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Spain's Economic Freedom Improves—But Post-COVID Risks Are Enormous

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KEY TAKEAWAYS

Spain's economic 2020 freedom improved slightly, but many policies implemented by the current government threaten to derail or even reverse that modest progress.

The government's priority is to defeat the pandemic and get the nation back to work. However, it should avoid unnecessary interventions in the economy to do so.

Spain should reduce non-essential government spending to zero, consider pandemic-related tax relief, and resist increasing structural spending imbalances.

Spain's economic freedom, as measured by The Heritage Foundation's annual *Index of Economic Freedom*, improved slightly in 2020. Many policies implemented by the current PSOE/Podemos government of Prime Minister Pedro Sánchez, however, threaten to derail or even reverse that modest progress towards greater economic freedom.

Of special concern are the many anti-free-market and anti-capitalist measures the government has put in place in response to COVID-19. Recommendations in this paper, if adopted, would help the Spanish people—at the very least—to avoid losing more economic freedom.

Risks to Economic Freedom in Spain

In the 2020 *Index*, a higher fiscal health score helped boost Spain's score by 1.2 points to 66.9 (out

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of a possible 100),[1] making its economy the 58th freest out of 180 countries that were ranked.

The improvement in Spain's overall *Index* score is welcome news, reflecting higher scores for several of the 12 *Index* indicators—i.e., indicators measuring government spending and the strength and independence of rule-of-law institutions (property rights and judicial effectiveness). However, there remain many areas of concern.

The Spanish economy has been stuck in the *Index*'s "moderately free" category for nine years, and the country's score and ranking are far below the world's most prosperous and free economies. The 2020 *Index* warns of several ongoing and important risks to economic freedom. For example, scores for *Index* indicators measuring tax burden and government spending remain far below global averages. More ominously, much of the progress that was made in the *Index* in 2020 reflects the ongoing legacies of the previous, center-right administration.

The current administration, a coalition between the socialist PSOE and the extreme-left Podemos parties, is unlikely to build on those positive legacies and has, in fact, already taken measures that are eroding economic freedom. For example, government spending rose significantly in 2019, and taxes—predominantly on labor and consumption—also increased.

In 2019, despite economic growth of 2 percent of gross domestic product (GDP), job creation was the weakest since 2015, and the public deficit rose to 2.7 percent of GDP, despite government claims in that it would fall to an even 2 percent.

Many Pandemic Response Mistakes

The deterioration in public accounts and the new burdens placed on job creation meant that the country lost the opportunity to end calendar year 2019, when the global economy was just beginning to slow down, with a stronger base from which to confront the pandemic. Furthermore, the government went ahead with massive public political demonstrations throughout the country in late February, even after the World Health Organization recommended that countries "prepare to immediately activate the highest level of emergency response mechanisms."[2]

When the government finally did declare a state of emergency, it put into place unprecedented measures against economic freedom, private businesses, and investor security. The Sánchez Administration, faced with millions of jobless claims, decided to forbid dismissals due to the emergency during the crisis. It also seized the cash of state-owned enterprises for the use by the fiscal authorities, implemented measures to ban foreclosures, and adopted other extreme measures of intervention into the entire supply chain.

Additionally, the government rejected *all* proposals to suspend collection of taxes on small businesses and the self-employed during the crisis. Instead, the government has opened new credit lines to allow companies to take on more debt to pay taxes in the future.

These populist measures were intended to protect workers—but they ended up harming those workers more than the virus itself. By banning payroll tax relief, many small and medium enterprises (SMEs) may have to close their doors for good, laying off workers at a time when Spain's chronically high unemployment rate is already 13 percent.

In addition to the short-term downside, these extreme and counterproductive measures will likely have a longer term negative impact. Post-crisis, they could make many investors and job creators more risk averse. Why hire workers or invest fresh capital when, if push comes to shove again, the government could implement another round of draconian measures against investor security?

Instead of instituting policies to protect the business fabric of the country, the government erected new obstacles. Economic damage from interrupted supply chains does not aid the public and is deeply irresponsible. Using the crisis as an excuse to expropriate businesses or micro-manage companies is even more so.

Instead, the government should be providing protocols, equipment, and sanitary measures for companies to efficiently manage and operate during the crisis. It is businesses, not politicians, who know what activity is essential and how to manage it.

Pre-Crisis Burdens on Economic Freedom

The Spanish economy already suffered from heavy burdens on job creation and investment before the pandemic. For example, while 90 percent of Spanish companies are SMEs, they tend to be smaller than those of peer EU countries. In fact, most SMEs—almost 87 percent—are micro-companies with fewer than 9 employees and annual sales of less than 2 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,[3] and ranks among the nine most onerous tax regimes for businesses in Europe. This substantial tax wedge is a very significant obstacle to growth and prevents many companies from transitioning from SME to large size.

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 Organisation for Economic Co-operation and Development, and this works as a deterrent to job creation since the cost of the employee for employers is almost twice what the worker receives as net salary.

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 boost receipts as economic activity rises and companies become more robust and grow.

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

In addition, the bureaucracies that administer Spanish labor laws should be streamlined to reduce the costs to employers of hiring and employing Spanish workers. The tangled web of separate regional, local, and national labor regulations add to the burden on companies.

The Spanish legal and regulatory system is needlessly complex as well. 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.

Recommendations for the Spanish Government

The 2020 *Index* outlines policies that the Spanish government should adopt to deliver better growth, higher quality employment, better welfare, and more social cohesion. Understandably, the government's priority now is to defeat the pandemic and get the nation back to work.

In working towards that goal, however, the government should strenuously seek to avoid unnecessary interventions in the economy. To wit:

- **Keep the government's focus on defeating the novel coronavirus.** Some Spanish politicians have said the country now has a "war economy" that is needed to defeat the pandemic. Given the seriousness of the threat, that posture is appropriate. What is not appropriate would be to use the crisis as an excuse to fund non-pandemic policy objectives.

- **Reduce all non-essential government spending to zero.** To deal with this severe crisis, all the non-essential items in the budget should be drastically reduced—to zero. That means, *inter alia*, ending unnecessary subsidies and duplicate expenses, and cutting the ranks of non-pandemic-related ministries and senior officials.

- **Exempt from taxation companies and self-employed workers that have no revenue during the crisis.** This will allow, together with non-recourse liquidity lines, the preservation of the business fabric of the country. Inflexible insistence by the Ministry of Finance on collection of what little tax revenue it can find will jeopardize the tax base in 2020 and the years ahead because it will force thousands of businesses into bankruptcy.

- **Do not use the fiscal space granted by the European Union to increase structural imbalances in current spending.** The enormous liquidity at negative real rates that reaches the state from the European Central Bank should be deployed carefully and effectively.

Conclusion

The Spanish economy is under serious threat. The current Administration is using the excuse of a serious health crisis to enact policies that undermine investor and business security and restrict personal and economic freedom.

Such interventionism will trap the economy by increasing fiscal imbalances—Spain's historical mistake—and put the country on a destructive track that will erode freedom and result in excessive spending, more debt, and rigidity. The long-term social and economic consequences of these mistakes can be enormous. Instead, the government should implement serious measures to enhance economic freedom and allow a strong recovery soon.

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Endnotes

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