The Heritage Foundation

ISSUE BRIEF

No. 4690 | APRIL 26, 2017

Spain: Moving from Recovery to Greater Economic Freedom

James M. Roberts and Diego Sánchez de la Cruz

The Spanish economy has recovered slowly from the deep economic slump that began during the 2008 global financial crisis when a housing bubble that had fueled an artificial boom between 2004 and 2008 came crashing down, causing high unemployment and exposing the need for structural reforms.

In responding to the crisis, then-Prime Minister José Luis Rodríguez Zapatero refused to reform Spain's inflexible labor market laws and failed to stop the rise in unemployment. Instead of implementing structural reforms to enhance economic freedom and improve Spain's competitiveness, Zapatero's Socialist government attempted to mask the recession by increasing public spending—a policy that eventually led to a debt crisis. Public debt ballooned from under 40 percent of gross domestic product (GDP) in 2007 to over 80 percent of GDP in 2012,[1] the result of falling tax revenues, debt-financed deficit spending, and an overall lack of fiscal discipline in the public sector. The debt crisis ultimately propelled the center-right opposition Partido Popular party into power at the end of 2011.

Since 2012, the conservative government of Prime Minister Mariano Rajoy has led Spain to a notable rebound, due largely to cuts in the inefficient and oversized government sector and labor market reforms that enabled an impressive turnaround in job creation. Lower world oil prices and a reduction of high marginal income tax rates on individuals and corporations in 2015 also spurred growth. More reforms, however, are still needed.

Recovery Mode

The Rajoy government's reforms began to bear fruit within a year. Growth picked up significantly. After a contraction of nearly 3 percent in 2012, the economy began to grow steadily in 2013–2014, reaching an annual growth rate of 3.2 percent in 2015–2016.

Economic reforms from 2011–2015 included significant improvements in the Spanish labor code and regulations that moderated wage pressures and increased employer flexibility, as well as reforms in the costly state-funded pension system and the tax code. The result was an improved business environment. An increase in net exports, reflecting Spain's enhanced international competitiveness, also made a solid contribution to growth.

Political Gridlock

The continuing expansion of the Spanish economy is even more notable in the context of the political gridlock that seized the country in 2016. Spain held a general election in December 2015, and the Popular Party failed to win a legislative majority, opening the door to negotiations with the Socialist Party and Podemos, a far-left populist party whose leaders have financial ties to Venezuela's *chavista* regime.

Ongoing political gridlock led to a second general election in June 2016. This time, the Popular Party

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214 Massachusetts Avenue, NE
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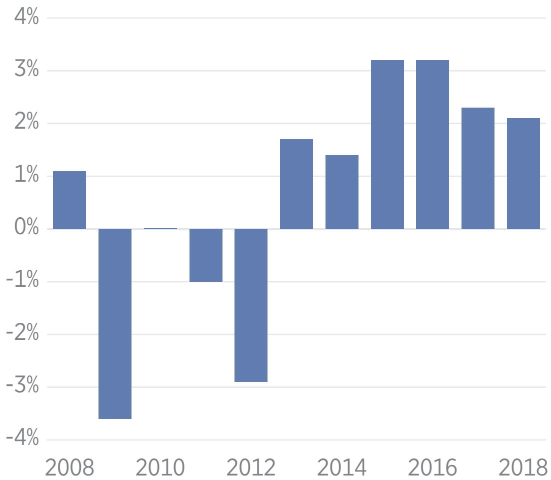
CHART 1

Spain's Long Road Toward Economic Recovery

ANNUAL PERCENTAGE OF CHANGE OF GDP



SOURCES: Spain's National Institute of Statistics, National Economic Accounts, http://www.ine.es/prensa/pib_prensa.htm (accessed April 12, 2017), and Bank of Spain, Macroeconomic Projections 2016–2018, http://www.bde.es/f/webbde/INF/MenuVertical/AnalisisEconomico/AnalisisEconomico/ProyeccionesMacroeconomicas/ficheros/be1606-proy.pdf (accessed April 12, 2017).

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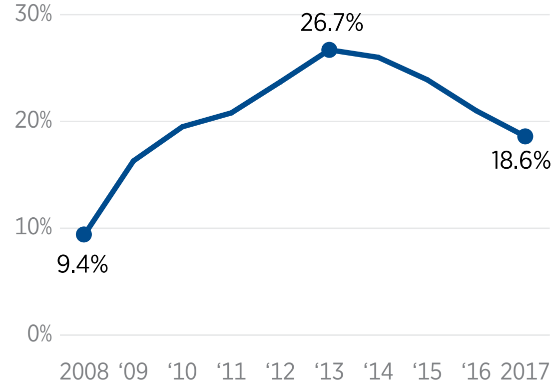
CHART 2

Unemployment Rate in Spain



SOURCE: Eurostat, Unemployment Statistics, http://ec.europa.eu/eurostat/statistics-explained/index.php/Unemployment_statistics (accessed April 12, 2017).

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won a decisive plurality of parliamentary seats but still fell short of securing an outright majority. The Socialist Party plunged into a deep fratricidal despair after failing to increase its vote margin, while Podemos lost one million votes. Ultimately, and thanks to the Socialist Party's abstention, Mariano Rajoy was able to form a minority government coalition with the centrist Ciudadanos party in late 2016.

Despite political turmoil, the economy performed well in 2016 and generated strong numbers in terms of GDP growth and job creation. That economic strength has continued into 2017, as evidenced by a report that job creation accelerated again in March.[2] Although the (central) Bank of Spain[3] is forecasting lower—but still respectable—growth rates of 2.8 percent and 2.3 percent, respectively, for 2017 and 2018, the country's GDP expansion remains the strongest among the eurozone's largest economies. (See Chart 1.)

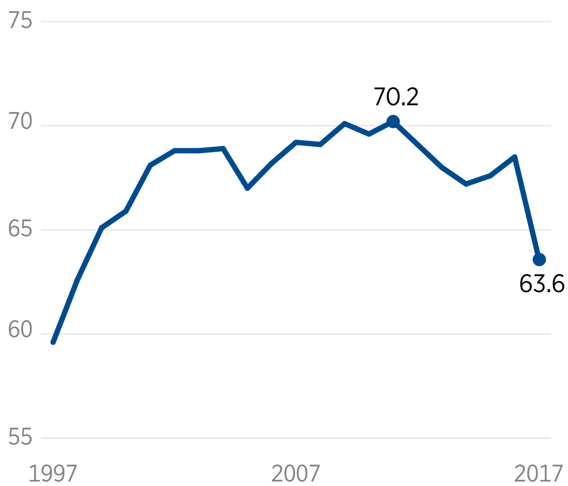
The political climate remains suboptimal, however, due to the continuing threat posed by far-left populism combined with the limitations on new policy implementation imposed by the fragile parliamentary arrangement undergirding Rajoy's minority government. Another source of uncertainty emanates from the Catalonia region, home to Spain's second largest city (Barcelona) and source of about 20 percent of Spain's GDP,[4] where pro-independence parties continue to flex their muscles.

1. Luis Gordo, Pablo Hernandez de Cos, and Javier J. Pérez, "Developments in Spanish Public Debt Since the Start of the Crisis," Banco De España, July–August 2013, http://www.bde.es/f/webbde/SES/Secciones/Publicaciones/InformesBoletinesRevistas/BoletinEconomico/13/Jul/Files/art3e.pdf (accessed April 21, 2017).
2. Manuel V. Gómez, "Unemployment Falls by 48,559 in March Thanks to Record Job Creation," *El País*, April 4, 2017, http://elpais.com/elpais/2017/04/04/inenglish/1491291306_919941.html (accessed April 20, 2017).
3. Jeanette Neumann, "Spain Central Bank Raises Growth Forecasts as Recovery Takes Hold," *The Wall Street Journal*, April 3, 2017, https://www.wsj.com/articles/BT-CO-20170403-702427 (accessed April 21, 2017).
4. Everett Rosenfeld, "Catalonia Is Critical Contributor to Spain's Economy," CNBC, October 5, 2015, http://www.cnbc.com/2015/10/05/catalonia-is-critical-contributor-to-spains-economy.html (accessed April 20, 2017).

CHART 3

Declining Economic Freedom in Spain

OVERALL SCORE IN THE *INDEX OF ECONOMIC FREEDOM*



SOURCE: Terry Miller and Anthony B. Kim, *2017 Index of Economic Freedom* (Washington: The Heritage Foundation, 2017), http://www.heritage.org/index.

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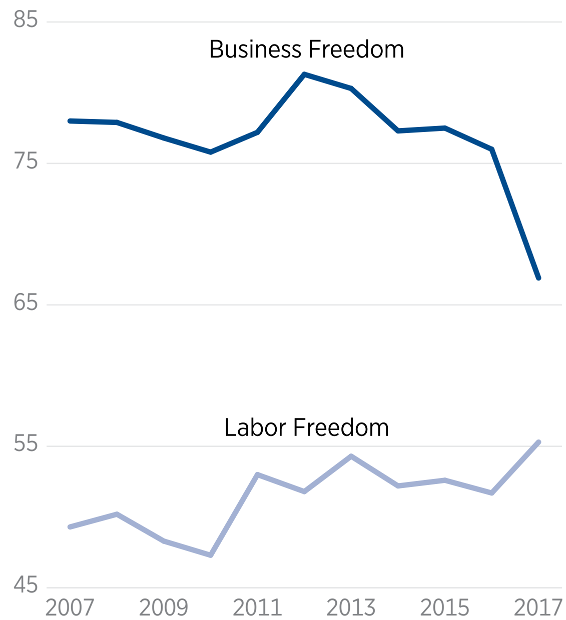
CHART 4

Regulation Indicators in Spain

COMPONENT SCORES IN THE *INDEX OF ECONOMIC FREEDOM*



SOURCE: Terry Miller and Anthony B. Kim, *2017 Index of Economic Freedom* (Washington: The Heritage Foundation, 2017), http://www.heritage.org/index.

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Additionally, the ongoing economic recovery will remain vulnerable if the government falls victim to what political observers call "reform fatigue" and fails to introduce additional needed reforms to spur new investment and job creation.

Additional Reforms Needed to Increase Economic Freedom

Spain ranked 69th out of 180 countries scored in the 2017 edition of The Heritage Foundation's annual *Index of Economic Freedom*.[5] Spain's overall score of 63.6 points is 4.4 points lower than the European average and uncomfortably close to the minimum score of 60 that a country requires to be considered "moderately free." (See Chart 3.)

The country has benefited from European integration, which opened new markets and brought monetary stability. Spain has made slow progress, however, in reining in its fiscal deficits and faces ongoing challenges to improving the rule of law. As the *Index* reports, worryingly low levels of judicial effectiveness—the lowest in the eurozone after Slovakia—have caused growing frustration among Spanish entrepreneurs. (See Chart 5.)

In terms of fiscal freedom, in addition to lowering the top individual income tax rate to 45 percent, the government has lowered the highest effective corporate tax rate to about 20 percent. Meanwhile, tax competition among Spain's various autonomous regions has increased in the past decade, mainly as a result of the free-market policies enacted in the Madrid region by former governor Esperanza Aguirre, who lowered the regional income tax, abolished the wealth tax, and reduced the inheritance tax to 1 percent.

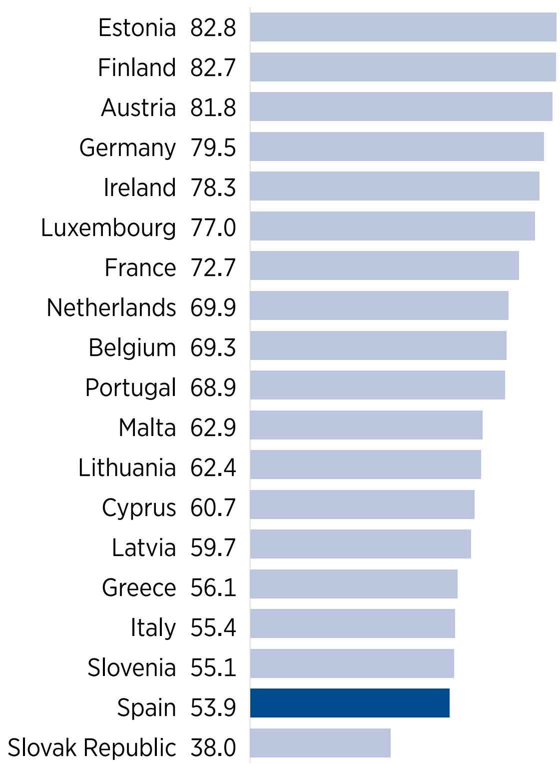
Unfortunately, government spending has not been reduced in tandem with fiscal reforms. Rajoy's

5. Terry Miller and Anthony B. Kim, *2017 Index of Economic Freedom* (Washington: The Heritage Foundation, 2017), pp. 284–285, http://www.heritage.org/index/country/spain.

CHART 5

Quality of Judiciary in the Eurozone

JUDICIAL EFFECTIVENESS SCORE IN THE *INDEX OF ECONOMIC FREEDOM*



SOURCE: Terry Miller and Anthony B. Kim, *2017 Index of Economic Freedom* (Washington: The Heritage Foundation, 2017), http://www.heritage.org/index.

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2017 budget deficit exceeds 3 percent of GDP.[6] Due to these ongoing deficits, the International Monetary Fund projects that government debt will fall only slightly to 95.6 percent of GDP by 2021.[7]

Although new business start-up procedures have been streamlined, Spain's *Index* score on business freedom is lower than a decade ago: 66.9 today versus 78 in 2007. (See Chart 4.) On the other hand, the 2012 labor market reform has ended collective bargaining and added much-needed flexibility, which has reduced unemployment from a peak rate of 27 percent to a seven-year low of 18.6 percent. (See Chart 2.) Some restrictions remain; additional reforms are needed to lower hiring costs and reduce youth and long-term unemployment.

The Rajoy government ran into a roadblock with its most recent labor reform effort, however. In February, the government issued a decree-law to abolish the "closed-shop" hiring of cargo-handling workers at such ports as Algeciras and Valencia, a practice that the European Court of Justice ruled in 2014 violates European Union rules. In March, opposition parties in parliament voted down the port labor reform in a major setback for the government. As Reuters reported, it was first time since the late 1970s that parliament had rejected a prime ministerial "royal decree."[8] As a result, application of the new liberalized regime is on hold, and Spain is still racking up heavy daily fines owed to Brussels because of its ongoing failure to open up port hiring processes.

There are two other notable challenges in the current regulatory climate. One is that many autonomous regions have passed laws and requirements that constrain the overall market in Spain and make it difficult for businesses to grow. The other is that governments at all levels continue to impose thousands of pages of new regulations every year, adding complexity and uncertainty while also increasing the cost of doing business.

Financial Freedom in Spain has improved as the country gradually puts its 2012 banking crisis behind it and overall conditions in the financial sector slowly improve. Nevertheless, difficulties remain with the semi-public savings banks (*cajas de ahorros*) despite a costly restructuring and government bailout that restored solvency but angered taxpayers. It is important that Spain continue to move toward a fully private banking system, especially now that most citizens are aware of the fragile nature of public-sector banking.

6. Jesús Aguado, "Spain Says Will Meet 3.1 Percent Budget Deficit Target in 2017," Reuters, April 2, 2017, http://www.reuters.com/article/us-spain-economy-deficit-idUSKBN1740V6 (accessed April 20, 2017).

7. International Monetary Fund, *Spain: Staff Report for the 2016 Article IV Consultation*, January 30, 2017, p. 57, http://www.imf.org/en/Publications/CR/Issues/2017/01/30/Spain-2016-Article-IV-Consultation-Press-Release-Staff-Report-Informational-Annex-Staff-44599 (accessed April 20, 2017).

8. Immaculada Sanz, "UPDATE 1–Spanish Opposition Blocks Dockers Reform in Blow to Government," Reuters, March 16, 2017, http://in.reuters.com/article/spain-ports-idINL5N1GT41T (accessed April 20, 2017).

The Road Ahead

Spain's ongoing economic recovery remains highly vulnerable to challenges related to ensuring fiscal stability and restoring financial-sector competitiveness. Despite relatively sound economic institutions and transparent regulatory and judicial systems, the indebted public sector is still a drag on overall economic dynamism.

Unfortunately, Rajoy's minority government is one of the weakest in recent Spanish history and is not likely to survive for an entire four-year term. For the good of the Spanish people, the next election, whenever it comes, should be a referendum on and produce a mandate for adoption of additional reforms to increase economic freedom in Spain.

*—**James M. Roberts** is Research Fellow for Economic Freedom and Growth in the Center for Free Markets and Regulatory Reform, of the Institute for Economic Freedom, at The Heritage Foundation. **Diego Sánchez de la Cruz** is Director of Foro Regulación Inteligente (regulacioninteligente.org), a Madrid think tank that focuses on improving the regulatory climate in Spain.*