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The Business Community, Policy-makers, and Tax Reform in Spain (1977-2004)

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Introduction

Over twenty-five years have passed since the original predecessors of today's Personal and Corporate Income Taxes came into force on January 1, 1979 and since the Urgent Measures on Tax Reform were published on November 14, 1977. The latter signalled the start of a major reform process aimed at modernizing Spanish public finance, which continues today.

With the perspective of time, this long fiscal reform process contains elements of considerable interest for the analysis of taxation. Personally, so many years of tax reform in Spain places one in an ambivalent position. On the one hand, it is stimulating to study, with the objectives I will soon establish, such an important issue as a country's tax reforms over such a lengthy period. On the other hand, and this is slightly less pleasant, one of the possible comparative advantages I have when

considering these matters is age; having been an active witness of the preparation and onset of the 1977-78 tax reform and the large number of changes made since then.

Indeed, there have been a considerable number of legislative and tax management changes for close to three decades. There certainly has been enough time for progress and reversals, for both implicit and explicit doubts, and for the economic, political and social constraints on the system to have changed quite substantially.

One analytical alternative would be to study the reforms in more or less detail in chronological order. This could be beneficial for research from a legal perspective but would evidently be lengthier than necessary. It would also be useful to consider the impact of some of the tax changes taking place in this period on tax revenue, distribution or efficiency, which would be a good subject for a doctoral dissertation. Readers should not be concerned, however, because the aim of this study is much simpler and, I trust, equally interesting.

This paper will start by analysing how this fiscal reform process came about, defining the fundamental characteristics of the 1977-78 reforms, in order to consider how these characteristics have changed over time. The purpose of this study focuses on the relationships between the policy-makers and officials who establish tax reform measures and the business community which demands or rejects them and investigates the interactions occurring over nearly three decades in certain aspects of taxation which were of special interest for businesses (organised or not in institutions) considering the economic and political changes of the period. To be more efficient, we will primarily consider the repercussion of income and wealth taxation on firms and entrepreneurs, and thus be in a better position to understand the current status of business taxation in Spain and reach reasonable conclusions concerning the types of reforms required in the near future.

A discussion of other tax reform questions would untowardly lengthen this paper. I have focused on the relationship between policymakers and the business community, regarding corporate income and wealth tax during the tax reform process starting in Spain back in 1977-78, because these are the areas where most friction and interaction existed along these nearly thirty years of reform. My aim is to provide some understanding of what has changed, and how, in Spanish business taxation in the last quarter of the 20th century and the first few years of the new millennium and to obtain an idea of possible new reforms.

Tax reforms can be contemplated from different perspectives. This paper falls within the conceptual framework of what we could call the "tax reform market" to which Alan Peacock (1979) referred some time ago. To explain why certain tax changes, and demands for them, arise, we have to consider the goals and constraints of business and economic policies in general and interpret the efficacy of certain measures in relation to others as a way of achieving these private and collective goals.

Taxes are means for collecting public funds, but they also serve other purposes under the constraint of the overall economic context. The "supply or demand of tax reform" arises when a tax instrument, or part of it, is no longer useful and indeed hinders achievement of desired goals. Basically, this can be the case because goals have changed, overall economic constraints have varied, certain taxes no longer have the same value in relation to others or, more commonly, it is considered that a different tax configuration would be fairer or more efficient. Additionally, it should be underlined that lobbies also have an impact on tax changes as the economy and power relations evolve over time.

A reform always implies changes in relation to a point of reference which, in this case, will be the original reforms of 1977-78. We will focus on direct taxation and,

more specifically, on business taxes, for investigating the interrelations between policy makers and the business community. The business community includes not only business organizations, but also the tax affairs of entrepreneurs and their families. These relations have not always ended in agreements, or agreements have taken years to reach, but changes have nearly always been supported on economic grounds related to the objectives and constraints on businesses and the Spanish economy.

In the following discussion, I will attempt to establish the major issues which, from a business perspective, have dominated the tax reforms involved in this lengthy process. I will not bore the reader with many dates, legal references or details. I will rather concentrate on the major reform issues, with special emphasis on the most recent changes (during the last ten or fifteen years), the present situation and possible new demands for prospective reforms. The chapter is divided into different sections reflecting the major issues affecting the Spanish business community since the start of the reform process in 1977-78. The time has come, however, to review how this process came about and the economic approach on which it was based.

The Origins of the Current Tax System

Background and Reasons for the 1977-78 Reform

The tax reform process that Spain embarked upon in 1977 was preceded by discussions in some university forums and the Ministry of Public Finance itself. The previous reform, in 1964, had established a tax system that could only be described as ineffective and unfair, largely due to its narrow tax bases and the associated high levels of tax evasion.

The economic context in the 1960s, and up to 1974, was characterised by high growth rates (an average of over 7 percent a year) and an inequitable distribution of personal income. The Spanish population was making a major effort to cover its private needs.[2] At the same time, the population was demanding from the State more and better education, healthcare and pensions, together with more freedom and equal opportunities. It must be remembered that, socially and politically speaking, this was the end of the authoritarian regime of General Franco, who died in November 1975.

Criticism of the 1964 system was voiced in areas of the tax administration itself, reports by international organizations and in a few, not very widespread, Spanish business forums. In 1969, when Enrique Fuentes Quintana was appointed the director of the Fiscal Studies Institute (*Instituto de Estudios Fiscales* - IEF), this agency of the Ministry of Finance started an important period of effective association and interaction between the Administration and Spain's universities, which eventually had a fundamental impact on the 1977-1978 tax reform. The IEF, from the early seventies to date, has been an important center of research on tax and public expenditure matters with considerable influence on government policies.

The numerous studies conducted by the IEF on tax reform issues resulted into two main reports. The first, entitled "*Informe sobre el sistema tributario español"* (called a "green paper" because of the colour of the covers) dated 1973, provided a thorough discussion and diagnostic of the ongoing problems with the tax system in Spain. The second report, entitled "*Sistema tributario español. Criterios para su reforma"*, dated 1976, became known as the "white paper" of the Reform, and it provided a blueprint for the reform of the entire tax system. However, the distribution of the two reports was limited. The 1973 report was never printed and all the copies

were ordered destroyed following orders from the highest political level. However, some of the copies remained safe in the hands of those who collaborated in the report and in the libraries and offices of the IEF and the Ministry of Finance. The 1976 report was printed but not distributed. Both these reports were recently re-published by the IEF in 2002.

These two reports, however, had a considerable impact, and they were widely distributed.. As pointed out, they represented a detailed summary of criticisms of the tax system in force at the time and presented a coherent proposal for tax reform. The 1977-78 reform may have been hidden in desk drawers, but it was ready for action.

After the democratic elections in 1977, the center/right-wing government headed by Adolfo Suárez included professor Fuentes Quintana as the economic vice-president and Minister of Economy and Francisco Fernández Ordóñez as the Minister of Finance. The economic situation was dire, with heavy internal price disequilibrium and a severe balance of trade deficit. Doubtless to say, there was a need for an effective stabilization program and higher tax revenues, In the 1975-1985 period, after the fifteen years of high growth rates mentioned earlier, the annual GDP growth rate slowed down to only 1.69 percent; overall, this was a decade of limited economic capitalization and falling employment rates, following the 1974 oil crisis which affected Spain severely.

The social situation was hardly appropriate for a policy program aiming at economic stability. The Spanish Constitution was not approved until December 1978 and political consensus was precarious. Spain was not a member of the European Community and had a closed economy. Business organizations were just starting to arise. For example, the Spanish Confederation of Business Organizations (*Confederación Española de Organizaciones Empresariales* - CEOE) had just been

created in 1977. Furthermore, the policies aimed at tackling the economic crisis that started in 1974 had taken too long to define, largely due to the flux political context at the end of Franco's regime and the economic problems that had accumulated during that period.

In such a difficult situation, the only possible solution lied in obtaining an agreement between the different political parties represented in Parliament with a view to defining the required reform. This possibility arose with the Moncloa Agreements ("*Pactos de la Moncloa"*)[3] signed in October 1977, in which the political parties accepted a Reform Programme centered on a policy of economic stability and a profound reform of the economic and social system. The costs of the economic crisis and all the adjustments to be made were to be shared among the population based on equity criteria, thus the need for reforming the tax system. In short, tax reform became an essential part of the Moncloa Pacts.

The 1977-78 tax reform arose from a social agreement or national compact in the context of a closed economy facing serious economic problems and a new democratic regime demanding widespread reforms. The studies and research work (especially in university departments and the IEF) that had been carried out some years before were now ready to be used. All these circumstances largely explain the very rare socio-political phenomenon consisting of all parties accepting the need for tax reform and agreeing to its content. Socially, including the business community, the reform also met with relatively widespread acceptance.

The Beginnings of the Reform in 1977

The first step in the Reform consisted of the Urgent Measures on Tax Reform Act ("*Ley de Medidas Urgentes de Reforma Fiscal*, Law 50/1977, of November 14). This

Act was fundamentally designed to provide the ground for voluntary compliance, so that in the future, their relations with the authorities would take place in a climate of transparency. Among other aspects, it focused on:

- Granting a tax amnesty, applicable both to individuals and legal entities, in order to start afresh and foster more honesty between the authorities and taxpayers. Fourteen years later, this was followed by a new quasi-amnesty which received the euphemistic name of Fiscal Regulation of Abnormal Situations (Additional Provisions 13 and 14 of the Personal Income Tax Act – Law 18/1991, of June 6th). There have been no further widespread tax amnesties or "regularizations of taxpayers' fiscal situations."
- Including tax offences in the Criminal Code. Articles 305 to 310 of the Criminal Code (Organic Law 10/1995, of November 23) that are currently in force refer to Public Finance offences punished with monetary fines ranging from 100 to 600 percent of the evaded tax amount and prison sentences ranging from one to four years in prison.
- Eliminating banking secrecy and regulating the collaboration of banks with the tax authorities.
- Integrating the taxation of shareholders in certain types of companies in a transparent taxation regime, which we will consider later in more detail, as a way of tackling tax evasion methods that used these companies as screens between the taxpayers and the tax administration authorities.
- Establishing a tax on personal wealth ("*impuesto sobre el patrimonio*"), basically aimed at generating fiscal information to control income and wealth, with highly progressive tax rates. We will also go into further detail later on the wealth tax as well as the inheritance and donation tax.

As far as we can tell, the fundamental idea creating the basis for the 1977 Act was to establish a clearer relationship between taxpayers and the administration, which provided the former with the opportunity to start from scratch and the latter with the means required to ensure better management of the new tax system.

The 1978 Reform of Personal and Corporate Income Tax

We have already mentioned that the new system was conceptually solid and supported not only by the green and white papers of 1973 and 1976, but also by research and analyses conducted by the Administration and several Spanish universities. The approach to the 1978 reform was based on the intellectual tradition, of Henry Simons (1938) and his comprehensive income taxation proposals that led up to the Carter Report (1966-67) drafted in Canada from 1962 to 1966. It also incorporated the taxation principles of Fritz Neumark (1970).

The taxation system was already designed and ready for immediate application. The reform program followed what we could call the "tax style" of the sixties, which was a synthesis of Anglo-Saxon and Continental direct taxation and the more clearly European indirect taxation represented by VAT, so it was already, possibly, out of date in an economic context of low growth and high inflation rates. It was designed for a primarily closed economy. Its major objectives were:

- To increase tax revenue and enable the Spanish Government to finance the public services demanded by the population.
- To provide appropriate instruments with which to develop a macroeconomic, stability-oriented tax policy.
- To make the system more equitable by adding a social component to the Moncloa Agreement and its reform program.

- To use the criterion of comprehensive taxation to increase revenue and fiscal capacity to ensure a more stable economy and a better distribution of income based on highly progressive taxes.
- To bring Spain's tax system up to similar levels reached by the tax systems of other European countries.

These objectives were achieved by January 1, 1979. Two laws on the personal and corporate income taxes were approved by Parliament (Law 44/1978, of November 8th on personal income tax and Law 61/1978, of December 27th on corporate income tax). In the field of direct taxes, income taxation was rounded up with a tax on personal wealth based on the, already in force, inheritance and donation tax. This tax would not be reformed again until 1988 by Law 29/1987, of December 18.

Major reform of indirect taxation had to wait until 1986, when Spain joined the European Community (VAT Act - Law 30/1985, of August 2, and Excise Act - Law 45/1985, of December 23, both of them amended again in 1992), with temporary systems established in the meantime. VAT has provided a considerable increase of revenue for the system over the years.[4]

The new territorial organization of the State arising from the 1978 Constitution gave rise to the Autonomous Region Financing Act (Organic Law 8/1980, of September 22), which later would be subject to important changes. The issue of the financing of central government versus the regions is today still the center of political disputes. The financing of local tax authorities (provinces and municipalities) was later addressed by Law 39/1988, of December 28, amended by Law 51/2002, of December 27.

Ultimately, the 1977-78 reform signalled the start of a major change in the Spanish tax system specifically affecting income taxation. This truly represented a revolution in the country's fiscal tradition. Since the mid-19th century, the Spanish tax system had maintained a basic structure of schedular taxes, which provided limited revenue, gave relatively more weight to indirect taxation, and had numerous serious technical defects. The problem of low revenue yields inherent to this system disappeared largely because of the sharp increase in personal income tax collections, followed later by VAT collections, both instruments capable of serving the purposes of a modern fiscal policy. With regard to this last point, it seems fair to say that the reform started in 1977-78 was more equitable and eliminated important distortions of the previous system.

The Role of the Business Community's Demands in Successive Tax Reforms

The starting point, in 1978, of the long tax reform process was well accepted by all political forces and the business community in general. This may seem surprising but is understandable given the serious economic situation and lack of political stability at the time. We have already mentioned that the 1977-78 reform took place within the framework of the Moncloa Agreements. Indeed, the new democratic regime played a fundamental role in getting the reform on its feet.

This explains why, in exchange for a tax amnesty, there was widespread acceptance of making tax evasion a crime (the so called "criminalization of taxation.") There is no doubt that these two types of measures represented powerful aids to improving tax management and enforcement. The introduction of a tax on wealth was questioned by the business community. The new tax transparency regime, which mainly applied to "passive" corporations, drew more questions than the wealth

tax. However, the initial resistance was rather weak, some thing to be expected given the low profile of business organizations at the time.

However, the political and social approval of the 1977 Act and the new income taxes in 1978 did not mean that the defects and shortcomings of the reform were not acknowledged, particularly those affecting the business community. The business community, in general, accepted the 1977-78 reform but, they criticized the excessive academic nature of the approach and the fact that it was poorly adapted to the reality of the time with an ongoing economic crisis. The reform introduced sharp increases in the progressivity of the system, both in the personal income tax and in the taxation of wealth. In addition, personal and corporate income taxes were not well integrated in relation to the double taxation of business profits. As just mentioned above, the new "tax transparency regime" for certain corporations was also contested. Last but not least, the reform failed to appropriately tackle international aspects of taxation required for Spanish businesses to operate in foreign markets. These, among others, were the principal issues leading the business community to demand further tax reforms.

The business organizations already established during the early years of the new democracy became stronger and more outspoken, at the same time new organizations arose. They all voiced strong opinions on taxation policy over the years. To mention just a few of these business organizations, the Spanish Confederation of Business Organizations –CEOE- (Confederación Española de Organizaciones Empresariales) played an important role corresponding to its status as a confederation of other organizations, especially through the members of its Fiscal Committee, primarily Javier Berruguete. In Barcelona, *Fomento del Trabajo Nacional* was always interested in fiscal affairs, with the collaboration of Alexandre Pedrós and others. In Barcelona

and Madrid, and now many other cities, the Family Business Institute (*Instituto de la Empresa Familiar)* considerably influenced aspects of the taxation of entrepreneurs at the personal and household levels. In Madrid, the Institute of Economic Studies and other organizations contributed to strengthening the institutions of the market economy, including fiscal aspects. And the same can be said of other business organizations, such as the Spanish Banking Association, the Confederation of Savings Banks, the Confederation of SMEs (*Confederación de la Pequeña y Mediana Empresa* – CEPYME) or Chambers of Commerce.

It is apparent that many business organizations played significant roles for or against aspects of the different tax reforms started in 1977. It is not possible to mention all of them and the organizations listed above are mere examples. But it is important to emphasise that, in most cases, business organizations have used persuasion not only aimed at the Administration but also at the general public, increasing the awareness of policy-makers, officials and taxpayers of the economic effects of the tax system. Overall, the business community demanded lower taxes, based on the economic restraints of the time and on other arguments emphasising, especially over the last twenty years, the liberalization of the Spanish economy, which was limited at the time of the 1970 Preferential Agreements with the Common Market and increased considerably after Spain joined the European Community in 1986. A reduction in the business tax bill was also demanded based on arguments related to desirable limits to the size of the public sector.

With regards to economic internationalization, one solid argument aimed at increasing the competitiveness of the Spanish economy, thereby improving the ability of Spanish businesses to defend their internal markets and to grow by exporting. Different Spanish organizations also have commonly referred to the need for

increased competitiveness in their demands for greater support for small or family businesses.

Most of the tax changes which have taken place in the last twenty-five years in Spain have been based on economic arguments demanding reforms in business taxation with a clear rejection of such aspects as the progressiveness of personal income tax, the taxation of business wealth, and the tax transparency regime for "passive" corporations. This is probably a good time to consider these issues in some detail, with reference to their essential aspects.

Corporate Income tax Reforms: Basic Aspects of the Tax

Fundamental Reform Trends and Demands Relating to Corporate Income Taxation

With regards to the Corporate Income Tax, the tax reformers of the seventies aimed at:

- increasing the scope of the tax,
- widening its tax base,
- rationalising the tax rates and system of economic incentives,
- reducing the double taxation of business profits, and
- avoiding the use of companies acting as screens between the authorities and individual taxpayers (who were subject to a global and highly progressive personal income tax).

The Spanish corporate income tax (with a history that goes back to 1900, with the creation of Tariff III – "Taxation of the utilities of movable wealth") had reached a reasonably acceptable technical level by the mid-70s. However, widespread tax evasion continued to reduce revenues quite considerably. In addition to the evasion

problem, augmented by weak tax management and inspection processes, there were other reasons for improving and strengthening the tax.

The legal regulation of taxpayers was not always appropriate. For instance, joint ownership companies were not subject to corporate income tax with regards to agricultural operations or earnings other than those derived from commercial or industrial activities. Passive companies holding securities and other assets were exempt even with regard to earned interest. Although the taxation of business holdings was legally regulated, specific regulations had not been drafted and they were not applied in practice, enabling the possibility of transferring earnings between group companies.

Another example of the limited scope of the tax was the capital gains obtained by non-residents without permanent residency. In this case, the only earnings considered to be obtained in Spain were those subject to a schedular tax on account of the corporate income tax. However, since there was no tax (on account of the corporate income tax) applied to capital gains, these were excluded from taxation for non-resident companies which were often owned by Spanish residents.

We could mention other examples of problems associated to the scope or base of the tax, and the other basic elements in any corporate income tax, but the above should suffice for now. In fact, other defects of the corporate income tax prior to 1978 will be mentioned later in this section., with an aim of understanding the solutions initially proposed. Generally speaking, these solutions involved a corporate income tax similar to that applied in other European countries that emphasized enlarging the tax base by using comprehensive taxation criteria. They reformulated tax incentives and established fiscal transparency in an attempt to tackle the use of companies acting as screens between the taxpayer and the administration. These were

the fundamental aspects of corporate income tax reform in the following quarter of the century.

Business reactions to corporate income tax regulations followed clear trends in the long period we are considering. As mentioned earlier, the tax was generally welcomed initially (this was true of the tax system as a whole), although the stricter legislation and its practical application introduced in the mid-80's led to important confrontations in the second half of the decade. One example was the document published by the CEOE management board on June 6, 1989 entitled *La urgente reforma del sistema tributario español* (The urgent reform of Spain's tax system). Another example arose from an academic perspective with the publication of a report entitled *La Reforma Fiscal y los problemas de la Hacienda Pública Española* (1990). Indeed, after the system became stricter in the eighties, the reforms introduced in 1991 became a turning point towards more realistic trends favouring consensus within the new personal income and wealth taxes (Law 18/1991 and Law 19/1991, both of June 6th). The less urgent changes in business taxation took a little longer. They followed after the Ministry of Economy and Public Finance issued the *Informe sobre la Reforma del Impuesto sobre Sociedades* (Report on the Reform of the Corporate Income Tax) in 1994, with the Corporate Income Tax Act (Law 43/1995, of December 27th).

Combining business perspectives and academic research proposals, or others put forward by policy makers themselves, the fundamental goals of the reform of the corporate income tax in 1995 can be summarised as follows:

- To limit (or reduce) the overall tax burden on companies, considering not only the corporate income tax, but also Social Security contributions and the income

taxation of entrepreneurs (which included the personal income tax, the wealth tax, and the inheritance and donation tax).

- To achieve an appropriately neutral corporate income tax with the aim of enhancing economic efficiency related, among others, to the sources of business financing, investment projects, location or legal status, and company size.

The fulfilment of this last goal, however, was affected by the constraints represented by other goals informing the reform, such as:

- To foster saving and business investment as a means of ensuring an increase in productivity and sustained economic growth.
- Incentives to increase business competitiveness that increasingly focused on R&D activities, occupational training, small enterprises, certain intangible assets or company restructuring or alliances.
- International coordination in terms of possible harmonized lines of corporate income tax in the EU and fiscal support for the integration of Spanish firms in a more global economy.

The tendency to include fiscal incentives in the corporate income tax with the aim of making Spanish firms more competitive on an increasingly international scale has been fundamental, especially since the tax was reformed in 1995 and other changes that were made in the following years. Arguably, the overall impact of this tendency has been positive, because the competitiveness of a national economy largely depends on the competitiveness of its firms,[5] without prejudice to the beneficial effects of a stable macroeconomic framework, especially in relation to prices or interest rates, of budgetary discipline or an appropriate choice of public expenditure policies.

The consensus interpretation of the available statistical evidence is that the application of these ideas to the corporate income tax generally helped Spanish firms maintain their market shares, become more international and increase their export capabilities. Spanish corporations are open to internationalization since the early nineties as Canals (2004) shows. However, the specific effect of corporate taxation in this process is difficult to discern since it is intertwined with the effects of the devaluations of 1992 and 1993, the competitive rate of exchange maintained after those years which led to the fixing a the peseta-euro exchange rate for Spain and the greater openness of the economic setting during the last fifteen years

In general, trends in corporate tax reform, particularly in the last ten years, have converged, both in demands and actual changes, on the introduction of tax incentives aimed at fostering the following activities:

- R&D and innovation in products and processes
- business internationalization
- exports
- vocational training
- support for small and medium-sized enterprise (SMEs)
- business restructuring and alliances

The effectiveness of these incentives seems unequal. For example, the international oriented incentives may have been proved as positive but R&D and innovation is still lagging in spite of very generous tax benefits. In any case, these new tax incentives, which are only a recent trend in corporate income tax and will be discussed later, have been accompanied by reforms in other aspects of the tax, which we discuss next.

Tax Rates

The reformers of the sixties proposed a reduction in the variety of tax rates applied in the corporate income tax to a single overall rate of 36 per cent, with one or two lower rates for specific cases. However, not much progress has been made since then, because in effect there are now twelve different rates plus two additional rates applicable to passive holding companies that we will be considering later.

The corporate income tax started in 1979 with an overall tax rate of 33 per cent, plus three reduced rates for specific situations (savings banks, mutual insurance companies and some cases of non-residents or exempt entities). In 1985 the overall corporate tax rate was increased to the 35 per cent, which continues to be applied today.

Until approximately seven years ago, the nominal tax rate had not been particularly questioned (except for the taxation of reinvested capital gains, which we will return to later). Actually, during the first two decades of the reform, the nominal corporate income tax rate in Spain was relatively moderate compared to that of most other countries. However, in more recent times, this situation has changed due to fiscal competition between countries in the form of reduced tax rates and other measures.

A European Commission study (2001) on corporate income taxation in the EU identified important differences in the effective taxation of businesses, which could have an impact on international competitiveness and the location of direct investment. The Commission's study provides no evidence on the impact of business taxation on economic location decisions. These decisions involve many other non-fiscal aspects such as labor or transport costs or the quality of human capital and infrastructure. However, Devereux and Griffith (1998) show that, although the decisions of North

American multinational corporations to establish their production in Europe or the United States have not been significantly affected by tax reasons, such reasons did have a considerable impact on their location within Europe.

All this has become more important with the enlargement of the EU from fifteen to twenty-five countries. The average nominal rate of corporate income tax in Europe was 33 per cent in the year 2000. This average, however, has fallen considerably when taking into account the new EU members. Poland and the Slovak Republic, for instance, reduced their corporate income tax rate to 19 per cent in 2004 (from 27 and 25 per cent, respectively). Hungary applies a 16 per cent tax rate and Estonia does not tax reinvested profits. A debate concerning the convenience of reducing fiscal competition by establishing a minimum corporate tax rate, and the harmonization of the tax base, is certainly in the cards, at least in Europe. [6]

In Spain, there are certainly reasons, arising from international fiscal competition, for contemplating a reduction (after twenty years) in the present overall corporate tax rate of 35 percent.[7] This could have a considerable impact on tax revenues and have consequences for other important issues such as the integration of corporate and personal income tax, and the accounting effects of a rate reduction in companies with advance or deferred taxes on profits, due to positive or negative time differences, or with losses pending compensation.

The EC Commission itself (2001) underlines the importance of nominal tax rates in the field of fiscal competition between member States. Future fiscal reform in Spain will probably involve a reduction in nominal corporate income tax rates. However, the tax rate is not the only issue of interest in relation to international business competitiveness. We also have to consider the principal components of the tax base.

The Tax Base

Many of the issues discussed, and confrontations between policy makers and the business community in relation to the different reforms of corporate income tax in Spain have been related to the definition of the tax base. More specifically, the discussion has focused on the relationship between accounting and taxation. In practice, the corporate income tax has logically always been based on business accounts. Although the reform reports of the seventies and the initial legislation contemplated the differences between the corrected value of fiscal capital at the start and the end of the tax period as a way of determining income, this idea was soon abandoned. Instead, the debate focused on adjusting the profit and loss account to determine the corporate income tax base.

Generally speaking, the tax that came into force in 1979 involved important differences between the accounting result and the computation of the value of the tax base for tax purposes. Evidence of this is the fact that the Corporate Income Tax regulations (Royal Decree 2631/1982, of October 15th) had more than 400 articles by compared to 34 articles in the 1978 Act. The 1982 regulations contained 135 articles related to the tax base, 90 of which were concerned with accounting aspects. With these figures, it is easy to understand why the tax base differed considerably from the accounting profit and losses of the period. The situation changed radically in the new 1995 Corporate Income Tax law and, without prejudice to certain adjustments to the economic result which give rise to temporary or permanent differences, accounting-business standards are generally accepted in the determination of the tax base.

However, article 148 of the current law empowers the tax authorities to apply fiscal precepts when calculating the accounting result. I believe that this cautionary measure is meant to be used only when there is evidence that there has been failure to

comply with accounting-business standards and that this non-compliance has fiscal effects. In practice, the Tax Administration does not applying this article. It is generally understood that if a firm, for instance, has been audited and the auditors have issued a favourable technical opinion, considering that the criteria followed by the firm are in accordance with accounting principles, it would make no sense and would also be a frontal attack to legal certainty, to apply this (cautionary) measure. In any case, this clause continues to be a source of friction between policy makers and the business community.

This issue of differences between fiscal and accounting criteria was a source of many disagreements and considerable controversy between the business and academic communities and the tax authorities during the initial reforms in 1978 and the most recent reform of 1995. To mention just a couple of examples, until 1996 the LIFO method was not admitted for inventory valuation for tax purposes. While this method had already been accepted in the General Accounting Plan and the 4th EU Directive, negotiations to make updates to balance sheets during periods of high inflation rates, although fiscally admissible (specifically from 1979 to 1983), were always difficult.

The trend in relation to fiscal (and accounting) amortization over the last twenty-five years has consisted of offering Spanish firms, especially small ones, financial competitive advantages by applying higher depreciation coefficients and reducing the useful life of assets. The fiscal admission of deductible provisions was another source of confrontation between the business community and policymakers. From the initial highly restrictive positions, there is now more flexibility since the 1995 corporate tax reform. For instance, since 2002, non-financial insolvency provisions can be deducted six months after the obligation becomes due, instead of the previous twelve months.

There are other aspects of interest in relation to the corporate income tax base On the one hand, there has been the gradual strengthening of the fiscal regulation on "not at arm's length" transactions since 1978. On the other hand, there has been application of "advance price agreements" and rules referring to the "undercapitalization" of Spanish subsidiaries of foreign companies. We should also mention the progress made in the consolidated taxation of holdings. At the same time, business restructurings (mergers, spin-offs, transfer of assets and share swapping), courtesy of the application of Community directives, have progressed from the discretionary application of tax benefits by the authorities, to an automatic system based on deferring income for tax purposes. The reduction in the double national taxation on dividends and capital gains has continued to progress; since 1978, it has followed the trend of deductions to tax payable, either eliminating or halving the double taxation of a firm obtaining revenue from shares in national companies.[8] The business community, of course, has always been in favour of the complete disappearance of double taxation in all cases.

As for the capital gains obtained in the transfer of business assets, Spanish corporate income tax has traditionally always encouraged the reinvestment of such earnings, which could favour business capitalization. Naturally, the greatest encouragement consists of making reinvestments exempt, and this was the case in the 1978 Corporate Income Tax Act, although it was only applicable to capital gains from the transfer of tangible fixed assets. Before 1978, the system reduced the tax base by a certain percentage of the profits allocated to the investment provision fund or the reserve for export investments, but the fact that there were no time limits to these investments meant that firms could benefit from this fiscal advantage to finance themselves without investing.

In this field, the exemption approach was followed by the alternative of deferring payment of the tax on the capital gains obtained if the transfer of fixed assets was reinvested in other fixed assets. In turn, this benefit was enlarged to include the sale of shares when total shares represented no less than 5 percent of the stock capital of other firms. With a deferral period of usually ten years, this fiscal benefit meant that the effective tax burden was 25 percent instead of the nominal 35 percent. Since 2002 (Administrative and Social Fiscal Measures Act - Law 24/2001, of December 17) this has changed again. There is now a tax payable deduction for reinvestment which, starting in 2003 represents 20 percent of the capital gains (reinvestment of a less than the total amount obtained from the transfer reduces the deduction in proportion to the reinvested amount). This deduction is applied to the tax payable for the tax period in which the reinvestment is made (which must be made between the year prior to the transfer date, in which case the deduction is effective in the year of the transfer, and the three following years, or exceptionally according to a special reinvestment plan). With this deduction, given a nominal corporate tax rate of 35 percent, the nominal tax burden is reduced to 15 percent (personal tax rate on capital gains earned in a period of over 12 months).

Finally, with regards to compensation for losses, the business community's proposal for retroactive compensation with a return of corporate income tax paid in previous years has not been admitted by policymakers. What the business community did achieve was a considerable extension to the period during which negative tax base can be compensated in the future. The five years initially contemplated in the 1978 Act grew to seven in 1995, and the current law allows fifteen long years starting with the tax period following the one in which the negative tax base was registered (for new firms and for negative tax bases derived from the operation of new toll

motorways, tunnels and roads by concessionaires, the term starts with the first tax period in which fiscal income is positive).

Tax Credits and Fiscal Incentives for Investment and Other Business Activities.

When referring to depreciation in the previous section concerning the tax base, we mentioned the tendency, common to many countries, to shorten depreciation periods for tax purposes in order to provide firms with financial advantages and encourage investment. Currently in Spain, although this is a temporary measure, the maximum linear coefficients established in the official depreciation tables are multiplied by 1.1 for new asset acquisitions in 2003 and 2004. Free depreciation is used in some cases, as with elements related to R&D activities (excluding buildings, which can be depreciated by tenths) or R&D costs accounted for as intangible assets. Free depreciation has occasionally been used, as was the case in 1985, in order to compensate for the effect of deferring investments until 1986, the year that VAT came into force, since the new tax treated investments better than the indirect tax it was replacing. In the previous section we also referred to reinvestment of the product of asset transfers in the form of reducing taxation on the resulting capital gains. Here, however, we will be focusing on tax credits (as opposed to deductions) as incentives for investment or other business activities.

Starting with tax incentives for investment, the basic idea of the reformers of the seventies, generally accepted by the business community, consisted of rationalizing the incentive system current at the time. The idea was to replace the incentives included in the 1964 corporate income tax with other more effective mechanisms. The investment provision and export investment reserve system mentioned earlier was seriously inefficient and the chosen alternative was to provide fiscal support for investment by means of tax credits consisting of deducting a percentage (initially 10

percent in 1979) of the total investment made from the tax due in the tax period. The tax credit system appeared to be more effective, particularly because it promoted investment and not the self-financing resulting from the provision and reserve system. Furthermore, the tax credit system was easy to modulate according to the fiscal policy needs of the time.

Pressure from the business community, during the economic slowdown, prevailing since 1975, considerably increased the weight of fixed asset investment incentives, which became quantitatively significant in relation to revenue. On the other hand, as Cuervo and Trujillo (1987) showed, investment deductions were largely applied in capital intensive sectors generating relatively little additional employment.

The new corporate income tax had successfully attenuated the cost of using capital, reducing the negative impact of the high financial costs of the eighties (Espitia, *et al.,* 1988). However, the short-term efficacy of the tax incentives for the investment system also had its costs. Besides generating efficiency costs on the labour market, the tax incentives had undesirable effects on the composition of investment. These effects were compounded by other aspects of the tax system, such as tax rates, loss compensation and the treatment applied to depreciation, capital gains, and sources of financing in general. These issues were studied by Sanz (1994) in relation to Spain.

For example, the tax system discriminated against investment in inventories, with special benefits for investment in vehicles, machinery and equipment. In general, effective marginal tax rates also depended on the firm's financial structure, with debt financing being the most favoured by the tax system. Throughout the eighties, the result was that the marginal effective rates on investments by small firms tended to be

higher than those applied to large companies, because the latter needed proportionally lower inventories and had better access to financing, in particular debt financing.

Academic criticism of the fact that the tax system was not neutral, with important effects on the composition of investment, had a significant impact on policymakers' opinions concerning new lines of reform in the early nineties. In fact, neutrality was, in general, a priority objective of the corporate income tax reform of 1995, in which the basic criterion for investment was understood to be its own productivity rather than induced tax responses. However, the business community, now that Spain had an open economy, demanded support for international competitiveness in the form of incentives for the internationalization of Spanish firms –which will be considered in the following section– and also demanded that the tax system benefited certain business activities. The result of the battle between the two objectives, fiscal neutrality and the promotion of certain business activities or behaviours was the disappearance of tax credits for investment and the multiplication of other credits supporting activities which the business community considered to be increasing the competitive level of Spanish firms.

According to current legislation, incentives for certain activities of the Spanish corporate income tax include, among others, the following:

- Deductions for R&D and technological innovation activities and the promotion of information technologies. This is a generous tax credit, particularly in relation to R&D, despite problems of definition of its different concepts, justification and verification. For small firms (with turnover totalling less than 8 million euros), there is a specific deduction to encourage the use of information and communication technologies.

- Deductions for investment aimed at environmental protection, the acquisition of new industrial or road transport vehicles in the part of the investment helping to reduce atmospheric pollution, or the use of renewable sources of energy.
- Deductions for occupational training costs, including the cost of providing employees with Internet connections or equipment, or grants for access to equipment, even when they are used elsewhere and outside working hours.
- Deductions for export activities, divided into two concepts: a) for investment to create foreign branches or subsidiaries, and b) for the cost of promoting goods and services produced in Spain and abroad. On the other hand, earnings from the export of film and audio-visual productions, books, parts of books or all educational publishing work are applied a 99 per cent deduction of the tax payable.

Policymakers and the business community are largely in agreement concerning this new tax incentive system, although the latter continues to demand direct incentives for investment in general by means of either tax credits or the fiscal policy applied to asset depreciation. For the time being, tax credits are limited to encouraging business activities other than the acquisition of fixed assets and are focused on increasing competitiveness. A careful revision of the efficiency of the current tax credits is still pending.

Promoting the Internationalization of Spanish Firms

The objective of enhancing the competitiveness of Spanish firms has been the motivating force behind the significant fiscal promotion of business internationalization carried out over the last ten years. Until Spain joined the EU in 1986, corporate income tax was designed for a closed economy and its only

international component was a deduction for tax paid in other countries to avoid double taxation, which is logically still in force.

However, since the corporate income tax reform of 1995, the international aspects of the tax are now highly significant, largely thanks to the demands of the business community. Overall international aspects are well managed in the current Spanish corporate income tax system, which, in the wide field of business internationalization (and the enhancing of export activities), includes:

- The exemption of dividends received from non-resident corporations (in which the holding represents at least 5 percent of the stock capital), and capital gains derived from transfer of shares in the same corporations. This exemption eliminates double international taxation and is also an improvement on the existing deduction for dividends and profit shares from foreign sources. The reason for this is that the deduction is made according to the imputation technique and limited by the Spanish tax itself. However, if the foreign tax on dividends is lower than the Spanish tax, the deduction maintains the Spanish tax burden, whereas the foreign burden is favoured with the exemption method. If the foreign tax is greater than the Spanish tax, the resulting tax burden is the same with either one of the two methods – exemption and deduction – and equal to the foreign tax. At the same time, the exemption method eliminates capital gains taxation in Spain (the exemption method is also applied to certain income obtained abroad by the permanent establishment of a firm resident in Spain)
- The special regime applicable to foreign-share holding firms. This regime benefits firms managing and administering equity of non-resident enterprises. The tax incentive consists of the exemption, applicable to the Spanish company, of income from non-resident firms in the form of dividends or net capital gains.

- The deduction from the tax base of investments for the establishment of enterprises abroad by purchasing shares in non-resident companies representing a voting majority or by establishing a company outside Spain. The effect of this tax benefit is deferred taxation, with the deducted amounts being added to the tax base, in equal parts, in the tax periods ending in the four years following the investment.
- Deductions for export activities, as mentioned in the previous section.
- The improvement and considerable enlargement of agreements to prevent double taxation signed by Spain, also benefiting non-residents who, with no agreement in place, are applied a specific tax since 1998 (Non-resident Income Tax Act - Law 41/1998).
- The application of the Advance Price Agreements system to transfer pricing.

The Fiscal Framework for SMEs and Family Businesses

Income Taxation

Consideration of the taxation applicable to small and medium-sized enterprises (SMEs) has been very important throughout the Spanish tax reform. We should begin by considering the personal income tax applicable to individual business owners and independent professionals, or artists. Since 1979 the general system determining taxable income for economic activities performed by these types of individuals consisted of deducting expenses and asset depreciation from total revenues. However, the tax has always contained cautionary measures. For example, payments made to the spouse or children under legal age were not deductible and neither were they classified as fiscal income of the latter. If there is an employment and social security contract, these payments are now deductible from income and taxed as

earnings of the receivers. With some exceptions, there has been a tendency to gradually apply corporate income tax rules to determine net income, but with the fiscal benefits for corporate SMEs still in force. Furthermore, the capital losses or gains derived from property associated with the economic activity have traditionally been taxed as such and not as business income.

The definition of economic activity has also been subject to cautionary measures in relation to property rental or sale. For these activities to be considered "economic" for tax purposes, and for revenue not to be taxed as real estate returns, there has to be an office in charge of managing the property and at least one full-time employee. On the other hand, there is currently a simplified general regime application system for activities with a net turnover of 600,000 euros or less in the immediately previous year.[9]

However, the most radical simplification of personal income taxation for individual entrepreneurs and professionals arose with a scheme introduced in 1979. This is the voluntary return assessment system for certain economic activities performed by small enterprises and professionals, applying indices or returns established by the Administration for modules according, for instance, to turnover, number of employees, cost of purchases, surface area of premises or land, fixed assets, power consumption or capacity, etc. The quantitative limits for the application of this scheme are, according to the current legislation, 450,000 euros of total returns in the preceding year for all a taxpayer's economic activities, and 300,000 euros if they consist of farming and livestock breeding.

It is easy to imagine that both the technical and economic studies conducted to determine the value of signs, indices and modules in the different sectors of economic activity and definition of the scope of the scheme –the activities to which it applies

and within which limits– have been the source of frequent confrontations between policymakers and business organizations. The system is useful and effective for the small enterprise –indeed it is not compulsory, but few waive their right to apply it– and it is simple and inexpensive for the Administration to control, although it reduces revenue on the income generated by such activities and gives way to inequalities since the tax burden of these activities is lower than it should have been (recall it is a voluntary scheme and that most entrepreneurs covered accept it).

As for corporate SMEs, we have a special corporate income regime known as "tax incentives for small firms". Fiscal support for Spanish SMEs is significant and affects firms with a turnover of less than 8 million Euros (according to current legislation) in the previous fiscal year. This is higher than the figure established in business legislation for presenting an abridged balance sheet and not being obliged to audit the annual accounts (4.75 million euros), so the definition of a "small firm" is quite broad. To prevent companies from hovering on the borderline, it would possibly be better for them to have to exceed the turnover of 8 million euros in two consecutive years in order to cease to be entitled to the special incentives for SMEs.

Both the business community and policymakers, who also have to follow EU criteria, have agreed on the need for fiscal support for SMEs. The economic reason for this is the large number of small firms capable of generating considerable employment. There is need to strengthen their competitive position, which may be negatively affected particularly by financial constraints (their lack of access to capital markets, insufficient collateral for credit institutions and limited information mean that SMEs depend on financing from banks, generally at a high cost).

SMEs receive a reduction of 5 percentage points in the tax rate applicable to their first 120,151.81 euros of profit (which is, therefore, taxed at 30 percent). This is a

relatively small advantage for the firm (6,010.12 euros), although it represents a considerable loss of tax revenue.

Other tax incentives for small firms include accelerated depreciation via the doubling of coefficients, free depreciation for more situations than in the general scheme and the deductibility of global provisions for possible insolvent debtors.

Taxation on Wealth and the Family Business

It is usually thought that a family business, in which the entrepreneur is either the owner or represents a group of people with family ties, is an SME. This, however, is not the case. Individual entrepreneurs are indeed family businesses and many small firms fit into this category, but some of them are large. In fact, as Santana and Aguiar (2004) show, over half (52.7 percent) of the non-financial firms trading on the Spanish stock market are controlled by family groups[10]. Like any other businesses, family businesses and their shareholders have been affected by this long period of tax reform. However, particularly in the nineties, large family firms approached policy makers with a series of specific fiscal problems which could negatively affect the growth of their businesses and their transmission to other generations. These problems were divided into two groups. The first referred to the difficulties derived from holding shares in family firms due to the wealth tax, the fiscal transparency system, and double income taxation on dividends. All these issues will be considered in the next section. The second was related to the fiscal costs of transferring businesses, due to the effects of the Inheritance and Donation Tax. Discussions with policymakers in regard to these problems were spearheaded by the Family Business Institute (*Instituto de la Empresa Familiar*).

To begin with, the wealth tax, as we have learned above, arose from the social pact known as the Moncloa Agreements of 1977 in a peculiar political context and

with the ultimate objective of generating fiscal information for the control of earnings and wealth. This objective was not achieved and was even further hindered by the transfer of the tax revenue to autonomous regions in 1984. Since that date, the better equipped central tax administration had less incentive for auditing and enforcing this tax.

Although the revenue from the wealth tax is not sizeable, it generates a burden on wealth, which can be very high depending on its mean return and can lead to family business, for instance, paying out dividends simply for tax payment purposes.

Since it was first applied in 1992, the current wealth tax (established by Law 19/1991 of June 6th, which derogated the 1977 law) has tax rates progressing from an initial 0.20 percent to 2.50 percent for tax bases in excess of just under 10.7 million Euros (according to current legislation). These tax rates, t, would have to be divided by the mean returns, r, on wealth P, to determine the equivalent tax rate, t' in terms of personal income tax revenue, accordingly: $P \cdot t = P \cdot r \cdot t'$. Thus, if the marginal wealth tax rate is 2.50 percent, with r=0.03, the equivalent personal income tax rate is 83.34 percent. The exemption minimum, only applicable to residents, is established by deducting 108,182.18 euros (unless the autonomous region in question has established a different value) from the tax base. There have also been limits to the sum of payable wealth and personal income tax, also exclusively applicable to residents, which, in the tax approved in 1991, was 70 percent of the personal income tax base, with payable wealth tax reduced accordingly. However, these reductions could not exceed 80 percent of the latter. In other words, payable wealth tax is never less than 20 percent of the assessed amount.

With this regulation, the marginal (and mean) tax rate was 70 percent and, because of the minimum assessed amount, greater than 70 percent for additions to

wealth. Likewise, there were cases, relatively simple to determine, in which the tax limit was 100 percent or more, with clearly confiscating effects. At the same time, as we have mentioned, the tax was often the reason for dividend payments, causing serious problems when firms were operating at a loss, with low profits or when profits should have been retained to improve financing.

In view of this devastating taxation framework, in January 1993 the Family Business Institute presented a report (Albi, 1994) , at the highest political level, referring to wealth tax, inheritance and donation tax, the fiscal transparency of the system, double taxation and other aspects of corporate income tax, suggesting several alternative solutions. It appears that the report was well accepted in general terms by policymakers at the time, but with some reluctance from Ministry of Pubic Finance officials. However, it was the political influence of the Convèrgencia y Unió party, a regional political party from the industrialized region of Catalonia (a region where the importance of family business is quite considerable) that led to certain solutions being put into practice to the satisfaction of family enterprises.

The first objective of family firms, and indeed of the entire business community, was the abolition of the wealth tax, which family firms had objected to since it was first introduced in 1977. This objective has not been achieved. However, in 1994 – Law 22/1993, of December 29th – a regulation came into force exempting the personal assets required for regular, personal and direct business activities which are the taxpayer's main source of income. It also exempted shares in corporations for those individuals whose main activity was not asset management, provided that the taxpayer holds more than 20 percent of the shares, performs management functions for the corporation, and receives payment representing over 50 percent of his/her total business, professional and employment income from this corporation. Starting in

1995 –Law 42/1994, of December 30th –, this 20 percent minimal shareholding was reduced to 15 percent.

In 1997 –Law 13/1996, of December 30th – a new amendment was made to the minimal shareholding requirement. Taxpayers filing individually qualify for a minimum shareholding exemption of 15 percent, and taxpayers filing jointly with his/her spouse, children, parents or siblings qualify for a 20 percent exemption. This regulation establishes that the right to exemption is also applicable to shares in firms traded on the stock exchange. Holding companies with shares in other active enterprises are included in this provision if the shares they manage represent more than 5 percent of the voting rights in those enterprises. Furthermore, in 1998 –Law 66/1997, of December 30th– the scope of the exemption was increased to include the assets of independent professionals.

Finally, in 2003 –Law 51/2002, of December 27th– the minimum individual shareholding for this exemption to be applicable was reduced from 15 to 5 percent. In 2004 –Law 62/2003, of December 30th– the scope of the exemption was again increased to include not only share ownership but also a beneficial life interest in exempt shares.

This long period of tax changes, which led to family businesses being exempt from wealth tax, has been accompanied, since 2003 –Law 46/2002, of December 18th–, by the reduction from 70 to 60 percent of the combined limit of payable wealth tax plus the portion of payable personal income tax corresponding to the general part of the latter's tax base. This new 60 percent limit is now calculated on the general part of the personal income tax base (which does not include capital gains generated over more than one year). Before this change, capital gains generated over more than one year (now taxed at 15 percent) could, like other income, be subject to a 70 percent

tax rate, due to the combined limit. However, the minimum wealth tax payable continues to be 20 percent, so taxation may still be confiscatory.

As for the negative effects of the inheritance and donation tax on family businesses, the basic problem lies in actually paying the tax because the property transferred between generations usually consists of productive assets, without the necessary cash being available for the payment. Since inheritance and donation tax rates range from 7.65 to 34 percent (currently applicable to tax bases of just over 797.55 million euros), when taxable wealth is very large, a third of it may be paid in tax. Furthermore, depending on the taxable wealth of the acquirer prior to the transfer, coefficients are applied to increase the tax payable. For example, for an acquirer receiving a transfer from a parent, with pre-existing taxable wealth totalling just over 4 million euros, the tax increase is 20 percent, so that the total tax payable would represent a mean rate of around 40 percent and a maximum marginal rate of 40.8 percent.

Response to the demands of the Family Business Institute and other business community organizations in relation to the inheritance and donation tax took a little longer than their demands on wealth tax. Initially, in 1995, the conditions for deferral and splitting payment that were already applicable to individual businesses were also applied to family businesses exempt from wealth tax. In 1996, legislation came into force establishing a 95 percent reduction in the inheritance and donation tax - only for *mortis causa* acquisition – applicable to assets exempt from wealth tax by the family business regulation, with a series of additional conditions. The rule was redrafted in Law 14/1996, of November 30th, applicable in 1997 and, in turn, Law 13/1996, of December 30th , completed the rule by applying the 95 percent reduction to the *inter vivos* transfer of family businesses exempt from wealth tax, also with some additional

requisites. In 1998 –Law 66/1997, of December 30th-, the reduction was also applied to professional activities and the transfer of beneficial rights on businesses. In both cases this reduction was based on compliance with the conditions for wealth tax exemption and the other requirements established for inheritance and donation tax purposes (for example, maintaining ownership for at least 10 years and, in the case of donations, the donor being 65 or over).

With the combination of the wealth tax exemption and the 95 percent inheritance and donation tax rebate (in the form of a reduction to the tax base), family businesses achieved most of their objectives over ten years of reform. This is a good example of the interrelations between policymakers and the business community, based on the economic and fiscal arguments put forward by the two sides, and ultimately the results depending on political alliances. Entrepreneurs continue to demand the elimination of the wealth tax, or at least a reduction in its high rates (only five countries in the EU have a wealth tax, and maximum rates are much lower than the 2.5 percent applied in Spain). In any case, what we have called the "minimum payable" in wealth tax (20 percent of the assessed amount) represents greater taxation than the 60 percent of the limit applicable to the sum of assessed personal income and wealth tax (which is also often exceeded in the way it is regulated). Therefore, the business community continues to demand that the "minimum payable" only be applicable in specific cases as a way of preventing attempts to evade the wealth tax (transferring wealth to the spouse or children with no income, for instance).

Finally, the regulation of family businesses in wealth tax and inheritance and donation taxes, together with other aspects of these taxes, is calling for a major reform of taxation on wealth. This reform has to be coordinated with the autonomous regions, to which these taxes and part of their regulation, were transferred in 2002.

This subject is large in scope and of considerable importance. The enormous disparity in how different assets are treated – for example between family businesses and other assets – both in wealth and inheritance and donation tax is certainly not logical, and is worse in some autonomous regions. In the latter, following the traditional exemption position in the Basque Country and Navarre, the reduction was increased to 99 percent in regions such as La Rioja and the autonomous cities of Ceuta and Melilla, with different conditions applicable to *mortis causa* transfers to descendants and Cantabria, which practically suppresses the tax in some cases. This wide variety of fiscal treatments and other problems associated with the taxation of wealth require, in my opinion, an urgent study and debate on wealth taxation in the Spanish tax system.

Relations Between Personal and Corporate Income Tax

Integration of Personal and Corporate Income Tax

The total integration of business profits in the personal income tax was proposed in the Carter report (1966-67), one of the intellectual foundations of the 1978 Spanish Tax Reform. Such a criterion led to various academic proposals for Spanish Reform during the 70's that would have abolished the corporate income tax. At any rate, firms must be taxed for a variety of basic control reasons, and when this is done it leads to the problem of double taxation.

The double taxation, in personal and corporate income tax, of company profits is an old problem affecting tax systems. The double taxation of dividends discourages the distribution of profits to shareholders and the issue of shares to make new investments. Debt becomes the best financing method that avoids double taxation. At the same time, it is evident that firms continue to pay dividends as a sign that they

are profitable, and also to prevent managers from "over-investing", but double taxation of dividends may still be an important business and economic problem. The double taxation of profits set aside for reserves depends on how capital gains are treated in the personal income tax. We will not go into the detail of this, but the favourable treatment given to capital gains in the current Spanish tax system and the deferral of taxation until shares are transferred do mitigate the problem.

The domestic integration of personal and corporate income tax is the most general solution to the problem of double taxation of dividends. It would be costly in revenue terms to take international shareholders into account, and, in any case, countries of residency of shareholders take care of the issue through foreign tax credits or other means. Additionally, double taxation should not seriously affect the cost of capital in a small open economy, in which the returns for investors (before personal income tax) are internationally determined. The personal tax affecting a country's savings reduces savers' returns, but it does not affect the firm's cost of capital for making investment decisions if the economy is open in regard to capital markets. The double taxation of dividends does also have to be addressed both at national and international scales. Internationally, these issues can be addressed via tax Treaties, foreign tax credits or other schemes provided by residency countries.

However, the issue to be considered now is the double taxation of dividends in personal and corporate income taxes within Spain. A Tax credit system was initially chosen in 1978. Shareholders were entitled to a personal income tax deduction of 15 percent of the dividends received from resident firms, which was reduced to 10 percent in 1987. In this situation, Spain was next to last in the ranking of European Community countries in relation to the degree of compensation for double taxation.

The level of compensation is easy to calculate. Since a profit unit paid 0.35 in corporate income tax and the dividend deduction was 0.1(1-0.35) after 1987, the degree of compensation was:

$$\frac{0.1(1-0.35)}{0.35}=18.57\%$$

The business community demanded a reform for many years, but it only came about in 1995, and did not fully eliminate the double taxation of dividends.

The system used in Spain since 1995 is based on imputation, with domestic dividends integrated in the personal income tax base multiplied by a percentage (which "adds" the underlying corporate tax) which is, in turn, the percentage used to calculate the assessed tax deduction for such dividends. Imputation may be a good system for eliminating double taxation while maintaining the individual tax burden if one considers only dividends received by resident individuals from resident companies. Below we explain how the imputation system actually works.

Double taxation is due to the fact that corporate income tax reduces the profits from which dividends taxed by personal income tax are paid. An imputation system completely eliminates the problem of double taxation if the shareholder is returned the corporate income tax and taxed on the income from which the dividend comes. In Spain, with a corporate tax rate of 35 percent, one euro of profit is nominally taxed with 0.35 euros, with 0.65 euros left for distribution. To eliminate double taxation completely, the percentage deduction (p) to assessed personal income tax which compensates the corporate tax paid, with a nominal rate of 35 percent, would be:

$$p(1\text{-}0.35) = 0.35$$

$$\text{so,} \quad p = 53.84615\%$$

The system's logic would require the return integrated in the personal income tax base to be one euro: what the shareholder receives (0.65) multiplied by 1.5384615. With this situation, the shareholder's personal income tax would apply to the profit from which the dividend comes (dividend received plus its underlying corporate tax), eliminating the corporate tax already paid by deducting it from the assessed amount.

However, the general imputation percentage currently used is 1.4, so double taxation is only partly corrected by 74.28 percent.

To discover the degree to which double taxation is mitigated in the case of the 1.4 integration percentage (p) in relation to the 35 percent nominal corporate tax rate (t), the question we have to ask is what proportion of each euro of profit before corporate tax is passed onto the shareholder before applying the personal income tax? The shareholder receives one euro less corporate tax plus the compensation for double taxation:

$$1 - t + (1 - t)\,(p - 1) = (1 - t)\,p$$

If double taxation were to be fully eliminated, the $(1\text{-}t)\,p$ factor would be equal to one. That is, one euro of distributed business profit is compensated either in corporate or personal income tax to completely cancel out the corporate tax. In the case of partial correction, the uncorrected part is:

$$1 - (1 - t)\,p,$$

So, there is no double taxation per unit of underlying corporate tax in the following proportion:

$$\frac{t - \left[1 - (1 - t)\,p\right]}{t},$$

resulting in the following coefficient of attenuation of double taxation of dividends:

$$C = \left[1 - \frac{1 - (1 - t)\,p}{t}\right] 100,$$

Complete correction would imply C=1, and with complete double taxation C=0.

Applying the current Spanish system values of $t = 0.35$ and $p = 1.40$:

$$C=74.28\%$$

Since on the other hand, if double taxation was fully eliminated:

$$(1 - t)\, p=1,$$

with p=1.40 there is complete elimination of double taxation if the effective rate is:

$$t_{efec} =28.57\%$$

Policymakers often mention the fact that this rate, 28.57%, is close to the average rate of corporate income tax actually paid, so the 1.4 imputation percentage is appropriate. However, the argument that the effective corporate income tax rate is lower than the nominal rate because of existing fiscal incentives is incorrect. If an average effective rate is used for these calculations, these incentives are not passed on to the shareholder and, therefore, cancelled. If it is thought that the effective corporate tax rate is below the nominal rate of 35 percent because of tax evasion, the correct reaction would be to prevent such evasion and eliminate the double taxation of dividends. Consequently, the business community continues to demand that the imputation system should not only mitigate double taxation but get rid of it altogether.

One difficulty associated with the proposal for complete elimination of double taxation following the imputation method, however, lies in the corporate tax reduction for reinvestment of fixed asset transfers which leaves capital gains taxed at 15 percent instead of the nominal 35 percent. With this measure, and without considering the reduced 30 percent rate for SMEs, using g to refer to the tax rate on extraordinary profits with reinvestment (this is 15 percent) and c to refer to the percentage of distributed typical profits and, therefore, $(1 - c)$ to refer to atypical profits, the

expression for the imputation coefficient is considerably more complex than the previous one, depending on *t*, *g* and *c*.

Following the same reasoning as before:

$$1 - tc - g(1 - c) + [1 - tc - g(1 - c)]\,[p - 1] = p\,[1 - tc - g(1 - c)],$$

so to fully correct double taxation:

$$p = \frac{1}{[1 - tc - g(1 - c)]}$$

This expression shows that it is, in practice, impossible for the imputation system to fully and precisely eliminate double taxation. We could argue that, since the reinvestment deduction is a fiscal credit, for it to remain with the shareholder, we would have to assume that the reference rate is the general corporate tax rate. Therefore, if we have a nominal rate of 35 percent, there would be nothing wrong with using an imputation coefficient of 1.5384615, even if capital gains are taxed at 15 per 100.

However, this would mean that someone who, with a marginal personal income tax rate of 45 per 100, receives a dividend from typical profits would have a 45 per 100 tax burden, and someone who receives it from capital gains would have a 28.08 percent burden, with intermediate values for dividends from profits with different proportions of typical and atypical profits. On the other hand, with regards to individual shareholders in passive holding companies, from 2003 (which we will be considering shortly), taxation remains at 40 per 100, or 15 per 100 in the case of capital gains; in other words, it is the rate that corresponds to the passive holding companies themselves. There is a manifest dispersion of the tax burden and a deterioration of the neutrality principle, which could lead, in a not too distant future, to the need to seek other solutions to the problem. These new solutions are also needed given certain rulings of the High Tribunal of Justice of the European

Communities which establish that it is contrary to the EU Treaty to give different tax treatment to dividends received from domestic corporations or from corporations resident in any other EU member country. The possible solution to the problem of double taxation, in personal and corporate income tax, will be considered in the conclusion of this paper

Fiscal Transparency and the Solution of the Passive Holding Company Regime

The fiscal transparency regime was one of the new aspects introduced by the Urgent Measures on Tax Reform Act (Law 50/1977, of November 14th) that the business community objected to from the start. It initially contained a voluntary component, since the regime eliminated the double taxation of dividends (later derogated in 1985) and a compulsory component aimed at preventing tax evasion by means of creating companies acting as screens between the taxpayer and the administration. The main objective for the screen companies was to seek a corporate income tax rate lower than the equivalent personal tax rate. An international regime of fiscal transparency was introduced in 1991, which is still in place today.

Fundamentally, the national transparency regime aimed, since its first implementation in 1978, at "passive" firms which, without performing business activities proper themselves, are concerned with the ownership of shares or assets (real estate, for instance) and firms set up by independent professionals, artists and athletes, provided they complied with a complex series of conditions. Firms classified as transparent, according to the last regulation, paid the assessed amount of corporate income tax but this amount was considered as a "payment on account" of the personal income tax of resident shareholders (non-residents were also included initially), individuals or legal entities. Negative tax bases were used to compensate positive tax

bases in later periods (in the early stages of the regime, both positive and negative bases were charged to shareholders).

The national fiscal transparency system, which was subject to many changes over the years, as shown in the previous paragraph, had highly general ambitions and was too complex both for the Administration and the taxpayer. It is also true, however, that it had one major advantage in that it completely eliminated double taxation, so it was effective, for instance, for professional firms distributing all their profits.

One serious problem, among others, in relation to fiscal transparency for quite a few years concerned holding companies. These holding companies, which could be generally classified as transparent, had direct control over at least 50 percent of the voting rights in their subsidiaries, unless they managed the business activities of the subsidiaries with human and material assets. As aresult of the more transparent holdings, the shareholders residing in Spain were taxed at a marginal and mean, rate for individuals, and due to the effect of the wealth tax, could be as high as 70 percent. Holding companies, therefore, were only able to reinvest 30 per cent of their profits because they had to pay out 70 percent so that shareholders could pay their taxes. Together with other business organizations, the Family Business Institute contemplated the problem in their January 1993 report. This problem was mitigated in 1999 by reducing the holding company's share in its stock portfolio to 5 percent to be excluded from the tax transparency regime Likewise, the transparency regime was not applied to certain firms which, in spite of performing actual economic activities, could suddenly and temporarily find themselves with a balance sheet where the majority of the assets were shares or assets unrelated to the firm's activity, ready for future investments.

The business community's proposals always emphasized complexity of the fiscal transparency regime, both from a fiscal and accounting perspective, and that the regime caused business problems and failed to serve its purpose. The system was valued, on the other hand, as a way of avoiding the double taxation of dividends. The business community also pointed out that the regime would not be justified if, as proposed, the rate of corporate income tax was to be close to a maximum marginal rate of personal income tax.

The new amendments to the national fiscal transparency regime led to its derogation in 2003 and the creation, as an alternative, of the passive holding company system which, in general, has been accepted by the business community. The system does not apply to firms set up by independent professionals, artists or athletes, and is compulsory for resident companies in Spain who passively hold assets and comply with a series of circumstances concerning the composition of their assets and share ownership. Among other cases, the composition of assets classifying a firm as a passive holding company excludes shares representing at least 5 percent of voting rights controlled by the "holding" or "controlling" firm. It also excludes shares or assets unrelated to economic activities, the purchase price of which does not exceed the amount of non-distributed profits of the year in question plus the ten previous years. This was to avoid, for instance, situations arising when profits are retained for future business investments.

Corporate income taxation on passive holding companies is configured with hybrid elements from both corporate and personal income tax. The firm's tax base is divided into two parts, a general and a special part, following personal income tax regulations. The general part consists of typical and atypical profits, excluding the capital gains and losses occurring on occasion of the transfer of assets acquired more

than one year prior to the transfer date. These capital gains and losses generated in a period of over twelve months make up the special part of the tax base.

The general part of a passive holding company's tax base is taxed at a rate of 40 percent, 5 percentage points higher than the general corporate income tax rate, to discourage the use of such companies by individuals (the maximum marginal personal income tax rate is currently 45 percent). The special part of the tax base is taxed at 15 percent, the same rate applied to the special part of the personal income tax base and the rate applied to corporate capital gains when the proceeds from the transaction are reinvested.

In general, individual resident shareholders in passive holding companies are not further taxed when they receive dividends from them, but if they are firms, the dividend deduction that applies only halves the double taxation (a form of penalization). The capital gains obtained by individuals in the transfer of shares in holding companies are not taxed as non-distributed profits. On the other hand, if the transferor is a firm or a non-resident with permanent establishment, the deduction cannot be applied to avoid the double taxation of domestic capital gains. This, in fact, penalizes other firms with shares in passive holding companies.

Consequently, in many cases where such companies are used by individuals, the returns obtained are taxed at 40 percent and capital gains obtained in a period of over one year at 15 percent of non-distributed profits. The current solution would appear to be stable and satisfactory both to the policymaker and the taxpayer.

Conclusions and Final Remarks

Other varied fiscal issues have affected the relationship between policymakers and the business community over this long period of tax changes. For example, in the process

of preparing for the introduction of VAT in 1986, collaboration between the authorities and business organizations was very positive. One subject that was discussed on many occasions over the following years was the reduction in the business contribution to the social security system, by means of higher VAT rates. The subnational government tax on economic activities, (municipal tax, as specified in different schedules, for performance of economic activities) affecting all businesses, has always been questioned, and since 2003, this has resulted in a considerable increase in the number of exempt cases together with a significant rise in the amount due in certain cases.

With regards to personal income tax, of which we have studied several aspects earlier, of particular interest to the business community has been how capital gains from the sale of company shares are treated. Likewise, in relation to personnel benefits, one essential aspect has been the development of pension plans and retirement funds, since 1988, or the fiscal treatment given to payments in kind. Problems related to the financing of the autonomous regions have also possibly had a collateral impact on matters of interest to the business community. Finally, issues related to legal certainty and the rights and obligations involved in taxation, or the administrative costs associated with taxes, have often been at the centre of discussions between policy makers and the business community. Reasonable solutions to these questions have been included in the Statute of the Tax Payer and the new General Taxation Act that came into force in 2004.

Turning now to the main content of the paper, the Spanish business community accepted most of the fiscal measures adopted in 1977-78, but fundamentally objected to the introduction of taxation on wealth and the fiscal transparency regime. It also objected to the limited attempts to avoid the double taxation of dividends and the

heavily progressive nature of personal income tax, based on the fact that, in general, economic circumstances had changed a great deal since the system was designed between 1970 and 1975. Later, due to the fact that the Spanish economy had opened up on an international scale since 1986, and especially during the nineties, the focus of attention of both policymakers and the business community shifted to reforms aimed at increasing business competitiveness and internationalization. These goals have been largely satisfied over the last fourteen years. In fact, economic and public finance considerations and, to a considerable extent, persuasion, have been key elements in the relationship between policymakers and the business community, with a few bitter disputes, in these twenty-eight years of tax reform.

The new tax system was particularly difficult, from a business perspective, in the eighties, and the decade saw serious confrontations between the business community and policymakers. The early nineties signalled a change in attitude by policymakers, who tended to be much more receptive to the business community's demands. For example, the inclusion of incentives in corporate income tax to increase business competitiveness in an open economy has been consistently supported since the tax was reformed in 1995 and in all its more recent amendments.

As for the essential elements of corporate income tax, tax rates have not varied greatly in the period we have considered. The current 35 per cent standard rate was established back in 1985. For reasons of fiscal competition in the EU, however, the possibility of lowering the rate may need to be considered. This, in turn, would have a clear impact on the stock market because the cost of corporate taxation is "capitalised" on the stock exchange and its reduction would generate gains. In any event, it will be important to pay attention to the loss of revenue derived from decreases in nominal tax rates. In this respect, the subject of the integration of

corporate and personal income tax, which we shall refer to later, would also have to be considered, together with the maximum marginal personal income tax rate.

With regards to the corporate income tax base, the discussions between policymakers and the business community have, to a great extent, been centred on taxation regulations and standards not requiring major adjustments to accounting results. The application, as of 1st of January 2005, of new International Financial Reporting Standards (IFRS), in accordance with EU regulation, to corporations forming part of a group will require fiscal changes to accommodate tax to accounting norms, and this may produce new controversies. An example is the valuation of intangible assets such as trademarks or R&D expenditure, or the financial goodwill entered into the accounts when substantial shares are acquired in other firms. The change to IFRS consists of replacing the currently applicable amortization criterion with the depreciation concept. There will be no charge to the accounting result for the amortization of intangible assets, but the year's accounting profits, if applicable, will be reduced by the depreciation of such assets. Other reform issues due to the IFRS are centred on the tax on profits and the advance and deferred taxes arising from differences between the fiscal and accounting value of assets and liabilities.

In relation to tax benefits, incentives for investment have tended towards accelerated depreciation and have become schemes to promote R&D activities or technological innovation, staff training, exports, more appropriate environmental conduct and, above all, support for the internationalization of Spanish firms. Little is known about the efficiency of these tax incentives, but the foregone revenue might be more usefully used by applying lower corporate income tax rates.

Better tax treatment of SMEs was a basic component in the relationship between policy makers and the business community, both for individual enterprises and

companies. Family business organizations have, in turn, concentrated on the taxation of wealth (wealth tax – inheritance and donation tax), with positive results leading to an in-depth review of this type of taxes in the future. The business community also demanded the elimination of the fiscal transparency regime, and were successful at the cost of establishing a taxation system applicable to passive holding companies.

The complete elimination of the double taxation of dividends is still a pending issue. With regards to double taxation of dividends in personal and corporate income tax the present imputation system lacks neutrality, as discussed in 6.1 above, and is easily subject to attack by European institutions since it only applies to dividends paid by resident corporations.

A European Commission communication dated December 19, 2003, concludes that member States should apply the same tax treatment to inbound dividends from other member States as to domestic dividends, in order to eliminate restrictions to free movement of capital (prohibited by articles 56 and 58 of the European Community Treaty). This position followed the jurisprudence of the European Community High Court in the Verkooijen case (C-35/98). This jurisprudence has continued after the aforementioned Commission communication with the Lenz case (C-315/02) and more recently –September 7, 2004- with the Manninen ruling (C-319/02) establishing that the Finish imputation system restricts the free movement of capital. Given the content of the Manninen ruling, the Spanish system preventing the double taxation of dividends should include dividends paid by corporations resident in other EU countries to personal income taxpayers resident in Spain.

The imputation system, however, is ill suited to deal with a wide array of corporate tax rates underlying the distributed dividends, as is now the case internationally and very clearly in the EU (the range of corporate tax rates in EU

countries is 12.5 - 40 percent). To apply the same imputation coefficient to dividends distributed from profits subject to different tax burdens is unreasonable, and it is impracticable to use different coefficients or "add" to the dividend the corresponding corporate income tax paid in other countries (to be credited against personal income tax liability). This is the reason why "pure" imputation systems, which were of widely used in EU countries until recently, are now very seldom applied (Spain and Malta).

The solutions chosen by EU member countries to integrate their personal and corporate income taxes are varied. Many of them follow "modified classical systems", permitting double taxation on only part of the dividends via exemption from personal income tax of, say, 50 or 60 percent of the dividends. Others simply exempt the dividend if the shareholder's share in the distributing corporation exceeds a certain percentage and apply a flat rate of 20 to 25 percent to other dividends that do not benefit from this exemption.

In fact, these solutions show that tax systems have moved away from comprehensive or global taxation –all types of income are treated in the same way for tax purposes– and back to schedular systems. Following this approach, a final and more general solution may be dual taxation. A dual income tax structure is a schedular system, taxing employment and capital income separately, although homogenously. Capital income is taxed according to a separate and lower tax schedule than labour income. This is an important departure from comprehensive income taxation, which was the cornerstone of the Spanish tax reform initiated in 1977-78. However, it represents a compromise solution not only to the problem of integration of personal and corporate income taxes, but to many other difficulties of comprehensive taxation, administrative or not.

I believe that dual taxation deserves careful consideration for a possible future reform of the Spanish tax system. If a schedular personal income tax structure was chosen, using a common corporate and personal capital income tax rate would help to solve the problem of integrating corporate and personal income taxes. It would represent a complete overhaul of the present system, initiated under a comprehensive tax approach, which would show that the road between a closed economy with severe problems in 1977-78 and Spain's fiscal situation today has certainly been a long one.

Notes

1. My thanks for comments provided as an assessment of the paper and the financial support provided by the Institute of Fiscal Studies, Ministry of Economy and Public Finance, Madrid. Author's contact: ealbi@retemail.es
2. This included overtime work, emigration outside the country and to other regions within Spain, and savings, which clearly supported the fast rate of growth of the economy.
3. The Palace of the Moncloa is the official residence of the prime minister (or Presidente del Gobierno) in Madrid..
4. The amendment of the Tax on Capital Transfers and Documented Legal Acts (Law 32/1980, of June 21) was prior to major changes in indirect taxation.
5. The basic assumption is that the fiscal incentives have been effective in strengthening competitiveness as opposed to protecting weaker domestic enterprises against foreign competition.
6. However, if we were to extrapolate from the United States' experience with corporate income taxation at the state level, coordination and harmonization will be hard, if not impossible, to achieve.
7. A lower 30 percent is applicable to the first 120.202,41 euros of profit obtained by small and medium-sized enterprises, defined as firms with a turnover of less than 8 million euros in the previous year.
8. The issue of double taxation between personal and corporate income tax will be discussed later.
9. The regime follows a very simple depreciation method with provisions being estimated *a forfeit* applying a coefficient of 0.05 to net income (calculated excluding the provisions as an expense
10. The next group of owners consists of banks and savings banks, controlling 18 percent of stock market enterprises.

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