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Spain Must Opt for Economic Freedom

James M. Roberts and Anthony B. Kim

National legislative elections on March 9 could well be a defining moment for the economic future of Spain. The bombing of several commuter trains in Madrid transformed the dynamic of the 2004 contest, the last general election between the center-right People's Party (PP) and the Socialist Party. The murder of 191 innocent train passengers by al-Qaeda terrorists helped to galvanize the electorate against the government and its pro-U.S. President, Jose Maria Aznar, propelling to power the socialist candidate, Jose Luis Rodriguez Zapatero, whose platform called for Spain's immediate withdrawal from Iraq.

Although terrorism remains an important issue, a different set of problems could cause a reversal of Spain's political direction in this year's elections. Spain's economy has started showing signs of fatigue, pushing economic issues to the forefront of the electoral debate.

Spain must resume the reform efforts begun under the Aznar government. The economy is sagging under the restrictive policies and unfavorable labor conditions that have been aggravated by the current socialist government. Without a second wave of economic reforms coupled with decisive political will by the government, Spain's competitive position in the globalized economy will continue its gradual decline, putting its citizens' standard of living at risk.

Spain's Rebirth. Ruled by fascist dictatorships in the decades after World War II, Spain and Portugal lagged behind the rest of Western Europe in their economic, political, and social development.

Over the past 15 years, however, the Spanish economy has registered impressive economic growth, due in large part to the country's general openness, the benefits of membership in the European Union (EU) common market, and fiscal and structural reforms that were implemented in the 1990s. Since 1995, Spain has enjoyed a dynamic economic expansion, registering an average growth rate of over 3.5 percent, which is more than one-and-a-half times the average growth for the EU as a whole during the same period.¹

Driven by strong consumer confidence, increased private consumption, and high investment rates in recent years, Spain's average annual growth rate has edged up to 3.6 percent. This growth is reflected in a buoyant construction boom and an upsurge in employment opportunities. It has also been helped by "the positive supply-side effects of the strong rise in immigration as Spain needed more workers to afford the construction boom."² The gap in the standard of living between Spain and the rest of the euro area has narrowed from 20 percent to less than 12 percent.³ The average Spaniard's purchasing power now exceeds that of the average Italian citizen.⁴

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Many reforms were driven by competition between EU member states to attract investment, create jobs, and increase economic dynamism. Spain and other countries adopted measures to cut personal income tax rates and improve their business climates. Spain reduced corporate taxes considerably under both the Aznar and Zapatero governments, although the impact on competitiveness has been greatly offset by the abolition of corporate tax allowances. The top rate dropped to 30 percent in January 2008, while the effective corporate tax rate remains mostly unchanged.

The Recent Slowdown. After a remarkable 14 consecutive years of growth, the vitality of Spain's economy is showing signs of slackening. Inflation is at a 10-year high of 4.4 percent, while recent unemployment figures were the highest in eight years.⁵ This weakening may be part of a cyclical trend, but voters should be concerned.

The key to sustainable economic prosperity in today's rapidly changing global economy is a consistent policy environment that favors innovation and entrepreneurship. That is the conclusion reached every year in the *Index of Economic Freedom* (IEF), an annual study by The Heritage Foundation and *The Wall Street Journal* that examines the economic policies of 157 countries to measure their level of economic freedom.⁶

With a score of 69.7 in the 2008 *Index*, Spain's economy is ranked "moderately free." Its score remains higher than the world and European averages, but it dipped slightly in 2008 due to corruption and higher inflation. Although Spain's economic

freedom has grown by 11.2 percent from 1998 to 2008, it has grown by just 1.3 percent over the past five years, which covers the Zapatero government.

What Reforms Are Needed. The recent slowdown suggests the need for a second wave of economic reforms. Spain needs to pursue fundamental structural reforms that can boost productivity and competitiveness over the long haul.

The primary focus should be the lack of flexibility in Spain's labor market, one of the main factors holding down the country's overall economic freedom. Under current Spanish law, permanent workers are protected by high severance payments, and temporary workers are not. Despite recent efforts to reduce this segmentation, a new OECD study found that "structural bottlenecks" caused by "overuse of short-term contracts" have limited labor market productivity.⁷

Inflexibility in this area hinders overall productivity growth and employment opportunities. The non-salary cost of employing a worker is high, and the rigidity of hiring and firing a worker makes companies risk-averse with respect to taking on new employees.

Conclusion. Sustaining Spain's competitiveness and prosperity over the long term should be the central economic issue in the pre-election debate. The Spanish economy is in a vulnerable situation and risks becoming less dynamic if the causes of the current slowdown are not addressed.

By pursuing more profound structural reforms that can boost economic freedom and long-term

1. International Monetary Fund, *World Economic Outlook*, October 2007, at www.imf.org/external/pubs/ft/weo/2007/02/weodata/weoselco.aspx?g=2001&sg=All+countries.
2. Organization for Economic Cooperation and Development, *Economic Survey of Spain, 2007*, at www.oecd.org/dataoecd/6/17/37916699.pdf.
3. *Ibid.*
4. Eurostats, at http://epp.eurostat.ec.europa.eu/pls/portal/docs/PAGE/PGP_PRD_CAT_PREREL/PGE_CAT_PREREL_YEAR_2007/PGE_CAT_PREREL_YEAR_2007_MONTH_12/2-17122007-EN-APPDF
5. Organization for Economic Cooperation and Development, at www.oecd.org/statsportal/0,3352,en_2825_293564_1_1_1_1_1,00.html; Instituto Nacional de Estadística (National Statistics Institute).
6. Kim R. Holmes, Edwin J. Feulner, and Mary Anastasia O'Grady, *2008 Index of Economic Freedom* (Washington, D.C.: The Heritage Foundation and Dow Jones & Company, Inc., 2008), Executive Summary, at www.heritage.org/research/features/index/chapters/pdf/index2008_execsum.pdf.
7. Organization for Economic Cooperation and Development, "Territorial Reviews: Madrid, Spain," at www.oecd.org/dataoecd/3/44/39905260.pdf.

competitiveness, a new Spanish government can continue to build a brighter economic future and go beyond what the country has achieved so far in catching up. That is the choice that Spanish voters will face on March 9.

—James M. Roberts is Research Fellow for Economic Freedom and Growth, and Anthony B. Kim is a Policy Analyst, in the Center for International Trade and Economics at The Heritage Foundation.