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Spain Becomes One of Europe's Highest Taxed Countries

by Juan Ramón Rallo, Ángel Martín Oro, and Adrià Pérez Martí

Last year's election of Spain's conservative People's Party opened up an opportunity to implement much needed fiscal and structural reforms. However, merely a week following the December 21, 2011, inauguration of Prime Minister Mariano Rajoy, the government announced a significant tax hike that will have pernicious effects on the Spanish economy.

The main reason for the tax hikes, according to Spain's new leadership, was that the government would miss its budget deficit target for 2011. While the previous Socialist Party government had promised the figure would be 6 percent of GDP, the revised data showed a budget deficit of 8 percent, a difference of approximately 20 billion euros ($26.3 billion).[1] That change makes it more challenging for the government to fulfill its deficit pledge of 4.4 percent by the end of 2012.

While the government claimed that missing the target for 2011 was unexpected, few if any independent analysts believed the previous administration's official estimates. Nonetheless, the Rajoy administration seized the opportunity to announce one of the largest tax increases in recent Spanish history—which aims to raise 6 billion euros ($7.9 billion)—along with a spending cut of nearly 9 billion euros ($11.8 billion). The measure mainly consists of a so-called solidarity surtax to come on top of tax rates on income and capital gains; it also includes an increase in real estate taxes. The government announced the tax hike as "temporary" and "inevitable." In fact, the measure demonstrates nothing more than a lack of political will to cut excessive and unsustainable public spending.

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Spanish Income Taxes among the Highest in Europe

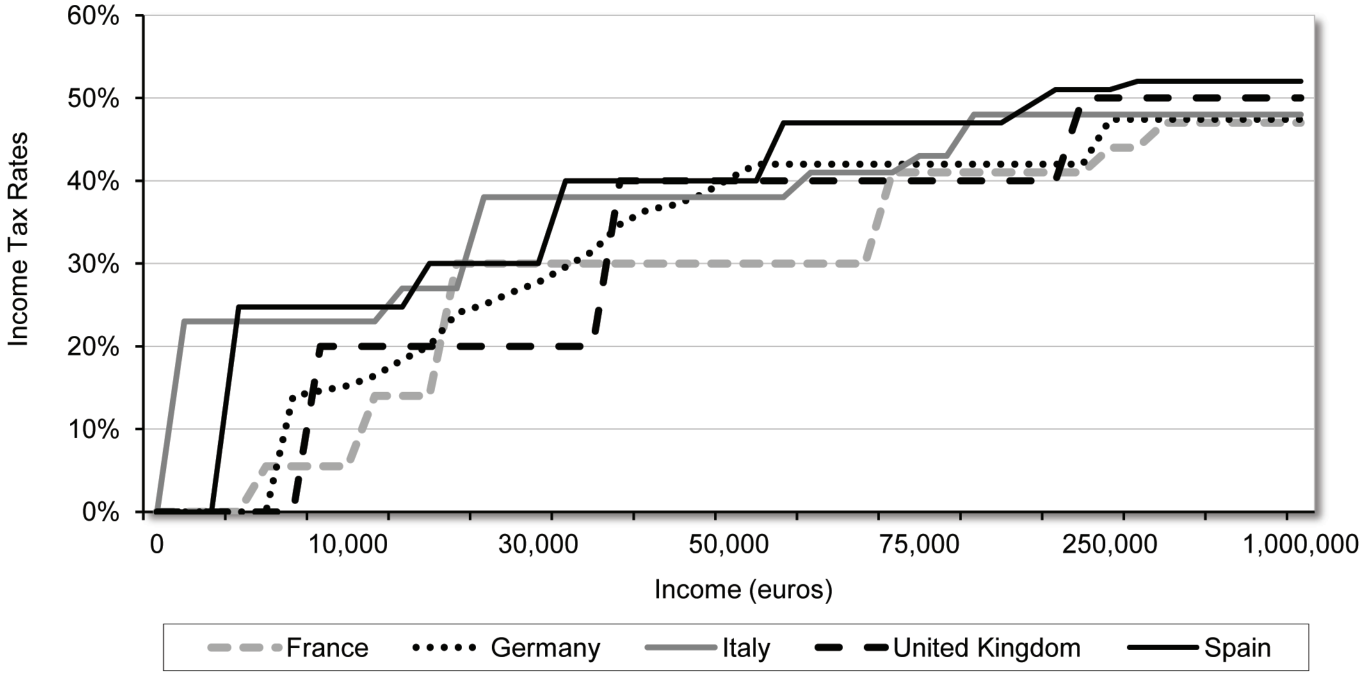
Following the tax increase, Spanish individuals will be paying one of the highest personal income tax rates in Europe.[2] For instance, from 2012 onwards, only Sweden and Belgium, with 56.4 percent and 53.7 percent, respectively, will have a higher top marginal income tax rate than Spain, which stands at 52 percent.[3] However, if one takes into account local surcharges imposed by some Spanish regional governments, the top marginal rates rise further. In Catalonia, for example, the top tax rate is 56 percent.

It is important to also consider the structure of personal income tax brackets and compare Spain with other major European countries, such as France, Germany, Italy and the United Kingdom. As we can see in Figure 1, personal income tax rates in Spain will be among the highest for any income bracket in the countries considered.

As for the tax on capital gains, the rates will no longer remain low and competitive, relative to other European countries. Before the tax increase, capital gains were taxed at a progressive rate of 19 percent for the first 6,000 euros and 21 percent for gains above that amount. Now, there will be three different rates: 21 percent for the first 6,000 euros, 25 percent from 6,000 to 24,000 euros, and 27 percent for capital gains above 24,000 euros. Thus, the rates will now be as high as in Germany and considerably higher than those of Italy, and the top rate will almost match those of Finland and Norway.

All of those countries enjoy a considerably higher income per capita than Spain and thus can more eas-

Figure 1
Personal Income Tax Rates in Selected European Countries



Source: Observatorio de Coyuntura Económica, Instituto Juan de Mariana.

ily withstand higher taxes than a poorer country.[4] With Rajoy's tax hike, Spain suffers from the worst of both worlds: very high taxes combined with decreasing income and employment levels. At 23 percent, Spain has the highest unemployment rate in the European Union.

The tax increase is especially harmful given the 1.5 percent economic contraction expected for 2012. The new measures are going to further hinder the economic recovery in two ways. First, the higher income taxes will take away a portion of the disposable income that many over-indebted families need to repay their debts. Second, the tax hike on capital gains will reduce the incentive for Spanish individuals to save. Similarly, the tax increase will diminish the appeal for foreigners to invest in Spain. By decreasing the availability of capital—which is essential to finance the restructuring of the productive and banking sectors—higher taxes on capital gains will only worsen the country's economic prospects.

The Problem Is Too Much Spending

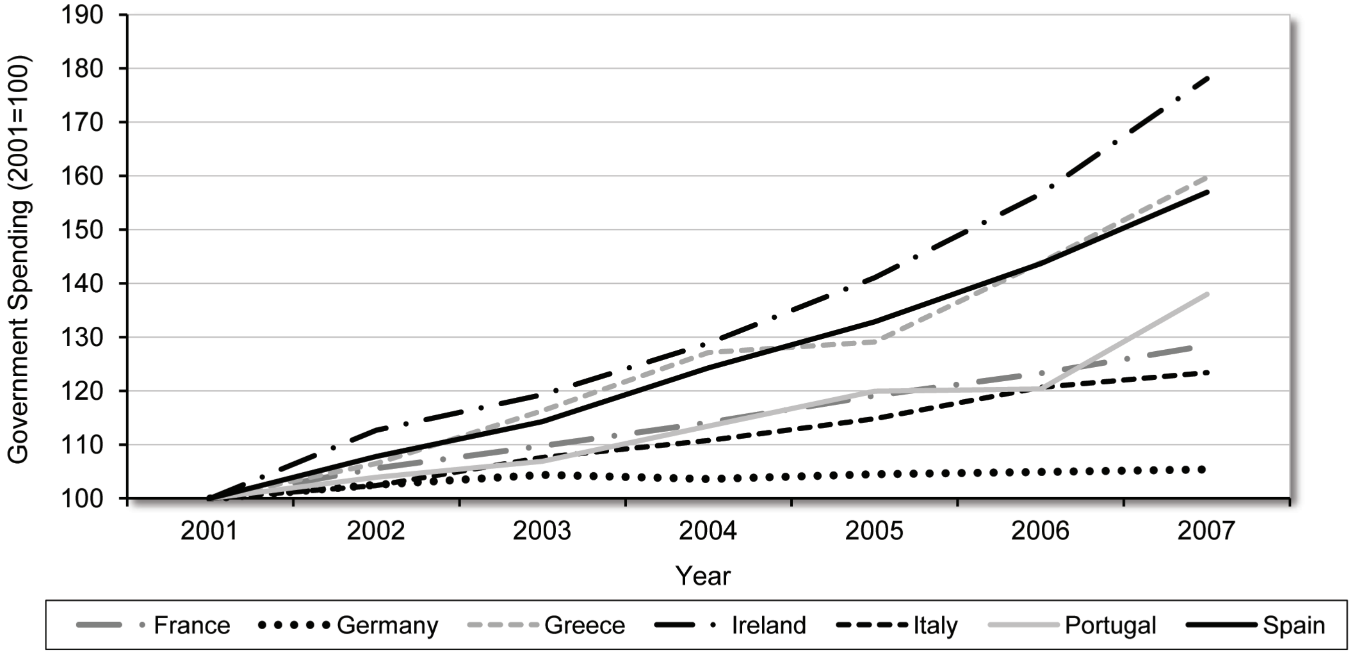
The Rajoy administration claims that the tax increase represents an essential and inevitable policy change to reduce the deficit and fulfill the budget target for 2012. However, given the anti-growth bias of these tax hikes, the taxes can hardly be expected to generate substantial revenues to significantly reduce the deficit. The real problem behind Spain's dire public finances is not an insufficient level of government revenues; rather, it is a problem of excessive spending. This becomes evident by looking at the evolution of both government spending and revenue from 2001 to 2007 in absolute (nominal) terms in a set of European countries. The data show that while government revenues increased substantially in Ireland and Spain due to a period of unsustainable credit-induced growth, government spending also increased the most in Ireland, followed by Spain and Greece (see Figure 2).

The picture is somewhat different if one pays attention to the ratio of government spending to GDP from 2001 to 2007. This figure increased slightly from 38.6 percent to 39.2 percent in Spain. But the data should be interpreted with caution, given that GDP was growing at an artificially high rate. (It is notable that the Spanish trend contrasts with that of Germany where spending fell from 47.8 percent of GDP in 2001 to 43.6 percent in 2007.[5])

Instead of looking at the recorded budget balance—which shows a surplus of around 2 percent in 2006 and 2007—consider the structural budget balance, that is, the budget balance adjusted for cyclical factors,[6] which shows that there was not a single surplus year from 2001 to 2007. This lack of surplus is caused by the government financing a large volume of long-term spending, such as social benefits or public sector wages, with short-term and temporary revenues—mainly produced by the housing bubble. It should come as no surprise that the deficit soared when the bubble burst.

In other policy areas, the Rajoy administration has been somewhat more sensible. For instance, the recently approved labor reform is a step in the right direction. It addresses an important cause of rigidity in the labor market by establishing the primacy of individual agreements—between firms and workers—over collective agreements in which labor unions have much weight. The effect of this reform on job growth, however, is uncertain because such growth also depends on other factors—such as the

Figure 2
Government Spending in Selected European Countries, 2001–2007



Source: Observatorio de Coyuntura Económica, Instituto Juan de Mariana.
Note: Spending is in nominal terms, that is, not adjusted for inflation.

rate of credit expansion or the international context—that are independent of the labor market. The financial reform, on the other hand, postpones the day of reckoning without addressing the root of the problem, because not all bank losses have been recognized and the financial sector will continue to be far from well-capitalized. Thus, the reform leaves the door open for a further injection of public funds into the banking sector. In addition, very little is known about forthcoming reforms to remove obstacles to entrepreneurial activity that make starting a business extremely burdensome.[7]

The Case for Cutting Spending Is Clear

It appears that Spain's new conservative government considers raising taxes to near Scandinavian levels its most urgent policy action.[8] Rajoy's priorities should instead be to implement measures to increase productivity, employment, and entrepreneurship, and put public finances in order.

Raising taxes will only put an additional drag on private sector recovery by reducing workers' disposable income—and consequently, their ability to consume, save, or repay their large amounts of outstanding debt—and by decreasing foreign investment. Moreover, high taxes and high public spending are negatively correlated with economic growth and entrepreneurship.[9] To reduce the deficit, cutting government spending substantially would be a better alternative than raising taxes. (The Spanish government could even fulfill its deficit pledge of 3 percent in 2013 and keep basic social services through a deficit reduction policy that relies solely on spending cuts.)[10] That public spending should adjust downward to more reasonable levels—as is the case in the private sector—is supported by recent empirical work that shows that the impact of tax hikes on short-term growth is worse than that of spending cuts.[11]

Notes

1. Dollar calculations are based on the exchange rate of February 3, 2012, of $1.31 per euro. On February 27 the government announced that the official budget deficit for 2011 was 8.5 percent.
2. This is one of the main conclusions of a report by the Observatorio de Coyuntura Económica of the Instituto Juan de Mariana, "España: en la cola del paro y a la cabeza de impuestos," January 23, 2012, available in Spanish at http://www.juandemariana.org/estudio/5340/espana/cola/paro/cabeza/impuestos/.
3. European Commission, "Taxation Trends in the European Union 2011," July 1, 2011, http://ec.europa.eu/taxation_customs/taxation/gen_info/economic_analysis/tax_structures/index_en.htm.
4. For instance, at the end of 2010, French and German GDP per capita was more than 30 percent higher than Spanish income. In the case of Italy, GDP per capita is more than 10 percent higher than that of Spain. See International Monetary Fund, World Economic Outlook Database.
5. International Monetary Fund, World Economic Outlook Database.
6. The structural budget balance is defined, according to the IMF, as "the government's actual fiscal position purged of the estimated budgetary consequences of the business cycle (for example, the amount of windfall tax revenue during boom times), and is designed in part to provide an indication of the medium-term orientation of fiscal policy." International Monetary Fund, "The Structural Budget Balance: The IMF Methodology," IMF Working Paper, 1999, p. 1, http://www.imf.org/external/pubs/ft/wp/1999/wp9995.pdf.
7. According to the latest *Doing Business* report by the World Bank, Spain is ranked 133 out of 183 countries in the category of "Starting a Business", which measures how hard it is for

entrepreneurs to start up and formally operate an industrial or commercial business due to all sorts of regulations and administrative burdens. See, World Bank, *Doing Business 2012: Doing Business in a More Transparent World* (Washington: World Bank, 2011).

8. Contrary to what many people believe, the Scandinavian experience does not vindicate a belief in big government. See, Graeme Leach, "Economic Lessons from Scandinavia," October 2011, Legatum Institute, http://www.li.com/attachments/Economics_Scandinavia_2011_WEB.pdf.

9. On the negative impact of big government on growth, see Andreas Bergh and Martin Karlsson, "Government Size and Growth: Accounting for Economic Freedom and Globalization," 2010, *Public Choice* 142, pp. 195–213. Available as a working paper at http://www.ratio.se/pdf/wp/ab_mk_governmentsize.pdf. On the negative correlation between the size of government and entrepreneurship, see C. Bjørnskov and N. Foss, "Economic Freedom and Entrepreneurial Activity: Some Cross-Country Evidence," 2008, *Public Choice* 134, pp. 307–28.

10. See Juan R. Rallo, "El recorte que debería haber aprobado Rajoy," January 2, 2012, *Libre Mercado*, available in Spanish at http://www.libremercado.com/2012-01-02/juan-ramon-rallo-el-recorte-que-deberia-haber-aprobado-rajoy-62621/.

11. See Alberto Alesina and Silvia Ardagna, "Large Changes in Fiscal Policy: Taxes versus Spending," January 2010, National Bureau of Economic Research Working Paper no. 15438.

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