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# Limits to Redistribution in Late Democratic Transitions: The Case of Spain<sup>1</sup>

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## 1 Introduction

Inequality increased strongly during the Great Recession (2007–14) in Spain, rising almost 2.5 Gini points or 7 percent, in contrast with the average of 0.3 percent in the EU-27. At the same time, the country suffered a severe fiscal crisis, with public deficits at an average of 8 percent of GDP over the period 2008–15 (double the EU-27 average). In autumn 2016 experts were still calling for an adjustment of the revenue.<sup>2</sup> In fact, nearly all measures to curb the deficit during the recession were expenditure cuts, but tax revenue in Spain is currently well below the EU average – 33 percent versus 39 percent of GDP during the crisis years.<sup>3</sup>

Can history help explain the current situation? This chapter provides an affirmative answer. In 1970, Spain collected few taxes, and did so inefficiently and unfairly. Tax revenue was just 16 percent of GDP, slightly over half the level in EU-15 countries. After a series of substantial reforms in 1977–86, this rose to 80 and 90 percent, where it remains to the present. The fiscal system shows a seemingly permanent incapacity on the revenue side, which limits the government's ability to redistribute income.

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<sup>1</sup> This chapter stems from my PhD dissertation, *Tax System and Redistribution: The Spanish Fiscal Transition (1960–1990)*, written under the supervision of Alfonso Herranz Loncán and Alejandro Esteller Moré, to whom I am most grateful. I acknowledge financial support from the Spanish Ministry of Education's scholarship program *Formación del Profesorado Universitario* and Research Project ECO2012-39169-C03-03. I also thank the editors for their comments, which greatly improved this chapter.

<sup>2</sup> See, for example, the opinions expressed in *El País*, October 2016: [http://economia.elpais.com/economia/2016/10/22/actualidad/1477122682\\_243716.html](http://economia.elpais.com/economia/2016/10/22/actualidad/1477122682_243716.html).

<sup>3</sup> All data cited in this paragraph come from Eurostat.

Nineteenth-century tax principles were in force until democratization was introduced in the late 1970s. Low revenue, rigidity and reliance on indirect taxation were commonly identified by public finance scholars during General Francisco Franco's dictatorship (1939–75), but could not be resolved politically. The current system, introduced in 1977, tried to make the country more like its neighbors in this respect: taxes were to be more flexible, guided by the idea of progressivity, and revenue should increase enough to fund a modern welfare state. The fact that these changes were only possible after democratization makes Spain different from the other countries analyzed in this volume. Democracy triggered the tax reform, but the economic context differed from that which saw the initial development of welfare state taxation in the forerunners.

This chapter investigates tax policy in Spain during the political transition, with a focus on the distribution of the tax burden and attitudes towards equality. The fiscal reform has been closely studied, but only a recent quantitative study established the limited results of the new tax system with respect to progressivity and redistribution.<sup>4</sup> Why was tax equity, so widely proclaimed, not achieved? Was it not a social demand, or did it face other obstacles?

This chapter investigates two interrelated aspects: social preferences and the mechanisms for their translation into policy. Demand for redistribution is the result of a complex process, with intervening factors, such as the development of ideas about fairness in the income distribution and the capacity of taxation, to impact it.<sup>5</sup> Economic theory about taxes and the policies followed in leading countries have changed radically since the mid-twentieth century from defending progressivity to severe criticism of it as an obstacle to efficiency, giving rise to the privileged treatment of capital income. Inequality and its various dimensions will also condition social demands and the potential formation of interest coalitions.<sup>6</sup> Understanding how tax equity developed is my first focus, where I consider ideas on distributive justice, progressivity, and income redistribution in sociological surveys, the media, and political debates.

The second question is the translation of citizens' preferences into political measures. During the period covered in this chapter, authoritarianism was replaced by a parliamentary system, based on political parties. Did that mean going from the "only

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<sup>4</sup> Comín, *Reaching a Political Consensus*; Pan-Montojo, "Larga e inconclusa transición"; Albi, *Hacienda Pública en Democracia*. For social expenditures, see Espuelas, *Evolución del gasto social*. Torregrosa, "Did Democracy...?" offers an evaluation of the redistributive incidence of the old and new systems.

<sup>5</sup> Steinmo, "Evolution of Policy Ideas."

<sup>6</sup> Lupu and Pontusson, "Structure of Inequality."

voter” of Francoism to the “median” or “swing” voter of democratic political economy? To what extent were social demands reflected in policies? Which aspects explain continuity in tax incidence despite the extensive fiscal reforms?

I argue that the first years of regime configuration had a long-term impact on the distribution of political power. My focus is on the electoral system. Although formally proportional, in its operation it deviates significantly from proportionality, favoring conservatism.<sup>7</sup> Differences in political participation would further extend this bias, given that the low turnout of low-income groups generally limits the votes received by the pro-redistribution parties.<sup>8</sup> The activities of pressure groups are also reviewed.

The international context and its implications are then explored. In our globalized world capital mobility and tax competition are key factors for understanding the pressures at play that are opposed to fiscal progressivity. Spain’s economic openness increased during this period, with the milestone of accession to the European Economic Community (EEC) in 1986 and the subsequent construction of the Common Market which liberalized the movement of factors of production.

## **2 Inequality and taxes during the democratic transition**

The transition to democracy (1976–82) was intrinsic to tax reform, which declared progressivity as its guiding principle.<sup>9</sup> As we shall see, the resulting system failed, however, to apply this idea generally and effectively.

The roots of tax reform went deep. In the early 1970s, some projects were in accord with Professor Enrique Fuentes Quintana and the Instituto de Estudios Fiscales (Institute of Fiscal Studies), which is dependent on the Public Finance Ministry. These suggested the adoption of a European taxation model based mainly on personal income taxation, complemented by wealth, inheritance, and value-added (VAT) taxes. Personal income tax did not exist as such in Spain at the time (separate taxes were raised on labor income, capital income, and so on), nor did a wealth tax. Consumption was subject to a turnover

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<sup>7</sup> According to Persson and Tabellini, *Economic Effects*; and Iversen and Soskice, “Electoral Institutions,” proportional systems would favor the introduction of redistributive policies. For studies on the Spanish electoral system and its design, see Gunther, “Electoral Laws”; Montero and Riera, “Sistema electoral”.

<sup>8</sup> Montero, “Vuelta a las urnas.”

<sup>9</sup> The specific dating of the transition to democracy has been the subject of some debate. Franco died in November 1975, but regime change can only be dated to early July 1976, when Adolfo Suárez became prime minister. 1986 signals the first democratic change of party in government, when the Socialists succeeded Suárez’s centrist group.

tax. The new system was to be fairer, more efficient, and hence more flexible, so that the state could meet the needs of a new stage of development. It also meant convergence with Europe and would thus facilitate integration into the EEC.

However, Franco's government rejected these proposals in June 1973, and the plan was not made public, though the minister was dismissed. After this, Fuentes Quintana and his group were convinced that a modernizing tax reform of this kind would only be possible in a democracy, something that came into effective in 1977, two years after Franco's death.

Another prominent member of Fuentes's group was Francisco Fernández Ordóñez, a high-ranking official at the Ministry of Public Finance and a member of Madrid's upper middle class. He studied law and economics, including studying abroad. He had progressive, liberal ideas and as such was one of the founders of the Social Democrat Party in 1976.<sup>10</sup> This party was integrated into the centrist coalition Unión de Centro Democrático (UCD) in 1977, which, headed by Adolfo Suárez, won the first democratic elections that year. Fernández Ordóñez was then appointed Public Finance Minister, while Fuentes Quintana took over at the Ministry of Economics.

Fernández Ordóñez presented a comprehensive tax reform project consisting of a set of general anti-tax evasion measures and the complete reorganization of both direct and indirect taxation. In the end, not all of these proposals were passed as planned. The first law presented to parliament, in November 1977, introduced a wealth tax and several regulations to combat tax evasion: the lifting of the veil of banking secrecy, the introduction of tax crime,<sup>11</sup> and other related issues. Personal income tax came into force in 1979 as the principal milestone; VAT was also planned then but only introduced in 1986, then as a condition for accession to the EEC. The wealth tax of 1977 had symbolic importance, but only a trivial real impact because of its low revenue-generating capacity; it was transitory until new regulations were set in place in 1991. Similarly, a new inheritance tax was deferred until 1987.

The Public Finance Minister was a proponent of progressivity – or as a minimum of a marked decrease in the regressive nature of the existing system – and an expansion of public services. He also placed huge importance on combating tax evasion, not only by

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<sup>10</sup> For more information about him, see Serrano Sanz, "Francisco Fernández Ordóñez."

<sup>11</sup> Until then, tax evasion was an administrative infraction only. The introduction of tax crime meant that, starting at a given amount, it could be prosecuted in the criminal courts and thus lead to a longer prison sentence.

prosecution in the courts, but also by encouraging voluntary compliance. He wanted to usher in a new era in the relations between the (now) citizens and the (now democratic) state, based on responsibility and fair exchange. In his view reducing inequality through the tax system was less contentious than attempting to do it in salary negotiations. This was central to the legitimation of the capitalist economy, particularly in a crisis, which the West was experiencing at the time:

*The fragile Spanish economy is going through difficult times, and we think that adequate restructuring will only be possible if there is fairness in the distribution of sacrifices and the part of effort that we all must share. As much as we respect the market economy as the main instrument for obtaining resources, we firmly demand the public sector's correcting action through the tax system and redistributive expenditure.<sup>12</sup>*

Reform of the social security system was also envisaged. It did not, however, fall under the competence of the same minister, but of the Ministry of Health (and later the Labor Department). Contributions to social security were strongly regressive, as they were not assessed on real wages but on a base established by different worker categories. They also imposed a significant tax burden on wages, making labor more expensive for firms and thus probably affected employment rates. The main demand was to integrate social security into the overall budget, increasing the general taxation to finance its expenditures or fully funding them with taxes. However, the actual reform did not go that far. Administrative reorganization in 1978 improved transparency, but the contributive system remained largely unchanged until the end of the 1980s.<sup>13</sup>

All in all, the tax reforms made public finances more efficient and flexible, enabling an increase in revenues and the funding of a nascent welfare state.<sup>14</sup> But the overall tax system was not made progressive. The expansion of direct income and wealth taxes was counteracted by onerous social contributions and widespread tax evasion.

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<sup>12</sup> Fernández Ordóñez, *España necesaria*, 60. Author's translation. When he wrote "we" he meant the Social Democratic Party.

<sup>13</sup> Non-contributory pensions were introduced in 1990. Currently, whether survivors' and orphans' pensions should be funded by general taxation is under discussion.

<sup>14</sup> Elasticity in the context of tax revenues means that public incomes increase when the economy is growing.

Table 1 shows the relation between taxation and income distribution. If we compare pre- with post-tax incomes, in all years the inequality index was higher for post-tax incomes, which shows that tax distribution was now worse. Throughout the period inequality in disposable income fell only slightly, and final post-tax-and-transfer incomes, which include benefits received by households, were slightly more unequal at the end.

<TABLE 1. IMPACT OF TAXATION, 1970-90, AROUND HERE>

Total tax rates were higher in the second decile than in the top percentile. The tax system became less regressive over time, but the value of the indices never turned positive.<sup>15</sup> So why was a progressive tax system not attained? Was it not demanded, or did preferences not result in political measures?

### 3 Public opinion

An extensive literature has analyzed collective attitudes with respect to taxes. The evidence starts in the mid-1960s. Early inquiries generally focused on tax legitimacy and evasion in an effort to provide insight for tax administration design. The evidence is disjoint and heterogeneous across time; nevertheless, we can reach some general conclusions.<sup>16</sup>

The Spanish were strongly in favor of redistribution, and a large majority did not believe their tax system was effective in this respect. Both before and after the 1970s reforms over half of the survey respondents considered the distribution of the tax burden unfair. They wanted more progressivity, but also lower overall taxation at the same time as better public services.<sup>17</sup> This can be related to framing inconsistency, which is a problem found in similar studies.

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<sup>15</sup> Torregrosa, “Sticky Income Inequality”; Torregrosa, “Did Democracy...?” For more information on the data shown in Table 1, see the latter. These impacts would probably be worse if the impact of fraud could be taken into account. Such is the case in the personal income tax; see Torregrosa, “Bypassing Progressive Taxation.” On the other hand, welfare state transfers are not included here; see for them Espuelas, *Evolución del gasto social*.

<sup>16</sup> The authors of the surveys and reports of the 1970s summarized their results in three popular critiques: unfair distribution of the burden; excessive complexity; and inequitable impact of tax evasion. See Alvira and García, “Límites de Efectos.” My own interpretation adds further points. A more detailed review of these data is available in Torregrosa, “Political Economy.”

<sup>17</sup> For example, in 1975 89 percent of the respondents agreed with progressivity postulates (versus 11 percent who favored a proportional system). Personal income tax was supported by 68 percent as an acceptable revenue method.

Across the following decades citizens came to believe increasingly that they had become heavily taxed since the changes to public revenues. This perception started to fall though around 1990, coinciding with the stabilization of the tax-to-GDP ratio. During the 1980s, the sense of bearing a heavy tax burden can be traced to a perceived disequilibrium with respect to services due to delays in building the welfare state and also to the regressivity of taxation in general. An “anti-fiscal” atmosphere seems to have been developing, which comes through in these indicators and other sources. At the same time, fiscal drag was increasing income tax for the low- and middle-income strata.<sup>18</sup> This seems to have negatively affected its legitimacy owing to greater increases in the tax than in real earnings for several years.<sup>19</sup> Moreover, it coincided with economic distress and indebtedness, creating an impression of poor management and wastefulness.

Tax evasion was also a key topic in the surveys. In general, fraud was disturbing and unfair, but social sanctions against it were lax. Throughout the period the perception seems to have been that tax evasion was widespread, persistent, and possibly increasing. We might venture (as the literature has shown) that a slight improvement coexisted with growing concern among the public, which is evident in more recent surveys.

These conclusions are similar to those reached by studies on other OECD countries in the closing decades of the twentieth century, but the Spanish seem to be comparatively strongly in favor of redistribution.<sup>20</sup> For example, the French, Germans, Spanish, and Italians showed strong support in 2000 for the status quo, but more Spanish preferred an increase in both taxes and benefits (30 percent of respondents, versus 14–17 percent in the other countries), which is consistent with the incomplete harmonization in welfare provision levels.<sup>21</sup>

With the democratic transition, both employers’ and workers’ associations were legalized in spring 1977. Albeit illegally, trade unions had existed under the dictatorship and had played an important role in opposing late Francoism. However, in the first years of democracy, with high inflation and rising unemployment, they were mainly concerned with maintaining the purchasing power of wages and pensions; tax objectives ranked low

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<sup>18</sup> Fiscal drag occurs when tax thresholds are fixed in nominal terms and there is high inflation. Increases in nominal incomes drive taxpayers into the higher rates even in the absence of improvements in real purchasing power.

<sup>19</sup> A point made in Lagares, “Aceptación Social.”

<sup>20</sup> For example, Edlund, “Public Attitudes”; Singhal, “Quantifying Preferences.” The relatively pro-redistribution stance taken is confirmed by Fernández-Albertos, “Making of Egalitarian Spain.”

<sup>21</sup> Boeri et al., “Would You Like . . . ?”

on their agenda. Support for the unions, furthermore, decreased during the 1980s, with membership lower than in other European countries.

Business associations, by contrast, started to organize in the late 1970s and were quite aggressive in their defense of economic liberalization and their opposition to welfare expansion and tax progressivity. According to Carlos Ferrer Salat, president of the Confederación Española de Organizaciones Empresariales, the main employers' association, tax reform was "going to put an important brake on investment."<sup>22</sup> Small firm owners, on the other hand, were more in favor of the proposed changes as they were suffering from the old system through presumptive assessments and the weight of social contributions for labor-intensive establishments. A small business owner from the metal sector told the press in June 1977:

*I don't mind the tax reform, what matters to me is that it is done taking into account the economic capacity of each firm and that it prevents that the most powerful ones get benefited. I hope that this democracy makes things go that way.*<sup>23</sup>

Editorials in the journals depict interests and opinions for and against the reform. The most popular newspaper, *El País*, conducted a series of interviews in 1978 with the politicians negotiating the proposed taxes in parliament; these interviews informed readers about some of the main issues. The interviews make clear the extent to which the principle of progressivity was generally accepted at the time. The Center and Left-leaning parties generally defended it, notwithstanding some differences between them. Those on the Right, however, represented conservative voters and so were not in favor of progressivity. This became apparent only in their concrete proposals on detailed issues concerning tax exemptions, allowances, or credits, and not as a general statement or challenge to increasing tax rates.<sup>24</sup>

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<sup>22</sup> *Cuadernos para el Diálogo*, 233, October 15–21, 1977. These words correspond to a conference about the situation of businesses.

<sup>23</sup> *Cuadernos para el Diálogo*, 216, June 18–24, 1977.

<sup>24</sup> The same conclusion is reached in Pan-Montojo, "Larga e inconclusa transición," 286.

#### 4 The political transition: malapportioning the party system

Given the results from surveys, it would seem that attitudes to progressivity were not translated into effective policy-making. Why was that? My conclusion takes in a national and an international story. The first looks at the consequences of the democratic transition for the policy process and how the new system was institutionalized. The second focuses on international economic circumstances and how they changed in the period when the tax model was originally designed. The two stories are not mutually exclusive. The internal context helps us to consider the nature of the regime itself as it now emerged. The external context is addressed in section 7.

The transition to democracy was not the result of a revolution, but came about only after Franco's death in November 1975. By then, the political elite was no longer a homogeneous bloc, as some had adopted a slightly reformist stance. Nor was the opposition united in spite of efforts, headed by the Communist Party, to achieve a regime breakdown and have a provisional government, formed by all democratic forces, call for the first elections. Significant social unrest was observed too, with labor disputes and mobilization at various levels.

The usual conclusion is that neither the Francoists nor the opposition were sufficiently strong or united to impose their views, so a compromise had to be reached. The transition took the form of a reform conducted from above, that is to say, from Adolfo Suárez's government, who himself had been appointed by King Juan Carlos, Franco's designated successor. The new regime did not break legal continuity with the dictatorship, but the strength of the political and social opposition made it possible to obtain some aspects of a breakthrough. Were those enough to ensure a democratic tax policy in the sense that the tax system expressed the preferences of the electorate?<sup>25</sup>

Different institutional settings have been found to be more or less favorable to redistribution. Centralized, parliamentary, and proportional systems would be more redistributive than their federal, presidential, or majoritarian counterparts.<sup>26</sup> For Spain, Fernández-Albertos has argued that proportional elections had a positive effect on redistributive policies as well as the existence of large and cohesive parties, and a

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<sup>25</sup> Albertus and Menaldo, "Gaming Democracy," discuss the importance of the transition process for new democracies in the sense that redistribution would only come through strongly if the elite's control had been hampered by revolutionary threat.

<sup>26</sup> Steinmo, "Political Institutions"; Persson et al., "Comparative Politics"; Iversen and Soskice, "Electoral Institutions."

socialist government from 1982 to 1996.<sup>27</sup> But was parliamentary representation actually proportional?

The elections show very low levels of proportionality when compared to other European countries. One of the reasons was district malapportionment. This term refers to the disproportionality found in territorial representation, which generally favors less populated regions where more conservative voters are found, and so decreases any possibility of redistribution, but potentially favors establishing democracy in a transitional context.<sup>28</sup> A number of studies have underlined the interests evident in the design of the electoral system during the transition.<sup>29</sup> Whereas nominally proportional, in its operation it leads to both a majoritarian and a conservative bias (i.e., Right-leaning parties benefit more from the first than Left-leaning ones). Spain's malapportionment value was 0.0963 in 1996, 16th of a sample of 78 countries.<sup>30</sup>

During the first years of democracy, the electoral system especially benefited Suárez's party, the UCD (see Table 2). It won a significant number of seats in parliament of 1977, although not an absolute majority. The UCD was also the most successful in the 1979 election. The impact of the first elections on the party system was very significant: parties obtaining representation not only gained institutional power, but also reinforced access to public opinion, and last but not least funding from the state budget. The ones that did not – and they were many – were dissolved or were disadvantaged in the next elections. In that way, elections were an active element in the configuration of the party system during the first years of the new regime.<sup>31</sup> Similarly, because of the foundational moment for many aspects of political life, the majorities enjoyed by the UCD had a long-term impact on public policy.

#### <TABLE 2 PARTIES BENEFITING ABOUT HERE>

After 1982 the most successful party was the Socialist Party (Partido Socialista Obrero Español, PSOE), which won the most parliamentary seats. PSOE's absolute majority in 1982 entailed it to expand the welfare state and complete the tax reform, including anti-fraud measures and the introduction of VAT. Both the party and the context,

<sup>27</sup> Fernández-Albertos, "Making of Egalitarian Spain."

<sup>28</sup> Samuels and Snyder, "The Value of a Vote."

<sup>29</sup> Gunther, "Electoral Laws;" Lago and Montero, "Todavía no sé quiénes."

<sup>30</sup> Samuels and Snyder, "The Value of a Vote." This means that nearly 10 percent of the seats are allocated to districts that would not receive them under proportionality.

<sup>31</sup> Gunther et al., *Sistema de partidos*.

however, had by then changed in many respects. A review of its electoral manifestos shows how, by 1986, tax progressivity had all but disappeared as a means of redistribution, which now focused on social expenditure.

## 5 The tax positions taken in parliament

If malapportionment meant that UCD's vision was overrepresented, what ramifications did this have for policy? Which tax positions were reinforced and which weakened? I have studied in-depth the parliamentary debates on the tax laws and the proposals defended by each party (see Table 3).

<TABLE 3 MAIN TAX PROPOSALS, ABOUT HERE>

Only the first two tax proposals, presented by the government in 1977–79, were approved. These were debated during a period of political consensus among the main parties. The consensus period is clearly expressed in the Moncloa Pacts of October 1977, which set an agreed policy response to the economic crisis. These included several points on taxation.<sup>32</sup> The tax debates coincided with debates on the new constitution, which was the main focus. After its enactment in late 1978 the scenario became more confrontational; at the same time a crisis within UCD unfolded. The remaining tax reforms did not make it through parliament and the delay made it possible for those against them to come up with alternative models in the 1980s.

The first reform of Minister Fernández Ordóñez was LMURF, passed in November 1977. It included the creation of a number of provisional taxes – a wealth tax and a surcharge on high-income taxation – and a set of anti-evasion measures – a tax amnesty, tax crime, and lifting the veil of banking secrecy. These were expected to usher in afresh start in relations between taxpayers and the tax administration.

With respect to the initial project, the law as finally approved shows an increase in the progressivity of the tax rates on wealth, following quite closely some socialist proposals. This was, however, accompanied by a reduction in revenue-generating capacity, since rates were lowered in the initial brackets, where the majority of estates would be found.

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<sup>32</sup> Comín, *Reaching a Political Consensus*.

By contrast, the structure put forward by the Communist Party was less progressive on paper, but would have brought in more revenue from the propertied classes.<sup>33</sup>

The parliamentary debates focused on two especially contested issues. The Socialists pushed for the inclusion of legal entities in the wealth tax, arguing that leaving them out introduced inequality among firms with respect to individuals, the very reason why they had been included in the first government project. This point was important, according to the socialists, because the wealth tax was meant to serve as a register of the estates for the rest of the prospective reform; thus wealth held by legal entities should also be registered, together with that held by individuals. UCD justified the change because of concerns about double taxation and a negative impact on investment. The socialist proposal was backed by the Communists, but nevertheless rejected by 164 votes to 147.

Also discussed was the starting date of the duty of financial entities to cooperate regarding the lifting the veil of bank secrecy. Catalan socialists suggested that this principle should be backdated to June 1977, that is, before the law was enacted but notably after the principle had been made public. They argued that during the year important capital movements had gone through and the government ought to be able to investigate these, since the law would not change the legality of their owners' actions. The Right argued against this, defending the principle of non-retrospective action. The point was also rejected, but only just: by 147 to 142.

Next came the cornerstone of the reform: personal income tax. Members of the government party presented 19 percent of the amendments (38 out of 202). In all, Center-Right groups, which includes the UCD, put forward 70 percent of the amendments. They were also more critical, proof that the Public Finance Minister had taken a more progressive position than many in his own party.

Remarkably, the structure of rates received very little discussion, with a progressive schedule accepted by all parties, at least in theory. Resistance is shown in the debate on tax credits and allowances, when the conservative parties defended significant increases. Some of their suggestions were accepted at least in part, which entailed moderating the law during its passage through parliament.<sup>34</sup> How tax credits are designed profoundly affects progressivity, but it does so in a less transparent way than the tax rates.

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<sup>33</sup> In fact, this may be part of the explanation for the distance between the initial revenue estimate in the project (39,649 million pesetas, of which the government's objective was to reach 20,000 million pesetas) and the actual revenues in 1978 (8,589 million compared to 15,000 million in 1979).

<sup>34</sup> Family allowances, new tax-deductible investments, reduction in imputed incomes from home ownership, and a cap on effective taxation at 40 percent.

Amendments presented by the Left failed, among them strict limits on the application of presumptive taxation.<sup>35</sup> The discretionary power left in the hands of the government was criticized by almost all parties in this respect and also, notably, the capacity to alter the schedule and credits by annual decree. Several groups demanded compulsory adjustment in line with the annual inflation rate, which was high at the time. This had had a strong fiscal drag effect during the 1980s.

The new regulations included an obligation on the Ministry to publish fiscal data at the individual level, a transparency measure which had the aim of exposing tax evaders and improve general tax compliance. It was, however, the object of considerable controversy. The principal argument against it was the threat posed by the Basque terrorist organization ETA: publishing detailed information about taxed incomes would have made it easier for them to target wealthy individuals for extortion and kidnapping. It was finally resolved in 1981 with the publication of aggregate statistics, before it had been applied to the data from the new tax.<sup>36</sup>

In order to make taxation of wealth and capital incomes effective, withholding and third-party information from the banks had to be generalized. The lifting of the veil of banking secrecy in the November 1977 Act, however, was met with a fierce opposition campaign, which argued that the right to personal autonomy was being threatened, and that the measure would have negative economic consequences. The progressive journal *Cuadernos para el Diálogo* denounced the strong pressure being exerted on the reformers.<sup>37</sup> Conservative *ABC*, on the other hand, voiced the concerns of Rafael Termes, president of the Bankers' Association, who showed a willingness to cooperate, but complained about the onerous task of supplying information on all its clients.<sup>38</sup> Under the law, however, detailed data about amounts and transactions were requested only when a tax inspection was undertaken. This was appealed in court in 1983 by one taxpayer. He lost the case in November 1984 in the Supreme Constitutional Court. In 1985, the government published new legislation on the obligation to inform the tax administration about each individual's withholdings. This was appealed by 116 financial entities, which

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<sup>35</sup> Presumptive taxation uses indirect means to approximate the tax base and/or tax liability, instead of being based on calculation of actual incomes. In Spain it is called *estimación objetiva* and was widely used, resulting in low taxation and regressive results.

<sup>36</sup> Lists of taxpayers corresponding to 1977 and 1978 were on public display at the Ministry of Public Finance in 1979 and 1980, with the press commenting on some dubious cases. These were data from the old, pre-reform tax.

<sup>37</sup> *Cuadernos para el Diálogo*, 221, July 23–29, 1977.

<sup>38</sup> *ABC*, December 29, 1977, 51.

lost their case the following year.<sup>39</sup> In short, during this period the banking sector was unwilling to cooperate.

The tax reform leaders accused the opposition of *de facto* power as the reason for the partial derailment of the initial plan. For example, Fuentes Quintana asserted in 1996: “The reform measures were effectively stopped. A big part of the tax changes were paralyzed by vested interests. [...] I am certain that there were [business] interferences to address what should be done.”<sup>40</sup>

Fuentes resigned in October 1978, one year after the tax reform came in, when the personal income tax had just been approved. He quit politics owing to vehement resistance to his economic plan, of which Fernández Ordóñez’s tax measures were only a part. Fuentes had backed the Moncloa Pacts, which included a range of liberalization measures as well as the stabilization program. Some of these were opposed by the banking and energy sectors, as well as by fellow members of the government who wanted a more conservative policy, which reflected the uneasy coexistence of different tendencies within UCD.<sup>41</sup>

Fernández Ordóñez stayed in government until April 1979, but left before he could complete his program. A year later, he denounced the reactionary character of resistance to the reform:

*In Spain, where public spending has not yet reached the levels of industrial countries, and where the tax system has very recently taken its first steps toward justice, a conservative phenomenon has been born, fueled not only by the international process, but by nostalgia for the past. . . . This has strengthened the pressure of conservative forces, from public manifestations against the tax reform and the Moncloa Pacts, to a greater control of government policy.*<sup>42</sup>

The 1977 wealth tax was supposed to be temporary, and was therefore called an “extraordinary” measure. In the event, it stayed in force for 14 years. The proposal to

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<sup>39</sup> Castillo, *Fraude fiscal*.

<sup>40</sup> From an interview with A. Missé, reproduced in Fuentes Quintana, “Pactos de la Moncloa.” Author’s translation.

<sup>41</sup> *El País* was quite clear in this respect: “The pressures of the financial sector against the reform and the manifestations of the more conservative flank of business, along with the maneuvers to form a big right-wing party outside UCD, undoubtedly frightened the party’s political cadres and Suárez himself,” *El País*, Editorial, October 25, 1978.

<sup>42</sup> Fernández Ordóñez, *España necesaria*, 137. Author’s translation.

replace it was presented to parliament in January 1978, but was not approved before the dissolution of the government. A similar process took place April 1979, again with respect to inheritance tax and VAT (see Table 3).

Among the main issues in the debates on the new wealth tax was the socialist suggestion of annual adjustments to the local government's estimation of the value of property (the cadastral value), in line with the price of rental property. This was intended to tackle the widely known problem of under-valuation, which was used as a reference for other taxes as well.<sup>43</sup> On the other hand, the parties of the Center-Right strove for individual rather than joint taxation, an increase of the exempted threshold, and annual adjustments to inflation, all of which would negatively affect public revenue.

The main conception in the 1978 inheritance tax proposal concerned the recipient, whose other property would be taken into account to calculate the tax levied on him or her. This had the effect of making the tax more progressive and so was rejected by representatives of the Right. It was finally approved in 1987. The same parties again proposed an increase in exempted thresholds and annual adjustments to inflation. Left-wing parties, on the other hand, suggested higher or more progressive rate structures.

Finally, VAT was hotly debated in what is a clear example of special interest politics, with representatives of the different parties aiming for more complexity by granting exemptions or reduced rates for more activities.<sup>44</sup> VAT has been considered a "revenue-raising machine," and as such has many advantages. It is efficient, which encourages compliance among businesses and favors savings with respect to consumption. It also represents a significant improvement in neutrality when compared to turnover tax. Ultimately, however, two aspects made it difficult to introduce: the anticipated impact on prices at a time of double-digit inflation; and the fact that it meant bringing an end to covert protectionism.<sup>45</sup> VAT finally came into force in 1986 with other changes related to accession to the EEC.

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<sup>43</sup> Cadastral values can be found in the Public Finance Ministry's land registry (*cadastre*). Because of lack of adequate updating, cadastral values in Spain have often been found to be far below the values that the same properties would have if they were on the market. Since real estate property is taxed according to its cadastral value, this means that the tax base remains significantly smaller than the economic capacity it is supposed to capture. Furthermore, such undervaluation will introduce inequities between taxpayers, according to the share of these assets in their portfolios. This is also relevant for the income tax when imputed rents from owner-occupied housing are taxed.

<sup>44</sup> For example, health services, insurance, cars, fashion, wine, perfumes, even shotguns.

<sup>45</sup> Rojo, "Economía española."

## 6 Social Security Reform

By 1977, social security contributions represented half of public revenues, and 11 percent of GDP. These contributions were administered by several institutions introduced during the twentieth century. Several problems had resulted in the call for reform: the complexity of the system, small pensions, inequalities among various groups of workers, the high regressivity of the contributions, and the negative effects on employment.

Reform proposals were found in the 1977 programs of the main political parties. There was little difference between those proposed by the Right and the Left: they called for universality, collective control, and government funding (or at least an increase in general participation).<sup>46</sup> The government had appointed a commission to design a new model, which appeared in the *White Book of Social Security* in April 1977. However, over the following years electoral platforms continued to raise the same issues because they had not been translated into practice.<sup>47</sup>

Universalization and pensions, in a context of rising unemployment, had to be funded with larger transfers from the government's general budget. This, however, could not in reality be achieved before the tax reform had accomplished what it was intended to do in terms of revenue and progressivity.<sup>48</sup> In 1978, institutional reorganization improved the administration of social security, but the main reform – health expenditure and non-contributory pensions assumed by the general budget – would not become a reality until 1989–90, when VAT came into force and simultaneously the economy improved. It is in this sense that continuity during the transition years has been emphasized. Government's participation in its funding increased largely due to growing expenditures on unemployment benefit, and minimum pensions grew faster than those in the top bracket. But the basic nature of the regime, with differentiated categories of workers, was maintained and even bolstered.<sup>49</sup>

The contributory system was simplified in 1978, ending a long transitory period starting in 1972 which attempted to bring the tax bases progressively closer to the wages

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<sup>46</sup> The Left also insisted on increasing minimum pensions to the minimum wage level, annual adjustment to inflation, and improved conditions for agricultural workers.

<sup>47</sup> The main exception was the proposals of the right-wing Alianza Popular, which by 1982 had evolved towards a two-pillar model, with basic-public and complementary-private levels (private institutions also cooperated in the first one too).

<sup>48</sup> In the words of the *White Book*, the objectives could only be attained “with more active government involvement. But this leads to the need for a more sufficient and progressive tax system. It would be vain to base redistributive action on regressive government contributions” (author's translation).

<sup>49</sup> Guillén, *Construcción política*.

paid, which had been at a much lower level in the 1960s.<sup>50</sup> Starting in 1978, the government set minimum and maximum caps each year. Maximum caps have the effect of exempting a fraction of the higher salaries; it has a regressive impact. The official explanation was that caps were being increased especially for the higher-paid workers, thus reducing regressivity. In hindsight, however, it does not seem to have been like that. The increase was indeed higher for the top categories in absolute terms, but during 1976–88 all groups saw their bases grow by the same percentage. Moreover, the caps only increased in real terms in 1977/78 and slightly in 1983. In the other years growth seems to have been impeded by the crisis and the desire not to drive up the cost of labor. Compared to the average wage, tax caps were lowered (except in 1983/84). Of course, to the extent that higher wages experienced above-average rises during the decade, regressivity with respect to wages increased.

This lack of thorough updating of the tax caps was consistent with the position taken by the business sector, which lobbied for a lower fiscal burden in light of the economic crisis, and expressed serious concern about the possibility of any increase in social contributions. These were paid nominally by employers in around 80 percent of the total. Although the statutory regulation does not necessarily reflect the economic incidence of the tax, relaxation of these payments constituted potentially appreciable relief for firms.

## **7 International integration**

We now turn to the external factors. Arguably, and despite domestic democratization, the international context made it increasingly difficult to introduce and maintain progressive taxation. Spain's economic openness increased along with political liberalization, eventually culminating in integration with the EEC in 1986 and the subsequent commitments in trade, population, and financial movements.

That economic openness is an obstacle to progressive taxation has been long established in the literature. This arises from the exit option given in a common market to the holders of moveable tax bases – mostly capital, as opposed to labor. Openness would entail a falling tax burden on the factors of production that can be moved to prevent their

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<sup>50</sup> Monasterio, “Financiación de las pensiones.”

relocation overseas.<sup>51</sup> Therefore, an open economy might reduce the feasibility of relying on progressive taxes to fund welfare state services.<sup>52</sup>

Why did European countries not reach an agreement on harmonization to get round these problems? The issue formed part of the Common Market talks within the European Commission (EC), but the results were highly uneven: While there was considerable unification in criteria concerning indirect taxes, the same was not reached with respect to direct taxation. Corporation tax rate harmonization had been proposed by the EC in 1975, but deferred by the need to define a common tax base – a complicated issue, which is still underway. As early as 1991, however, a decision reached prevented double taxation of dividends across national borders.<sup>53</sup>

Unification of criteria in personal income taxation has not been on the table in full, but some initiatives were intended to reduce the anticipated downward pressure on capital revenues. These incomes were easily subject to fraud if there were no automatic information-sharing and/or homogeneous withholding, thus giving their recipients more leverage to obtain tax privileges in advance and after the lifting of controls in July 1990. The EC's proposal in 1989 would have set a uniform 15 percent minimum withholding tax on the interest income of EEC residents, but this was abandoned in favor of cooperation. These decisions required unanimity. Scholars claim that interests in the United Kingdom and Luxembourg prevented the adoption of general agreements on an automatic information exchange and uniform withholding at source, and that, for Spain, "this situation is forcing, in order to avoid massive outflows of domestic savings, to put taxation of capital incomes and capital gains in line with that existing in the rest of countries of the Community."<sup>54</sup>

Of course, these developments are an epilogue to our story. They might, however, be a very relevant one. Even though Spain entered the EEC in 1986 and free circulation of capital was not a reality until 1993, the prospect of these events existed long before that. Furthermore, even if actual capital flows were not that big a hole in the tax base, the relevant issue here is that their possibility was seen as such in the economic literature and featured as an argument in tax debates starting in the mid-1980s.

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<sup>51</sup> Bates and Lien, "Note on Taxation"; Persson and Tabellini, "Politics of 1992"; Boix, *Democracy and Redistribution*; Freeman and Quinn, "Economic Origins."

<sup>52</sup> Beramendi and Rueda, "Social Democracy Constrained." Similarly, Genschel, "Globalization, Tax Competition," contends that, in the absence of international tax competition, taxes are higher and more progressive, with stronger burdens on capital and lower burdens on labor and consumption.

<sup>53</sup> Kopits, "Overview."

<sup>54</sup> Lasheras, "Percepción social," 59. Author's translation.

The failure to harmonize thus gave way to competition and national adjustments in tax regulations. In the Scandinavian countries, as is well known, globalization pressures resulted in double taxation of personal income. In Spain, the path to reinforcing capital taxation was “nipped in the bud.” Subsequent reforms in the 1990s reduced the top marginal tax rates and granted privileged treatment to capital gains. Finally, steps towards dualization were taken at the beginning of the twenty-first century.

Changes in economic theory occurred too.<sup>55</sup> The tax model introduced in Spain in the late 1970s was a product of the postwar era and the supremacy of Keynesianism. General, progressive, and redistributive taxation peaked in the 1960s and 1970s, with the Carter Report 1966 favoring a system of personal taxation which would be as integrated and comprehensive as possible. A proliferation of allowances and credits, however, made real tax systems different from the ideal, and riddled them with horizontal and vertical equity problems. The proposed solutions rested on new theoretical approaches related to the optimal tax theory developed during the 1970s, which focused on the behavioral effects of taxation: a disincentive to work or save, and thus the negative impact of tax rates on the tax base. Policy proposals have since tended to reduce progressivity, especially at the top, and to prioritize neutrality over equity considerations.

All this coincided with Spain’s catch-up to the developments of earlier decades. Whereas there was no strong alternative at the end of the 1970s, soon these new ideas figured in public debates across the country and hindered the full realization of the reform. Pan-Montojo has described a program for “reform of the reform” in the early 1980s, which called for savings and investment to be protected.<sup>56</sup> It was put forward by Alianza Popular in the 1982 elections, but its influence can be found at both ends of the political spectrum too. That the Socialist Party evolved in a similar sense is clear from reforms undertaken by them when they held power in the 1990s and beyond. The tide had changed.

## 8 Conclusion

Conditions surrounding tax reform in Spain in 1970–86 were different from those that saw the birth of the European welfare states in the postwar period. In spite of popular demand for progressivity and redistribution, as well as extensive regulatory changes, these objectives were not fulfilled. Public revenue increased and was raised more efficiently,

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<sup>55</sup> Slemrod, “Professional Opinions”; Steinmo, “Evolution of Policy Ideas.”

<sup>56</sup> Pan-Montojo, “Larga e inconclusa transición.”

but the overall burden remained regressive. Capital incomes managed to escape from taxation to a large extent. All in all, general redistribution was trapped at comparatively low levels.

Opinion in the 1970s was highly favorable to progressive reform, which initially had no clear alternative to it. Survey respondents, politicians, and commentators across the political spectrum declared themselves favorable to progressivity and a system in which the income tax played a central role. A policy alternative, however, first appeared as a supply-side program at the beginning of the 1980s.

Political institutions and the external context influenced how citizens' demands were translated into policies. Several constraints limited achievement of this reform. Malapportionment in parliament was one: the design of the electoral law during the transitional period was made under significant right-wing influence and gave rise to a system that benefits the rural, conservative districts. The importance of this should not be dismissed as it contributed to the formation of the party system after the first democratic elections of 1977. Successful parties gained access to power in the constitutional talks, prominence in the media, and public funds for their subsequent activities.

Economic distress and changes in public finance theory were closely related. Rising unemployment and sluggish growth made it difficult to increase taxation. Social security reform was delayed by resistance to increased labor costs. Finally, the introduction of VAT was also deferred, owing to its inflationary effects. The model aimed at was the product of postwar Keynesian economics, a period of unprecedented growth and social harmony in western democracies. The oil shocks ushered in a different context, one in which emphasis would be on the promotion of personal savings and investment. Finally, international openness reinforced this process by affording capital owners a credible exit option.

How does our case fit into the pattern identified by the literature, according to which large, redistributive welfare states rely on regressive taxation (e.g., Sweden), while progressive tax systems give rise to limited redistributive government (e.g., the US)?<sup>57</sup> Was the Spanish experience a result of a compromise, where the expansion of social expenditures in the 1980s and 1990s could be funded only by the recently introduced VAT and persistently heavy social contributions?

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<sup>57</sup> Steinmo, "Political Institutions"; Kato, *Regressive Taxation*; Lindert, *Growing Public*. For empirical analyses, see Piketty and Saez, "How Progressive"; Prasad and Deng, "Taxation and Worlds"; Bengtsson et al., "Lifetime versus Annual."

Certainly, as much as the expansion of public revenues in the late 1970s could only be achieved by increasing the burden at the top, where economic capacity was concentrated and very lightly taxed, a sustained further expansion during the economic crisis seems to have been politically feasible only if it also limited progressivity.<sup>58</sup> But we should not overlook the insights provided by the comparison of effective levels of redistribution attained in different countries: by 1990, the joint tax-and-transfer scheme in Spain remained less redistributive than those in the UK and US – the prototype of small, liberal welfare states.<sup>59</sup>

The experience of the southern European periphery might therefore not fit into a dichotomous model. Welfare state laggards resorted to regressive taxation to expand social spending, as the leaders in redistributive policies had done before them. But lower revenue from personal taxes, higher inequality, and slow growth impeded the establishment of a highly redistributive tax-and-transfer system.

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<sup>58</sup> Timmons, "Fiscal Contract."

<sup>59</sup> Torregrosa, "Did Democracy...?"

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### Illustrations (tables)

**Table 1 The impact of taxation on inequality in Spain, 1970–90**

	1970	1982	1990
<i>Inequality (Gini index) across phases of income</i>			
Pre-tax income	38.0	42.1	42.5
Post-tax income	41.4	44.5	49.2
Disposable income	34.7	33.0	32.9
Post-tax-and-transfer income	36.2	34.5	37.3
<i>Average effective tax rates on selected quantiles of the income distribution</i>			
2nd decile	28.3	43.6	70.7
Top decile	20.0	34.9	46.5
Top percentile	16.4	32.3	44.4
<i>Tax progressivity and redistribution indices</i>			
Progressivity (Kakwani)	-0.0849	-0.0274	-0.0485
Redistribution (Reynolds-Smolensky)	-0.0332	-0.0239	-0.0667

*Notes:* The Gini indices are calculated using the OECD equivalence scale and individual weighting.

Average effective tax rates are obtained adding all taxes paid by households, including indirect taxes and social contributions.

The progressivity and redistribution indices also refer to the joint tax system.

*Source:* Torregrosa (2015b).

**Table 2 Parties benefiting from the electoral rules, 1977–86**

	<b>UCD</b>			<b>PSOE</b>		
	<i>% votes</i>	<i>% seats</i>	<i>Diff.</i>	<i>% votes</i>	<i>% seats</i>	<i>Diff.</i>
1977	34.5	41.1	6.6	24.4	29.4	5.0
1979	35.1	48.0	12.9	30.5	34.6	4.1
	<b>AP coalitions</b>			<b>PSOE</b>		
1982	26.5	30.6	4.1	40.8	50.6	9.8
1986	26.1	30.0	3.9	37.9	46.6	8.7

*Note:* From 1982 the main party on the right was Alianza Popular (forerunner of the Popular Party), which headed coalitions in the two next general elections.

*Source:* Author's calculations using data from *Junta Electoral Central*.

**Table 3 Main tax proposals, 1977–79**

<b>Law</b>	<b>Proposal presented</b>	<b>Sanctioned</b>	<b>No. amendments</b>
LMURF: wealth tax, anti-fraud measures	July 1977	November 1977	139
Personal income tax	January 1978	September 1978	202
Net wealth tax	January 1978	-	82
	April 1979	-	115 (incl. 57 prev.)
Inheritance and gift tax	January 1978	-	64
	April 1979	-	80 (incl. 46 prev.)
VAT	July 1978	-	54
	April 1979	-	81 (incl. 48 prev.)

*Notes:*

LMURF: *Ley de Medidas Urgentes de Reforma Fiscal*, Law of Urgent Measures of Fiscal Reform.

A net wealth tax was finally passed in 1991, inheritance and gift in 1987, VAT in 1985.

(incl. ... prev.): how many amendments from the previous parliamentary process were reintroduced by the parties in the next debate.

*Source:* Archive of Congress, Public Finance Commission: Folder 12, Legs. 1069, 1696-2, 1698-3, 1700, 1714-8, 1715-1.