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BACKGROUNDER

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Spain Can—and Should—Improve Its Economic Freedom Ranking in Europe

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Abstract

Although economic freedom has expanded somewhat in Spain, only seven of the 28 member countries of the European Union scored lower than Spain in The Heritage Foundation's 2019 Index of Economic Freedom. *Under the 2011–2018 center-right government of Prime Minister Rajoy, Spain slashed its fiscal deficit, expanded exports, reformed financial and labor markets, contained public debt, moderated government spending, and cut taxes. Unfortunately, the current socialist government of Prime Minister Sánchez has reversed some of those policy achievements, putting the Spanish recovery in jeopardy and weakening the economy. Spanish voters could elect a new government on April 28, 2019, that will pursue the additional needed reforms outlined in this* Backgrounder*: deeper public spending cuts, elimination of redundant central and regional governmental systems, and further labor market and fiscal reforms. If voters do so, they will help to put Spain back on track to become an economic freedom leader in Europe.*

Key Points

- In the midst of economic decline in Europe, Spain's 2019 ranking in the *Index of Economic Freedom* has demonstrated encouraging improvement.
- But Spain's current socialist government is threatening to undo those gains with higher taxes and harmful minimum-wage increases.
- There are also external forces that could threaten growth and job creation. The International Monetary Fund is requesting that Spain raise value-added-tax rates, which could hinder nascent growth of consumption. Additionally, the EU seems adamant on pressuring Spain to adopt anti-growth measures by returning to the old mistake of raising taxes.
- The foundation for a more sustainable growth and higher job creation has been set. The next government of Spain must be adamant about sticking to a reformist agenda and avoiding past errors.

The 2019 edition of the annual Heritage Foundation *Index of Economic Freedom*[1] shows moderate slippage in the economic-freedom rankings of some eurozone economies. This is a concern, especially as this trend coincides with the peak of the largest monetary stimulus in European Union history, the goal of which was to provide EU economies with opportunities to modernize, and to implement important structural reforms aimed at delivering more robust growth, more sustainable job creation, and the generation of higher-quality jobs.

In the midst of this decline in Europe, Spain's 2019 economic freedom score has demonstrated encouraging improvement. It rose from 65.1 in 2018 to 65.7 (of a maximum 100) in 2019,[2] making the Spanish

This paper, in its entirety, can be found at **http://report.heritage.org/bg3398**

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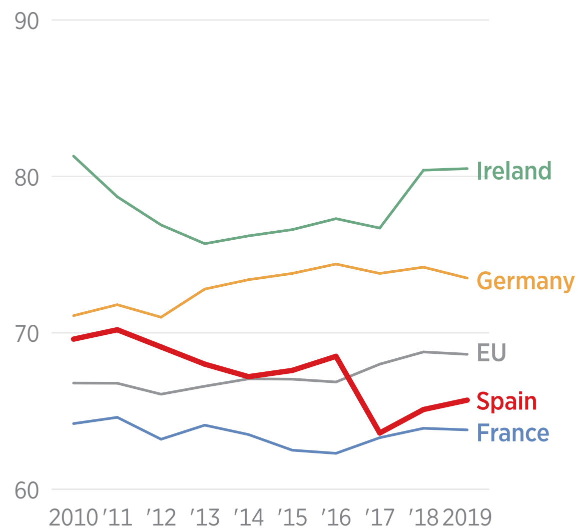
economy the 57th-freest in the 2019 *Index*, aided by a significant increase in fiscal health after tax cuts in 2015 and 2016 helped to boost the economy while preserving budgetary stability. While Spain is ranked 28th among 44 countries in the *Index*'s entire European region, only seven of the 28 member countries of the European Union scored lower than Spain in the 2019 *Index* (Slovenia, Portugal, Hungary, Slovakia, France, Italy, and Croatia). Spain's overall score is below the regional European average of 68.6, but it is above the world average of 60.8.

This *Backgrounder* examines how the next government in Spain can return the country to an upward trajectory in the years to come and propel Spain to the top economic-freedom rankings in Europe.

CHART 1

Economic Freedom Lagging in Spain

HERITAGE FOUNDATION'S *INDEX OF ECONOMIC FREEDOM* SCORE



SOURCE: Terry Miller, Anthony B. Kim, and James M. Roberts, *2019 Index of Economic Freedom* (Washington, DC: The Heritage Foundation, 2019), http://www.heritage.org/index.

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A Role Model for Europe

Under the government of former Prime Minister Mariano Rajoy, which was in power from 2011 to 2018, Spain became something of a role model for how a country can implement significant and vitally necessary structural reforms during a financial crisis. Its labor-market reform was a key factor in stopping the massive increase in unemployment, and other crucial reforms also played an important part in the country's rebound.

Spain's subsequent recovery from its worst economic crisis in decades was impressive, especially because relatively few international observers expected the country to deliver consistent above-trend growth and rapid job creation. Between 2012 and 2017, Spain recovered more than half of the jobs lost during a crisis that was initially: (1) denied by the previous Socialist administration of José Luis Zapatero (in office from 2004 to 2011); and (2) then exacerbated by Zapatero's misguided policies, deficit spending, and mounting structural imbalances.

Since then, Spain has slashed its fiscal deficit by 70 percent and brought what had been a dangerously high trade deficit nearly into balance. The fact that exports have risen to 33 percent of gross domestic product (GDP) is also relevant, as Spain's largest trading partners have remained stagnant or in recession during the same period.

External factors have helped, of course. Support from the European Central Bank (ECB), low interest rates, and cheap oil prices support the economy, but those factors should have also helped other EU economies, such as Italy, which are similarly vulnerable to volatile energy prices and interest rates. Nevertheless, it has been Spain that has created more than 1.5 million jobs in the past three years—the second-highest country in the EU in terms of full-time job creation.

The main reason for the difference in performance of Spain relative to neighboring EU countries has been the achievement of a very ambitious set of structural reforms: a financial reform that helped change the perception of risk in the Spanish financial system; a labor-market reform that turned around a seemingly unstoppable trend of rising unemployment and recovered jobs and salaries; a moderation in govern-

1. Terry Miller, Anthony B. Kim, and James M. Roberts, *2019 Index of Economic Freedom* (Washington, DC: The Heritage Foundation, 2019), https://www.heritage.org/index/.

2. Ibid., pp. 386 and 387.

ment spending without reducing social expenditures; and a fiscal reform in 2015 that reduced corporate and income taxes. Public debt, although elevated, has been contained relative to GDP in the past three years.

These have been the deciding factors that have driven a recovery under which inflation was nonexistent and global trade growth was slowing down. These structural reforms were achieved at a high political cost, however, as has been the case in numerous other EU countries where tough decisions had to be made to achieve greater economic freedom in the long run, such as in Ireland.

In the case of Spain, the Rajoy government paid that political price when it was unable to secure an absolute majority in the elections in 2015 and 2016 and, ultimately, was forced from power in 2018. A weak minority socialist government under Prime Minister Pedro Sánchez replaced it and proceeded to unleash a variety of damaging internal forces that, together with some negative external developments, could put the Spanish recovery in jeopardy and weaken the economy again.

For example, *Forbes* reports that, at the end of 2018, the Sanchez government "approved the largest increase in the minimum wage since 1977, raising the minimum wage to €900 ($1,030) per month, representing an increase of 22 percent."[3] Policy backsliding triggered by the implementation of these sorts of socialist policies is the main reason why a significant improvement in economic freedom is necessary.

If this higher minimum wage is permitted to continue under a new government, the negative effects will include a spike in inflation and many companies avoiding the hiring of more expensive permanent workers. In fact, in the months since the minimum wage increased, the number of unemployed workers in Spain has risen. January and February of 2019 have been the worst equivalent months for employment in Spain since 2013.[4]

A Complicated Political Landscape

In 2018, still under the Rajoy government, Spain saw tax receipts rise more than nominal GDP and achieved record revenues after much-needed tax cuts. Corporate tax receipts rose 29 percent after the nominal corporate tax rate was cut to 25 percent. Unfortunately, the socialist Sanchez government has been dependent on the votes of radical left and nationalist parties, whose policy priorities are generally to increase spending, raise taxes, and run budget deficits. These historically bad policies alone will make pushing for more economic freedom in Spain a bigger challenge if another left-of-center coalition manages to win the April 28, 2019, election and form a new government.

Spain has had deficits every year since 1980 except during the years of the real estate bubble—2005 through 2007—that preceded the crisis. Relying on tax increases and revenue measures has historically been a bad choice, however, because when spendthrift governments whose leaders are seeking to buy votes are in power, government spending consistently rises above those revenues and revenue estimates tend to be optimistic, as the ECB has pointed out in its paper on "Fiscal Forecasting: Lessons from the Literature and Challenges."[5]

Calls by Prime Minister Sanchez's government to re-introduce previous rigidities and eliminate the Rajoy government's 2012 labor-market reform will also not solve Spain's structural problems. Spain has had an average of 17 percent unemployment since 1980, with three different periods where it rose above 20 percent. Temporary jobs were already more than 25 percent of all contracts before the crisis. Going back to the mistakes of the past will not solve a long-term problem that has more to do with low productivity and the inefficiency of many small and medium-sized enterprises (SMEs). Promising greater workers' rights will do more harm than good in that context. Solving Spain's unemployment problem can only be achieved by creating an economic climate conducive to the creation of many more private companies, attracting more investment, and allowing micro-enterprises to grow into SMEs, and SMEs to grow into large firms. This goal can be achieved by removing perverse, government-imposed

3. Ana Garcia Valdivia, "Spain Approves an Outstanding Increase of 22% of the Minimum Wage to Fight Against Job Insecurity," *Forbes*, December 29, 2018, https://www.forbes.com/sites/anagarciavaldivia/2018/12/29/spain-approves-an-outstanding-increase-of-22-of-the-minimum-wage-to-fight-against-job-insecurity/#3096d43278d1 (accessed February 15, 2019).
4. Joe Gerrard, "Spain's Unemployment Rate Sees Highest Increase in Five Years," *Euro Weekly*, February 6, 2019, https://www.euroweeklynews.com/2019/02/06/spains-unemployment-rate-sees-highest-increase-in-five-years/#.XIvZfihKi70 (accessed March 15, 2019).
5. Teresa Leal et al., "Fiscal Forecasting: Lessons from the Literature and Challenges," *Fiscal Studies*, Vol. 29, No. 3 (November 21, 2008), https://doi.org/10.1111/j.1475-5890.2008.00078.x (accessed February 15, 2019).

incentives for firms to remain small and non-competitive—such as through punitive tax and labor code provisions that increase interventionist government measures once a firm reaches an arbitrary threshold of more than one million euros in revenue or more than 10 full-time employees.

There are also external forces looming on the policy horizon that could threaten growth and job creation. The International Monetary Fund is requesting that Spain raise some value-added-tax (VAT) rates ("tranches"), which could hinder nascent growth of consumption. Additionally, Brussels seems adamant on pressuring Spain into adopting anti-growth measures by returning to the old mistake of raising taxes.

This pro-higher-tax policy of the EU reflects the desperation of Brussels bureaucrats as they ponder how to confront the massive future unfunded spending liabilities resulting from decades of over-promising generous welfare state benefits to European voters. Brussels is also pushing the Organization for Economic Cooperation and Development's (OECD's) "anti-tax base erosion" project with the aim of increasing tax collections.[6]

Policymakers in Spain cannot and should not ignore the global trend to decrease, not increase, corporate taxes. It is well established that reducing the tax wedge has a direct positive impact on investment, job creation, and attraction of capital.[7] Likewise, Spanish policymakers cannot ignore that the positive effects of labor-market reform have been recognized even by France, notorious for decades of labor-code inflexibility, which is currently planning labor-code reforms similar to Spain's in order to boost job creation.

The bottom line that the next Spanish government must face is that the imbalances of the Spanish economy (an elevated public debt, a large deficit, and still-high unemployment) will not be solved by looking to the past, but by improving economic freedom. The imbalances can be solved through supply-side reforms, attracting foreign investment, allowing companies and families to keep more of their money, and improving public-sector efficiency while retaining a strong but sustainable social component.

In this way, Spain can grow faster than the rest of the European Union in 2019 and beyond, and faster than the forecast 2.5 percent in 2019 (as it has done in the past two years). Spain has proven that it can create more than 500,000 jobs a year. To do so, however, the next government will have to overcome the vast array of powerful forces mentioned above that would put the brakes on additional job creation.

Perhaps, as a start, it would be instructive for socialists in Spain to study the recent "success" enjoyed by so-called progressives in New York City, whose unrelenting anti-business demands effectively killed the creation of 25,000 new high-paying jobs in that city by Amazon.

Assuming that saner heads prevail and a pro-free-market government takes power, how can it position Spain within the eurozone so that the country's economic freedom score improves from its current "acceptable" level and the country makes the leap into the ranks of continental and even global leadership?

Recipe for Success

A careful analysis of the Spanish economy reveals the minor, but important, adjustments that can be made to increase the attractiveness of the economy.

Prudent Fiscal Policy and Spending Cuts. Spain is a country of SMEs. Ninety percent of Spanish companies fall into this category. However, these Spanish companies tend to be smaller than those of peer countries. Furthermore, the vast majority of SMEs, almost 87 percent, are micro companies (fewer than nine employees, annual sales of less than two million euros). This corporate structure means that the Spanish economy is very vulnerable to economic cycles, and it means that unemployment can rise much faster than in other countries because more than 80 percent of jobs are created by SMEs. Better tax policy could reduce this vulnerability.

The Spanish tax wedge on companies is too high[8] and ranks among the nine most onerous tax regimes

6. James M. Roberts and Adam Michel, "Trump Cut America's Taxes: Now He Should Defund OECD Efforts to Raise Them," Heritage Foundation *Issue Brief* No. 4861, May 29, 2018, https://www.heritage.org/taxes/report/trump-cut-americas-taxes-now-he-should-defund-oecd-efforts-raise-them.

7. Karel Mertens and Morten O. Ravn, "The Dynamic Effects of Personal and Corporate Income Tax Changes in the United States," *American Economic Review*, Vol. 103, No. 4 (March 2012), pp. 1212–1247, https://economics.mit.edu/files/7666 (accessed February 15, 2019).

8. PriceWaterhouseCoopers and World Bank Group, "Paying Taxes 2019," November 2018, https://www.pwc.com/gx/en/services/tax/publications/paying-taxes-2019.html (accessed February 15, 2019).

for businesses in Europe. This substantial tax wedge is a very significant obstacle to growth and prevents many companies from transitioning from an SME to a larger size. The Spanish tax system adds to their burden, since it is oriented toward trying to increase revenues at any cost, even if that makes companies weaker and more cyclically dependent.

Taxes on labor are particularly high as well. An average salaried worker in Spain pays almost 40 percent in taxes. Social contributions are among the highest in the OECD, and this works as a deterrent to job creation, as the cost for employers is almost twice what the worker receives as net salary. As a result, many employers and employees have been driven into the country's large, informal economy.

In addition to the heavy tax burden, Spain retains an obsolete system of subsidies and deductions that could be reduced in order to make the tax system simpler and clearer. A simple, lower, and attractive tax system can be implemented, and it would help to boost receipts as economic activity rises and companies become more robust and grow in size.

Government public spending in Spain could be significantly more efficient by eliminating the duplication and "parallel administrations" created by some regional communities. The savings from these cuts could be used to implement a large and innovative tax cut to boost productivity and growth.

Additional Labor Market Reforms Through Administrative Reorganization. In addition to the reforms advocated above that are essential to reduce unemployment, further reforms and re-organization are necessary in the bureaucracies that administer Spanish labor laws, in order to reduce the costs to employers of hiring and employing Spanish workers.

The Spanish economy is held hostage by a tangled web of separate regional, local, and national labor regulations that make it very difficult for companies to manage such a complicated system when trading or conducting business between regions. An effort to normalize rules and regulations as well as a high-priority campaign to cut this red tape would benefit the economy enormously.

The Spanish legal and regulatory system is needlessly complex, too. It aims to contemplate all possible scenarios and tries to provide guarantees for any eventuality. However, it ultimately fails to deliver the job security it promises, and instead acts as a burden on growth and economic development. The next government should make the cutting of red tape and regulations "Job Number One" in order to boost competitiveness and attractiveness of the economy.

Conclusion

Spain can lead economic freedom in the eurozone by implementing the policies outlined in this *Backgrounder*. The next government should also study similar pro-market and pro-growth reforms and policies undertaken by Ireland, which have helped that country grow faster and attract more investment than other economic freedom leaders in the European Union (such as the U.K., the Netherlands, Denmark, and Estonia). Thanks to the reforms implemented by successive Irish governments over the years, Ireland is now one of only six countries in the world, and the only EU country, that ranks as "free" in the 2019 *Index of Economic Freedom*.

It is time to avoid the temptation of relying on low interest rates and falling into the trap of increasing imbalances, which has been Spain's historical mistake. Every time that conditions start to improve, Spanish governments seem to backslide into a destructive pattern of excessive spending, more debt, and rigidity. The foundation for a more sustainable growth and higher job creation has been set. As was the case in 2012, however, the next government of Spain must be adamant about sticking to a reformist agenda and avoiding past errors. It will be challenging and difficult for all parties to agree, certainly, but they must not forget history: Raising taxes and spending never adds spice to a recipe for success. It ruins the dish.

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