

## THE WELFARE STATE AS AN UNDERLYING CAUSE OF SPAIN'S DEBT CRISIS

*Pedro Schwartz*

The ongoing crisis that so dramatically hit Spain in 2008 was at least in part caused by the countercyclical monetary policy the Federal Reserve and the European Central Bank applied in the first years of the new century. Their artificially low interest rates must in part be responsible for the excessive leveraging in banks, businesses, and households. Their unwarranted use of monetary policy to foster growth has recoiled on them with a vengeance. Now central bankers and their political masters find that they cannot perform as expected. A constant feature of financial crises in the past two centuries, as Reinhart and Rogoff (2010) have noted, is that, when banks collapse, companies fail, and families go insolvent they all turn to the central bank and the government to bail them out. The authorities usually find it difficult to answer those anguished calls even when they have the power to print money, so that devaluations and write-offs ensue.

But matters are made worse when a constant undertow of unfunded social spending makes efforts to change the course of the economy toward safer waters practically impossible. This is what happened in Spain. A housing bubble expanded by artificially depressed interest rates burst when the returns on overvalued assets became too low to attract new investors. As the Spanish government, lacking the power to print money, moved to act as lender-of-last-resort to the financial sector, it discovered that it did not have the funds and could not borrow them, because it was incapacitated by a financial bubble

---

*Cato Journal*, Vol. 33, No. 2 (Spring/Summer 2013). Copyright © Cato Institute. All rights reserved.

Pedro Schwartz is Rafael del Pino Research Professor at CEU San Pablo University in Madrid.

of its own—an uncontrolled entitlement policy. A doubly severe sovereign debt crisis hit the economy.

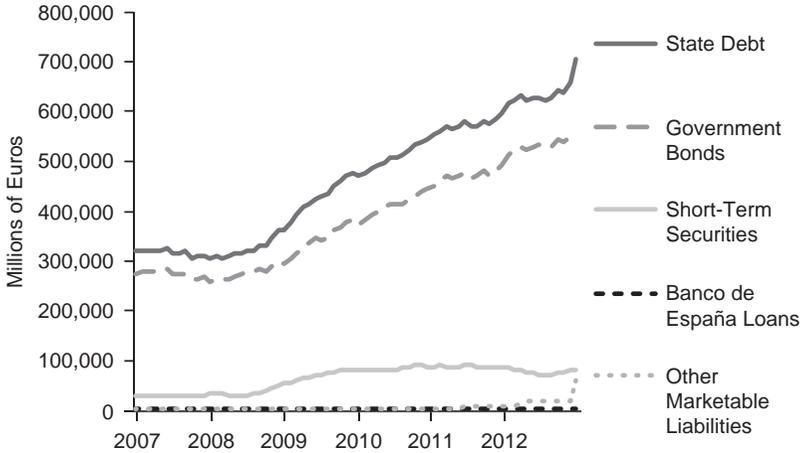
It is now obvious that the social policies of most European nations and those of the United States are financially unsustainable. Welfare states are not suffering from a temporary liquidity problem but from structural insolvency. Since voters will not accept large cuts in entitlements, the only way to maintain those entitlements seems to be to raise taxes and Social Security contributions. But those higher exactions constrain growth and compound the inability to finance social policies. This leaves only one remedy at hand: the hope that inflation will in the end reduce the burden of public debt.

This silent acceptance of hidden default through inflation is only one of the moral consequences of the continuous expansion of entitlements. Women use repeated pregnancies to extend their reliance on welfare. Men elude responsibility for their offspring. Families shift the burden of educating their children onto the state. People do not save for health care or pensions. Governments react to unemployment by increasing the minimum wage. Rent seekers decry competition, especially from the poor. All this puts democratic politicians in an impossible situation: they ought to tell the voters about the depth and probable default of the unfunded obligations of the welfare state; they should warn of the corruption of social mores caused by the expectation of entitlements; and they should at least think of new institutional arrangements making it possible to attend to the needy without destroying individual self-government. Meanwhile, the problems of the welfare state refuse to go away.

## Spain's Debt Problem

To state the obvious, the sovereign debt problem of Spain is a large and continuous budget deficit feeding into its accumulated debt. The growth of the debt made financing it more and more expensive, as borrowers demanded larger risk premia. Fiscal consolidation has not yet corrected the drift (see Figure 1). The net increase in debt in 2013 is expected to be €48 billion (\$61.5 billion) and the gross issue of public debt €207.2 billion (\$267.3 billion). These are large sums compared with Spain's GDP of €1.05 trillion (\$1.37 trillion). I mention the gross figure because the refinancing of maturing debt must be covered, and the new paper may have to be issued at a higher interest rate if confidence falters—that is, at higher

FIGURE 1  
SPAIN'S OUTSTANDING LIABILITIES



SOURCE: Banco de España (2013).

spreads than the old debt it replaces. Also, when new public debt reaches such a high percentage compared with current production the market will only accept it for shorter and shorter maturities. Spanish sovereign debt has an average life of 6.4 years, which makes it a tax for present taxpayers rather than a generation shift.

According to the much flouted Lisbon Treaty of the European Union, the total sovereign debt of eurozone countries must not be larger than a sum equivalent to 60 percent of its GDP and budget deficits not higher than 3 percent of GDP. By means of structural reform and large tax hikes, the Spanish government has been able to avoid direct rescue like Greece, Portugal, and Ireland. Spain had to undertake reducing the size of its budget deficit from 11.5 percent of GDP in 2011 to 3 percent in 2014. That task is proving to be difficult, given faltering growth, so Spain (and other errant countries) have been granted a longer period to achieve the 3 percent target.

The Spanish government, when presenting its budget for 2013, admitted that total public debt had reached the equivalent of 85.3 percent of GDP in 2012 and forecast its total sovereign debt would top 90.3 percent of GDP in 2013 (Ministerio de Hacienda

2012). This is not only much higher than allowed in the EU Treaty but also just over the danger level of debt intolerance observed by Reinhart and Rogoff (2010) in industrial countries.<sup>1</sup>

Once a state is so indebted that it finds it impossible further to finance itself on the voluntary market, it faces default unless other states or international institutions supply it with funds from political motives. The immediate problem for Spain, as for other peripheral countries of the eurozone, was not so much sovereign debt as the mountain of private debt and especially the paltry state of the assets of its savings banks.

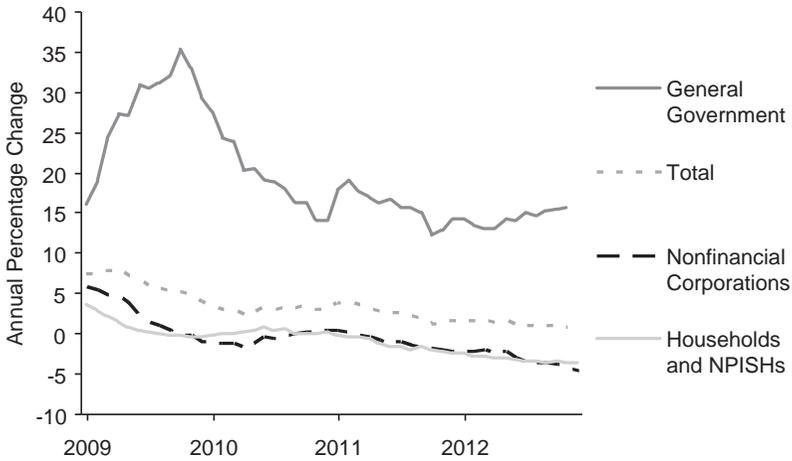
Foreign help has come in the shape of a €100 billion (\$126 billion) facility to be used to rescue failed Spanish banks, of which €42 billion have been drawn. On top of this credit line, Spanish banks were able to discount paper with the ECB, and by December 2012 they had been lent some €120 billion. True, all these funds were aimed at rescuing banks, not the Spanish state itself. In normal times banks could have run to the Spanish government for help. But the government had problems enough of its own without having to come to the rescue of its financial sector. The main problem was the difficulty of consolidating its finances given its welfare obligations.

Spain's debt—both private and public—is too large. Households and companies are slowly deleveraging. However, the government is far from having taken the harsh measures forced on the private sector by a combination of market forces and tax increases. Though the government speaks of consolidation, it has concentrated efforts on trying to save failed banks while refusing to cut down (much) on welfare services. Consolidation thus paradoxically leads to the issue of more debt domestically and internationally, and to the increase of taxes on investment, income, and labor.

As can be seen in Figure 2, the general government is hogging the funds available in the system, resulting in negative growth of the funds supplied to households and firms. With the excuse that a decided cut in public spending would reduce aggregate demand, and hence constrain growth, the crowding-out effect of excessive public

<sup>1</sup>One of the conclusions of Reinhart and Rogoff (2010: 577) is that there appears to be a level of “debt intolerance.” For advanced economies when the ratio of public debt to GDP goes above 90 percent, growth slows by roughly 1 percent a year. For less advanced economies when the ratio goes above 60 percent “market interest rates can begin to rise quite suddenly, forcing painful adjustment.” See also Reinhart and Rogoff (2009: 21–33).

FIGURE 2  
FINANCING OF NONFINANCIAL SECTORS IN SPAIN



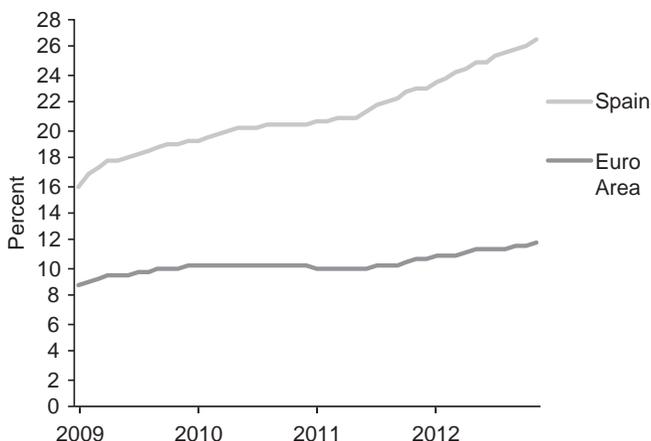
SOURCE: Banco de España (2013).

spending in a crisis is overlooked. No doubt there are other causes for the drying up of loans to the private sector, but the continuous increase in credit to the general government must be having a negative effect that is most unwelcome in the circumstances. That continued increase could at least be contained if public expenditure and public employment had been decisively cut. Indeed, out of a labor force of 22.9 million, of which 6 million are unemployed, 2.9 million (13 percent) are employed in the public sector.<sup>2</sup>

Again, the fast growth of joblessness in Spain is certainly due to the bursting of the housing bubble and the subsequent contraction of the housing market (see Figure 3). But the level of unemployment, now above 26 percent of the labor force, must in part be the effect of a high legal minimum wage and of contributions to Social Security acting as a tax on labor. Such regulations, which the Spanish government has just begun to lighten, make joblessness impinge differently on different groups. The most glaring instance is that of the

<sup>2</sup>The 2.9 million include public teachers and people employed at public hospitals. Teachers in public schools are around 496,000. Teaching staff at public universities number 102,000. Medical staff at public hospitals number some 100,000 doctors and 115,000 auxiliary. The total for these professions is about 815,000.

FIGURE 3  
UNEMPLOYMENT RATES IN SPAIN



SOURCE: OECD.

young, 55 percent of whom are without a job. The general government and private industry are also differently affected. Though unemployment is now growing in state companies, the picture is quite different if the whole period from 2007 to the present is taken in: private corporations have lost 2.95 million employees while the public sector has gained 3,900.

### The Size of the Welfare State in Spain

The four pillars of the Spanish welfare state are health, education, pensions, and unemployment benefits. An attempt was made to subsidize home care for the elderly and incapacitated, but it stopped due to lack of funds.

Health care is mainly administered by the autonomous regions, although a large part the funds needed are transferred by the central treasury from general taxes. Social Security health care is free at the point of demand. Various attempts have made to charge one euro per prescription at the pharmacy. Very recently illegal immigrants have been excluded, with very uneven enforcement. As a result of these savings, the amounts budgeted for Spain as a whole have been reduced to a certain extent. The expenditure for 2009 was

€53 billion, for 2010 €68.7 billion, and for 2011 €66 billion (6.3 percent of GDP).

Public expenditure on education is of the same order. Basic education from 5 to 16 years is compulsory and free. Further education and university are heavily subsidized. Here again there has been some reduction, from €53.1 billion in 2009, to €51.5 billion in 2010 and €50.1 billion in 2011 (4.8 percent of GDP).

Pensions are a much larger expense and an unavoidable one due to the demographics. The reduction in the labor force due to the crisis has brought the ratio of workers to pensioners below 2, which would be unsustainable if prolonged. Despite this, the government decided to augment them by 4.9 percent. The result has been an increase from €115.6 billion in 2012 to €121.6 billion in 2013 (11.6 percent of GDP). Admittedly, the government has made an effort to reform public pensions despite the question being so touchy. Early retirement makes the effective pensionable age 63.9 years and the government is trying to bring that up to the legal 65 as quickly as possible. But the main reform effort centers on setting back of the legal retirement age by small steps from the present 65 years for both sexes to 67 years by 2027.

Another two lines of expenditure, though not of the essence of the welfare state, do make the burden heavier. One is the unemployment subsidy, which is forecast to be €27 billion in 2013 (2.6 percent of GDP). The other is interest payable on the public debt, no less than €36.5 billion. If we set aside interest payments, the total sum of “social” expenditure for 2013 is forecast to be 63.6 percent of the consolidated state budget—equivalent to no less than 25 percent of GDP.<sup>3</sup>

Total social expenditures budgeted for 2013 are €258.3 billion, while the deficit of the consolidated state budget is forecast to be €133.6 billion. Thus, without counting interest payments on the government debt, social expenditures are expected to be nearly double the state deficit. Hence, it is no exaggeration to say that Spain's deficit, attributed by many to a sudden collapse of tax revenues, is really the consequence of the huge burden of the welfare state.

<sup>3</sup>This does not mean that welfare makes up a quarter of the value added yearly in the Spanish economy. Much of what the welfare state redistributes will be counted again as a product of the beneficiaries. The figure of 25 percent of GDP is a comparison of size, not an attribution of output.

From 2007 to the present, we have not witnessed a crisis of capitalism but a crisis of the overblown, overstretched state.

## Saving the Welfare State

Welfare protection of citizens was started by Bismarck in the second part of the 19th century. Now it is seen in most democracies as an essential element of human rights. Welfare schemes try to protect individuals from unexpected risks. Now even communist China speaks of redistributing wealth by means of free education, public health, minimum wages, and worker protection.

Nobel laureate economist James Heckman (2009: 3) notes, “In principle, a welfare state can provide the proper incentives for productivity and at the same time afford a measure of security and dignity for its citizens.” However, in practice, welfare states “blunt incentives and reduce productivity.”

The general failure of welfare states around the world has given rise to quite an industry of piecemeal reformers trying to save them from their failed logic. It all boils down to perverse incentives and incalculable opportunity costs. Any welfare state, because it functions outside the normal economic market for services, will have great difficulty to satisfy individual demands and minimize costs. It will be hell for the genuinely needy and paradise for free riders.

Attempts to save the welfare state are exercises in second-best calculus—that is, the discovery of byways and side paths to reach the best results, given the restrictive assumption that there will always be a welfare state. If we at all want to have a public welfare system to save people from the consequences of their lack of foresight, correct some of the inequalities born of natural endowments or social deficiencies, and achieve national progress, then we must design it so that people do not game the system for their own personal advantage—and scarce resources are not squandered needlessly. This task, however, is more easily said than done.

Here is not the place to review the myriad proposals and experiments that have come forth under the pressure of insatiable and dysfunctional welfare systems. The best minds have applied themselves to the task of saving the welfare state from a tailspin. Two of the better known proposals were presented by Milton Friedman. One was the use of vouchers, especially for education (1955); the other, a negative income tax combined with a flat-rate tax on income (1962).

Education vouchers would force public and private schools to compete and allow parents freely to choose the kind of education they thought best for their children. The negative income tax would end the high marginal tax rate falling on workers when they move from welfare into employment, and it would do away with the need for minimum wages, food stamps, welfare payments, and other government assistance programs. In practice, negative income tax schemes in different American states have been added to existing assistance programs, so that bureaucracy and waste have not been done away with.

Another plan, this one regarding public pensions and health insurance, was launched in Chile in 1980 by the initiative of José Piñera. Existing employees would stay in the public pension and health system until the last one retired. New laborers would have to take their 10 percent payroll tax to privately managed pension funds, and they could if they so wished take their mandatory 7 percent health contribution to private health companies. This kind of reform is easier when the number of pensioners and prospective pensioners is relatively small and the tax burden of continuing to finance public pensions is bearable. Also, the heavy regulation of Chilean private pension funds has made them less than fully profitable. Still, the way shown by Chile's defined contribution pension plans has been followed by an increasing number of nations, most notably some of the new arrivals in the EU formerly in the Soviet bloc.

The much touted reforms of the Nordic welfare states—in Sweden and Denmark principally—have rekindled the hopes of welfare state pipe-dreamers. Sweden has widened the education voucher scheme from schools to hospitals, whereby public and private suppliers of education and health have to compete. However, a subtle adaptation of the Friedman idea has made vouchers more palatable to egalitarian Swedes: families are forbidden to make any payment above the school and health vouchers provided by the state. This system undermines incentives to save for education and sickness.

Denmark seems to have found the philosopher's stone with its "flexsecurity" scheme. Firms are allowed full flexibility in hiring and dismissing employees, and workers are protected from the danger of prolonged unemployment by enrolling them in retraining courses. As Heckman (2009) points out, European interventionists who extol the low unemployment of Nordic countries ignore the large numbers of workers who are unemployed but hidden in training courses or "active labor market" programs, as they are more grandly called.

In Sweden unemployed trainees are classified, with no compunction, as public employees.

Another line of intervention in Europe comes in for criticism by Heckman: progressive taxation reduces incentives to acquire skills. The large role of public funds in the support of education, especially university education, opens it to funding cuts in periods of crisis, precisely the moments when human capital accumulation should be maintained or increased.

## Public Virtues

The question is not so much one of growth, though Heckman also throws doubt on Nordic growth rates. The question is the impact welfare states have on democratic virtues and private initiative.

When “nanny states” become respectable, interest groups can argue in favor of their comfort and income in the name of the great ethical values. When the welfare becomes a human right, pork can be dispensed in the name of fairness or equality. This approach helps the demanders of special favors to avoid a more cynical justification that would make them less acceptable to the general voting public. Individuals also become less honest as they learn to play the system—for example, by claiming sick leave or collecting unemployment benefits when they are fit or even at work in the underground economy. Finally, the work ethic and personal initiative suffer, as do family cohesion and personal charity, when people can receive state help as a right.

All this scrounging makes welfare states highly unstable. Despite partial corrections they tend to grow without limit until financial crises such as the one we are undergoing at present puts a temporary stop to public profligacy. People lose even the memory of the time when the arts, hospitals, schools and universities, and help for the poor were financed by selling their services or by private savings. With the growth of the welfare state nobody believes that public services can grow like a *Beautiful Tree*, purely on the basis of private enterprise and brotherly altruism.<sup>4</sup>

<sup>4</sup>This is a reference to James Tooley’s (2009) book, *The Beautiful Tree: A Personal Journey into How the World’s Poorest People Are Educating Themselves*. Tooley shows how, despite general skepticism, private education is capable of supplying the poor with much better education than that afforded by public schools organized by the state and financed with international aid.

## References

- Banco de España (2013): *Economic Bulletin* (January). Available at [www.bde.es/bde/en/secciones/informes/boletines/Boletin\\_economico/anoactual](http://www.bde.es/bde/en/secciones/informes/boletines/Boletin_economico/anoactual).
- Friedman, M. (1955) "The Role of Government in Education." In R. A. Solow (ed.) *Economics and the Public Interest*. New Brunswick, N.J.: Rutgers University Press.
- \_\_\_\_\_ (1962) *Capitalism and Freedom*. Chicago: University of Chicago Press.
- Heckman, J. J. (2009) "The Viability of the Welfare State." University College Dublin Geary Institute, Discussion Paper Series (March). Available at <http://researchrepository.ucd.ie/bitstream/handle/10197/1823/gearywp200904.pdf?sequence=1>. Published in Spanish by *Cuadernos de Pensamiento Político*, No. 20 (October-December 2009): 135–71.
- Ministerio de Hacienda y Administraciones públicas (2012) *Presupuestos generales del Estado. Libro Amarillo, 2013*. Congreso de los Diputados, Madrid.
- Reinhart, C. M., and Rogoff, K. S. (2009) *This Time Is Different: Eight Centuries of Financial Folly*. Princeton, N.J.: Princeton University Press.
- \_\_\_\_\_ (2010) "Growth in a Time of Debt." *American Economic Review* 100 (2): 573–78.
- Tooley, J. (2009) *The Beautiful Tree: A Personal Journey into How the World's Poorest People Are Educating Themselves*. Washington: Cato Institute.