Spain: the challenge to set an effective tax policy

2012

Rafael Fuster says that Spain faces significant economic and social challenges as a result of the crisis

Spain faces significant economic and social challenges as a result of the crisis. The latest events seem to indicate that the GDP evolution will soon form a 'W' (although it is still lacking the final upward trend), with a forecasted contraction of 0.7% for year 2012. The deleveraging of the economy, particularly of the private sector, coupled with the difficulties for refinancing existing foreign debt in the currently unstable international financial markets have vanished hopes of a fast return to growth.

In addition, unemployment is reaching long forgotten figures (24.7% estimated for 2012) which will be difficult to revert (Spain traditionally required growth rates well over 2% to reduce unemployment). Naturally, the combination of lower economic activity, reduced public revenues, and higher public spending to provide welfare assistance to those in need, resulted in public deficit soaring to 11% of GDP in 2010 and 8.9% in 2011, and are increasing the otherwise reasonable public debt levels (68.5% of GDP).

On the other hand, the burst of the real estate bubble, which hit its peak in 2007, has caused a very sharp decline –and this is an understatement– in the number of new homes constructed or acquired. In addition, the increasing difficulties for indebted home owners, land developers and construction companies to pay their mortgages has sent waves of concern to the banking sector which, until two years ago, –unlike its US or European peers – had coped relatively well with the early crisis years due to their low exposure to toxic financial products.

In this context, since it took office in late December 2011, Mr Rajoy's government has had to act with determination and take many hard and unpopular measures. The government's initiatives focus on three lines of action:

> Firstly, a thorough and long awaited reform of the labour market in order to introduce flexibility, reduce labour unitary costs and, ultimately, gain competitiveness;

Secondly, a crucial reform of the banking sector, which is still under way, aimed at ensuring solvency of the systemic financial institutions, consolidating the sector in order to improve efficiency (especially among savings banks – cajas) and, most importantly these days, dismissing fears of the real estate exposure and implicit losses affecting banks beyond a point where, given the limited ability to finance through public funding, EU or international help would need to be sought –as has finally happened.

Lastly, there is a strong urge to sharply reduce public deficit and bring it to the target levels agreed within the EU (5.4% in 2012 and 3% in 2013, although it looks like the European Commission might accept to postpone the 3% requirement until 2014). This last objective (which in 2012 alone roughly implies a € 35 billion adjustment) is obviously a bitter pill – we shall see whether or not the prescription causes an overdose that might harm the patient– that demands drastic cuts in public spending as well as trying to raise public revenues through the tax system despite the weak economic pulse. This last point about boosting public revenues has been the *leit motiv* of tax measures taken in Spain during the last year and will be the focus of this article.

So, what's next? I am afraid that there are more tax increases down the road

Back in 2007, the Spanish tax system (excluding regional or local taxes managed by the autonomous regions or the municipalities) collected an all-time record of €200.7 billion. By 2009, that figure had plummeted to €144 billion. (roughly the same, in nominal amounts, as in 2004). In 2011, total revenues reached €161.7 billion. It is particularly relevant to notice that by far, the strongest drop in tax revenues is from corporate income tax. Indeed, while personal income tax and VAT revenues have decreased by 9.6% and 8.8%, respectively, from 2007 to 2011, revenues from corporate income tax have plummeted a staggering 63%.

There is fear that the recession might bring tax collection figures down again (figures of the first quarter of 2012 are not encouraging), at a time when most efforts are on reducing public deficit. So, what is the government doing about it?

The previous government had already taken some action. In August last year, the first package of measures (the 'summer package') was implemented. The measures are transitory until fiscal year 2013. They essentially focus on raising corporate income tax revenues and re-established wealth tax, which had been abolished in 2008. Payments on account of corporate income tax (not final tax rates) were raised significantly for companies with a turnover higher than €20 million, thus anticipating the collection of tax and providing free financing to the Treasury. Also, the ability to use tax loss carried forward credits was limited to 50% or 75% for companies with a turnover exceeding €60 million or €20 million, respectively, and the carry-forward period was extended to 18 years.

Only a few days after forming his government, Rajoy decided to put forward a new package of measures – the 'winter package' – that are in stark contrast with the basic tax principles that he has always defended. Indeed, the mounting pressure to comply with public deficit commitments together with the realisation that the 2011 deficit would be off target by 2.5% (an estimated 8.5% at the time, vs. 6%) forced the implementation of some unpopular measures.

The most significant one was an increase in personal income tax rates for 2012 and 2013 by imposing a 'complementary tax'. Depending on the region, total maximum marginal rates were set to range from 52% to 56% where income exceeds €300,000. However, high rates (47%) already apply with respect to income over a threshold of just €53,400; quite a change when one thinks that just two years earlier, maximum marginal rates were generally 43%. Moreover, withholding taxes on financial income or gains were raised from 19% to 21% and the final tax liability may reach 27% if they exceed €24,000.

Other measures, such a slight increase in non-resident income tax and a more substantial property tax burden, were included in the package. But, indirect taxes – in particular VAT – remained practically untouched. The government's stance was that VAT should not be raised (it had already gone up two years ago from 16% to 18%) because of the impact it would have in consumption and domestic demand at a time when they are particularly weak; furthermore, the point was made that raising VAT is regressive, since it hurts the most those in need given that they must use substantially all of their income for consumption. While these are by no means secondary issues, raising income taxes significantly drains not only consumption but also savings; indeed, at a time of deleveraging, one wonders whether reducing by way of higher income taxes the ability of families to repay existing debt is the wiser thing to do and what impact it could have in banks and in making the deleveraging process last longer.

But events kept unfolding... By March, the government realised that despite the first measures introduced, further action would be required if public deficit targets were to be met. Consequently, yet another tax package – the 'spring package' – was implemented on 30 March. Again, tax measures were all revenue driven.

First of all, significant changes were introduced in corporate income tax legislation in order to restrict tax credits and deductions. The most relevant ones are the elimination of tax depreciation freedom, which allowed taxpayers to depreciate certain new investments in full and had been introduced without further requirements a year before as a means of fostering corporate investment, and the restrictions for the deductibility of financial expenses. The latter are clearly inspired in the German rules and establish that net financing expenses in excess of 30% of adjusted EBITDA in a given year will not be deductible for companies belonging to a Group (although they may be carried forward for future years).

While it is true that in an over-indebted private corporate sector this measure may have an impact in corporate income tax revenues, it looks awkward that, in a crisis context the lower the EBITDA, the lower the tax deduction and the higher the tax liability; especially, if one thinks that since the lender receiving interest is paying taxes on it, there is bound to be a blatant double taxation.

A third measure worth noting is the establishment of a special 8% tax to be applied in lieu of corporate income tax at the choice of the taxpayer in fiscal year 2012 on dividends or gains deriving from foreign subsidiaries that do not comply with the requirements to benefit from the otherwise applicable exemption upon repatriation. In other words, an incentive is established for Spanish parent companies to repatriate profits from other jurisdictions at a cost of 8% which are currently 'locked', because repatriation to Spain would trigger a 30% tax burden.

There is a myriad of other measures but, clearly, the star of the spring package in terms of social impact is the special programme for voluntary disclosure of undeclared assets, which the media insist on calling the 'tax amnesty'. It is, no doubt, unfair for compliant taxpayers to offer an advantageous way out to those who evaded taxes.

However, it is also an exercise of pragmatism in times of dire circumstances for the country to seek mechanisms to bring hidden money out into the open, start circulating and generating new flows of tax revenues in the future. I think the government was brave to put the programme on the table, since it was conscious about the political cost it would entail, and that, while it is certainly arguable how good the deal should be for tax evaders (and this one is, perhaps, too good), overall it is positive for the country. So, what's the deal?

The deal consists of a payment equal to 10% of the acquisition value of assets or amounts of money concealed or held offshore, subject to those assets or money having connections with undisclosed income. The payment results in that income becoming declared for income tax purposes; no penalties, surcharges or delay interest will be imposed. The window of opportunity to use this mechanism closes on 30 November.

Not surprisingly, following a carrot and stick policy, the voluntary disclosure programme is coupled with a bill of law on measures to combat tax fraud that was sent for discussion to the Parliament. Amongst the many relevant measures contemplated in the coming legislation two stand out: first, a new obligation is established for any Spanish resident individual or entity to report to the tax authorities each and every asset or right that they hold outside Spain. Failure to do so will result in specific penalties and, in addition, the statute of limitation will not elapse with regard to income or gains deriving from those assets.

Secondly, the statute of limitations for criminal tax offences will be extended from five to ten years where the taxes evaded exceed €600,000 per tax and per year or complex structures are used. Penalties on tax offences will be raised up to six years' imprisonment. Therefore, the government is sending a strong signal to tax evaders: either they take advantage of this opportunity or they face a much more worrisome future if caught. Compliant taxpayers will undoubtedly agree at least with this second proposition.

So, what's next? I am afraid that there are more tax increases down the road. The government, very much forced by the European Commission's latest recommendations, has recently suggested that a VAT increase is just around the corner (probably in 2013). The figures seem to indicate that it will have no choice but to pull one of the few effective levers that remain available to raise revenues. Having said that, obvious as it may seem, there is no better lever than expanding the tax base, which means increasing the number of compliant taxpayers and making reforms to make money circulate and the economy grow. That is the challenge, that is what they are up to. ■

Rafael Fuster heads the Tax Practice of Uría Menéndez