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Spain needs a new deal for its regions

By Carles Boix

As Mariano Rajoy's government completed 100 days in office, the interest rate on Spain's 10-year bonds jumped again. Monday's successful bond auction may have soothed nerves, but rates remain worryingly close to 6 per cent. Demand for Spanish bonds has declined sharply, especially among foreign financial institutions, leaving Spanish banks as the main buyers.

Markets are punishing the Rajoy government for three mistakes. First, it delayed presenting its budget for three months to avoid being penalised in Andalusia's regional elections. Second, it demanded that the EU relax the cap set on the Spanish deficit – only to retreat after earning the ire of EU leaders and losing credibility.

Third, it proposed a fiscally ill-advised budget that circumvents true regulatory reform and puts Spain on a dangerous populist path. The budget includes a tax amnesty (which, by the government's own calculations, will yield at most 0.25 per cent of output), while fiscal fraud is rampant and confidence in future growth (and thus the incentive to use the amnesty to invest) is very low. It raises corporate taxes at time when incentives for job creation are needed. It cuts Spain's R&D budget by 25 per cent. It funds construction of high-speed train lines that are hardly used while halving public investment in export-led regions, defying priorities set by the EU. It breaks previous, binding budgetary agreements with several regions, pushing them into higher deficits.

To develop a credible reform agenda, the government must revise this budget – extending to Spain the much tougher decisions implemented by the Catalan regional government. It should cut public servants' wages, freeze pensions, postpone retirement ages and make unemployment benefits more flexible. It should introduce market-based mechanisms in the health system. It should stop punishing the only sectors that can pull the country out of crisis.

A rational, forward-looking budget is only part of the solution. Spain's crisis is structural

– in the past 40 years the unemployment rate has shot above 20 per cent three times – and it demands wide-ranging reform. Measures to modernise the labour market, approved by the government, are insufficient to create jobs. The underperforming education system must also be overhauled. Spain’s rule of law must be strengthened: it is so weak that the country was judged only the 31st least corrupt country in Transparency International’s 2011 world ranking, and in 2009-10 it was ranked 34th out of 55 countries in judicial independence by the World Economic Forum. Finally, the government needs to dismantle the system of “national” companies that operate as monopolies or oligopolies, distorting markets and employing on their boards former government politicians and politicians’ relatives.

Spain’s central government has shifted much of the blame for the country’s deficit on to (allegedly free-spending) regional governments. Yet in fact, although most regions manage education and health, most regulatory and tax-and-spend powers remain with central government. More important, the regional system relies on huge fiscal transfers. Catalonia transfers 9 per cent of its gross domestic product in net terms every year, while Extremadura receives resources close to 18 per cent of its GDP. This is heavily distortionary. Net paying regions have to raise debt to cover services (at standards set by Madrid) and even then they cannot make it; Catalan per capita spending on health is about 15 per cent lower than the national average (and this does not take into account income and wage differences). By contrast, net receiving regions are splurging: one in four Andalusians work for the regional government, against one in 10 in any net paying region.

This situation cries out for a “new federal deal”. Inter-territorial transfers must be reduced to a minimum: they hurt the more productive areas of Spain. More boldly, most autonomous governments should be absorbed back into central government, while full tax-and-spend powers should be granted to historical nations, such as Catalonia, that support the bulk of transfer programmes and are growing restless.

Spain will only get back on track if the government offers a bold plan that rationalises the state and liberates free enterprise and productive territories.

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