the income and substitution effects work in opposite directions, empirical evidence suggests that the composition of household saving is quite sensitive to tax policy (OECD, 1994*c*). In Spain, the tax system has encouraged investment in home ownership, insurance and pension schemes, as well as mutual funds. This has reduced the supply of finance for newly created, innovative and fast-growing enterprises. Further hindering the reallocation of funds between enterprises is the taxation of dividends, which could give firms an incentive to retain their earnings, while providing shareholders with more lightly taxed capital gains. The tax differentiation in favour of long holding periods may also reduce the liquidity of the Spanish stock market and hinder an efficient allocation of resources.

Preferential tax treatment of housing

22.		Tax incentives for housing investment were reduced by the 1998 personal income tax reform but remain generous, both compared with other savings instruments and by international standards (Dolado, Gonzales-Paramo and Viñals, 1997). In 1996, more than one fourth of personal income taxpayers were entitled to a housing-related tax credit, and tax expenditure on owner-occupied housing amounted to 4.6 per cent of personal income tax revenues.[28] In the 2000 State Budget, they are projected to rise further, to 9.1 per cent of personal income tax revenues. These tax incentives are reflected in a very high rate of owner-occupied houses by international standards (Figure 5). By far the most important tax incentive on housing is the 15 per cent tax credit on loan costs (both interest and principal repayments), up to a ESP 225 000 limit.[29] This contrasts with the absence of any tax deductibility of interest on consumer credits. In addition, capital gains on owner-occupied dwellings are corrected for inflation developments, whereas those on financial assets are not, and they are tax-exempt if reinvested in housing. Furthermore, money invested in housing saving accounts gives right to a tax rebate. In principle, tax deductibility of home ownership cost should only apply if housing is consistently treated as an investment good, with imputed services from home ownership being taxed. However, from 1999 the returns to an owner-occupied main residence (imputed rent) are no longer taxed; in any case taxation was already low before 1999.[30]

23.		This set of tax incentives on housing investment poses several problems. *First*, they have questionable distributional consequences since they benefit disproportionately higher income groups. *Second*, given the low responsiveness of housing supply to demand — partly reflecting strict regulations on land use — existing tax provisions designed to encourage access to housing may largely be capitalised in higher house prices. *Third*, tax advantages on owner-occupied housing may contribute to the low geographic mobility of labour (Oswald, 1997). Finally, by favouring the allocation of saving towards real estate assets, the tax system may have a crowding-out effect on the availability of capital for other investment.

28.		Tax expenditure does not include the low taxation of imputed rents on owner-occupied housing.

29.		Before 1999, interest expenses were deductible from the tax base — to which marginal rates apply — though with a ESP 800 000 ceiling for an individual (ESP 1 000 000 for a joint declaration), and principal repayments entitled to a reduction in the total tax due.

30.		Before the 1998 personal income tax reform, an imputed income — calculated at 2 per cent of the catastral value of the taxpayer's home if the catastral value had not been reestimated before 1994, and at 1.1 per cent otherwise — was included in the taxable income. However, imputed rent was unrealistically low, largely because the housing market value was much higher than recorded in the land register (about 50 per cent).

Figure 5. Owner-occupied housing in selected OECD countries (1)
As a per cent of the residential housing stock
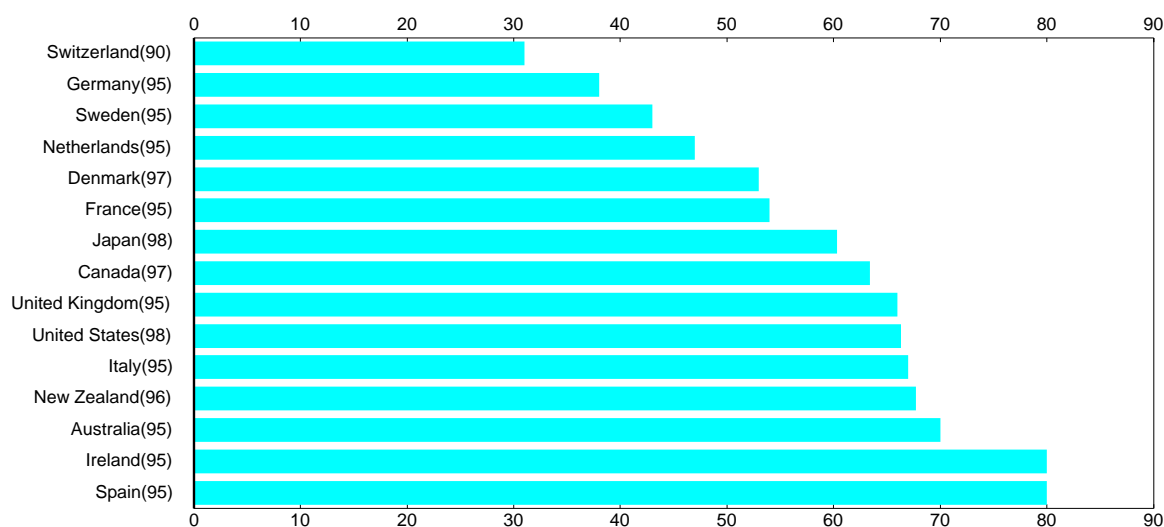
1. Data in brackets are the census year.
Source: National sources and OECD Secretariat.

Figure 6. Composition of households' financial portfolio
Billion euro
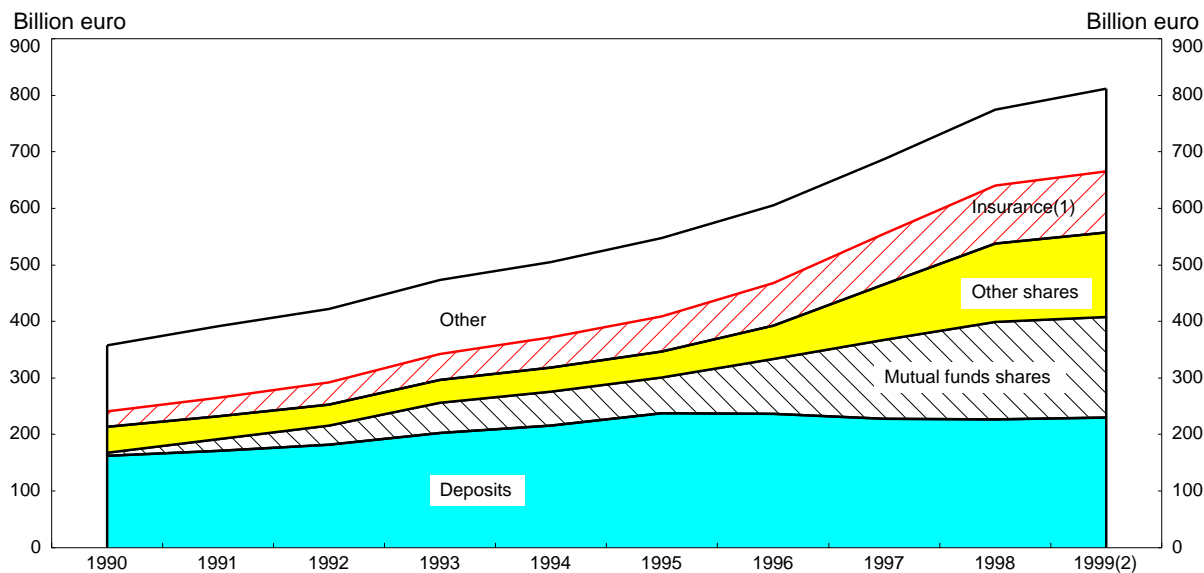
1. Including life insurance and pension funds.
2. Data for 1999 are second quarter data.
Source: Bank of Spain, Financial accounts.

21

Distortions towards long-term saving concern mutual and pension funds, as well as life insurance

24.   The preferential tax treatment of income from returns on some financial instruments up to the 1998 tax reform, combined with the decline in interest rates since the mid-1990s, has profoundly affected the composition of households' portfolios. The most striking feature has been the drop in time deposits in absolute terms since 1995 while mutual funds were booming (Figure 6). The personal income tax reform has reduced the tax bias in favour of mutual funds, both in terms of withholding taxes and tax rates, and has been reflected in a rebound in time deposits in early 1999. Specifically, withholding tax on deposit income has been cut from 25 per cent to 18 per cent and the reform introduced a 20 per cent withholding tax on investment funds (they were not subject to withholding payments before). In addition, the difference between the tax rate applying to investment funds held for more than two years and deposits was cut significantly — from 35 to 13 percentage points for individuals taxed at the top rate (Table 3).

25.   Progress towards greater tax neutrality has been a hallmark of the 1998 personal income tax reform. It abolished many tax exemptions and reduced tax distortions associated with investment financial assets. Broadening the "regular" taxable income base to include most financial income has been an important step towards the "comprehensive income tax model" according to which tax neutrality is achieved when all sorts of income are taxed equally.[31] However, despite the reduction in tax distortions on financial assets, investment in pension funds and life insurance contracts continue to benefit from a preferential tax treatment. While there is a case for sheltering retirement savings, as a complement to pension reform, tax privileges granted to life-insurance contracts and mutual funds are less justifiable. Nevertheless, differences in tax rates on interest income and life insurance investment remain high, and pension fund contributions are deductible.[32] These differences continue to affect the composition of financial saving and, in turn, the financing of the economy since institutional investors differ from other financial intermediaries in their asset allocation choices. In particular, and partly for tax reasons, institutional investors tend to weight their portfolios heavily towards general government's and mature enterprises' securities.[33] Furthermore, contrasting with the practice in many OECD countries, the Spanishtax system does not offer special incentives for direct share purchases. For individuals in the top income bracket, the combined corporate and personal tax burden on distributed profits far exceeds that on retained earnings (44 per cent versus a statutory 35 per cent for the corporate income tax and an even lower effective rate). Firms have thus an incentive to retain their earnings, while providing shareholders with lower taxed capital gains. Overall, the taxation on saving hinders the widening of share ownership and the reallocation of funds from mature, slow-growing, companies to more innovative firms.

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31.   The 1998 personal income tax reform abolished: *a)* the ESP 29 000 tax exemption on capital income; *b)* the exemption of capital gains when the sale value was inferior to ESP 500 000; *c)* the zero-tax rate applied on the first ESP 200 000 capital gains; and *d)* the revaluation coefficient on equities (used to correct capital gains for past inflation). The new personal income tax only maintains the revaluation coefficient for real estate assets.

32.   Investment in pension funds is deductible from taxable income up to ESP 1.1 million or 20 per cent of labour income (the lower amount is binding). For people older than 52, the deduction can be higher and reach ESP 2.2 million for 65 year old persons. Since the 1998 personal income tax reform, contributions to life insurance contracts do no longer give rise to a tax credit. For pension funds and insurance schemes, tax is deferred until the taxpayer is eligible to withdraw money from the fund. Annuities are fully taxed with other labour income. For lump-sum payments, the taxable income is defined as the difference between the premium and the payment. Tax rates on these capital gains vary, as for other financial income, according to the holding period (Table 3).

33.   A high-income individual will pay 48 per cent on T-bill income. If the person holds the same T-bill through collective investment institutions, he will only pay a 20 per cent tax rate.

Table 3. **Tax rates on financial saving**
By income bracket, 2000

	Tax bracket (in ESP thousand) and tax rate (in per cent)						*Memorandum items:* withholding rate
Income ceiling for the tax bracket	0 - 612	612 - 2 142	2 142- 4 182	4 182 - 6 732	6 732 - 11 220	>11 220	
Marginal personal income tax rate	18.0	24.0	28.3	37.2	45.0	48.0	
Financial products/income							
Held less than 2 years							
Bank accounts, life insurance contracts	18.0	24.0	28.3	37.2	45.0	48.0	18.0
Treasury bills	18.0	24.0	28.3	37.2	45.0	48.0	0.0
Private bonds	18.0	24.0	28.3	37.2	45.0	48.0	0.0
Capital gains on shares	18.0	24.0	28.3	37.2	45.0	48.0	0.0
Capital gains on mutual funds	18.0	24.0	28.3	37.2	45.0	48.0	20.0
Dividends[1]	16.0	22.0	26.0	34.0	41.0	44.0	18.0
Held more than 2 years							
Bank accounts	12.6	16.8	19.81	26.0	31.5	33.6	18.0
Housing savings schemes	12.6	16.8	19.81	26.0	31.5	33.6	18.0
Pension funds (lump-sum payment)[2]	10.8	14.4	17.0	22.3	27.0	28.8	18.0
Life insurance contracts (lump-sum payment)	10.8	14.4	17.0	22.3	27.0	28.8	18.0
Capital gains on shares	20.0	20.0	20.0	20.0	20.0	20.0	0.0
Capital gains on mutual funds	20.0	20.0	20.0	20.0	20.0	20.0	20.0
Held more than 5 years							
Life insurance contracts (lump-sum payment)	7.2	9.6	11.3	14.9	18.0	19.2	18.0
Held more than 8 years							
Life insurance contracts (lump-sum payment)	5.4	7.2	8.5	11.2	13.5	14.4	18.0

1. Taxes paid at the company level are included here, reflecting the partial imputation system which allows an individual to deduct a 40 per cent imputation credit against his tax liability. The system embodies a 26 per cent effective corporate rate, which contrasts with a 35 per cent statutory rate and a 30 per cent rate for SMEs.
2. Contributions to pension funds are deductible from the taxable income up to ESP 1.1 million or 20 per cent of labour income (the lowest amount). The ESP 1.1 million ceiling increases gradually for people older than 52, up to 2.2 million for a 65 years-old.

Source: OECD Secretariat.

26.   The taxation of household saving continues to embody significant incentives for long holding periods after the 1998 IRPF reform. For the highest-income group, the tax rate applied on life insurance varies from 48 per cent for investments held less than two years, down to 14.4 per cent for those held more than 8 years (Table 3). Other OECD countries also tax short-term capital gains more heavily than long-term ones. However, the threshold holding period to avoid this tax surcharge is generally shorter.[34] Incentives towards savings maintained over such a long period may create a "lock-in effect", because individuals have an incentive to hold assets for longer periods. This could limit the financing available for newly-created and dynamic firms, as well as reduce the liquidity of the Spanish capital markets.

Investment, entrepreneurship and the tax system

Low average effective corporate taxation but a rather high overall tax wedge on distributed profits and investment

27.   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. Estimates suggest that over 1990-96 the effective corporate tax rate has been 11 percentage points lower than the statutory rate (Figure 7), which is close to the average tax relief provided in the European Union.[35] Nevertheless, such international comparisons should be digested with great care.[36] Major corporate tax incentives are economy wide and take the form of investment tax credits. Targeted activities mainly include R&D expenses, staff training, and participation in foreign entities directly related to export activities. Moreover, a number of special sectoral and geographic corporate tax regimes exist.[37]

28.   The most important ones apply to banks and finance companies, mining companies, collective undertaking institutions, activities of cultural interest, small and medium sized enterprises (SMEs), foreign security holding companies, and companies subject to the Basque Country and Navarra tax legislation, as well as tothe Canary Islands special tax regime. In 1996, 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 (Figure 8).[38]

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34.   Households are not subject to tax on capital gains if financial assets have been held for more than one year in Austria and in Germany.

35.   Buijink, Janssen and Schols (1999).

36.   These estimates are drawn from the consolidated financial statement data of a panel of 2 118 European Union, mainly listed, manufacturing companies — excluding therefore important sectors such as insurance and financial services. As data are drawn from income statements published by the firms in the sample, cross-country differences in effective tax rates may also partly reflect differences in accounting practices.

37.   The corporate income tax includes also provisions for partial or total (under the "Affiliation privilege") relief of double taxation of domestic inter-company dividend distributions.

38.   In the 2000 State Budget, tax expenditures are projected to amount to 20.9 per cent of gross corporate income tax liabilities.

Figure 7. Effective corporate taxation in the European Union
Average 1990-96
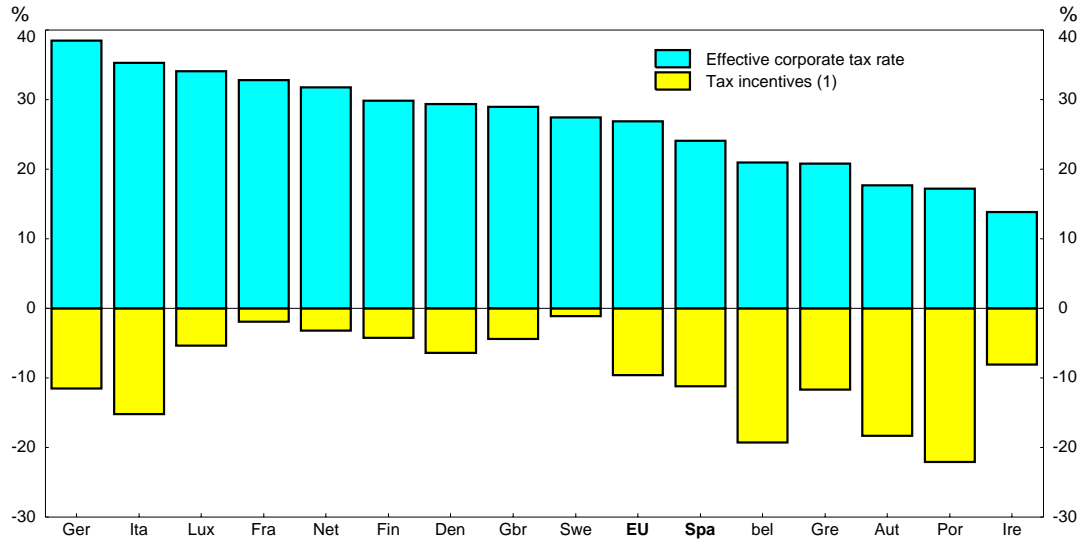
1. Difference between the effective corporate tax rate and the statutory corporate tax rate.
Source: Maastricht Accounting and Auditing Research and Education Center, April 1999.

Figure 8. Breakdown of gross corporate income tax liabilities
1996

A. The gross corporate tax liabilities

B. The structure of tax reliefs (2+3)
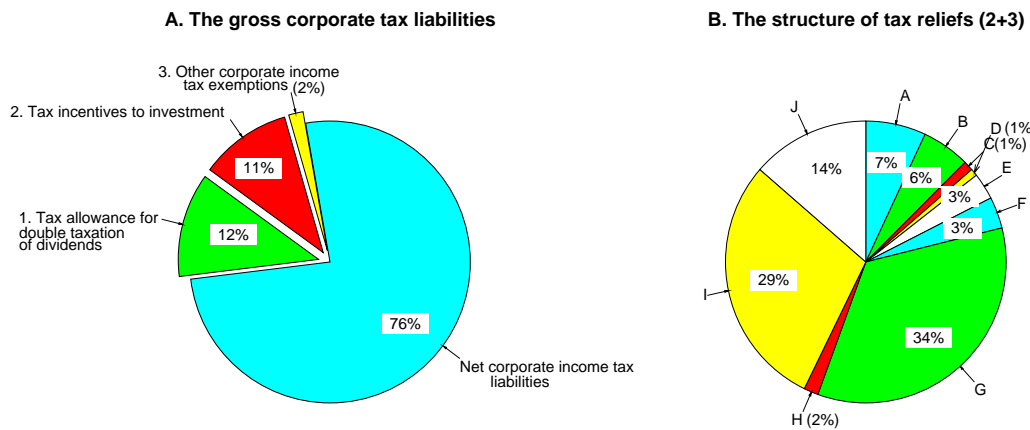
Note: A: Canary Island special regime, B: Transitory 3-year tax relief for business start-ups in 1994 and 1997,
    C: Cooperative societies, D: Tax credit applying in Ceuta y Melilla, E: Tax relief for exporters of educational
    and cultural goods, F: Other corporate tax incentives, G: Carry over of tax exemptions, H: Tax relief for employment
    creation, I: Transitory 1996 5% tax credit on investment, J: General tax incentives to investment (R&D, training...)
Source: Ministry of Economy and Finance.

29.   Because of the relatively high marginal tax rates for higher-income taxpayers, the overall tax wedge on physical investment — reflecting both corporate income taxes and personal income taxes at the level of the individual investor — is rather high in international comparison (Table 4).[39] Spain applies a partial imputation system for distributed profits that provides tax credits for dividends of domestic origin. The taxation of dividends adds to the overall tax wedge on investment. However, taking into account the more favourable tax treatment (at a 20 per cent flat rate, instead of a 48 per cent top marginal rate) of capital gains on assets held for at least two years, the overall tax wedge on investment falls by a third. It then stands close to the average for the OECD countries. Finally, lack of systematic indexing of depreciation allowances to inflation increases the tax wedge by artificially inflating taxable profits. Specifically, in Spain the tax allowance for depreciation is based on assets' purchase values. From time to time, the government allows companies to revalue their assets. This occurred in 1983 and 1997.[40]

A level playing field for physical investment but unbalanced incentives to invest in intangible assets

30.   Compared with other OECD countries, the tax system in Spain shows a higher degree of neutrality across physical capital assets and sources of investment financing (Table 4).[41] Nevertheless, the relatively high taxation of distributed profits still provides a disincentive to finance investment by new equity issues. Even after the 1999 personal income tax cuts, the tax system drives a combined corporate and personal income tax wedge of 53 per cent on distributed profits (Figure 9), suggesting that there might be room for further enhancing tax neutrality towards corporate financing decisions.[42] This is most obvious in the case of the flat-rate taxation of long-term capital gains, which biases financing towards retained earnings by reducing the tax wedge considerably below that for new equity. This feature of the tax system is likely to distort investment decisions of "immature" and rapidly growing companies that may not be able to generate sufficient retained earnings to finance their investment plans.

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39.   Tax wedges are computed using the King-Fullerton method — see Gordon, K. and H. Tchilinguirian (1998). They assess the pre-tax rate of return an investment must earn to be worthwhile from the standpoint of the company's shareholders — which may, as an alternative, invest in a risk-free bank deposit. Since the ultimate decision-maker is the individual shareholder, his personal income tax liabilities (against interest, dividends, and capital gains earned on firms' investments) are added to the corporate income tax to assess the overall pre-tax profitability of investments. To focus on cross-country differences related only to the tax system — abstracting thus from interactions induced by differences in inflation — the estimates reported in Table 4 were computed assuming the same inflation rate across countries of 2 per cent.

40.   In 1997, the government levied a 3 per cent tax on the capital gains arising from the (voluntary) revaluation of firms' assets. Despite this, most companies preferred to revalue their assets to reduce their future tax burden and improve their access to capital markets through improved capitalisation.

41.   As an exception to the overall tax neutrality towards physical investment comes, however, the special regime applying to mining companies, which are entitled to a reduction in taxable profits of up to 30 per cent.

42.   This calculation is based on statutory corporate tax rates and on the top-income earner tax rate. Because of various corporate tax reliefs, which vary across countries, effective corporate tax rates are much lower than statutory rates. Their cross-country comparability is subject to caveats. For instance, in Spain the effective corporate tax rate amounted to 26 per cent in 1996, compared with a 35 per cent statutory rate.

Table 4. **Marginal effective tax wedges on physical investment, R&D and human capital[1]**

1998, in per cent

	Sources of financing[2]			Physical assets[3]			Overall weighted average[4]	R&D[5], 1996		Human capital, 1996	
	Retained earnings	New equity	Debt	Machinery	Building	Inventories		Short lived	Long lived	Training[6]	Tertiary studies
Spain, 1999a[7]	3.7	2.7	2.0	2.7	3.2	3.4	3.0	-7.7	-1.3	1.6	-0.1[9]
Spain, 1999b[8]	1.7	2.7	2.0	1.7	2.1	2.2	1.9	-8.0	-1.8	0.8	..
Canada	4.7	5.7	1.4	2.5	4.3	5.5	3.7	-4.0	-0.4	1.1	-0.7
France	4.4	8.5	0.8	2.6	4.1	4.8	3.5	-1.1	0.1	0.6	0.0
Japan	4.5	7.4	-0.3	1.8	5.1	3.7	3.1	0.2	0.6	0.5	0.7
Luxembourg	4.0	2.7	1.8	2.4	3.0	4.7	3.1	1.7	1.7	1.6	..
Denmark	2.4	3.2	2.9	2.2	2.6	3.8	2.7	-1.7	0.6	1.6	..
Australia	2.6	2.5	2.5	2.1	2.7	3.4	2.6	-6.0	-1.0	0.9	-0.6
United States	2.0	5.7	1.7	1.7	3.0	2.6	2.3	-3.8	-0.2	1.0	0.0
Ireland	1.9	3.4	2.4	1.8	2.1	3.1	2.2	0.8	0.8	0.8	-0.8
United Kingdom	2.2	2.8	1.8	1.7	2.1	3.1	2.2	0.8	0.8	0.8	..
Netherlands	0.6	6.3	3.0	1.8	2.3	2.0	2.0	-3.6	-0.1	1.0	-0.5
Sweden	2.4	3.4	1.0	1.7	2.1	2.5	2.0	1.1	1.1	1.0	-1.8
New Zealand	1.8	1.8	1.8	1.7	1.5	2.3	1.8	0.7	0.3	0.0	..
Finland	2.5	1.0	1.0	1.4	1.9	2.9	1.8	0.7	0.7	0.7	-0.7
Italy	2.2	2.5	0.6	1.0	1.8	3.1	1.7	0.3	0.3	0.0	-0.1
Portugal	2.1	4.4	0.0	1.5	1.5	2.0	1.6	-0.2	-0.2	-0.3	-0.7
Iceland	2.2	2.7	-0.1	1.0	1.6	2.3	1.5	1.3	1.3	1.0	..
Switzerland	0.5	4.1	2.2	1.3	1.6	1.7	1.4	0.5	0.5	0.4	-0.3
Norway	1.3	1.3	1.3	1.0	1.2	2.0	1.3	0.1	0.1	0.0	..
Germany	1.4	0.9	1.3	1.1	1.7	1.3	1.3	0.0	0.0	-0.2	-0.4
Greece	1.8	1.8	-0.1	0.9	0.5	2.4	1.1	-0.6	-0.6	-0.6	..
Belgium	1.6	3.0	-0.7	0.1	0.8	3.1	1.0	-0.5	-0.5	-0.5	..
Mexico	1.5	1.5	0.2	0.9	0.9	1.3	1.0	-0.3	-0.3	..	..
Austria	1.0	3.2	0.2	0.0	1.1	2.6	0.9	-2.4	-0.8	-0.1	-0.8

1. These indicators show the degree to which the personal and corporate income tax systems scale up (or down) the real pre-tax rate of return that must be earned on an investment, given that the household can earn a 5 per cent real rate of return on a demand deposit. See OECD (1991*b*) for discussion of this methodology. Calculations are based on top marginal tax rates for the personal income tax and a 2 per cent inflation rate.
2. The weighted average uses the following weights: machinery 50 per cent, buildings 28 per cent, inventories 22 per cent.
3. The weighted average uses the following weights: retained earnings 55 per cent, new equity 10 per cent, debt 35 per cent.
4. The weighted average uses weights indicated in footnotes 2 and 3.
5. The weighted average uses the following weights: 5 per cent machinery, 5 per cent buildings and 90 per cent current expenditure across assets and weights in footnote 3 for financing.
6. The weighted average uses weights in footnote 3 for financing.
7. Using the 1999 top marginal personal income tax rate.
8. Using the 1999 top marginal personal income tax rate and a 20 per cent flat rate for capital gains.
9. Using the 1998 personal income tax parameters.
Source: Calculated by the OECD Secretariat.

Figure 9. Combined corporate and personal income tax wedge on distributed profits
1998, resident top earner individuals
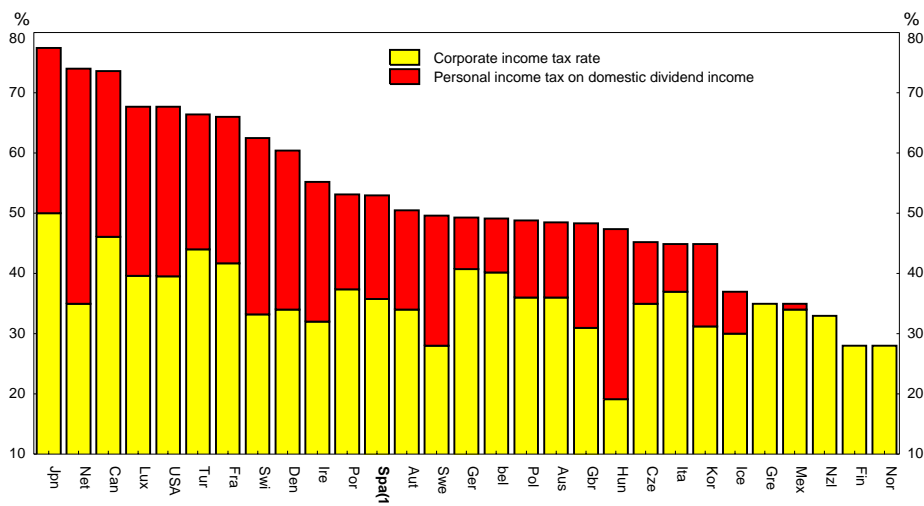
1. Using the 1999 marginal personal income tax rate for top earners.
Source: OECD Secretariat.

31.   As elsewhere in the OECD, investment in R&D receives preferential tax treatment, which is set to increase further.[43] They are more generous than those for training. The incentive to invest in firm-specific training is low, since the level of the tax credit for employee training is set at only 5 per cent of the corresponding expenses. As workers that have been trained by firms may leave at any time, the firm cannot be sure to recoup its training investments, which could lead to an underinvestment in training. Though this is typically thought to hold true mainly for general training, in practice the same applies also to firm-specific training by competitive enterprises that use quite similar technologies.[44] Moreover, as unemployment is still pervasive in Spain, this kind of intangible investment might create a social pay off even more sizeable than elsewhere by enhancing bonding of workers to firms — owing to better tuning of workers' abilities to firm requirements. It is noteworthy that the Basque Country already provides a more favourable tax treatment of training expenses (10 per cent tax credit) and is suffering less acute unemployment problems than the rest of Spain. Household-sponsored investment in tertiary education also receives a favourable tax treatment in Spain, though rather less than elsewhere in the OECD. By taxing away less of the increase in lifetime earnings induced by higher education, the tax rate flattening of the 1998 personal income tax reform is expected to further enhance incentives in this area.

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43.   A tax credit of 20 per cent of R&D expenses is available through the corporate income tax, which can rise up to 40 per cent for incremental expenses if their overall level is above that in the preceding two years on average. In addition, R&D investment (except buildings) may be freely depreciated over time. The government has further enhanced tax reliefs for R&D investment within the 2000 budget law. Tax relief for R&D investment will be provided up to 50 per cent of tax liabilities — against 35 per cent for other types of investment tax credits. Additional public support in the form of investment subsidies and public credits is being planned with the aim of raising R&D expenditures to 1.2 per cent of GDP by 2003.

44.   For a review of issues concerning training and a synthesis of empirical evidence see OECD (1991*a*).

Tax incentives granted to SMEs may hinder entrepreneurship

32.   As in other OECD countries, special tax schemes targeted at SMEs (Annex I) aim at correcting perceived cost disadvantages. These involve mainly difficulties in raising finance, as well as coping with regulations and cumbersome tax procedures. Regarding unincorporated business and the self-employed, it can be argued that, though the new simplified rules go in the right direction and should lead to a reduction in potential tax fraud, the "forfaitaire" tax system (based on activity indicators) has outlived its initial purpose of simplifying tax compliance for micro-enterprises. Moreover, the "forfaitaire" system is detrimental to horizontal taxpayer equity, as firms whose profits are underestimated by the relevant activity indicators may free ride on the system. As the use of accounting is becoming more widespread and "simplified direct estimation" schemes of tax assessment are being introduced, the "forfaitaire" system should eventually be phased out.

33.   Regarding corporate businesses, the progressivity built into the tax system through the reduced rate of 30 per cent may distort incentives for tax compliance. Even though truncating business firms only for tax purposes might not be worthwhile as it involves higher management costs, the existence of corporate tax thresholds may induce tax avoidance through under invoicing and revenue under reporting. Moreover, corporate tax progressivity could hamper business expansion. It treats profits and losses asymmetrically, by taxing increased profits more heavily but not making appropriate allowance for losses. This feature of the corporate tax may discourage risk taking and hence weaken entrepreneurship.

Existing corporate tax regimes could generate distortions in competition

34.   Special corporate income tax regimes apply to the three historic Basque Country territories (Alava, Guipuzcoa, Vizcaya) and to Navarra. They provide several more generous tax incentives to companies than the general regime, as outlined in Box 5 below. In the case of the Basque Country special corporate tax regime, the general investment tax credit and the extra tax relief granted for business start-ups seem very generous and may lead to inefficient use of taxpayers' resources as well as to distortions in resource allocation. Generous corporate tax incentives, aside from possibly generating tax revenue displacement effects across regions through plant and employment shifts, may be viewed as a form of state aid to industry that distorts competition and resource allocation. This is of particular relevance for the special corporate tax credit granted for fixed-asset investments above ESP 2 500 million. As only big companies may be able to carry out such sizeable investments, it might be argued that such incentives are discriminatory and distort competition against companies that do not receive such aids. On these grounds, the European Commission has referred the case of the investment by the Korean multinational Daewoo to the European Court, stating that it was granted illegitimate *ad hoc* state aid in the form of special tax incentives. This enterprise might hence be requested to refund the 45 per cent special tax credit it had been granted to build a refrigerator plant in Vitoria. On the other hand, the more generous tax subsidies granted for environmental expenses and staff training are of a generic nature, well focused, and could help companies internalise the externalities arising from these activities.

Preferential tax regimes aimed at financial and related services

35.   The Basque Country and Navarra also operate potentially preferential headquarters tax regimes (the Basque and Navarra Co-ordination Centre regimes), targeting "Management, Co-ordination and Financial" activities of international corporate groups. Companies qualifying for this special corporate income tax regime may choose to assess taxable income according to the general method (based on their accounting profit) or according to the simplified method (25 per cent share of their non-financial expenses). The Basque Country and Navarra headquarters regimes potentially discriminate against domestic profit taxation (being hence of concern for horizontal equity), while the assessment of taxable

income on the basis of non-financial expenses may be less transparent. The Basque and Navarra co-ordination centres are being examined by the Spanish courts. Therefore, a verdict in domestic courts is expected. A holding company regime (ETVE) also applies in Spain to all foreign equities holding companies. Dividends paid to and capital gains realised from the sale of shares by qualifying entities are exempt from tax provided that: *a)* the qualifying entities manage for at least one year 5 per cent or more of direct or indirect participation in non-resident companies; *b)* the income of the non-resident company has been subject to a tax identical or analogous to the corporate tax in Spain; and *c)* the dividends or capital gains received do not relate to income of a passive character. The ETVE holding company regime seems consistent with the domestic corporate tax regime. Since these schemes may potentially have international ramifications, they are currently being examined by the OECD Committee on Fiscal Affairs under the recently adopted Guidelines for Dealing with Harmful Preferential Tax Regimes in the OECD Member Countries (see Box 3 below).

Box 3. The OECD's work on harmful tax practices

Globalisation and new electronic technologies can permit a proliferation of tax regimes designed to attract geographically mobile activities. This can occur when discriminatory tax regimes attract investment or savings originating elsewhere and when they facilitate the avoidance of other countries' taxes. To provide co-ordinated action for the elimination of harmful tax practices, the OECD issued in May 1998 the Report on Harmful Tax Competition (OECD, 1998*e*). The Report created a Forum on Harmful Tax Practices, set forth Guidelines for Dealing with Harmful Preferential Regimes in Member Countries, and adopted a series of Recommendations[*] for combating harmful tax practices. This work focuses on geographically mobile activities, such as financial and other service activities.

The Forum on Harmful Tax Practices is responsable for undertaking an ongoing evaluation of existing and proposed preferential tax regimes in Member and non-member countries, analysing the effectiveness of counteracting measures, including non-tax measures, and examining whether particular jurisdictions constitute tax havens. The Forum has a one-year time period within which to prepare a list of tax havens, taking into account factors set out in the Tax Competition Report. The main factors are: *a)* no or low effective tax rates; *b)* lack of effective exchange of information; *c)* lack of transparency; and *d)* absence of a requirement of substantial activities.

The Forum is also co-ordinating a self-review by Member countries of their preferential regimes to determine whether those regimes constitute harmful tax practices. Member countries' measures that constitute harmful tax practices must be reported to the Forum within a two-year time frame. The key factors to be used in identifying and assessing harmful preferential tax regimes are: *a)* no or low effective tax rates; *b)* "ring fencing" of regimes; *c)* lack of transparency; and *d)* lack of effective exchange of information. The Forum is also working to associate non-member countries with the Guidelines.

The Guidelines on harmful tax practices incorporate a standstill provision, and a roll-back provision. Under the standstill provision, the Member countries are to refrain from: *i)* adopting new measures; and *ii)* extending the scope of or strengthening existing measures, that constitute harmful tax practices.

Under the roll-back provision, the harmful features of preferential regimes must be eliminated before the end of five years. The Guidelines also provide that the Forum should be used by Member countries to co-ordinate their national and treaty responses to harmful tax practices.

The Forum on Harmful Tax Practices is exploring the possibility of a wider mandate and also is assisting with work on other topics that may be relevant to the subject of harmful tax practices. These topics include, among others: restricting the deductibility of payments made to tax haven entities; imposing withholding taxes on payments to residents of countries with harmful preferential regimes; the application of transfer pricing rules and guidelines; and financial innovation issues.

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[*]   Luxembourg and Switzerland abstained, and will not be bound in any manner by the Report or OECD Recommendations in this area.

Figure 10. International comparisons of average personal income tax rates and total tax wedges
1998, by multiples of APW taxable income

——— Spain   ⋯⋯ United States   – – Japan   –⋅– European Union

A. Average income tax rates

B. Average rates - total tax wedge (1)

Single, no children

Single, no children

Married, 2 children, spouse without income

Married, 2 children, spouse wihout income

Married, 2 children, spouse with income (2)

Married, 2 children, spouse with income (2)
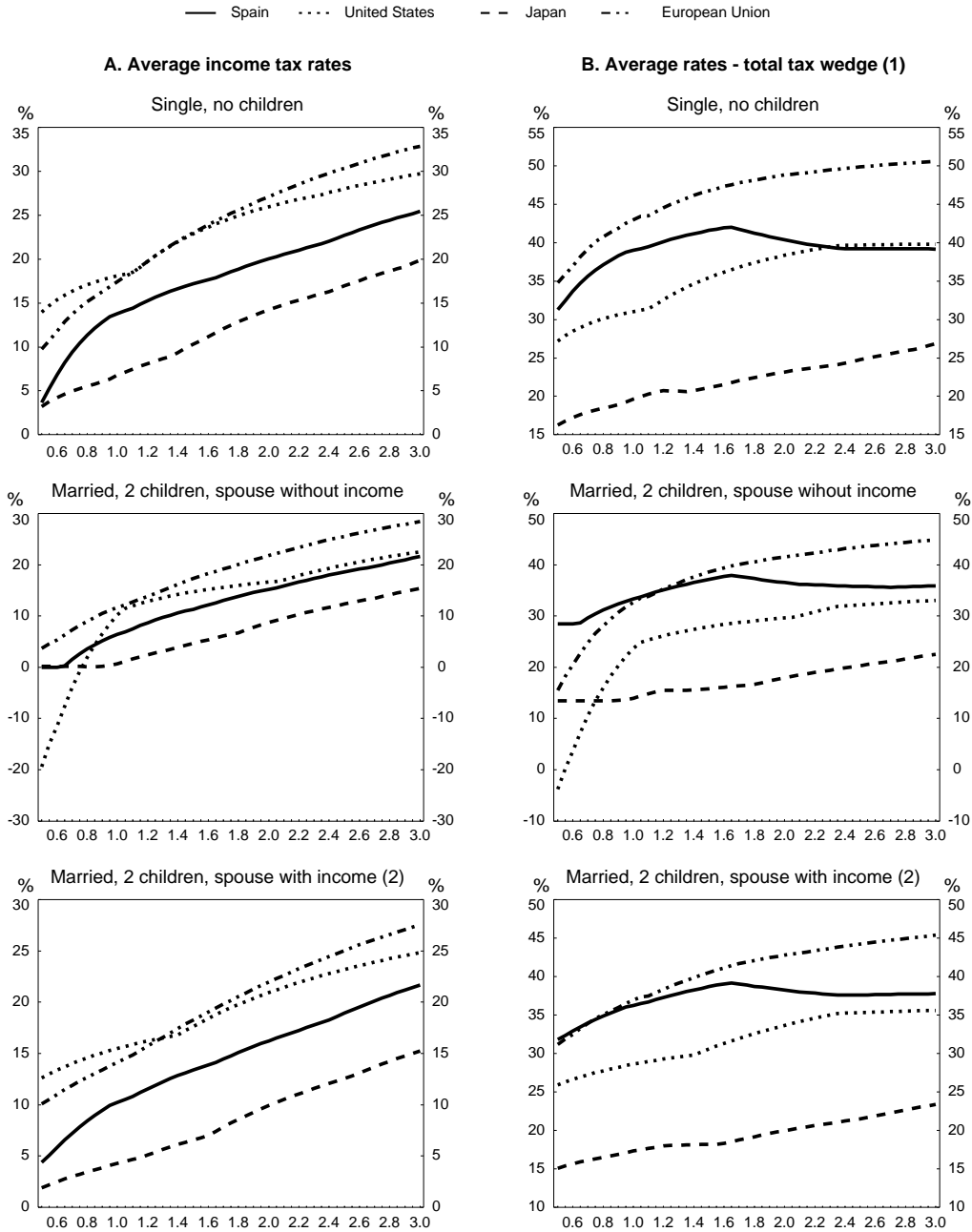
1. Income tax plus employers and employees social security contributions, less cash benefits.
2. Spouse earning 0.67 per cent of the income of the Average Production Worker.
Source: OECD, The tax/benefit position of employees.

Income redistribution and the tax system

36.   Up to 1998, the top marginal rate of the personal income tax in Spain was 56 per cent, among the highest in the OECD. This has, however, not translated into massive income redistribution, as the effective income tax rate did not increase faster along the income scale than in most other OECD countries (Figure 10, panel A). Progressivity is reduced by the vast set of tax allowances and credits, some of which benefit mostly higher income groups.[45] Specifically, tax credits for owner-occupied housing and health expenses — which accounted for 17.1 and 6.6 per cent respectively of total personal income tax expenditures in 1996 — were rising rapidly with income (Figure 11). Tax exemptions and reduced rates on capital income, which benefit mainly high-income groups, further weakened the progressivity of the personal income tax and created horizontal inequities. The reportedly low degree of tax evasion on wage income compared with other income sources may have reinforced this distortion. In fact, while wages and pensions accounted for 61 per cent of household disposable income in 1996, they represented 79 per cent of the personal income tax liabilities.[46]

37.   Despite a decline in top marginal rates, the 1998 personal income tax reform is likely to raise progressivity. Official estimates suggest that the overall tax burden will be cut by 11 per cent, and benefit mostly lower income groups: taxpayers with an annual income of less than ESP 2 million should see their final tax liabilities cut by almost one third (Table 5). This partly reflects the introduction of a progressive tax allowance for labour income, contrasting with the proportional scheme before the reform.[47] The reform also implies a shift of the tax burden from labour to capital as exemptions on capital income have been curtailed. In addition, the reform replaced several tax credits by a tax-exempt living minimum — the *minimo exento*. This has affected the progressivity of the personal income tax in several ways. On the one hand, the tax value of the living minimum grows with the individual's marginal rate and thus benefits mostly higher income groups in absolute terms. On the other hand, some of the tax credits that the living standard minimum has substituted for, were proportional to expenses. As the overall amount was increasing for richer individuals, they also benefited mostly higher income groups.

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45.   Before the 1998 reform, deductions from the taxable income included: a lump sum of 5 per cent of wage earnings which could be deducted from the taxable income up to a maximum of ESP 250 000; mortgage interest payments related to the purchase of a main residence; severance payments up to the statutory maximum amount; contributions to pension schemes. Tax credits included: 15 per cent of health expenses; 15 per cent of the costs incurred in the year for the purchase or restoration of the taxpayer's primary residence; 10 per cent of the premiums for certain life insurance policies.

46.   See Ministerio de Economía y Hacienda, Dirección General de Tributos (1998*f*).

47.   Before the 1998 PIT reform, employees could deduct 5 per cent of their wage earnings from their taxable income. From 1999, tax allowances are declining with the level of gross earnings: set at ESP 500 000 for income below ESP 1 350 000, they drop to ESP 375 000 for incomes above ESP 2 000 000.

Table 5. **Cut in the tax burden: estimated impact of the 1998 personal income tax reform**
By level of income

	Taxpayers (as a percentage of total taxpayers)	Cut in personal income tax liabilities (percentage)
Less than ESP 2 million	60.3	29.7
More than ESP 2 million and less than ESP 3 million	19.8	15.0
More than ESP 3 million and less than ESP 5 million	14.3	8.3
More than ESP 5 million	5.6	6.2
Total	**100.0**	**11.1**

Source : Ministerio de Economía y Hacienda (1998), *Memoria Económica del Anteproyecto de ley de Reforma del IRPF*.

Specifically, taxpayers are no longer granted a tax credit equal to 15 per cent of their health expenditure; the tax-exempt living standard minimum is supposed to cover a standard amount of health expenditure.[48] Furthermore, the reform has introduced a ceiling on tax credits for expenses related to owner-occupied housing, which tends to increase for richer individuals. As a side effect, streamlining deductions as well as cutting marginal statutory rates for the most affluent income groups could reduce avoidance, and thus increase the actual progressivity of the system (high-income earners typically have better access to avoidance instruments, *e.g.* by shifting income into foreign countries with low taxes).

38.   Income distribution is also affected by the financing rules and the associated transfers of the social security system.[49] Family benefits, for instance, are tax-exempt but are means-tested. Drastically flattening total tax schedules are the floors and ceilings on social security contributions.[50] Floors penalise low-income wage earners. And, contrasting with most other OECD countries, the overall tax burden decreases for incomes above 1.5 times the average wage (Figure 10, panel B) reflecting social security ceilings. Another channel of redistribution is the taxation of consumption. In order to introduce some

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48.   However, contributions to health insurance paid by employers are considered as payments in kind for employees and have been made tax-exempt up to ESP 60 000 for individuals and up to ESP 200 000 when the insurance covers the spouse and children.

49.   Would a dynamic perspective be adopted, the impact of social security contributions on income redistribution would be less negative. The perspective adopted here is how taxes and transfers redistribute income among persons at any given point in time. Another aspect of the tax and transfer system is how it redistributes income over the life-cycle of the individual. For this analysis, breaking down transfers into two components would be necessary — those pertaining to redistribution over the life cycle, and those to inter-personal redistribution. Social security contributions associated with future income (pension) flows largely pertain to the first category.

50.   Employees whose total compensation exceeds the maximum contribution base, or does not reach the minimum base for their category, pay social security contributions according to the maximum or the minimum payment, respectively. In 1999, the minimum social security contribution applied up to a ESP 80 820 monthly income.

Figure 11. Progressivity of the personal income tax
1996

Tax rate

A. Marginal statutory and average effective tax rates

Effective tax rate (1)
Marginal statutory tax rate

Multiples of APW taxable income

Thousand Ptas

Thousand Ptas

B. Tax expenditures on housing and health for individual taxpayer

On health expenditure (left scale)
On housing loan costs (right scale)
Saving account on housing (right scale)

Multiples of APW taxable income

1. Final tax liability divided by the taxable income.
Source: Ministry of Economy and Finance.

progressivity into the VAT system, Spain has one reduced VAT rate and a super-reduced rate — 7 and 4 per cent respectively — while its standard rate is below that of most EU countries.[51] However, international evidence suggests that reduced rates may not support redistribution since higher income levels could benefit most in absolute terms because they consume more of all goods and services.[52] This is particularly true for expenses on restaurants and hotels, as well as health, which typically rise with the level of income but are taxed in Spain at reduced VAT rates. An important issue is who finally bears the tax burden. Taxes levied on a given base may end up being shifted along the production and distribution chain depending on the degree of competition in labour and product markets. Tax shifting is difficult to assess but one may reasonably argue that taxes can less easily be shifted onto mobile sources, *i.e.* highly qualified labour and capital. Low-qualified, low-paid labour would thus bear most of the taxes.

Fiscal federalism

Incentives for expenditure restraint by territorial governments are weak

39.   Territorial governments have shared a significant part of the fiscal adjustment effort in the second half of the 1990s.[53] While in 1994 their consolidated budget deficit amounted to 1.1 per cent of GDP, in 1998 it had come down to 0.2 per cent of GDP. This is also reflected in the regional governments' debt-to-GDP ratio, which after rising steeply from 2.7 per cent in 1991 to 5.8 per cent in 1995, progressively stabilised. It reached 6.3 per cent in 1998 (*i.e.* nearly 10 per cent of total public debt), down from 6.5 per cent in 1997. However, progress in keeping debt dynamics in check has been uneven across regions (Figure 12). The new financing system for the regions, that is due to be discussed in 2001 and become effective over 2002-06, would need to further enhance the incentives for expenditure restraint by regional governments and their commitment to fiscal discipline. This will ensure that increasing fiscal decentralisation does not put the national fiscal consolidation targets at risk and, thereby, Spain's compliance with the EU's Stability and Growth Pact.

40.   Currently, to enhance fiscal discipline, the regional governments' borrowing policies are subject to legal constraints and, in addition, have to be consistent with the overall policy objectives on fiscal deficits at the national level. Co-ordination of fiscal policies is implemented within the CPFF (*"Consejo de Política Fiscal y Financiera"*), which sets four-year targets for regional governments' deficits and debt, and is monitored on a bilateral basis by the government and each region (Box 4). However, enhancing incentives for expenditure restraint by regional authorities involves matching their rising spending competencies by more extended responsibilities for raising taxes, so as to reduce reliance on transfers from central government that softens their budget constraint. Moreover, assigning broader tax bases to regional governments would reduce the volatility of their tax revenues and allow an easier transition to a lower level of resource guarantees.

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51.   Goods and services which are taxed at the super-reduced or reduced rates include: books, food, hotels, restaurants, drugs and medical services, water, private house acquisition (OECD, 1999*a*).

52.   See OECD (1999*b*), for an estimation of the costs of reduced VAT rates and its distribution along the income scale.

53.   Territorial governments comprise both regional governments (autonomous communities) and local administrations. The budget deficit of the consolidated territorial governments mainly reflects the financial deficit of regional governments, as the financial accounts of local administrations are practically balanced. The data referred to thereafter are from Bank of Spain, "Financial accounts of the Spanish economy 1989-1998".

Box 4. Borrowing constraints for regional and local administrations

The Maastricht criteria for nominal convergence rely on a broad definition of public administration in the computation of deficit and debt levels, by including also those of regional and local governments. Fiscal deficits of autonomous communities in Spain have evolved since 1980 depending on the level of competencies devolved to them and channels of financing. In general, they rose at the beginning of the 1990s, and have been contained since then to sustainable levels for most of them. The 1980 Law that regulates the financing system for regions, and subsequent legislation, have established different provisions that help restraining regional fiscal deficits:

- Credit operations of maturities above one year cannot exceed capital investment. This means that, apart from short-run cash management operations, budgets must have positive gross savings, following the golden rule principle by which deficits should only finance capital expenditure.
- Debt service in a given year cannot exceed 25 per cent of current revenues.
- Debt issues of regional governments and foreign borrowing must be approved by the State.

Local governments face similar restrictions on their budget balances and debt levels. In particular:

- Short term credit operations can only finance transitory cash management shortfalls, and should not exceed 30 per cent of current revenues of the previous year.
- New credit operations need the approval of the State when there has been negative net saving in the final budget of the previous year, or when debt levels exceed 110 per cent of current revenues. For large local governments, where debt is concentrated, these approvals may require the presentation of debt consolidation plans, which must be endorsed by the central government.

However, existing rules on deficit and debt restraint are not fully binding for regional governments, since governments that surpass ceilings are difficult to penalise. Non-authorisation of credit by the central government has been the only tool to penalise territorial governments. However, apart from debt issues, finance can be obtained through bank loans, though this source has become more expensive since the level of debt peaked in the early 1990s. Annual programmes of deficit reduction, which are bilaterally negotiated between the State and each region, have been in the end the main factor behind the deficit restraint of regions in recent years.

Figure 12. Debt of regional administrations
As a per cent of regional GDP
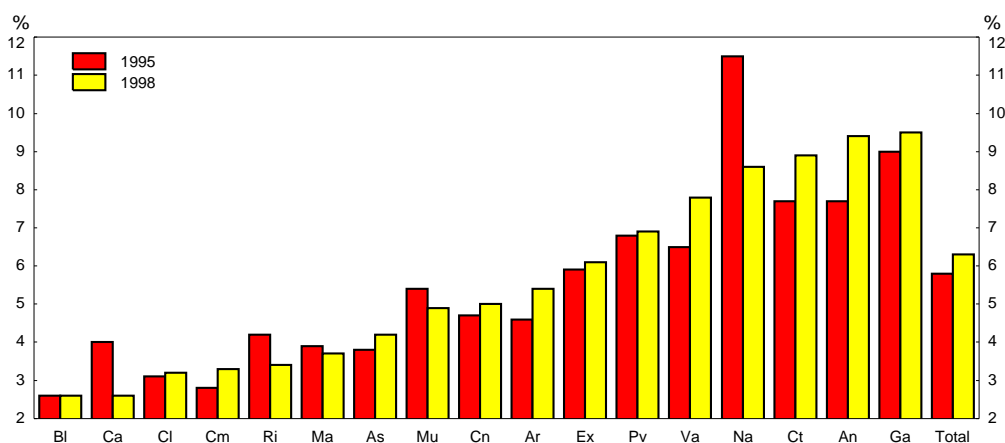
Note: An: Andalucía, Ar: Aragón, As: Asturias, Bl: Baleares, Cn: Canarias, Ca: Cantabria, Cm: Castilla-La Mancha,
Cl: Castilla y León, Ct: Cataluña, Ex: Extremadura, Ga: Galicia, Ri: Rioja, Ma: Madrid, Mu: Murcia,
Na: Navarra, Pv: País Vasco, Va: Comunidad Valenciana.
Source: Bank of Spain, Statistical Bulletin.

36

The Basque Country and Navarra regions have extensive spending and revenue raising powers

41.   Spending and revenue raising powers vary significantly across the 17 regional governments. At one extreme are the Basque Country and the Navarra region. These two regions now have their own personal and corporate income tax systems and collect most taxes. Most expenditure powers have been devolved, a main exception being social security transfers (excluding health) which are implemented by Spain's unitary social security system. For other spending programmes carried out exclusively at the State level (mainly foreign affairs, defence and some network infrastructure), these two regions pay a share to the State, the "*cupo*" (Box 5). Under this financing model, transfers across regions are thus limited to social security transfers and contributions, and to the participation in spending associated with defence, foreign affairs and some network infrastructure.

<div style="border:1px solid black; padding:10px;">

<div align="center">Box 5. **The economic agreement between the Spanish State and the Basque Country**</div>

Financial flows from the Basque Country to the Central government

Financial relations between the State and the Basque Country are shaped by a transfer, called "*cupo*". It flows from the region to the central government, very similar to the funding of EU common policies but contrasting with the model prevailing in most other OECD countries whereby financial transfers flow from the higher to lower authorities. A major reason for these peculiar arrangements is history. A similar system was in force from the end of the nineteenth century to the civil war. It was abolished in 1937 in two of the three Basque provinces because they were then considered as traitors to the Franco regime. The *cupo* corresponds to the Basque Country's contributions to the expenses which are borne by the State (mainly foreign affairs and defence-related expenditures, and some infrastructure investment programmes such as airports and ports). Since the amount of the *cupo* depends on expenditure decisions taken by the State, some observers describe this system as one of "unilateral risk" falling on the regional government, contrary to most existing models of fiscal federalism where the State bears most of the risks.[*] The Basque Country's contribution to expenditures at the State level is defined by the ratio of the regional GDP to the national GDP (for the period 1997-2001, the Basque Country's share has been set at 6.24 per cent).

Large responsibilities in setting and in collecting taxes

The Basque Country is responsible for setting the conditions, managing, inspecting and collecting all taxes, except for custom duties and some excise taxes (VAT rates and exemptions are set by the central government but collected by the Basque tax administration).

Most prominent tax incentives in the Basque Country and Navarra special corporate tax regimes are: *a)* a reduction in taxable profits during the first 4 years of profitable operation — by 99, 75, 50 and 25 per cent respectively (50 per cent in the case of Navarra); *b)* a general tax credit (15 per cent) granted for investment in new fixed assets — increased by an extra 5 per cent where there is concomitant employment creation; *c)* a special tax credit of 45 per cent granted for fixed investment above ESP 2 500 millions; *d)* more generous tax credits (30 per cent) for investment in R&D, as well as for expenses on staff training and on environmental improvement; and *e)* a reduced statutory corporate tax rate of 32.5 per cent, and *f)* carry-forward of tax losses over a longer period (15 instead of 10 years).

The personal income tax system differs also significantly from elsewhere in Spain. The tax schedule is more progressive (marginal rates ranging from 17 to 50 per cent — compared with a 18 to 48 per cent range in the rest of Spain), and tax credits covering family expenses have not been substituted by a family exempted income.

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*   See Lambarri, C. and van Mourik, A. (1998).

</div>

Extending this model to other regions would require to reconsider transfers across regions

42.   Revenue raising powers of the other regional governments are more limited. In 1997, these so-called "common regime" regions were granted revenue-raising powers on a share of the personal income tax and on the so-called "ceded" taxes (mainly on property and property transfers).[54] Taxes over which the common regime regions have revenue raising powers account for about one fifth and one half of their total and unconditional resources, respectively (Box 6). The remaining tax receipts are pooled at the central government level and redistributed across regions so as to guarantee each region the ability to provide a given standard of public services. Through this redistribution of tax receipts, rich regions contribute to the finances of the poorest regions. They would thus benefit most if the Basque Country model were extended to them. However, extending this system to the rest of Spain would entail to reconsider two principles embodied in the Constitution: solidarity across regions and sufficiency in resources to finance the activities transferred to each of them.

Enhanced reliance on the regions' own personal income tax receipts induces a high volatility of resources

43.   The implementation of the 1997-2001 financing system for the common regime regions implies that a larger proportion of a region's financial resources depends directly upon that region's economic performance. Specifically, for a region which accepted the agreement, the share of unconditional financial resources that depends on its own personal income tax doubled. It varies nevertheless significantly from one region to another (Figure 13), and is higher in the richest regions. However, the poorest regions, whose income is expected to grow on average faster than the richest ones, should benefit most over the medium term. The implementation of the agreement could result in an increased volatility of the regional tax base and a wide dispersion in the degree of revenue risks across regions. Reinforcing the associated risk for the regions' revenues is the volatility of the household income tax base, which is much higher than for private consumption or nominal GDP (Table 6). Furthermore, the volatility in personal income tax revenues is substantially higher in small regions with little industrial diversification. The standard deviation of Castilla La Mancha or Extremadura's personal income tax is, for instance, much higher than the national average.

44.   Tax competition across regions, allowed for 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 on tax rates) and a stricter definition of tax residence was implemented. So far, none of the regional governments has changed marginal rates on the regional component of the personal income tax though many of them have introduced or increased deductions associated with family or housing expenses. This may partly reflect the difficulties in estimating the potential revenue impact of any changes in marginal rates, while the costs of introducing tax credits according to the family situation of taxpayers are much easier to assess. Long delays in publishing data on regional personal income tax collection further reinforce this uncertainty and hinder the use of revenue raising powers by the regions (data for the 1997 personal income tax outcome on a regional basis were not made public before July 1999).

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54.   The so-called "common regime" covers two groups of regions: those (called the Article 151 regions) which have taken more extensive spending powers — including health and education — and the others (Article 143 regions). The "fast-track" group of regions (Article 151) includes: Andalucía, Canarias, Cataluña, Galicia, Valencia. The others (Article 143) are: Aragón, Asturias, Baleares, Cantabria, Castilla La Mancha, Castilla y León, Extremadura, La Rioja, Madrid, Murcia.

Box 6. **The financing of regional governments under the so-called common regime**

In addition to conditional State transfers earmarked for specific purposes (the largest being social security transfers), regional governments' financial resources include:

- Taxes whose administration was already transferred to the regional governments in 1997 (taxes on wealth, inheritances and donations, property transactions, stamp duties and gambling). These taxes accounted, on average, for 23.3 per cent of the regions' unconditional resources in 1996.

- User fees and charges for the services they provided. Related revenues account for 2.4 per cent of the regions' unconditional resources.

- A 15 per cent share of total personal income tax revenues collected in their jurisdiction and over which they do not have any taxing powers.[1]

- From 1997, an additional 15 per cent share of total personal income tax revenues collected in their jurisdiction. The 12 regions which have accepted the 1997-2001 financing model have gained the right to set rates and deductions, within some limits. This component accounts on average for less than one fourth of the regions' unconditional resources, though with significant variations from one to another region (from almost 60 per cent in Madrid to 12 per cent for Galicia, see Figure 12), largely reflecting differences in per capita income and competencies transferred.

- A given share of overall tax revenues collected by the State (the so-called *Participación en los Ingresos del Estado*, PIE), including all direct and indirect taxes, and social security contributions.

In the 1992-96 financing model, the total amount of unconditional resources made available to the regional governments was determined on the basis of the estimated cost of activities taken over by the regional governments. The main variables used for the estimation and the distribution of resources across regions were: "distributive variables" (population, geographic and administrative dispersion), and "redistributive variables" (mainly income per capita). The closing variable of this financing model was the share of the State tax revenues — revised every 5 years — which was allocated between regions so as to guarantee each region the ability to provide a given standard of public services. Sharing the overall tax revenues collected by the State was thus the main mechanism for implementing inter-regional solidarity transfers. The increase in the regions' unconditional resources over the five-year period was the result of both the tax performance in their jurisdictions (for the three first components of their unconditional resources) and in the overall Spanish territory (through the share in State tax revenues). Three regions (Andalucía, Castilla La Mancha and Extremadura), which have not accepted the 1997-2001 financing model, continue to be financed under these conditions, though without adjustment in the total amount of unconditional transfers allocated to them to reflect changes in distributive and redistributive variables. These regions do not have any taxing powers either on the so-called ceded taxes or on the regional component of the personal income tax.

The 1997-2001 financing model for 12 out of the 15 common regime regions has changed the rationale of the system, by replacing the implicit redistribution scheme between regions by two explicit guarantees on each region's financial resources.[2] *First*, the so-called "State revenue share" will increase in line with national GDP, from the 1996 reference year and no longer in line with tax revenues. The guarantee scheme means that if tax revenues at the national level grow less than national income, regional resources will not be affected. The State will have to bear the brunt of adjustment cost. *Second*, if personal income tax revenues collected in a region's jurisdiction, and devolved to it, grow less than the national GDP, the State is committed to proceed with a compensating transfer. If it were to grow more than the national GDP, the region keeps the extra-revenues, thus limiting the scope of the implicit redistribution across regions.

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1. Regional governments were deemed to gain taxing powers over this share when all of them have assumed the responsibility over the education system. This might not happen before the end of 2001. A few regional governments, for instance, the autonomous community of Madrid, have not been granted this share; their resource level would have exceeded the overall amount of unconditional resources required to undertake the activities transferred to them.
2. The model has been designed to be revenue neutral using 1996 as a base year. The total amount of unconditional resources allocated to each region has not been adjusted for distributive and redistributive variables. In particular, those regions where population growth has been rapid may be penalised.

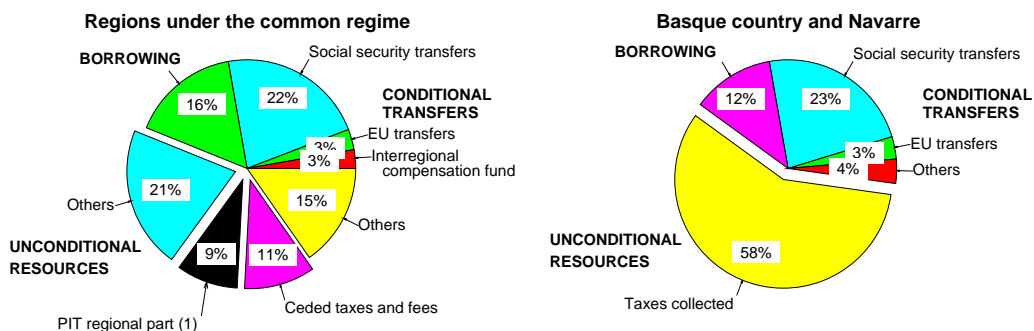Table 6. **Volatility of tax bases and revenues at national and regional levels**

	GDP[1] 1986-96		Private consumption		Household income (before tax) 1986-95		Indirect taxes 1986-96		Personal income tax 1990-96		GDP per capita
	Average growth rate	Standard deviation	Average growth rate 1986-96	Standard deviation 1992-96	Average growth rate	Standard deviation	Average Growth rate	Standard deviation	Average growth rate	Standard deviation	1995 Spain = 100
At national level	**8.6**	**3.0**	**8.4**	**1.4**	**9.3**	**3.5**	**8.2**	**5.0**	**6.8**	**3.2**	**100.0**
At a regional level											
Andalucía	8.5	3.8	8.4	2.1	9.4	3.8	n.a.	n.a.	6.9	3.5	74.3
Aragón	8.1	3.3	7.9	1.6	9.0	3.8	n.a.	n.a.	6.1	3.8	113.8
Principado de Asturias	7.0	2.5	7.6	1.5	8.0	4.0	n.a.	n.a.	6.5	2.9	91.3
Baleares	8.8	2.8	7.9	1.1	9.4	3.4	n.a.	n.a.	8.1	1.9	136.8
Canarias	8.9	2.8	8.8	1.6	9.6	3.2	n.a.	n.a.	8.9	2.3	92.8
Cantabria	8.4	4.0	8.4	1.8	8.3	3.7	n.a.	n.a.	5.6	2.5	97.2
Castilla y León	7.8	2.0	7.7	1.5	8.5	3.4	n.a.	n.a.	7.3	4.0	90.9
Castilla-La Mancha	8.9	4.1	8.4	1.4	9.2	3.9	n.a.	n.a.	8.4	5.1	82.2
Cataluña	9.2	3.3	8.7	1.4	10.2	4.5	n.a.	n.a.	6.5	3.7	124.6
Ceuta y Melilla	9.1	4.2	8.2	0.8	8.6	3.5	n.a.	n.a.	..	..	..
Extremadura	8.5	3.9	8.1	1.4	9.5	4.0	n.a.	n.a.	9.1	5.4	69.8
Galicia	8.2	2.4	8.0	1.4	8.9	3.7	n.a.	n.a.	8.5	3.2	77.7
Madrid	9.1	3.1	8.2	1.5	9.6	4.5	n.a.	n.a.	5.8	4.1	124.0
Murcia	8.1	3.9	9.5	1.9	8.8	3.9	n.a.	n.a.	7.7	2.7	88.8
Navarra	8.4	4.5	9.6	1.6	10.0	4.2	n.a.	n.a.	..	..	120.9
País Vasco	7.5	2.9	8.0	1.5	8.2	3.8	n.a.	n.a.	..	..	118.1
La Rioja	8.5	3.4	8.7	1.9	9.1	3.7	n.a.	n.a.	7.2	2.0	114.4
Comunidad Valenciana	8.2	3.2	8.1	1.9	9.5	3.9	n.a.	n.a.	7.6	1.6	98.9
Memorandum item:											
At national level, 1986-96	8.6	3.0	8.4	3.1	8.9	3.6	8.2	5.0	13.1	11.5	..

1. Value added data are used for the regions since GDP data are available only for a shorter period.

Source: INE, Agencia Estatal de Administración Tributaria and OECD Secretariat calculations.

Figure 13. The financing of the regional governments
1996

A. Total financial resources

Regions under the common regime

BORROWING
Social security transfers
16%
22%
CONDITIONAL TRANSFERS
3%
EU transfers
3%
Interregional compensation fund
21%
15%
Others
Others
UNCONDITIONAL RESOURCES
9%
11%
PIT regional part (1)
Ceded taxes and fees

Basque country and Navarre

BORROWING
Social security transfers
12%
23%
CONDITIONAL TRANSFERS
3%
EU transfers
4%
Others
58%
UNCONDITIONAL RESOURCES
Taxes collected

B. Unconditional resources in some regions under the common regime

Cataluña

State transfers (3) (16%)
Ceded taxes and fees
32%
26%
PIT, participation in State revenues (2)
26%
PIT regional part (1)

Andaluciá

Ceded taxes and fees
16%
11%
PIT regional part (1)
61%
11%
State transfers (3)
PIT, participation in State revenues (2)

Galicia

Ceded taxes and fees
15%
12%
PIT regional part (1)
61%
12%
State transfers (3)
PIT, participation in State revenues (2)

Castilla-La Mancha

State transfers (3)
Ceded taxes and fees
32%
25%
21%
21%
PIT regional part (1)
PIT, participation in State revenues (2)

1. Corresponds to the 15 per cent of personal income tax revenue collected in the region, over which those regions which accepted the 1997-2001 financing model have gained taxing powers since 1997.
2. Corresponds to the additional share (for most regions, 15 per cent) of the personal income tax revenues collected in their juridiction and over which they cannot modify the marginal rates or deductions.
3. Corresponds to the regional share of overall tax revenues collected by the State.
Source: Bank of Spain, Agencia Tributaria.

The associated revenue guarantee scheme may hinder fiscal consolidation

45.   Aiming to protect the regions against temporary revenue shortfalls, a guarantee scheme was designed in 1996, but amendments in 1998 significantly diminished the degree of fiscal co-responsibility of the regions. In the original agreement, the State committed to partly compensate a region with transfers in the event its personal income tax collection grows more slowly than at the State level.[55] Recognising the increased volatility of the regions' resources which could result from the implementation of the new financing system, the agreement was modified in April 1998, retroactively. From 1997, regional governments no longer face any downside risk on their core financial resources: the State is committed to grant matching transfers to each individual region if the 30 per cent share of personal income tax revenues collected in its jurisdiction or the so-called "share of the State revenues" grows less than nominal GDP.

46.   Such a guarantee scheme poses several problems. *First*, 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.[56] It may thus imply a significant cost for the State budget, though difficult to measure since data on the income tax collected by regions are made public with a long delay.[57] In 1997, personal income tax receipts grew less than the national GDP in 14 out of the 15 common regime regions while other tax receipts were booming. The regions thus received compensating transfers for the loss in personal income tax receipts and simultaneously kept the windfall increase in other tax revenues. Overall, additional resources transferred by the State to the regions as a result of the new financing system would amount to around ESP 90 billion (equivalent to 0.5 per cent of the State tax revenues in 1997) had the system been in place for all the common regime regions.[58] *Second*, guarantees do not provide regional governments with the right incentives to contain expenditures. This will thus make it more difficult to foster fiscal consolidation. *Third*, the guarantee scheme also constrains efforts to reduce the overall tax burden since the cost would have to be borne exclusively by the central government — as has happened with the personal income tax reform.[59] However, the low income tax revenue elasticity experienced since

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55.   The agreement stipulated that if a region's personal income tax revenues grew less than the national income, the central government would compensate through transfers up to 90 per cent of the rate of growth of the State personal income tax collection. For more details, see OECD (1998*a*), and Ezquiaga and García (1997).

56.   Before 1997, the law stated that the share of the State's revenues transferred to regional governments would grow as the State's tax revenues, but in any case could not grow faster than GDP.

57.   Past developments provide an indication of the likely frequency and magnitude of the transfers associated with the guarantee scheme: in 1995 and 1996, 8 and 12, respectively, out of the 15 common regime regions have had their personal income tax revenues growing less than the national GDP, and would thus have been entitled to compensating transfers had the guarantee scheme been in place. According to OECD Secretariat estimates for the period 1994-96, the cost of the personal income tax guarantees for the State would have amounted to around ESP 90 billion had the system been in place, with 50 billion in 1996 alone.

58.   In 1997, personal income tax receipts grew less than the nominal GDP in all regions but the Canary Islands. State transfers required to compensate for this loss amount to ESP 33 billion. Furthermore, in the previous financing model the amount each region would receive from the so-called "share of the State revenues" could not grow faster than the nominal GDP. By removing this upward limit, the State had to transfer an additional ESP 60 billion (State revenues grew by 11.3 per cent in 1997, compared with a 5.46 per cent growth in nominal GDP). Because three regions (Andalucía, Castilla la Mancha and Extremadura) are not entitled to compensating transfers since they have refused this model, the total cost for the State budget stands below the estimated ESP 90 billion.

59.   According to the analysis carried out by Carrasco *et al.* (1998), State transfers to the regions which will be required to compensate for the fall in the 15 per cent share of personal income tax revenues devolved to

the early 1990s, combined with highly income-elastic outlays devolved to the regions (*e.g.* health, or to a lesser extend education), may induce fiscal imbalances as real income grows that might partly justify these guarantees.

Issues of tax competition stemming from broadening the existing model of special corporate tax regimes

47.   Tax competition between lower levels of government may be a healthy feature of the tax system, enhancing its efficiency, as long as it does not erode tax bases to such an extent that this would lead to the underprovision of public goods. At present, corporate income tax revenues — other than those collected in the Basque Country and Navarra — are pooled nation-wide and, furthermore, companies with fiscal residence in the Basque Country but nation-wide operations are subject to the common regime (Box 7). More generous corporate income taxation and tax incentives for investment provided by the Basque Country regime might involve, first, shifts of the corporate income tax base — and hence revenue effects for government budgets. Second, they could induce shifts in plant location and employment that involve real resource reallocation and generate further revenue effects. Current arrangements are not likely to involve such shifts within Spain for companies below the ESP 500 million threshold, as tax incentives are granted according to fiscal residence — independently of operations or plant location.

48.   Tax-induced location shifts might, nevertheless, arise for companies above the ESP 500 million turnover threshold, in order to benefit from the more generous corporate tax provisions in the Basque Country special regime — particularly those granted for general investment purposes and business start-ups. A case in point, which the European Commission has been investigating on the grounds of distortions to the single market, concerns the tax subsidies received by the enterprise *Ramodin*. This firm shifted its fiscal residence to the Basque Country district of Laguardia (Alava), from the neighbouring district of Logroño, in order to benefit from the special corporate tax credits for investment provided by the Basque Country special regime. Fiscal residence shifts could deprive some regions of corporate income tax revenues to the benefit of regions offering more attractive regimes. Although existing corporate tax-sharing agreements may mute revenue effects, location shifts will involve changes in resource allocation, as well as revenue effects stemming from other taxable bases (personal income tax, indirect taxes).

Box 7. **Sharing corporate income tax revenues between the Basque Country and the central government**

Companies qualifying for the Basque Country corporate income tax must set their fiscal residence in one of its territories and realise at least 25 per cent of the turnover within their borders. Companies with fiscal residence in the Basque Country, with turnover falling short of this threshold, are subject to the general regime. Corporate income tax liabilities determined according to each of the two regimes are assigned to each jurisdiction (the central government or the Basque Country) according to the following rules:*

a)   Companies with turnover below 500 million pesetas are liable only to the jurisdiction of their fiscal residence — whichever the place they operate.

b)   Corporate income tax liabilities of companies with turnover above 500 million pesetas are assigned to the Basque Country if they operate exclusively in its area, independently of fiscal residence.

c)   Corporate income tax liabilities of companies with turnover exceeding 500 million pesetas that operate in both territories are shared — according to relative operations ascertained under VAT regulations — wherever the companies' fiscal residence.

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*   See, Basque Government (1998), art. 17 to 20.

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them, as a consequence of the 1998 reform, would amount to ESP 142 billion (close to 0.2 per cent of 1999 GDP).

Local governments: heavy reliance on taxes and licensing fees on land and real estate

49.   The high dependency of local authorities' resources on land values tends — in conjunction with long administrative procedures to requalify the potential use of land — to drive prices up. In 1997, 42 per cent of current revenues raised by local authorities originated from taxes on land and real estate (22 per cent of their total revenues).[60] Since then, a new State Land Regime and Valuation Law was approved (June 1998).[61] Its main objective of lowering land prices has not been achieved so far — prices have continued to rise steeply, by over 50 per cent for public land auctioned over the 12-month period following the reform. This development partly reflects the absence of alternative revenue sources for local authorities, giving them an incentive to restrict land supply in order to drive prices up and thus boost their revenues. On the other hand, local authorities' revenues from user fees and charges on specific services contribute a relatively low share of their resources, partly owing to the inadequacy of the law in stipulating over which goods and services these fees and charges could be levied, unclear responsibility for collection and lax enforcement (Petitbó and Povedano, 1998; Moreno, 1998; and Echebarría, 1998). The case of wastewater fees is revealing in this regard since municipalities are responsible for wastewater treatment.

Taxes to achieve environmental goals: the case of wastewater and energy

50.   Largely reflecting low prices, pressures on available water are among the highest in the OECD. However, a large amount of industrial and, in particular, agricultural effluents receives little or no treatment (see OECD, 1997*e*). The 1985 Water Act states that industrial and municipal discharge permit holders must pay a water pollution fee — *canon de vertido*. The fee was established to fund wastewater treatment facilities, though its level seems unrealistically low (Castillo Lopez, 1999). The proceeds can be shared *de facto* between the three levels of governments while responsibilities for building and managing these facilities are spread between several public entities and government levels, cutting the link between the fee and service provision. As a matter of fact, many industries have refused to pay, arguing that the investment plan for the associated treatment plants were not approved — 40 per cent of the levies for authorised dischargers were not paid in 1997. Furthermore, the fee is imposed only on holders of discharge permits while a large proportion of discharges was still carried out without a permit (80 per cent), partly reflecting complex permitting procedures and enforcement problems.[62] In addition, water used for irrigation is exempted from wastewater charges despite its significant pollution potential of ground and surface water resources associated with a generally intensive use of pesticides and fertilisers. Overall, wastewater charges amounted to only ESP 7 billion in 1997 — *i.e.* 1.3 per cent of the water bill paid by consumers. In addition, water prices often do not fully cover actual delivery costs.[63]

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60.   Taxes on land and real estate raised by local authorities include: the tax on real estate (IBI), the tax on the increase in the value of urban land, and the tax on construction and installations. The other main tax revenue stems from the tax on mechanically powered vehicles and the tax on economic activities.

61.   The new State Land Regime and Valuation Law aimed at: ensuring a greater supply of developable land by changing the philosophy of the law on land uses (all land is now considered to be developable unless specifically ruled otherwise); speeding up planning processes; and reducing land charges (by bringing down from 15 to 10 the percentage of land, destined for lucrative use, owners must cede to local authorities).

62.   One explanation, according to Castillo López (1999), is that the expected cost of sanctions is lower than wastewater charges or treatment costs.

63.   Water is highly subsidised in Spain: 80 to 90 per cent of the associated costs are financed through the State budget. See Castillo López. (1999).

51.   As with water, energy taxation is not well geared towards internalising environmental externalities. In this context, combating climate change by reducing greenhouse gas emissions as agreed in the Kyoto Protocol will probably be a major challenge. In the burden sharing amongst EU countries following the Kyoto Protocol, Spain has been granted a 15 per cent increase in greenhouse gas emissions for the period 1990-2010, while emissions will have to be reduced by 8 per cent for the EU as a whole. However, Spain's CO_2 emissions have already risen by 9.6 per cent between 1990 and 1996 and robust growth since then suggests that the ceiling will be reached quickly.[64] Changes to energy taxation could be part of a strategy to reduce CO_2 emissions. Energy taxation is in general lower in Spain than elsewhere in Europe (Table 7). It is currently not being used to promote consumption of cleaner fuels,[65] but taxation is primarily driven by the need to raise government revenues. In a first step, energy taxation could be restructured to reflect the carbon content of the various fuels, for instance, coal be more heavily taxed and gas more lightly. Fuel switching would reduce emissions. If that were not sufficient the carbon tax may have to be raised to induce further reductions. A climate change policy should be more comprehensive, though, and evaluate all the available options. Those would include a review of the moratorium concerning the building of nuclear power plants. Moreover, all greenhouse gases should be covered by the strategy, emission trading may be more attractive than taxation, and the flexibility mechanism allowed for in the Kyoto Protocol may provide attractive solutions, if abatement cost are lower elsewhere.

Table 7. **Share of taxes in energy prices**
1998

	Gasoline (Premium Unleaded)	Diesel	Electricity (Household)	Electricity (Industry)	Heating Oil (Household)	Gas (Household)	Gas (Industry)
Spain	**68.7**	**58.0**	**18.0**	**4.9**	**44.1**	**15.1**	**0.0**
Denmark	72.4	39.5	60.3	17.3	64.2	28.1	C[1]
France	81.2	69.5	28.1	n.a.[1]	43.4	17.1	0.0
Germany	75.2	63.1	13.8	n.a.[1]	33.4	18.8	12.7
Italy	74.7	65.2	26.5	17.5	72.0	43.3	9.7
Portugal	72.8	57.7	4.8	0.0	59.9	X[1]	n.a.[1]
United Kingdom	81.4	78.6	4.8	0.0	26.9	4.8	0.0

1.   X: not applicable, C: price is confidential, n.a. not available.

Source: IEA, *Energy Prices and Taxes* (OECD).

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64. CO_2 emissions accounted for 71 per cent of Spain's total greenhouse gas emissions in 1990. Data on other greenhouse gas emissions are not available for more recent years.

65.   The main exception is the large differential in excise taxes between unleaded and leaded gasoline. On the other hand, there is no differentiation in heavy fuel oil taxation according to the sulphur content. There is an electricity tax, but it is not differentiated by carbon content. However, tax incentives are granted, through the corporate income tax system, to co-generation activities.

Main options for reform

52.   The tax system has been designed to achieve a large number of objectives, which may conflict with one another. Reforming the tax system thus requires deciding which objectives are the most important and how far they should be pursued by the tax system or by other policies. Nevertheless, to take advantage of policy complementarities and improve the effectiveness of tax policy instrument assignments, further reform of the tax system would need to proceed in tandem with labour market and social security reforms. In addition, designing a comprehensive tax reform would have a stronger impact than reforming a limited number of taxes, because of the interconnection of the various activities of taxpayers. Moreover, taxpayers can transform the legal character of these activities — so as to reduce their tax burden — without affecting their economic content. Main tax reform options involve: *i)* Further reducing the tax burden on labour, with priority given to the low-paid, by shifting towards taxation of consumption; *ii)* Promoting tax neutrality across savings instruments and corporate tax regimes, and enhancing the effectiveness of tax incentives to investment. Improved tax neutrality would also promote tax equity, broaden the tax base and enhance tax compliance. *iii)* Strengthening tax decentralisation — also with a view to complying effectively with the Stability and Growth Pact — by: *a)* reinforcing incentives to match regional spending by locally raised tax revenues; and *b)* providing the right incentives for a sound management of public finance at the regional and central level. This section sets out the main options along these lines for reforming the tax system. They are summarised by main tax in Box 8.

Reconsider the cost-effectiveness of existing tax preferences **versus** *structural reforms*

53.   Some of the objectives pursued through differentiated tax treatments could be more efficiently handled through other policies. The highly progressive schedule of the personal income tax distorts economic decisions while tax reliefs have been used to pursue diverse social and economic goals: *e.g.* promoting housing, health, saving, SMEs and employment. However, most tax reliefs have had questionable impacts on income redistribution either because they cannot benefit the most needy (whose income is below the minimum taxable income) or because they increase the richer an individual is. In this regard, the cost-effectiveness of preferential tax treatments granted to housing, health, and leisure expenses should be reassessed. Expenditure programmes could achieve distributional objectives better. Better targeted, they are much less costly for the budget. Likewise, the reduced corporate tax rate for SMEs has been granted, partly, to compensate for higher financing and administrative costs. Tackling these impediments, in particular through an acceleration of the ongoing process to simplify administrative requirements, should become a priority. The social security system combines ceilings and floors on contributions and a complex system of reduced contribution rates on hiring several vulnerable groups of workers on a new permanent contract. These two features have raised non-wage labour costs for low-paid wage earners, and they should be re-examined. Streamlining tax reliefs which create labour market segmentation, and phasing out of ceilings and floors, combined with a labour market reform (in particular employment protection measures), could contribute more decisively to sustain the Spanish economy's employment performance. Along the same lines, easing the regulatory constraints on the supply and use of land would be more efficient than the granting of a preferential treatment of owner-occupied housing which is largely capitalised in home prices.

Box 8. **Synopsis of options for reforming the tax system**

Further reform the personal income tax

- *Further streamline tax expenditures to reduce distortions and broaden the tax base.* Aim at symmetry in the tax treatment of unemployment benefits and severance payments to reduce distortions in the labour market. Tax base broadening would allow to further reduce the tax rates, especially the top tax rates, which are still relatively high by international comparison.

- *Further reduce the preferential tax treatment granted to owner-occupied housing.* Phasing out tax preferences to housing would improve the allocation of saving, improve the distribution of the tax burden, and reduce disincentives to regional labour mobility.

- *Further alleviate the taxation of distributed profits.* This would enhance tax neutrality towards corporate financing and would raise households' participation in the market for risk capital.

- *Promote neutrality concerning financial savings decisions by eliminating differences in capital gains taxation for different holding periods.* Taxing all capital gains at the current flat rate would eliminate financial lock-in effects and improve the allocation of financial savings.

- *Replace the "forfaitaire" system of taxation ("módulos") for the self-employed by an income assessment* based on proper accounting rules, to improve transparency and enhance horizontal equity.

Further reform the corporate income tax

- *Implement a flat corporate tax rate.* This would improve corporate tax neutrality, encourage risk taking and eliminate opportunities for tax avoidance.

- *Balance tax incentives to intangible capital investment,* by raising the tax credit for staff training. This would reinforce the effectiveness of tax incentives granted to investment in R&D, which are very generous in international comparison. It would, furthermore, support labour market reform efforts.

- *Further improve provisions for carrying forward and backward losses.* This would smooth tax liabilities and enhance incentives for risk taking.

- *Phase out ad hoc tax incentives — especially those targeted according to investment size — in the Basque Country and Navarra corporate tax regimes* as they might distort competition. They should be replaced by a more neutral tax scheme, aiming to encourage risk taking. Bring in line the Basque Country foreign security holding company regime with the general regime. It is less transparent than the general regime, is very generous, and may give rise to tax avoidance.

Enhance tax administration and tax compliance

- *Assign more resources to reducing tax evasion.* Improve the use of property information and increase resources dedicated to the detection of undeclared activities. Enhancing tax enforcement will improve the distribution of the personal income tax burden.

Adjust the tax mix

- *Reduce rates of social security contributions on the low-income range by lifting rate ceilings, while abolishing contribution floors.* This would help rebalance the distribution of the tax burden on labour, and would improve employment prospects of low-skilled workers.

- *Reduce the tax burden on labour.* To finance revenue shortfalls, the priority should be given to expenditure cuts. As a second best, a switch to indirect taxes could be envisaged.

- *Apply more consistently the "benefit principle" on a wider range of publicly provided services.* This would provide a better link between private benefits and social costs. Increasing and better enforcing waste water pollution fees, for instance, would help both improve scarce water resource management and achieve environmental goals.

- *Consider taxing pollutants according to their environmental costs* in order to provide the right market signals to consumers and producers. To reduce greenhouse gas emissions, energy taxation should reflect the carbon content of the various fuels.

Enhance tax decentralisation

- *Match rising regional expenditure competencies by increased reliance on locally raised tax*es, rather than on transfers from central government. Greater tax decentralisation would give a better incentive to regions to grow their tax base and control expenditure, fostering fiscal consolidation at the national level.

- *A further devolution of taxing powers to the regions should rely on a wider basket of taxes*. This would reduce the volatility of regional tax revenues and the potential costs of guarantees for the central government. A tax-sharing arrangement on the less volatile VAT could be envisaged.

- *Assign to municipalities a broader tax bundle (especially excises and user fees)*, to reduce their reliance on land and real estate taxes that hinder urban land development. The urban land appreciation tax is most harmful in this regard and should be amended.

Reduce the tax burden on labour income

54.   Tax policy reforms aiming at improving labour market outcomes would need to be carried out in tandem with labour market reforms, to take advantage of policy complementarities. Cutting social security contributions at the low-end of the pay scale should be a priority. This would reduce the regressive pattern of labour income taxation and improve employment prospects of low-skilled workers who are more vulnerable to the adverse effects of a high tax wedge. Suppressing the minimum social security payment, which is even more penalising for the low skilled, would be of immediate concern. To achieve revenue neutrality, a first possibility consists in lifting social security contribution ceilings. As pensions covered by social security contributions are designed on an income support rather than on an insurance principle, a change in ceilings should not inevitably call for a matching increase in benefit entitlements. Raising the employment rate by reducing the tax wedge on the employed is also needed to enhance the sustainability of the pay-as-you-go social security system in view of ageing population prospects. Though a reduced tax burden on labour should be paid for by cuts in primary expenditure, as a second best, a shift onto other tax bases might also be considered. Raising consumption-based taxes would be a natural possibility, in view of their rather low GDP share compared with other OECD countries and given that consumption's share in GDP is broadly similar to that of the gross wage bill. However, altering the tax mix towards increased taxation of consumption changes income distribution in a way that might need to be taken into account in policy design. Such a tax shift involves higher effective taxation for those on transfer income — especially of unemployed and pensioners. At the same time, reducing social security contributions on the low-paid would help smooth the distributional consequences of a switch to consumption taxes to pay for the projected rise in the social expenditure burden.

55.   Macroeconomic model simulations — carried out by the European Commission using the Quest II model and by the OECD Secretariat using the Interlink model — can help to broadly assess the relative pay-off, in terms of growth and employment, of changes in the tax mix (Table 8; the main properties of the simulations are described in Annex II). A reduction in labour taxes matched by broader social security reform — mirrored in these simulations by reduced government transfers to households — has a much stronger employment and output impact than cuts in labour taxes offset by an increase in other taxes — especially consumption taxes. However, even though the long-run output response to a shift in the tax mix from labour to consumption taxes may seem subdued, the pay off is far from negligible. For instance, raising the effective VAT rate in Spain to the EU average would allow labour taxes to be reduced

in a revenue-neutral manner by around 2.5 percentage points of GDP.[66] This could lead to a 2/3 per cent permanent increase in the level of GDP. Moreover, there is considerable room to bring this growth impact closer to the — twice as high — average response in the European Union, by stepping up the ongoing process of labour market reform.

56.   To maximise the employment impact of labour tax cuts, after-tax replacement income should be kept constant in real terms, rather than as a fraction of income from work. If this were not the case, wage moderation and enhanced work incentives stemming from a drop in the tax wedge would be largely muted, leading to a rather weak employment response.[67] Moreover, to remove tax-induced distortions in the labour market and enhance incentives of workers on replacement income to re-enter employment, severance payments should be included in taxable income, as is the case with unemployment benefits since 1994. Tax cuts on personal income should not be reflected in increased after-tax benefits from employment security provisions and unemployment insurance.

57.   A broad window of opportunity for a more ambitious reduction of the tax burden on labour will be provided by the new round of discussions on the *Toledo Pact* in 2000. In the absence of pension reform, a substantial hike in taxation would be called for to offset the projected increase in social security expenditures stemming from population ageing. Simulations by the European Commission, using the Quest II model, have assessed the impact on GDP and employment of two alternative scenarios to match the projected increase in social security cost. *First*, an increase in labour income taxes and, *second*, a wider spreading of the cost by an increase in indirect taxes (Table 8). In Spain, the long-run output and employment costs turn out, in both cases, to be lower than the EU average. It is substantial, however, with a permanent GDP loss of nearly 3 per cent and an employment loss of 2.5 per cent (both assessed over the long term), if labour taxes were to finance the increased expenditure. The cost in terms of foregone output and lost jobs would be considerably lower if, instead, higher social spending were to be paid for by a rise in indirect taxation. The cost remains, however, sizeable and could be lowered only by a far-reaching pension reform.

Improve the neutrality of the tax system

Improve further tax neutrality on savings instruments and enhance firms' financing channels

58.   Improving further the neutrality of taxation on financial assets would increase the liquidity of the Spanish stock market and the efficiency of resource allocation. This would also promote corporate governance and help to diversify the ownership structure of companies, which is of special relevance for recently privatised enterprises, and thus remove one barrier to competition between firms with intertwined interests but in overlapping markets. Progress entails removing the preferential tax treatment on long-term capital gains, by taxing all capital gains at the current flat rate, eliminating thus lock-in effects that hinder the reallocation of funds from mature, slow-growing enterprises to the most innovative ones. Placing the taxation of dividends and retained earnings 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 — as for instance in the Basque Country special corporate tax regime. In addition, the preferential treatment granted to life insurance contracts should be reconsidered since it may induce a misallocation of resources at least for two reasons. *First*, it gives these financial intermediaries an undue competitive advantage over

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66.   In 1996, the effective VAT rate (VAT revenue as a share of consumption) in Spain was 4.3 percentage points below the (simple) average of European Union countries (according to OECD revenue statistics). The share of consumption in GDP is at present slightly over 60 per cent.

67.   See also OECD (1995). A formal analysis of these points can also be found in Pissarides (1998).

other financial actors. *Second*, institutional investors tend to weight their portfolio towards general governments' and mature enterprises' securities, at the detriment of risk-taking and newly created firms. One option for more comprehensive reform would be to tax all income from financial assets with the same flat tax rate, following the Nordic countries' model. This involves a trade-off between equity and efficiency. A low flat tax is likely to have a regressive impact. However, with the advent of the single currency, tax competition could raise pressures to align capital income taxation with that of lower-tax countries. A flat tax also has the advantages of lowering collection costs and being neutral for resource allocation.

Table 8. **Long-run effects of tax changes: model-based estimates**[1]
Differences from baseline in per cent

		GDP	Employment
1 per cent of GDP reduction in:[2]			
Labour taxes	**Spain**[3]	**0.80**	**1.00**
	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
1 per cent of GDP shift from:			
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
Tax changes to match projected rise in social security cost resulting from ageing[4]			
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

1. Simulations (except for first row) are based on the European Commission's Quest II model.
2. Offset by a reduction in government transfer payments to households.
3. Simulation using the OECD Interlink model.
4. Projected social security expenditures span over the period up to 2030.

Source: European Commission, DG II and OECD Secretariat.

Improve neutrality of corporate taxation to further enhance business investment, risk-taking and entrepreneurship

59.   Concerns that SMEs might face cost disadvantages have to be balanced against the need to promote tax neutrality. In the case of SMEs the tax system may not be the best way to deliver aid in a cost-effective way since, to benefit from tax incentives, they need to make profits. Hence, if deemed necessary, aid to SMEs would be best delivered through targeted expenditures (OECD, 1994*b*). On this principle, enhancing the cost effectiveness and the consistency of tax incentives to SMEs, granted through the corporate and personal income taxes and the tax on inheritances and gifts, would involve:

  – removing the reduction in the corporate tax rate for smaller companies. A flat-rate corporate tax structure would improve tax neutrality, encourage risk taking and reduce incentives for tax avoidance;

  – a further liberalisation of provisions for carrying forward and especially backward losses to enhance incentives for risk taking;[68]

  – the phasing out of the "forfaitaire" system of taxation, to improve transparency and enhance horizontal equity in the taxation of self-employed and micro-enterprises;

  – the further softening and extension to a wider range of descendants, of the provisions of the inheritance tax aiming to prevent the break-up of family businesses — relief of up to 95 per cent of the inheritance tax base for transfer of small businesses to the spouse, children and adopted descendants. Streamlining the inheritance tax and the associated exemptions would help improve horizontal equity in the transmission of small businesses.[69]

Focus investment tax incentives and special corporate tax regimes better

60.   Enhancing tax incentives to staff training would rebalance incentives to intangible investment and would help firms internalise the full productivity enhancing impact and labour market benefits of their investments. In addition, improved firm training, by better tuning worker skills to firm activities, could strengthen the links of workers to their companies. It might hence reinforce the impact of recent labour market reforms aiming to reduce the pervasiveness of temporary employment contracts. Promoting firm training could thus be seen as providing a form of implicit employment safeguard, and might allow easing the strict employment protection legislation. As far as the productivity of R&D investment increases along with the skills of the firm's staff, more generous tax incentives to training should enhance the effectiveness of the already generous tax subsidies granted to R&D investment. Carry-over of unused tax credits for investment in training could also be increased (currently limited to 5 years, for up to 35 per cent of tax liabilities).

61.   Tax incentives provided by special corporate tax regimes according to the amount of investment may distort competition and lead to efficiency losses. Moreover, *ad hoc* tax incentives that currently exist in special corporate tax regimes should be phased out, though tax competition based on generic rules,

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68.   In some EU countries, losses may be carried forward indefinitely to be set off against future profits (*e.g.* Germany, the United Kingdom and the Netherlands). Provisions for carrying backward losses also exist in Germany (one year), the United Kingdom (one year) and the Netherlands (three years).

69.   Examples of differences in the fiscal cost of inheritance transfers, according to compliance with existing regulations and tax exemptions, are given in De Aguiar (1998).

well-focused and transparently targeted, should not be discouraged. Banning *ad hoc* tax incentives would help overcome the structural bargaining weakness of lower-level governments which, faced with threats of firms to relocate, might see no alternative than granting a higher level of tax subsidies to keep firms from moving away. On these principles, the generous tax subsidies granted by the Basque Country special corporate tax regime should be replaced with a more neutral scheme. If the policy aim is to enhance risk taking and entrepreneurship, such a scheme could, for instance, take the form of free carry-back and forward of losses and unused tax credits, so as to smooth the inter-temporal stream of company taxes. Moreover, the preferential headquarters tax regime under the Basque Country legislation is less transparent than the general regime, very generous, and should be harmonised with the general regime.

Phase out tax incentives to owner-occupied housing and remove tax distortions in the housing market

62.   More ambitious steps to reduce tax preferences granted to owner-occupied housing would help remove underlying distortions in the allocation of savings and could rebalance the pattern of private investment towards business investment. This would lead to a higher capital/labour ratio that should enhance labour productivity and further improve employment growth prospects. Priority should be given to further reducing the generosity of personal income tax allowances for interest and principal repayment on owner-occupied home mortgages. This would also induce a more even distribution of the personal income tax burden, as these tax privileges are relatively more beneficial to higher-income taxpayers. Phasing out personal income tax preferences granted to home ownership could provide more impetus to the development of the rental housing market. By easing the pressure of demand on highly regulated urban land supply, this should be mirrored by a drop in home prices. Assigning to municipalities a larger tax bundle could usefully match more fundamental housing tax reform, to help reduce their reliance on real estate and land taxes and, at the same time, improve incentives to liberalise urban land development. This would also induce an easing in housing prices as well as a more even distribution of prices across regions — to the extent that differences in real estate taxes are capitalised into home prices. Enhanced development of the housing rental market, lower home prices and levelling out of price differences across regions might enhance the geographic mobility of labour and improve overall labour market adjustment.

Strengthen fiscal decentralisation

63.   Progress towards balanced and efficient fiscal decentralisation entails further closing the gap between sub-national governments' spending and revenue-raising powers and providing them with the ability to tailor the taxes devolved to them to their specific local conditions. The 1997-2001 financing agreement is a step in this direction. Also improving further the land register, in particular updating property values, would help regional and local governments to better tailor property taxes. Regional and local governments' ability to rely more on the "user/polluter pays" principle (*e.g.* for wastewater treatment or solid waste disposal, broadcasting) should also be enhanced. An optimal setting of user charges reflecting social costs requires the removal of existing legal impediments restricting both the type of goods and services over which such charges could apply and the level of these charges. Simplifying the administrative procedures (*e.g.* to grant wastewater discharge permits) and raising sub-national governments' enforcement abilities is also needed. Tax decentralisation may also entail further complex tax rules. Thus, in granting taxing powers to the regions, it would be important to avoid a rise in collection and compliance costs and in tax avoidance.

64.   On efficiency grounds, inter-jurisdictional competition in corporate tax regimes does not necessarily need to be regulated by a higher level of government. Competitive tax bidding by governments to attract businesses — even if it involves geographic externalities — could lead to efficient business location outcomes, provided governments' offers reflect governments' true valuation of the outcomes

(Besley and Seabright, 1999). Regulating inter-jurisdictional tax incentives would thus not necessarily result in better resource allocation, though it might help achieve the same outcome with a lower overall amount of tax subsidies to firms. This might be particularly welcome when governments are subject to hard budget constraints that restrict their ability to spend — as the new financing scheme for the "Autonomous Communities" needs to ensure. Should parts of the corporate income tax be transferred to the regions in the future (as for instance in the United States or in Canada), tax incentives — that may legitimately differ across jurisdictions — would need to be generic and focused on specific targets. In fact, subsidising through tax incentives the private provision of public goods (training, environment upgrading) according to their geographic scarcity does not distort competition. However, to increase transparency and prevent market distortions arising from *ad hoc* tax incentives, a certain degree of harmonisation in the definition of the corporate tax base should be sought, while allowing competition in setting a part of the corporate income tax rate, which should apply to all resident companies.

65.   In granting further revenue-raising powers to the regions to match their spending powers, care should be taken that fiscal decentralisation does not hinder sound fiscal management at the national level and allows solidarity across the whole territory. Further devolution of taxes which are also designed to achieve redistributional objectives is problematic since different rates could entail incentives for migration, and virtuous or vicious circles, if levied at a regional level — the rich moving to low-tax regions, thus enabling further cuts in rates there, while the poor would settle in the regions where social services are the most developed. Additional sources of revenues for the regions could come from consumption taxes. A tax-sharing arrangement could be envisaged for the VAT, following the experience of other EU countries (*e.g.* Belgium and Germany). Consumption taxes have the advantage of generating less volatile revenues than income taxes. In any case, if a revenue guarantee scheme for the regions is needed, it should mimic a true risk-pooling, funded, insurance scheme, and provide the regions with the right incentives to develop their tax base and control expenditure. The current guarantee system entails significant contingent costs for the State and may impair sound finances at the national level.

66.   Improving transparency, to allow an effective monitoring of borrowing policies of regional governments, could enhance the current system. In the *first* place, timely public information on the financial positions of sub-national authorities is needed. The Bank of Spain publishes the consolidated financial position of territorial administrations on a timely basis (currently up to 1996), but at present the latest publicly available information on individual regions' budgets on a national account basis dates back to 1994. Nevertheless, some evidence on underlying deficit trends can be obtained from data on debt of regional governments published regularly by the Bank of Spain, though there is no tight matching of deficits and changes in net debt. *Second*, the fiscal programmes agreed upon in the CPFF by the central government and the regional governments should be made public, to enhance accountability and improve monitoring of fiscal performance. *Third*, more transparency would seem desirable on the financial relationships between regional governments and local public enterprises. On the one hand, capital transfers to these enterprises that are off budget obscure the net financial position of territorial administrations. On the other hand, local public enterprises are not subject to borrowing restrictions and may borrow from banks under the implicit guarantee that capital transfers from regional governments would be forthcoming to cover their liabilities. Funds raised in this way by local public enterprises may in turn be funnelled to regional governments to finance investment projects, thus making it possible to partly overcome borrowing ceilings and further blurring the transparency of regional budgets.[70]

67.   Further ahead, there is a need to better enforce commitments to fiscal discipline by regional governments since the existing rules for deficit and debt control are not fully enforceable, and there are no

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70.   Local public enterprises have been expanding rapidly, with their number increasing by 45 per cent from 1990 to 1996. In the mid 1990s, these enterprises were receiving 20 per cent of total operating and capital transfers paid to public enterprises. See OECD (1998*a*), Chapter IV.

penalties in case a region fails to comply with them (Box 4). Better enforcement could be sought by implementing an internal stability pact, imposing deficit limits on regional governments. This would call for a clear definition of fiscal deficit targets or acceptable deficit ceilings, and should ideally include a system of sanctions in case of slippage. Nevertheless, for such a system to work, the level of central government guarantees would need to be lowered, matched by a wider range of tax powers transferred to the regions or a broader sharing of regional tax collections. A shortcoming of systems relying on strict deficit rules, which do not allow an escape in exceptional circumstances, is a lack of flexibility to deal with region-specific shocks, since in that case the application of sanctions may act in a pro-cyclical way. Moreover, they provide unbalanced incentives for fiscal consolidation, since they penalise fiscal slippage without properly rewarding sound fiscal management. Finally, selectivity in the application of penalties may impair the transparency of the system. Alternative market-based mechanisms to enforce fiscal discipline could be considered. Some federal systems function quite well since the markets themselves impose considerable discipline when local government borrowing is not underpinned by guarantees. Another — perhaps radical and difficult to implement — example would be the creation of a market for "tradable budget deficit permits". As in the case of a scheme setting deficit ceilings, such a mechanism recognises that fiscal policy slippage creates negative externalities by putting aggregate financial stability at risk. However, as in the case of market-based schemes of environmental regulation through tradable pollution permits, the rationale is to achieve a global deficit target as efficiently as possible, by minimising total compliance costs (Annex III). Such a mechanism would require an appropriate institutional setting to be in place.

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GLOSSARY OF ACRONYMS

CPFF	Consejo de Política Fiscal y Financiera (Council for coordination of regional fiscal policies)
CIT	Corporate Income Tax
EU	European Union
FDI	Foreign direct investment
GDP	Gross Domestic Product
IRPF	Impuesto sobre la renta de las personas físicas
LIFO	Last in, first out
METRs	Marginal Effective Tax Rates
PIE	Participación en los Ingresos del Estado (Share of the State tax revenues assigned to the regions)
R&D	Research and Development
SMEs	Small and Medium Enterprises
VAT	Value Added Tax

ANNEX I

SMEs AND SELF-EMPLOYED: SPECIAL TAX REGIMES

1.   Among Spain's 3.7 million enterprises (in the mid-1990s) 75 per cent are one-person businesses and 22 per cent are micro-enterprises with less than 10 employees. The share of self-employed is much higher than elsewhere in the European Union (50 per cent), probably reflecting extensive subcontracting arrangements owing to strict employment protection legislation.

2.   A special tax regime applies to incorporated small businesses with turnover of less than ESP 250 million. They benefit from a reduced corporate tax rate of 30 per cent, up to the first ESP 15 million of taxable profits — additional profits being taxed at the normal 35 per cent rate. In 1996, 55 per cent of companies subject to corporate income tax reported profits below ESP 25 million, whereas 36 per cent had profits lower than ESP 10 million. Under the Basque Country and Navarra special tax regimes, a reduced rate of 30 per cent applies up to the first ESP 10 million of taxable income for qualifying SMEs. Above that amount, profits are taxed at the standard 32.5 per cent corporate tax rate. Moreover, incorporated small businesses may benefit from more liberal depreciation allowances for new tangible assets.

3.   Unincorporated businesses, self-employed and other professionals are subject to the personal income tax, and may qualify for special simplified regimes. While SMEs with turnover of more than ESP 100 million are subject to a "direct estimation" system, involving fully-fledged accounting rules, SMEs below this threshold may choose between two simpler schemes. A "simplified direct estimation" system, based on less complex accounting rules, and a "forfaitaire" system ("*módulos*") relying on objective assessment of taxable income.

4.   The "*módulos*" system was introduced in 1992. The "simplified direct estimation system" came into effect in 1998. It replaced the "simplified flat rate system" ("*estimación objetiva por coeficientes*") which was a mixture of a "forfaitaire" system and estimation based on accounting rules. In 1996, among 2 463 000 unincorporated businesses were subject to those three regimes of the personal income tax, 75 per cent (half of which in agriculture) were taxed according to the "forfaitaire" system ; 10 per cent according to the "simplified flat rate" system ; and the remaining 15 per cent according to "direct estimation".

5.   Both systems allow depreciation deductions for tangible assets according to simplified rules. Income assessment under the "forfaitaire" system relies on business activity indicators — for instance the number of employees, power consumption, workshop surface, etc. This scheme was initially introduced with the aim of containing tax avoidance and simplifying tax compliance for micro-enterprises and self-employed. It has evolved into a highly complex system of tax assessment, covering at present 84 sectors, with specific provisions for each of them.

ANNEX II

SHIFTING THE TAX MIX: PROPERTIES OF MODEL-BASED SIMULATIONS

1.   The results presented in Table 8 refer to the long-run for the Quest II (European Commission) model (Roeger and in't Veld, 1997; 1998), when most macroeconomic adjustments following the tax changes have been completed, and to a four-year period for Interlink. Though the simulation period in the Quest model extends up to 30 years, a large part of the adjustments (ranging from 66 to 80 per cent depending on the tax) occurs within a 10-year period. The simulations assume that monetary policy responds to tax and spending cuts so as to keep inflation at the baseline. All tax changes are revenue neutral, being offset by an equal reduction in transfer payments or by an increase in other taxes. Compared with other taxes, cutting corporate income taxes appears to have the highest long-run impact on GDP (Table 8). This reflects the strong impact of a reduced corporate tax rate on companies' profitability and thereby on investment. The employment impact of a corporate tax cut is relatively weak, however, owing to factor substitution. In contrast, a cut in labour taxes has the strongest long-run impact on employment, as it increases directly the demand for labour. The OECD Interlink model projects an increase in GDP similar to the Commission's Quest model and a slightly stronger response of employment. Reduced consumption taxes turn out to be the least powerful instrument to boost GDP growth and employment.

2.   According to the simulations, output and employment effects of tax cuts might be muted in Spain by pervasive labour market rigidities, which are discussed in the main text. A main difference to other countries pertaining to the labour market in the Spanish version of the Quest model is a higher trade union bargaining strength — as measured by the indexation of real wages to productivity trends. On account of these rigidities, tax cuts translate more than elsewhere in the European Union into higher wages. That undermines competitiveness and dampens the rise in employment and output. Moreover, labour tax cuts offset by an increase in consumption taxes feed in part back into wages through indexation on consumer price inflation. This dampens the employment response to labour tax cuts through an increase in the reservation wage, as unemployment benefits are also indexed to inflation. Labour tax cuts offset by an increase in the corporate income tax have even a negative long-run output impact. This is because the multiplier effect of the ensuing drop in investment is much stronger than that of reduced social transfers — affecting mainly the disposable income of households — when tax cuts are matched by social security reform.

ANNEX III

IMPLEMENTING A SYSTEM OF "TRADABLE DEFICIT PERMITS"

1.   A tradable deficit permit scheme has been suggested by Casella (1999), drawing on Coase's (1960) principle of voluntary trading of property rights, and parallels institutional arrangements in markets for tradable pollution permits primarily experimented in the United States. Setting up such a system would involve: *i)* making a decision on an overall deficit ceiling; *ii)* making an initial allocation of deficit permits; *iii)* allowing participant entities (territorial administrations) to freely trade deficit permit holdings; *iv)* clearing the accounts of the system at the end of each exercise, ensuring that each participant entity holds enough permits to cover its reported deficits; *v)* enforcing a system of fines in case participant entities fail to meet their deficit permit requirement.

2.   Under competitive conditions the price quoted in the market should reflect the price of the right to issue a unit of debt. This should vary according to the strains exerted on the financial balance of the system, given the overall deficit ceiling and the cyclical position. In symmetric slowdowns, when the overall balance is under strain, the price of permits should rise, providing incentives to keep the rising deficits at levels that would not breach the overall ceiling. In case a region suffers an asymmetric shock, where more flexibility is needed, the price of the permits should remain low, as the system is not under strain. This would allow an offsetting increase in the deficit to smooth out the shock at relatively low cost. The system provides rewards for sound fiscal management, by allowing profitable selling of unused deficit permits — at a price that in principle should reflect their value at the best alternative use. This would make it more likely to keep budgets in balance in the long run.

Safeguards and added flexibility:

i)   To counter short-sighted behaviour, participants in the scheme should not be allowed to borrow against future deficit permit allocations.

ii)   To smooth expected deficits and improve planning, deficit permits might be saved within limits: for example, a deficit could be offset by contemporaneous permit allocations or by unused permits of previous years.

iii)   To improve systemic flexibility, the central government might increase the aggregate supply of permits in case of large symmetric shocks (meaning a temporary rise in the deficit ceiling).

iv)   To reflect the differing indebtedness of participants — and hence their differential impact on aggregate financial fragility — the number of deficit permits required to cover a given amount of deficit could grow in step with each participant's debt ratio.

3.   The implementation of such a mechanism might, however, be difficult, as it may not be easy to reach an agreement on a fair initial allocation of permits. Safeguards may also need to be introduced to prevent collusive behaviour on the part of big players that may distort prices in the market. Moreover, safeguards would be needed to ensure that regions in economic difficulties facing an election do not use the market as a means to issue more debt.

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