“Economics of Secession. The nationalism Project and the Basque Country”

The radicalization of Basque nationalism together with the nationalism of the government in the Basque region has naturally put the question of the secession of this region from Spain into the political arena, creating a multi-faceted problem both in legal and constitutional terms and in political and economic terms. From this last perspective, it appears necessary to analyse the prospective impacts that an event of this kind could have for the Basque economy.

Addressing an issue such as this implies advancing into unknown territory, since although the nationalists have, since their origins with Sabino Arana, always retained their aspirations for independence, these had been manifested until very recently in a rather rhetorical manner – with the exception, of course, of the members of ETA who have championed this cause via terrorism. As a consequence, these aspirations had not appeared in solid form in any government programme nor had they inspired any kind of studies attempting to evaluate the costs and benefits. Moreover, at the international level, perhaps because we economists, in the light of real developments, have been more concerned with the integration of markets rather than their division, there are hardly any studies into the implications of secession.

The main economic dimensions of the problems can be summarised by stating that the consequences of secession, which have a negative and costly outcome for Basque citizens, arise in three separate ways: firstly, from the establishment of frontiers between the Basque Region and Spain and likewise with the other European Union countries, the consequences of which include the loss of economic activity and employment and also companies moving out of the region; secondly, from the need to exercise the powers of the state through which sovereignty is expressed – that is to say, international relations, defence, the legal system and supervision of the financial system – as well as maintaining the welfare state, which must be translated in to a higher tax burden for residents of the Basque territory; and, lastly, from the necessity of giving up the Euro as its monetary standard, leading to significant macroeconomic instability which would increase the critical impacts of the reduction in productive activity, at least for some period of time. In short, what secession promises is nothing more than economic difficulties, unemployment and the loss of welfare for the Basques.

These outline conclusions must be developed through a deeper analysis of the main issues.

The first aspect which we need to examine in depth places us at the starting point of the secessionist project and is to do with the costs for the Basque region that have arisen from three decades of terrorism. Very often this subject is side-stepped and it is even denied that terrorism has any impact on the Basque economy, which flies in the face of all of the evidence accumulated internationally about armed conflicts in recent years. The only study of this subject in the context of the Basque Region also added to this evidence and was conducted by A. Abadie and J. Gardeazábal. Because of the breadth of its negative effects, terrorism has been the Basque Region's greatest economic problem. If we analyse the last half century of the Basque economy, we will see that from the middle of the 1970s its growth diverged from the trend of other developed regions in Spain and that this phenomenon is explained by the behaviour of capital investment, which is very sensitive to terrorist activity. As a consequence, in *per* *capita* terms, we can estimate that the Basque Region currently achieves a gross product some 8 per cent lower than the amount actually recorded. This is because the size of its economy is 25 per cent smaller in terms of GDP than it would have been if violence had not taken root in Basque society and because its population size is around 15 per cent lower than it would otherwise have been. In short, terrorism has reduced potential economic activity with a resulting loss of welfare. The most well-known effect of this has been the reduction of the share of the Basque region in the economy as a whole, both in terms of GDP and population and employment.

Secession, as indicated above, would involve the appearance of borders around the Basque Region and also, therefore, of costs associated with the protection of external markets and management of transactions with them. The more intense the relationship with the economy from which it is separating, the greater the impact of such costs will be. For this reason, it is relevant to analyse the intensity of this relationship by calculating the Spanish element in Basque trade. In other words, by analysing to what extent trade between the Basque Region and other Spanish regions is more vigorous than with other countries, all other things being equal – such as the size of their economies, distance, use of a common currency or membership of a free trade area. The empirical evidence shows that this Spanish element is very important. The Basque region trades between 11 and 16 times more with the rest of Spain than with any other country. This intensity indicates that the Basque region's trade flows would be difficult to replace and that, in the event of secession, their reduction would surely be matched by a fall in revenues as has happened in other European cases.

The effects of the establishment of borders which have just been alluded to, will in the end be shaped by the way in which corporate agents adapt their competitive strategies to the new institutional situation following secession. For this reason, it would be interesting to understand how Basque businessmen view the proposed political project which the Basque Government has been formulating since September 2002. From a survey conducted of a thousand non-financial, medium and large-sized enterprises in the Basque Region, we may conclude, firstly, that these companies are tightly bound to the Spanish national market, to the point that a good number of them have production and distribution facilities in that market as well as in the Basque Region. Secondly, businessmen indicate that, in recent years, both terrorism and the political situation in the region have had a significant effect – above and beyond such factors as demand, technological change and cost of capital – on their investment and location decisions. In around a third of cases, these factors have persuaded them to relocate to other regions. Thirdly, the survey highlights that businessmen have a negative view of the *plan Ibarretxe*[1], such that they believe not only that its implementation may harm their business but that it is already doing so, even before its formal legislative passage. And, finally, it reveals that four out of every ten companies have initiated a formal or informal evaluation of their future strategy and are considering various options. Of these, the most frequently cited is withdrawal from the Basque region through the transfer of their production activity or corporate headquarters to other regions in Spain.

Foreign investors form a business segment which is clearly important and which can be studied as a whole or in sectoral terms. Its interest derives not only from the

[1] Translator's note: the plan of the Basque Prime Minister Juan José Ibarretxe for greater autonomy in the Basque region.

importance that multinational companies have in driving regional development – both through their involvement in production and through their role in technology transfer – but also from the fact that their behaviour is usually very sensitive to political problems. In the case of the Basque region, using the available information about flows of foreign direct investment (FDI), we may conclude that, although their evolution has run parallel with that in the rest of Spain, the level in absolute terms has been very low – 3.5 per cent of the national total between 1988 and 2002 – and does not correspond to the relative size of the Basque economy. Therefore, the region has achieved 40 per cent less investment than should be expected given its size, with the flows of the last two years being particularly noteworthy when liquidations of investments have exceeded capital inflows, leading to a net deficit.

Earlier, I indicated that the costs of secession go beyond the effects arising from the creation of frontiers to the consequences of assuming powers of state. These imply carrying out spending programmes which may prove problematic to finance if tax revenues do not increase sufficiently. If we analyse the *household income account* prepared by the INE[2], we can see that the public sector balance is positive for the Basque Region. Unlike other Autonomous Communities with a high level of GDP per head, such as Madrid, Catalonia, Navarre or the Balearic Islands, the Basques make no contribution at all to the transfer of resources to other less developed Spanish regions; on the contrary, in 2000 it received 232 euros per person. Logically, this transfer would disappear in the event that the Basque region became independent from Spain.

If we consider the financial consequences of the *National Economic Agreement*[3], we can observe that there is a difference between the expenses assumed by the Autonomous Community in exercising their competences and the amount of taxes agreed to finance them, with the latter being very much higher than the former which leaves a sizeable margin in favour of the regional governments.

Thirdly, we can make an estimate of the costs which would apply to an independent Basque region in exercising the state competences that it currently does not have. Applying a methodology based on generally accepted criteria which take into account the divisibility of expenditure, the determination of its beneficiaries and whether there are economies of scale, leads to a figure of 10,659 million euros for 2002. Of this amount, 5,664 million are related to the Social Security system, defined in terms of the National Accounts, and 4,995 million to the expenditure of the administrations, principally on foreign affairs, defence, economic policy and social protection. This amount would only be partially compensated for by the 6,474 million euros that the State would cease to obtain. Of this amount, 4,252 million is related to social contributions, 1,187 million to net tax revenues received by the Tax Agency and 1,035 million to the region's contributions to the State budget. Therefore, secession would involve an immediate public deficit for the Basque Government of 4,185 million euros, which is the equivalent of 9.3 per cent of GDP. However, this amount could be less if instead of the above methodology, the state competence related expenditure is estimated using the system applied in the calculations of the national economic agreement. In this case, the total expenditure would amount to 8,487 million euros and the deficit to 2,013 million, or in other words only 4.5 per cent of GDP. Therefore, it is clear that secession,

[2] Spanish National Institute of Statistics

[3] Aan agreement signed between the State and an autonomous community whereby the community is empowered to set up and regulate its own autonomous tax system, in coordination with the national tax structure, and contributes in exchange an annual quota to the national exchequer.

whatever hypothetical situation is adopted, would involve a deterioration in welfare, since these public deficit figures (which would be well in excess of the values allowed by the Treaty of Maastricht in the context of the European Union) would have to be financed by removing resources from citizens through increased taxes and social security contributions; or, alternatively, through a reduction in public services, including social benefits.

Finally, if the fundamental aspects of the Social Security system are examined, taking into account the behaviour of the variables which shape it, a diagnosis of the current situation indicates that population ageing, which is more marked in the Basque region than in Spain as a whole, has begun to have an impact on the system. Moreover, the labour market, which generates less employment in the Basque region than the national average, does not help to mitigate the effects of this ageing. This is reflected in a financial situation which in 2002 was in deficit, with the imbalance between income and expenditure managed via the Central Treasury for Social Security amounting to almost 128 million euros, of which 41 million corresponded to the difference between contributions and pension payments.

If, on this basis, we project recent system trends up to the year 2010, the results indicate that for this time horizon the number of people liable to pay contributions will increase by 12 per cent and the number of pensioners by around 11 per cent. If the bases of contribution converge towards the rate of inflation, tax revenues will increase by 35 per cent above their current levels; but the number of pensioners will increase by 46 per cent because of demographic pressure. As a consequence, at the end of the current decade, the deficit will be multiplied by a factor of thirteen, reaching an amount greater than 525 million euros. In other words, the pensions system currently enjoyed by citizens is unsustainable in an independent Basque region; or to put it another way, only their integration in the Spanish Social Security system guarantees the rights acquired by more than 400,000 pensioners living in the region. This is because this system permits territorial transfers between Autonomous Communities where resources exceed expenditure and those, such as the Basque region, which have deficits.

Finally, we must consider the monetary aspects of secession. In order to have some freedom of movement in its economic policy, an independent Basque region would be forced to create its own currency, since the temptation to retain the euro unilaterally – and it would not form part of the euro area – would not be sustainable because of the rigidities it would introduce. Basically, these would arise because it would not be possible to set an exchange rate in harmony with the situation outside and because it would prevent the existence of a Basque Central Bank able to act as the lender of last resort in the financial system. Adopting a new currency has its own adaptation costs – which in the banking and commercial sector alone we can estimate would exceed 100 million euros – as well as currency exchange transaction costs estimated as 1 per cent of annual GDP. Added to this, there would be general uncertainty on the sustainability of the exchange rate between the new currency and the euro, which must have a negative effect on exports and inflows of foreign capital.

A prospective analysis of the exchange rate evolution tells us that, although the initial objective of the monetary authority would be to maintain parity between the new currency and the euro, external tensions would force an increase in interest rates and currency devaluation leading to a floating exchange rate. The consequence of all of this would be none other than a general increase in uncertainty in an inflationary scenario, high costs of capital and an external deficit, which would put the economy into recession. In these circumstances, the Basque region could not easily reintegrate into the euro zone, since even if it managed to overcome the political difficulties of accession to the European Union, it would have to comply with the strict Maastricht criteria for entry into the Monetary Union. This would take several years to achieve. And even if it were to achieve it, the way in which the European Central Bank is organized would mean that it would have a very limited ability to influence decisions on the single monetary policy, since it would only participate in a third of the votes of the Governing Council whereas Spain would participate in four fifths of them.

The conclusion to be drawn from my analysis is very simple: what secession promises is not prosperity, as the Basque nationalists like to say, but completely the opposite. An independent Basque region would suffer serious economic difficulties resulting in a loss of welfare for its citizens. They would find fewer employment opportunities and would be haunted by the spectre of unemployment; they would have to accept more modest public services and at the same time would pay higher taxes; the welfare state – and, within it, pensions as its principal instrument – would be severely cut back; and, they would be shrouded in a climate of general uncertainty for a long period of time.