SPANISH TAX POLICY AND THE LIBERALIZATION OF CAPITAL MARKETS*

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1. Introduction

First of all I would like to thank the Spanish Chamber of Commerce in Great Britain and the London School of Economics for their kind invitation to participate in this seminar on "Taxation and Free Movement of Capital in Spain". The issue of international capital movements is surely an important one, with many economic implications and certainly a question that figures very highly in the list of worries of practically all governments. The Spanish perspective, I believe, is also an interesting one, as it forces us to see the problem from the point of view of a country with a high growth potential, a lot of investment opportunities and, therefore, a great need of capital, both domestic and foreign.

But, in my opinion, what really makes this problem also a crucial one is the fact that we are about to embark on a very vast and ambitious experiment of market integration, which concerns countries of very different degrees of development and whose consequences are not all well understood. Certainly, we all agree that the medium and long run results of a large integrated market, with complete free movement of goods, services, labour and capital must be good, not only from an efficiency, but even from an equity point of view. However, this does not prevent governments and people in general to see the process of adjustment to this new political and economic environment as a worrying one.

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It is natural that these worries exist, if you only think of the scale and nature of the changes involved. In fact, the subject of this seminar offers a very good opportunity to examine with a specific example the consequences that these new rules may have, or indeed have already had, in the international capital market.

I want to focus this talk on the policy implications of the liberalization of capital markets, and particularly on its tax policy implications. Also, I will make special reference to Spain, although I will also consider the problem from a more general perspective.

I would like to organize my exposition in three parts. First, I will try to isolate the essential features of the problem; then I will go to the various policy options contemplated in Europe; and finally I will describe what is at present the official Spanish position.

2. The problem

Why are some governments concerned about the liberalization of capital movements?. And, in particular, why is it that the taxation of capital income plays such an important role in the international allocation of capital?.

In answering these questions, I think it is useful to take a microeconomic point of view, although it is obvious that there are also macroeconomic factors at play.

The concern of governments and people in general about the liberalization of capital markets is based on the perception, on the correct perception I would add, that capital is a highly mobile factor and that it will move in search of the highest return. To this you should add the presumption that lack of capital may result in lack of investment and jobs, and in a lower potential for economic growth. All these factors put together may explain why in the past capital markets have been subjected to severe legal and

administrative controls, and why the prospect of dismantling them worries people and governments alike.

This argument has nothing to do with taxes. But, of course, when taxes exist they tend to become a very significant factor, as then the return that matters for the allocation of capital is the return net of taxes.

Countries with low levels of taxation will be seen as locations attractive for capital and viceversa for countries with high levels of taxation. And this, indeed, in the context of an integrated market, has come to play an important role in the design of tax policy in the different Member States.

This argument, however, is not necessarily correct. Under the residence (or worldwide) principle of taxation -that is, under the principle that domestic residents should be taxed on all their investment income, irrespective of the country where that investment is placed-, tax policy should in theory have little or no effect on the location of capital. Under this principle a domestic resident will allocate efficiently his capital between the different available alternatives, because, irrespective of the country or countries where his capital is placed, the investor will face the same domestic tax. The tax therefore does not distort the allocation decision. It may distort the choice between present and future consumption, and therefore savings, but this is another matter and quite unavoidable if revenue has to be raised. Therefore, to summarise, domestic capital may go from one place to another, but its return will be maximized and this return will be taxed domestically.

Naturally, this situation can coexist with very different tax rates on capital in different countries. In that case it could possibly happen that people rather than capital are induced to migrate, and if this is so tax revenue may be lost. But, I think, we all agree that people move with much more difficulty than capital and, anyway, if the country is confident that it has good investment opportunities, capital should be available in sufficient quantities, be it domestic or foreign.

Why then do governments take so many precautions against the freedom of capital movements?.

To answer this question we have to abandon somehow the ideal world so far depicted and descend to the imperfections of reality.

If there are exceptions to the application of the residence principle, then countries with low taxes may enjoy comparative advantages to attract international capital; and, unfortunately, there are many exceptions to this principle. One of them is the limitation that some countries impose on foreign tax credits, which usually only go to the level of the domestic tax rate applied to foreign source income. This limitation brings down effective tax rates which are different for domestic and foreign investments and therefore distort the allocation of capital.

Deferral possibilities are also an important exception to the residence principle. If dividend income is only taxed when dividends are paid by the foreign subsidiary to the parent company, there is an incentive not to repatriate capital income if foreign taxes are low.

But, in my opinion, the main obstacle to the strict application of the residence principle comes from the possibilities that bank secrecy laws (and laws preventing the disclosure of economic information to foreign authorities) offer to potential tax evaders. Tax evasion is a reality that cannot be ignored and, given this fact, the existence of bank secrecy laws and blocking laws clearly offers a simple and powerful way to undermine the residence principle. Residents may be taxed at very different rates on their domestic and foreign investment, if they have the will to exploit to their benefit these obstacles to the free flow of information. And this is particularly damaging when the flow of information restricted is that among tax authorities. Indeed, in this case the Internal Market will have fallen short of one item in its liberalization agenda: all factors except one - information-

will be able to move freely. I think this asymmetry may be a cause of inefficiencies that as yet have not been sufficiently analysed.

Be as it may, it seems clear that the residence principle, although formally applied by most countries, plays in fact a very minor role. Limitations on tax credits, possibilities of deferral and secrecy laws have converted this principle into a very complex and fairly confused set of rules for the taxation of foreign source income, the economic consequences of which are very difficult to assess.

We are now somehow in the worst of both worlds. We clearly do not have a residence principle worth its name, as effective tax rates on capital income can vary widely depending on the country where the investment is placed, nor do we have a source principle that would tax all investments, irrespective of their domestic or foreign origin. We have something in between, which, in my opinion, has few of the merits of each of these two principles considered in isolation and many of their disadvantages.

In particular, the fact that for a given investor effective tax rates may vary depending on the country where he places his investment, not only introduces a clear distortion in the allocation decision but also sets the conditions for tax competition between countries. And, indeed, this is what seems to be happening as Member States of the EC are aware that by lowering taxes on foreign income they can attract capital.

Although there are many important details left out, this, I would say, is a fair description of the situation today. A situation which, of course, opens up many possibilities not only for tax arbitrage but also for outright tax fraud.

The possibilities for tax arbitrage include the use of conduit companies, to minimize withholding taxes through an adequate (someone may say, abusive) use of tax treaties; the setting up of foreign base companies, to take advantage of the deferral possibilities posed by the recognition of

foreign income only at the time it is paid to the parent company rather than when it is produced; and many other alternatives, some of them known and others possibly much less known but not less effective.

Tax fraud is of course a different question, but no doubt this situation is also conducive to it. In countries with traditionally low levels of tax compliance, the flight of capital to evade taxes is a well known phenomenon which may increase substantially under the more liberal conditions of the European Internal Market.

I think there is quite a lot of agreement among analists about the economic consequences of a situation like this. There are investment decisions taken only for tax reasons; the location of financial intermediaries is biassed towards countries with low taxes; and, perhaps more importantly, tax competition can lead to a very low level of taxation on capital, a consequence which raises serious questions not only of equity but also of efficiency, as the revenue lost will necessarily have to be made up with other distortionary taxes.

3. Policy options

What are the policy options contemplated in Europe vis a vis this situation?

Clearly, the best option would be to effectively apply the residence principle. But this may be an impossible objective to achieve. As I have argued before, experience suggests that for many reasons countries are not willing or capable of adopting a pure residence principle. And one of these reasons is that the unilateral adoption of this principle by a single country would leave it in a relatively disadvantageous position.

Leaving then aside the residence principle, which would in theory allow the coexistence of different levels of taxation in different countries, what are the alternatives left? The only option open is then the harmonization of tax

systems, at least the harmonization as far as the direct taxation of income is concerned. This has been, in a sense, the option taken by the European Community.

Contrary to what has happened to indirect taxation, which concerns mainly the circulation of goods and services and therefore relates directly to the original objective of creating a Single Market, the harmonization of taxation on savings and investments lacks an explicit legal basis in the Treaty of Rome, as no specific article exists regulating this subject. Even so, the spirit of the Treaty goes far beyond the formal contents of its few tax provisions. In fact, the Treaty of Rome provides for the convergence of national legislations inasmuch as they have direct influence on the functioning of the Single Market. And it is clear, from what has been said before, that the free movement of capital has a clear bearing on the functioning of the Single Market, and also a number of tax implications which should be the subject of coordinated action. Consistent with this, the Directive which frees capital movements acknowledges for the first time the necessity of proceeding to the convergence of tax systems to combat fraud arising from or favoured by such a liberalization. However this is no more than a declaration of intentions: the reality is that tax convergence has been subject to many setbacks.

As I see it, the real option now is not between a real residence principle, on the one hand, and a uniform system of direct taxation, on the other; but between whether we will reach this uniform tax system by political consensus or as a result of the workings of the market.

I myself would advocate a certain degree of political consensus. I know that this in the end may imply the transfer to Brussels of important areas of fiscal sovereignty, and that to this extent this option may appear very unattractive to countries with a long tradition of fiscal independency. But the alternative to this option may be, as we are already begining to see, a fierce process of

tax competition that may lead to very low levels of taxation, or even no taxation at all for capital income.

This, to me, would be an unsatisfactory outcome, as revenue has to be raised and, if it is not raised from capital income, it will have to be raised from other sources of income. I for one have no clear answer, neither from a political nor from an economic point of view, to the embarrassing questions of equity that a situation like this may raise. Also, from an efficiency point of view, I have some doubts that this is the best alternative, as the revenue lost will have to be made up by increasing the rates of other taxes that are themselves distortionary. To use a bit of technical jargon: this situation leads to an inefficient Nash equilibrium in the game played by tax authorities.

It also leads, and this is something that has not been so far sufficiently acknowledged, to the introduction through the back door of a sort of expenditure tax. Capital market liberalization is somehow achieving what brilliant academics did not manage. An expenditure tax may not be bad in itself, although on this there are many divergent opinions. However, I do not think that the system of direct taxation that may emerge will have the theoretical properties attributed to the expenditure tax, particularly because many of the concommitant changes on other taxes, like that on inheritances and donations, that would make the overall tax system a coherent one, will be missing.

In particular, the medium term implications for the distribution of the tax burden between different types of income are important and I do not think these implications have been sufficiently considered. We are slowly but surely drifting away from taxing global income towards increased taxation on expenditure. There is nothing wrong with this, provided we are aware of the process involved and know how to anticipate its implications for other taxes.

4. The Spanish position

Let me now turn to the Spanish position. I think, overall, the Spanish position could be fairly described as one favourable to the consensus or cooperative alternative to tax harmonization in the European Community.

As some of you may know, during the Spanish presidency of the European Council in 1989, we tried without success to introduce a minimum withholding tax on investment income throughout the Community. This of course does not really address the key issues. Withholding taxes are mainly justified in a context in which tax systems are segmented, information does not flow freely between tax authorities and, therefore, opportunities for tax evasion abound. But, if these circumstances persist, withholding taxes will tend to exist, and if they exist, it is better that they are equal. This is the "second best" type of rationale that would justify this proposal.

Nevertheless, I repeat that I am not sure that this proposal would by itself have solved the problem, as in the absence of the residence principle nothing short of a complete harmonization of all tax rules will do. Even so, I think that this proposal would have helped to accelerate the convergence of the underlying tax systems and, at least, it would have established a minimum level of taxation on capital income throughout the Community.*

This proposal was not successful and of course, given that circumstance, it would have been absurd and possibly irresponsable to remain on the sidelines in the tax competition process that began after the failure of this attempt of cooperative harmonization.

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* This raises the question, as suggested in the seminar discussion by Professor Goodhart, that maybe the best solution to this problem would be setting up a common Tax on Capital Income, whose revenue would form part of the European Community's own resources.

To a very large extent, the changes introduced in the taxation of investment income and capital gains in our recent Income Tax Law are a consequence of Spain's position in this international process of tax competition.

We have tried, first to encourage residents of other countries to place their savings in Spain's financial space and, second, to avoid the transfer of domestic savings to other financial markets purely for tax reasons.
An example of measures aimed at the first objective is the elimination of the taxation of interest and capital gains from financial assets obtained in Spain by other Community residents, and also from interest and capital gains from public debt obtained by any non-resident with no permanent base in Spain. Nevertheless, to avoid undesirable practices in the international tax context, we have taken the precaution of not applying this tax derogation when the income is obtained through tax havens.

For administrative reasons we have kept the withholding tax for all capital income, since at this stage it is difficult to distinguish between residents and non-residents. But at the same time we have established a special procedure to give back automatically and through the Bank of Spain the amounts retained to non-residents.

With regard to Spanish residents, the latest income tax reform has included two types of measures clearly motivated by a competitive strategy; one type has a general effect on all kinds of assets while the other aims at encouraging certain savings schemes.

In line with other reforms in the OECD, we have somewhat reduced the progressivity of personal income tax by way of a reduction in the minimum and maximum marginal rates and by an increase in the level of income they cover.

Other general changes which we have incorporated into our legislation not only reduce taxation on this type of income but also help to simplify the tax

for the majority of tax-payers. Thus, we have established an allowance for investment income and for capital gains. Specifically, capital gains will be exempt when the asset transfer involved does not exceed Ptas. 500.000

In addition, the new treatment of capital gains which is in line with that introduced in other countries to encourage permanent investment and penalize speculation, is going to mean a tax incentive to medium and long term savings. Capital gains generated over more than twenty, fifteen and ten years will not be taxed and there will be a linear reduction in taxation of gains depending on the number of years the asset has been held by the investor. This is possibly the most significant change we have introduced and the one which, in my opinion, should have the greatest influence.

We have also introduced several measures to encourage specific savings schemes, particularly with regard to the new Popular Savings Plans, the Retirement Pension Funds, and the Investment Funds.

I do not want to bore you with the particular details of all these changes, but, I have no doubt, that these new instruments in conjunction with the generic changes I mentioned before, and, particularly in combination with the new treatment of capital gains, offer a tax framework which is both significantly more favourable than before and perfectly comparable to those existing in other European countries.

Finally, I would like to make some comments on the Draft Decree on International Economic Transactions* which is now being reviewed at the State Council and which is the latest development as far as the tax and administrative treatment of international capital movements in Spain.

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* Royal Decree 1816/1991, of 20th December, regulating Foreign Economic Transactions, published in the "Boletín Oficial del Estado" of 27th December 1991.

As you all know, Spain has brought forward by one year the full liberalization of international capital movements, completing in this way a long process of innovations which began with the accession of Spain to the European Community. This decision involves important changes concerning the present tax controls mechanisms for both residents, based mostly on exchange control information, and non-residents, based mostly on the authorization of transfers abroad.

Spain has decided to streamline foreign transactions whilst maintaining (as permited by the Directive which establishes the Free Movement of Capital) rapid administrative controls for prior verification and declaration as exceptional measures. These enable the Government to prohibit and limit certain transactions, but only when these seriously affect the interests of Spain or have been prohibited by international bodies to which Spain belongs.

The incorporation of this Directive into our legislation is therefore going to mean the elimination of the remaining restrictions on foreign transactions, receipts and payments, with prior authorization required only for the physical exporting of coins and notes above 5 million pesetas per person and per journey.

As a result, perhaps the most remarkable consequence will be that from 1992 Spaniards will be able to open a current account in any bank abroad, as well as apply for a loan there, or carry out any operation relating to receipts or payments, the only requisite being to inform the Bank of Spain afterwards.

I would nevertheless like to make clear that the freeing of foreign transactions is not going to imply, under any circumstances, a greater ability to evade tax. To avoid international tax evasion, two kinds of measures have been designed. Some internal, although common in international tax laws, and others taken in conjunction with other countries.

The most important among the internal ones is included in the same Draft Decree on Foreign Transactions. The full and total liberalization of foreign transactions will go hand in hand with the maintenance of a general information and communication mechanism which will assure the fulfilment of national legal requirements in the sphere of taxation. This aspect has also been considered of the greatest importance by other State Members as can be seen by the interest shown by some countries to include these preventive clauses in the new Treaty on the Economic and Monetary Union.

The obligation to supply information tries to regulate two distinct legal relationships: that between whoever carries out the international transaction and the authority responsible for regulating and monitoring its monetary effects, and that between whoever carries out the operation and the authority responsible for tax matters. As a consequence, there are also two kinds of information requirements, one needed for statistical reasons, and the other for tax purposes. However, for reasons of simplification and effectiveness, both requirements will be fulfilled through a single information channel created with the collaboration of financial entities. Since practically all the operations are going to be carried out through a deposit accepting entity listed in the Bank of Spain's official registers, the availability of information about the transactions carried out is guaranteed through the general obligation that banks will have to supply a certain amount of data on these transactions to the economic and tax authorities.

In conjunction with the information requirements relating to the Directive on capital movements, Spain has also adopted other internal control measures.

These measures include the recent publication of a list of those countries and territories that we consider tax havens and therefore have no right to the special tax treatment for non-residents described before. Another measure is the introduction of a special tax on property in the hands of non-resident companies, given the proliferation of companies which have "residence of

convenience" in tax havens to avoid a number of Spanish taxes, despite owning property and carrying out their real economic activity in our country.

In addition, the clauses contained in the set of Double Taxation Agreements signed by Spain, which have, so far, been insufficiently implemented, will be used more systematically and frequently and we also intend to enlarge the set of Double Taxation Agreements.

As for external control measures, we intend to make use of the Directive concerning mutual assistance on direct taxes, whose philosophy and contents reflect the most advanced international proposals in this field, such as that concerned with the multilateral agreement between the OECD and the Council of Europe relating to the exchange of information and mutual assistance between tax authorities. This Directive covers all possible kinds of information exchanges: automatic, spontaneous or at the request of one party, although it is limited to specific cases.

Similarly, we have already begun to carry out joint programmes of tax management and inspection with other tax authorities together with exchanges of experiences between civil servants.

Lastly, we have a new regulation against money laundering, which affects all the Community's financial institutions.

All these measures, together with the reorganization of the Spanish Tax Administration, should allow the economic and social benefits from the European Single Market to be obtained without endangering tax compliance. The fear of increased tax evasion is not a Spanish peculiarity; it is shared by many other countries around us. Indeed, this worry was openly raised at the last Intergovernmental Conference on Economic and Monetary Union on November 11th, and will result in a greater level of national control over those capital movements which have tax implications.

5. Conclusion

I have taken more time than I was given and I should therefore bring this talk to its conclusion. I hope I have been able to transmit to you the idea that the Spanish Government is excited about the prospect of capital market liberalization, that it has taken all the steps necessary to comply with the Directive, even before the time limit given, and that it expects that the new economic environment this Directive opens will give rise to a better allocation of resources and therefore to more economic welfare throughout Europe.

At the same time, however, and I hope that this has also transpired in my talk, we think that the problem is a complex one, that the adjustment process may not be as painless as is sometimes argued and that we must be aware that the whole process has set in motion important structural changes. To finish, let me remind you of two of them. First, we are slowly but surely drifting away from taxing global income towards increased taxation on expenditure. As I said before, there is nothing worrying about this but we should be aware of the implications it may have for other taxes or, indeed, for economic policy as a whole. Second, we are entering into a new international arrangement of capital markets, that will require not only a higher degree of tax harmonization but also a much closer cooperation between Tax Administrations. Unless important advances are made in this field, we could face problems of tax evasion which all of us want to avoid.

Thank you.