Assessment and recommendations

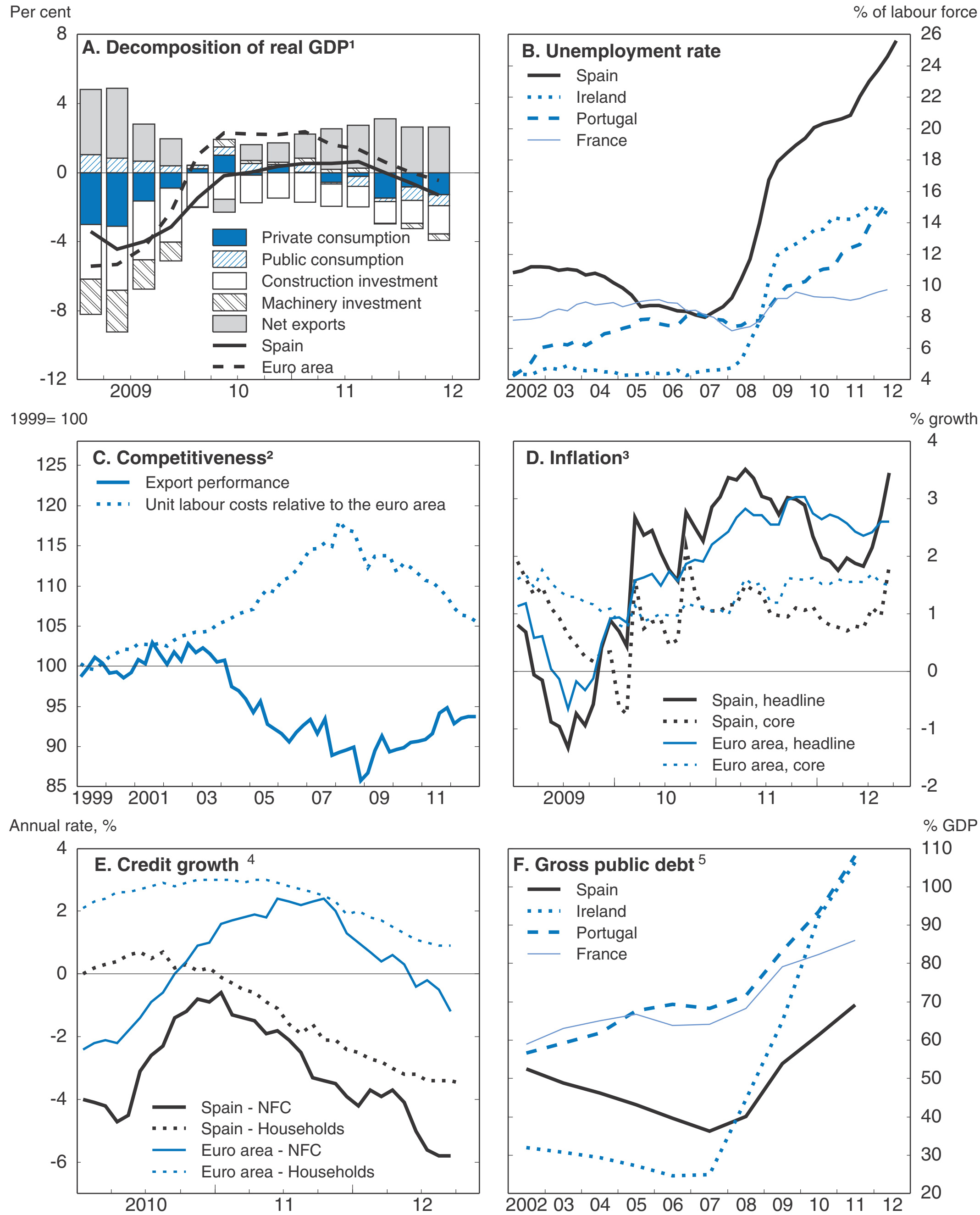
The economy is suffering a protracted recession

The economy is undergoing a prolonged recession since the outbreak of the global crisis in late 2008. The bust of the housing boom and persistent domestic structural weaknesses, especially in the labour market, have been compounded by the European debt crisis. Deleveraging in the private sector has resulted in a contraction of domestic demand, adding to mass unemployment and generating high government deficits (Figure 1). The feedback loops between confidence in government solvency and banking sector health, which reflect in part the absence of appropriate euro area institutions (OECD 2011a, 2011b), have resulted in high risk spreads on interest rates for government debt (Figure 2). This in turn has raised funding costs for banks and has kept lending conditions tight.

Exceptional liquidity provision by the European Central Bank (ECB) has only provided a temporary relief. Private external funding has been increasingly withdrawn and ECB funding for the banks has filled the funding gap. As a result, the net negative position of the *Banco de España* (including the Target 2 balance) vis-à-vis the eurosystem has risen, mostly reflecting recourse of Spanish banks to ECB long-term funding, while foreign holdings of Spanish bank and government debt have diminished markedly. In the short term, there is a substantial risk that the economy, notably the banks, will remain cut off from external funding. This would deepen the recession, especially if measures taken at the European level prove ineffective in easing tensions in interbank and sovereign markets. However, the rapid introduction of common bank regulation and direct recapitalisation of banks with euro area funds may eventually diminish the negative feedback loops between bank financial positions and sovereign spreads. Launching the new unlimited bond-buying programme (OMT) in the context of an EFSF or ESM programme would also help to reduce spreads on sovereign debt.

Against this adverse backdrop, the immediate policy priority is to restore confidence in the banking sector by rapidly recapitalising viable banks with capital shortfalls, resolving orderly non-viable banks and isolating doubtful assets into a an asset management company as foreseen in the Memorandum of Understanding agreed between the Spanish and the European authorities in the context of the requested external financial assistance for the recapitalisation of financial institutions. Exiting the negative feedback loop will also require a credible medium-term strategy to return public finances to a sustainable path, as well as making bond holders contribute to bank recapitalisation and loss absorption in banks. The government has responded to these challenges with a wide-ranging programme, including substantial budgetary consolidation and the reinforcement of budgetary rules, as well as labour market and banking sector reforms. Based on these ambitious reforms and a Memorandum of Understanding agreed with the European Union, the government can use the loan of up to 100 billion euros (9½ per cent of GDP) granted by euro area governments to recapitalise Spanish banks. These reforms have the potential to generate significant

Figure 1. **Recent macroeconomic developments**



1. Contributions to growth, year-on-year. The lines represent real GDP growth.
2. Unit labour costs for total economy. Export performance is the ratio between export volumes and export markets for total goods and services.
3. Inflation is measured by the year-on-year change in the consumer price index. Core inflation excludes food and energy.
4. Loans adjusted for sales and securitisation. NFC: non-financial corporations. Households includes non-profit institutions serving households.
5. Maastricht definition.

Source: OECD (2012), *OECD Economic Outlook: Statistics and Projections* and *Main Economic Indicators Databases*, November; and ECB (2012), Statistical Data Warehouse, European Central Bank, November.

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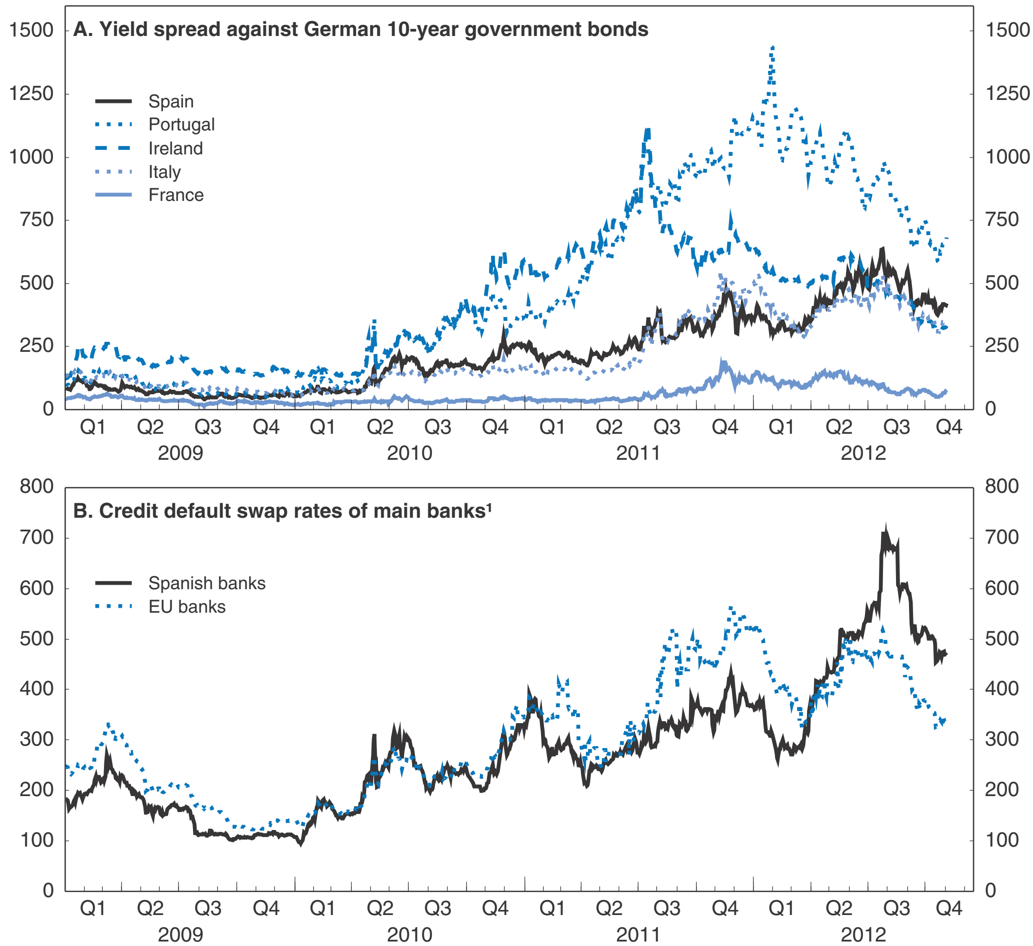
Figure 2. **Recent financial market developments**

Basis points



1. Credit default swaps, 5-year senior debt, mid-rate spreads between the entity and the relevant benchmark curve. Spain is an unweighted average of the four main banks. The EU average is calculated by Datastream and includes around 60 banks.

Source: *Datastream Database* (2012), November.

StatLink http://dx.doi.org/10.1787/888932740214

improvements in economic performance and should be actively pursued. Beyond these immediate needs, further structural reforms are needed to raise employment and productivity performance, improve competitiveness, and reduce risks of poverty and social exclusion, notably among the young. A credible policy strategy in this area would also bolster confidence in the short term.

This *Economic Survey* examines policies to improve financial market confidence as well as structural reforms required to boost growth and reduce imbalances, and achieve fiscal consolidation. Chapter 1 discusses progress in deleveraging in the private sector and policies to redress the banking sector. This is followed by an analysis of how to facilitate the integration of young workers, one of the most challenging issues in the labour market (Chapter 2).

The economy has contracted since the third quarter of 2011 due to lower public and private consumption and investment (Figure 1). Lower spending reflects deleveraging in the private sector and budgetary consolidation, both of which are needed to eliminate imbalances. Net lending to the private non-financial sector has turned negative. The unemployment rate has risen to 24% and above 50% for youth. The adjustment of residential housing construction is well advanced, as housing starts have fallen by 90% from their 2007 level, while the number of finished houses has dropped by about 80%. The share of housing investment in GDP has fallen from 13 to 6¼ per cent, reaching historical minima, although it is still higher than in many OECD economies. Export performance has been relatively strong. Relative unit labour costs have fallen since 2009 on the back of sharp productivity gains. These gains are mainly explained by cuts in low-productivity jobs, mostly temporary and construction sector jobs and further gains depends on the ability of finding new sources of productivity growth. In fact, employment costs accelerated in 2011, reflecting inertia in wage setting, including indexation to past inflation. Nevertheless, newly signed contracts stipulate considerably lower wage growth.

Overall, further output and employment losses are projected in 2012 and 2013, while inflation is expected to be subdued after a VAT-related spike in prices in the 3rd quarter of 2012 (Table 1). There are downward risks to the projection in 2013 if access to private external funding remains tight and capital outflows continue. Public debt may differ from

Table 1. **Short-term economic outlook**[1]

	Current prices, EUR billion	Percentage change, volume					
		Outcomes			Projections		
	2008	2009	2010	2011	2012	2013	2014
Gross domestic product	1 087.7	-3.7	-0.3	0.4	-1.3	-1.4	0.5
Private consumption	622.4	-3.8	0.7	-1.0	-1.9	-2.3	-0.5
Government consumption	212.0	3.8	1.5	-0.5	-4.1	-4.0	-0.8
Gross fixed capital formation	312.0	-18.0	-6.2	-5.3	-9.1	-9.0	-2.7
of which: Residential	117.8	-23.1	-10.1	-6.7	-6.7	-4.4	-2.7
Final domestic demand	1 146.4	-6.2	-0.8	-1.8	-3.9	-4.0	-0.9
Stockbuilding[2]	4.7	0.0	0.1	-0.1	-0.0	0.0	0.0
Total domestic demand	1 151.1	-6.3	-0.6	-1.9	-3.9	-4.0	-0.9
Exports of goods and services	288.2	-10.0	11.3	7.6	4.0	6.4	6.2
Imports of goods and services	351.5	-17.2	9.2	-0.9	-4.5	-1.3	2.4
Net exports[2]	-63.3	2.9	0.3	2.3	2.6	2.5	1.4
Memorandum items:							
GDP deflator	..	0.1	0.4	1.0	0.3	0.7	0.4
Harmonised index of consumer prices (HICP)	..	-0.2	2.0	3.1	2.2	1.2	0.4
Core HICP (excluding food and energy)	..	0.9	0.8	1.2	1.0	0.9	0.4
Private consumption deflator	..	-1.1	2.0	2.9	2.2	0.8	0.3
Unemployment rate	..	18.0	20.1	21.6	25.0	26.9	26.8
Household saving ratio[3]	..	17.8	13.1	11.0	9.3	7.7	7.7
General government							
Financial balance[4]	..	-11.2	-9.7	-9.4	-8.1	-6.3	-5.9
Gross debt[4]	..	62.9	67.7	76.9	93.8	100.2	105.3
Gross debt (Maastricht definition)[4]	..	53.9	61.5	69.3	86.1	92.6	97.6
Current account balance[4]	..	-4.8	-4.5	-3.5	-2.0	0.5	1.8

1. National accounts are based on official chain-linked data which introduces a discrepancy between real demand components and GDP. For further details see *OECD Economic Outlook*, "Sources and Methods" at *www.oecd.org/eco/sources-and-methods*.
2. Contributions to changes in real GDP (per cent of real GDP in previous year), actual amounts in first column.
3. Defined in gross terms, per cent of disposable income.
4. Per cent of GDP.

Source: OECD (2012), *OECD Economic Outlook: Statistics* and *OECD Economic Outlook 92 Database*, November.

what is projected here, owing to uncertainty concerning the extent of bank recapitalisation by the government. On current rules, European funds to recapitalise banks are included in public debt and the transfer of impaired legacy assets to an asset management company (AMC) is foreseen to be largely funded by debt issued by the AMC and guaranteed by the government.

The current account deficit has fallen markedly but the trade balance will need to improve further

Both falling imports and rising exports (Figure 3, Panel B) have markedly narrowed the current account deficit (Figure 3, Panels A and B) and the net foreign liability position of the economy has stabilised, though at a high level of close to 90% of GDP. This position reflects net financial liabilities, whereas the foreign direct investment balance is broadly balanced (Figure 4). To some extent, the improvement in the trade balance reflects the impact of the output gap (which is larger than in main trading partners) on the trade balance. The cyclically-adjusted trade balance is therefore likely to be currently in deficit even though the actual balance was in surplus in the second quarter of 2012. Export performance held up relatively well compared to the other large economies of the euro area since the introduction of the common currency (see also OECD, 2010a for a discussion of related issues). In recent years Spain has gained market share (export performance has improved since 2008, as illustrated in Figure 1), part of these gains being explained by improved cost competitiveness, with unit labour costs falling in all sectors, notably in the manufacturing sector.

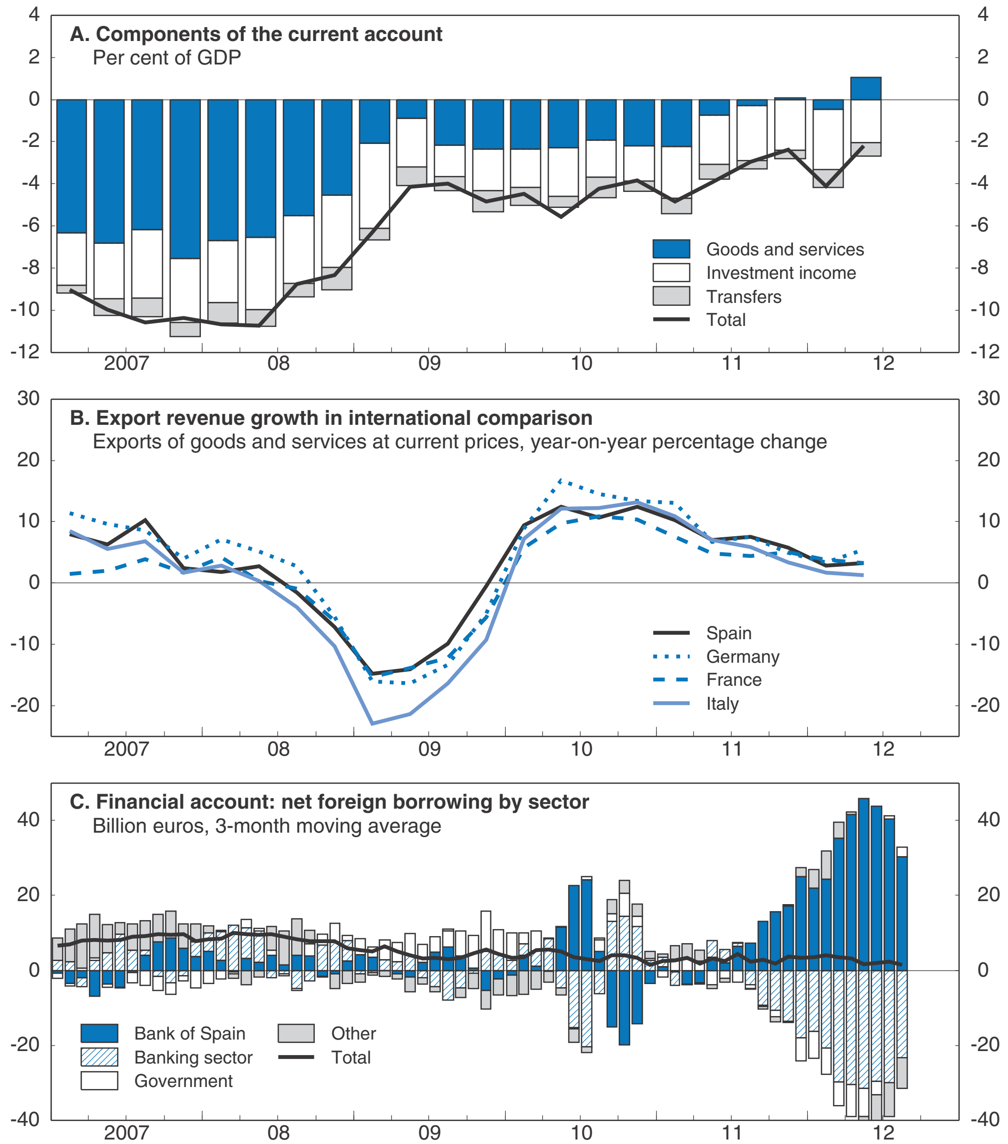
The high net foreign liability position will need to fall to reduce vulnerabilities. Assuming trend nominal GDP growth of 3% (broadly consistent with the current estimate of potential growth of the OECD), a current account deficit of less than 3% of GDP would be needed to begin reducing it. Moreover, even if the nominal return on net foreign liabilities were contained at 4½ per cent in future years, which is still above the current average return on foreign liabilities observed in 2012, the trade surplus may need to stay above 1%.

Restoring banks' access to funding is the most urgent priority

Wholesale funding conditions have also deteriorated substantially, including in the largest, internationally diversified banks which are only modestly exposed to domestic credit and the housing market, although the situation improved somewhat following the announcement, in September 2012, of the new unlimited bond-buying programme (OMT) in the context of an EFSF or ESM programme.

Credit ratings of banks depend to a large extent on sovereign ratings. The reduced value of the implicit government guarantee results in poorer funding conditions. Conversely the risks to government finances resulting from implicit guarantees led to a deterioration in sovereign ratings (Schich and Kim, 2012). Domestic retail funding appears to have broadly held up so far. A contained trend decline in deposits held by the domestic private non financial sector reflects to some extent household financial investments in government debt and commercial paper, declining gross household financial wealth and fluctuations in typically volatile business deposits. However, as the experience of Greece and, more recently, Italy shows, more significant reductions in deposits could occur, and deposits of non-residents have declined significantly.

Figure 3. **Developments in the balance of payments**



Source: OECD (2012), *OECD Economic Outlook: Statistics and Projections Database*, November; and Banco de España (2012), *Boletín Estadístico Database*, November.

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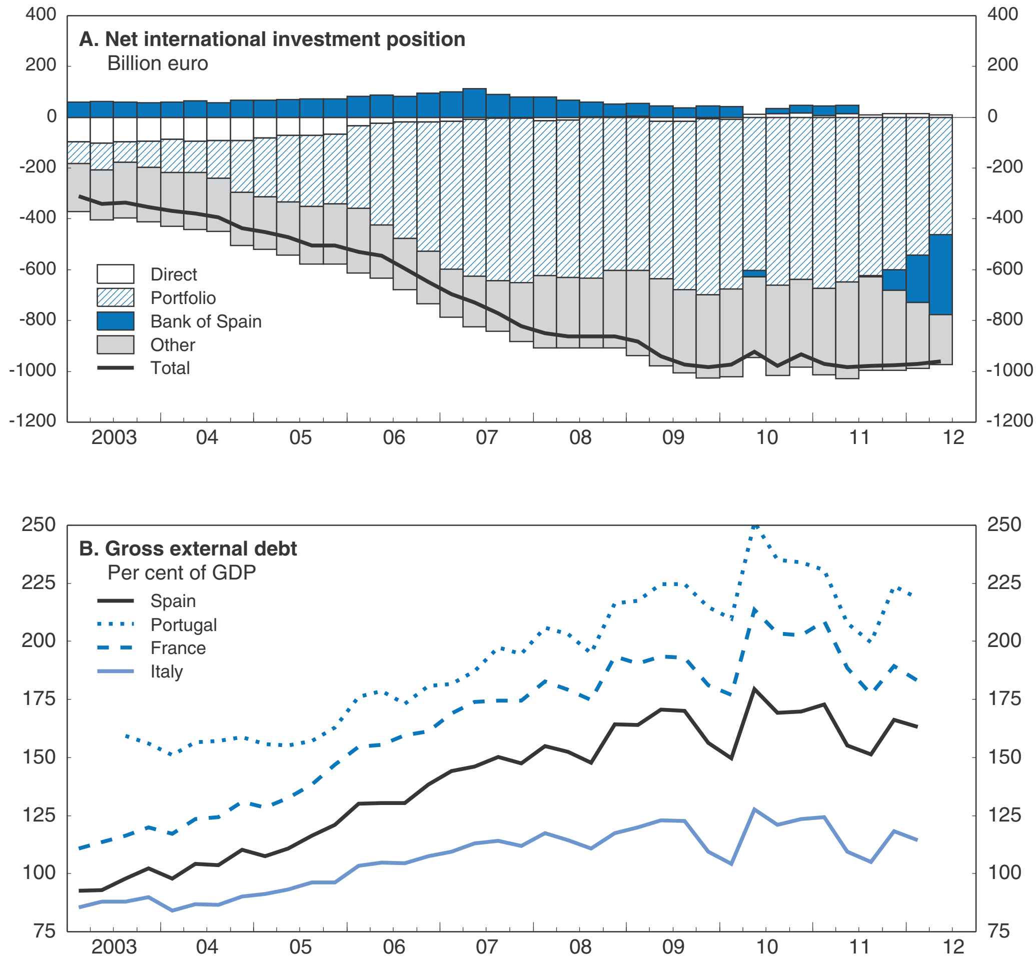
The ratio of doubtful loans (non-performing loans and loans which are performing but for which there are doubts as to repayment prospects) accelerated. This ratio is expected to rise further as economic activity continues to decline. Despite falling net lending, private sector debt burdens relative to GDP have been diminishing only slowly since they peaked in 2008, and remain high in international comparison, especially in the non-financial business sector. To a considerable extent, this reflects low growth of nominal GDP in comparison to countries which have deleveraged more quickly. For household mortgages, doubtful loan ratios have remained low so far, in part reflecting some regulatory safeguards taken in the boom period, as well as the prevalence of variable-rate mortgages and high net wealth relative to income by historical standards.

Figure 4. **Net foreign asset position and gross external debt**



Source: Banco de España (2012), *Indicadores Económicos Database*; World Bank (2012), Quarterly External Debt Statistics (World DataBank); and OECD (2012), *OECD Economic Outlook: Statistics and Projections Database*, November.

StatLink http://dx.doi.org/10.1787/888932740252

The banks' total exposure to real estate development (including repossessed real estate) reached 28½ per cent of GDP at end-2011, of which half was classified as "problematic" (that is, doubtful loans, loans showing more general weakness in repayment prospects as well as foreclosed assets). To accelerate loss recognition on real estate exposures the government has required banks to build up buffers worth about 45% of the total exposure to real estate development, which have to be in place by June 2013. While these buffers were assessed to be broadly adequate in the recent *Financial Sector Assessment Programme* (IMF, 2012), the policy has not stabilised financial market confidence, in view of the impact of the ongoing recession on banks assets more generally.

The government asked for an independent detailed stress-test on the whole portfolio of individual banks, which was conducted between June and September 2012. Under an adverse scenario, involving a significantly worse macroeconomic outlook than is currently projected, 7 banking groups representing 38% of the banking sector would need 53.8 billion euros (5% of GDP) more capital, once ongoing mergers (and some tax effects) are taken into account, and 59 billion euros without considering projected mergers. The stress testing exercise has been comprehensive and takes into account detailed information of balance sheets and loan portfolios of individual banks. It has been conducted under the supervision of European Union institutions (The European Commission, the ECB and the European Banking Authority) and the International Monetary Fund, and provides a solid assessment of the capital needs.

Up to 100 billion euros (9½ per cent of Spanish GDP) from a loan obtained from euro area governments may be used to cover capital shortfalls. Based on the Memorandum of Understanding agreed on 20 July, by end-October 2012 the banks will have to present plans to meet capital needs identified in the analysis of individual bank balance sheets, specifying requested public capital injections. These plans must be implemented by June 2013. The Spanish authorities should stand ready to react in the future if the economic situation deteriorates significantly beyond the prudent stress test assumptions.

Steps have been taken to accelerate the restructuring and resolution of banks

To stabilise the banking system and restart lending, the authorities need to promptly recapitalise viable banks in need of capital, as set out in the Memorandum of Understanding, while quickly resolving non-viable banks (see *e.g.* Bouis and Cournède, 2012). The lack of incentives for weak banks to recognise losses could slow the reallocation of credit and resources to productive use. It could also undermine confidence in the financial system as a whole owing to the financial links between the banks. With hindsight, several banks were resolved orderly too late, only in 2011. Numerous weak savings banks were merged into large institutions, supported by the government, even as late as 2012, and the financial market reform legislated in May reintroduced some incentives for banks to merge.

Mergers may not raise efficiency and can create large, weak institutions, aggravating issues of too big to fail. In fact, some merged institutions have themselves had to be resolved orderly or nationalised eventually, notably the 4th largest banking group, BFA, which the government has nationalised. In orderly resolving non-viable banks, mergers of weak banks should therefore be avoided. Government recapitalisation will be based on the needs identified by the independent assessments of individual bank balance sheets in order to ensure the adequacy of capital buffers. This avoids the perception of soft budget constraints in partially or fully nationalised banks.

Bank resolution procedures were reformed in 2009 but continued to fall short of the Key Attributes of Effective Resolution Regimes for Financial Institutions issued by the Financial Stability Board. As required by the Memorandum of Understanding, the Spanish authorities introduced legislation to notably accelerate resolution of non-viable banks in August 2012. This legislation is welcome. The legislation should be used to override shareholder rights, for example, to avoid that incumbent shareholders hold up decisions of the resolution authorities on the transfer of assets of banks subject to resolution and to impose losses on creditors. However, the new legislation specifies that losses be imposed on owners of hybrid capital and subordinated debt instruments only but not on senior debt. The Memorandum of Understanding also provides a timetable for restructuring and addressing viable banks' capital needs, with all significant capital needs met by end-2012, and for orderly resolving non-viable banks. It foresees transferring impaired legacy assets to an asset management company, and measures to strengthen the supervisory and regulatory framework to improve crisis prevention in the future.

The separation of legacy assets from all banks in need of public support in a dedicated asset management company, as foreseen in the programme, should improve confidence in the banks and focus bank management on the lending and deposit-taking business. The legislation requires that private capital contributes to the funding of the asset management company. However, most funding needs will be covered with the issuance of bonds guaranteed by the Spanish government, which exposes government finances to financial risks. It is therefore important that legacy assets transferred are conservatively priced. The Memorandum of Understanding foresees that legacy assets be priced at "long-term economic value" which risks pricing them above what current market conditions warrant. A relatively high transfer price also risks reducing the extent to which bank creditors take losses, even though the Key Attributes of Effective Resolution Regimes (Financial Stability Board, 2011) require only that owners of bank debt should not recover more funds than they would in case of liquidation. Legacy assets transferred to the asset management company should be conservatively priced. Another option would be to use bank debt that has been selected for loss absorption (see below) to help fund the transfer of assets from a bank with solvency problems to the asset management company.

Resolution of non-viable banks needs to impose losses to some creditors to protect tax-payers better

To protect the taxpayers and avoid aggravating feedback loops between government finances and the financial systems, some bank creditors should be forced to bear losses in the current crisis, as foreseen in the Memorandum of Understanding. Previously losses emerging in the resolution of insolvent banks were largely been borne by the deposit insurance fund, which is funded and managed by the banking sector. Losses born solely through the deposit insurance fund could impose a heavy burden on viable banks through their contributions to the deposit insurance fund. If the government were to take a larger share of these losses, this would risk impairing financial confidence further as it would deteriorate the fiscal position. Moreover, in both cases moral hazard is aggravated. Forcing bank creditors to assume losses in the context of bank resolution, as foreseen in the Memorandum of Understanding is, hence, welcome. So far, equity holders have generally been wiped out, while subordinate debt holders have been protected in full (Schich and Lindh, 2012), although such debt is contractually required to absorb losses in the event of bankruptcy.

A first option would be to require only holders of subordinated debt and lower-ranked hybrid capital to take losses (also called "bailing-in"), as foreseen in the Memorandum of Understanding, especially since *Basel III* solvency requirements emphasise the role of higher-quality capital, making the issuance of subordinate debt less important in future. Banks have substantial amounts of subordinated debt outstanding, amounting to 83 billion euros at end-2011 (8% of GDP). This policy should also be applied to absorb losses of banks which are recapitalised by the government rather than resolved orderly.

As many banks have sold preferential shares and subordinate debt to their retail customers, without necessarily providing transparent information about the risks, smaller haircuts need to be imposed on such investors in the interests of consumer protection. Even so, it should be noted that about half of subordinate debt issued by Spanish banks has been subscribed by institutional investors, where consumer protection concerns do not apply, offering ample room to apply bailing-in to these investors. To prevent recurrence of such practices in the future, it is important to investigate responsibilities of bank management in breaking consumer protection rules and review the effectiveness of consumer protection rules. Steps to limit the sale of hybrid capital instruments to private households were taken in legislation introduced in August 2012.

Banks have recently reduced hybrid capital and subordinated debt buffers by buying back such instruments or transforming them in part into deposits, perhaps in order to protect their relationships with clients or raise reported profits. This may have reduced the availability of these instruments for loss absorption, including in cases where such instruments are held by institutional investors. The authorities should be proactive in preventing any payouts or repurchases of capital when the capacity of loss-absorption is compromised. By contrast, their conversion in equity is desirable. Banks' operations reducing their hybrid capital and subordinated debt buffers should be closely supervised and stopped if these operations reduce the amount of funds which may be needed for absorbing losses. The bank supervisor, the *Banco de España*, needs to be endowed with the powers to take such action. Moreover, the provision in Memorandum of Understanding, which requires the *Banco de España* to stop banks which may need public support from repurchasing such debt instruments at above market price +10% may not be satisfactory, as market conditions may be difficult to observe and market prices depend on the announced bail-in policy. Contagion risks could also be reduced by giving depositors strict preference over other types of bank creditors. It is also appropriate to fund remaining costs of bank resolution with contributions paid by the banks, spread over time. These contributions, which should be separated from the contributions to deposit insurance, should be assessed on the total of bank balance sheets.

Potential fiscal costs could be reduced further by imposing losses on senior debt, in addition to subordinated debt, for banks in orderly resolution procedures. Such a bail-in would need to be carefully designed (IMF, 2012b). Contagion risks may be limited in a context of comprehensive bank restructuring, in which all non-viable banks are orderly resolved and viable banks with capital needs comprehensively recapitalised.

Reform of bankruptcy procedures can accelerate restructuring

Effective mechanisms to deal with bankruptcies among non-financial businesses and private households can accelerate the recognition of losses on loans that creditors cannot repay and can help to reallocate resources to productive use (IMF, 2002). These mechanisms appear to be relatively poorly developed in Spain (Mora and Fuentes, 2012 and references therein). Recourse to judicial bankruptcy proceedings is much lower than in other high-income economies. The procedures appear to be relatively slow and expected costs for entrepreneurs from undergoing such procedures are unusually high, in part reflecting personal liability clauses which are unusual in other countries and the absence of the possibility of full discharge of over-indebted creditors ("fresh start") in most cases. Creditors' recovery of loans from firms undergoing bankruptcy appears to be relatively low, although few firms appear to avoid liquidation and survive on the back of restructuring of their debt (Mora and Fuentes, 2012 and references therein). Bankruptcy proceedings for non-financial businesses should be reformed to raise their efficiency. For example, steps could be taken to accelerate judicial proceedings and to reduce expected costs to managers by limiting the threat of sanctions and widening the applicability of debt discharge. The government is planning to review bankruptcy legislation in order to address shortcomings in bankruptcy procedures for firms, which is welcome.

Ineffective bankruptcy rules may also hold back productivity performance in the longer term by biasing investment decisions (Mora and Fuentes, 2012 and references therein). Firms and their lenders in Spain may avoid the bankruptcy system by making extensive use of the mortgage system, which provides more effective protection to creditors. Ineffective bankruptcy rules may therefore strengthen incentives to invest in assets that can serve as mortgage collateral, notably construction and real estate, to the detriment of investment in assets which cannot serve as collateral, such as human capital or technological know-how, even if such investments are more profitable.

Box 1. **Key recommendations to exit the banking crisis**

- Viable banks with capital needs should be recapitalised promptly based on the capital needs identified by independent assessments of individual bank balance sheets and non-viable banks should be resolved in an orderly manner as soon as possible, as foreseen in the Memorandum of Understanding.
- Holders of subordinated debt and lower-ranked hybrid capital instruments should absorb losses of banks that are resolved or are recapitalised by the government, as foreseen in the Memorandum of Understanding, and financial operations of banks reducing the amount of loss-absorbing bank debt should be prevented. Where consumer protection concerns exist, smaller losses may be imposed on retail investors.

The government has introduced large front-loaded budget consolidation

The general government deficit of 9.4% of GDP in 2011 overshot the original target agreed with the EU by 3.4 percentage points. This figure includes ½ percentage point of expenditure reflecting financial support to banks that can be considered of a one-off nature. The overrun occurred mostly due to weaker revenue than expected, whereas the consolidation commitments undertaken in 2010, which focused on spending reductions (OECD, 2010a), were largely kept. Non-interest government spending fell significantly (Table 2). Most of the deviation from the target occurred at regional government level, in part because regional governments were hit by falling revenues from housing transactions, which fully accrue to them, and because of the rigidity of education and health spending, which account for a large share of their budgets (see OECD, 2010a for a review of budgetary policy issues at regional government level). To some extent the sensitivity of tax revenues to domestic demand reflects the characteristics of the tax structure, with higher VAT rates applying to consumer durables, the sales of which have fallen particularly strongly. The strong transmission of fluctuations in output to employment, which is relatively heavily taxed (see below), also plays a role.

In view of the deficit overrun and deteriorating growth prospects, the government agreed new deficit objectives with the European Union on 10 July 2012 (Table 3). The delay by one year to meet the 3% deficit target is a welcome decision as trying to meet it despite a deteriorating economic situation would have been self-defeating. The national targets have been distributed across the levels of government. The contribution of regional governments to budget consolidation is important because they account for about 35% of general government spending. Hence all levels of government will need to make a substantial contribution to consolidation.

Table 2. **General government revenue and expenditure**

Per cent of GDP

	2000	2007	2010	2011
Total revenue	38.2	41.1	36.6	35.7
Total current revenue	37.6	40.6	36.5	35.8
Households taxes	7.1	8.2	7.6	7.6
Corporate taxes	3.2	4.8	1.9	1.9
Indirect taxes	11.4	11.6	10.5	9.9
Social security contributions	12.9	13.0	13.4	13.2
Other current revenue	3.1	3.0	3.2	3.2
Capital revenue	0.6	0.5	0.0	-0.1
Total expenditure	39.2	39.2	46.3	45.2
Total current expenditure	36.1	35.4	43.0	42.9
Government consumption	17.1	18.3	21.4	20.9
Social security benefits	12.0	11.6	15.4	15.4
Interest/property income paid	3.2	1.6	1.9	2.5
Other expenditure	3.7	3.8	4.2	4.1
Gross saving	1.5	5.2	-6.4	-7.2
Capital expenditure	3.1	3.8	3.3	2.2
Investment	3.2	4.0	4.0	2.9
Capital transfers	-0.1	-0.2	-0.7	-0.7
Net lending	-1.0	1.9	-9.7	-9.4
Gross debt (Maastricht definition)	59.4	36.3	61.5	69.3
Structural budget items, as a per cent of potential GDP				
Structural current spending	37.3	37.0	40.2	39..8
Structural current revenues	37.7	40.6	36.4	35.7
Structural balance	-2.1	0.3	-6.6	-5.5
Structural primary current spending	34.0	35.4	38.4	37.5
Structural primary balance	0.8	1.4	-5.4	-4.4
Memorandum items:				
Potential output growth	3.9	3.1	1.4	1.3
Output gap	2.7	2.7	-5.4	-6.1

Source: OECD (2012), *OECD Economic Outlook: Statistics and Projections Database*, November.

Table 3. **Fiscal targets 2012-14 for general government**

In per cent of GDP

	2011[1]	2012	2013	2014
General government financial balance	-9.4	-6.3	-4.5	-2.8
of which: Autonomous regions	-3.3	-1.5	-0.7	-0.1

1. Budget outcome.

Source: Ministerio de Hacienda y Administraciones Públicas.

Meeting these deficit targets could allow public debt to stabilise relative to GDP by around 2014. According to OECD estimates, the targets require a reduction of the primary structural budget balance of 4% of GDP in 2012 and 2½ per cent in 2013, assuming economic activity evolves broadly as projected in Table 1. A further consolidation effort of 1¾ per cent of GDP is needed in 2014 even if GDP grows in line with potential (estimated at 1.2% by the OECD). If growth turns out somewhat smaller, as projected, consolidation needs may be somewhat larger. The structural consolidation needs are smaller according to the Spanish authorities owing to different assumptions on potential growth of the economy. In any case, the new targets remain challenging, given the macroeconomic context. Meeting the headline deficit target for 2014 will involve a large structural surplus according to OECD estimations of the output gap (which are larger than the estimates of the Spanish authorities). According to estimates of the government, the headline deficit target in 2014 is still projected to imply a structural deficit of 1.7% of GDP.

Budgetary measures introduced this year and next broadly match the consolidation needs in 2012 and 2013 estimated by the OECD (Table 4). The consolidation package announced in July 2012 includes significant tax increases, notably a 3 percentage point rise in the standard VAT rate to 21% while the 8% rate is raised to 10%, and the lowest rate remains at 4%. Some goods and services are also moved from the 8% rate to the standard rate. Cuts in expenditures are also significant, with notably the disappearance of the 14th month of salary for public employees in 2012 (except for workers earning less than 962 euros per month), the public employment freeze and a reduction in public employees' sickness benefits as well as a reduction in the unemployment benefit replacement rate for new unemployment spells from the 6th month onwards to 50%.

Table 4. **Expected improvement of the general government budget balance from measures taking effect in 2012 and 2013**

Per cent of GDP

	2012	2013
Expenditure	**2.6**	**1.8**
Public employment	0.5	-0.2
Labour market policies	0.2	0.4
Social spending other than health or education (mostly long-term care)	0.0	0.1
Other central government spending	0.8	0.4
Other specific regional government measures (may include revenue measures)	0.9	0.7
of which: Health and education spending	0.5	0.6
Reform of local government and local government measures (may include revenue measures)	0.1	0.3
Revenue	**2.2**	**0.8**
Nation-wide taxes	1.5	0.7
of which: VAT	0.1	0.8
Other indirect taxes (mostly fuel tax)	0.0	0.1
Personal income tax	0.4	0.3
Real estate tax	0.1	
Tax amnesty	0.2	-0.2
Corporate tax	0.6	-0.3
Other	0.0	0.0
Regional government revenue measures	0.5	
Social security contributions		0.2
Fight of social security fraud	0.2	
Total	**4.8**	**2.6**

Source: Ministry of Finance and Public Administration.

In August 2012, the government extended budgetary plans to the year 2014 with additional spending cuts of about 1% of GDP. A large part of these proposed savings are expected from measures that regional and local governments are expected to take to meet their deficit targets, and from a reform of local government, which is not legislated yet. Several of these measures have yet to be further specified. Measures in this order of magnitude would only offset part of the revenue losses as temporary measures introduced earlier on drop out. Temporary measures include notably the increase in personal income and real estate taxes, which are programmed to be phased out in 2014. Most of the corporate tax measures simply brings revenues forward and thus have no permanent effect. The salary cut in civil servants' pay may also not result in durable spending cuts as the salary payment will be reintroduced in 2015 as a compulsory contribution to a funded pension scheme, on the condition that the deficit targets are met. In addition, cuts in the level of public salaries are hard to sustain because they could induce hiring difficulties in the long term.

There are still risks that the budget deficit may exceed the target this year and next. In 2012 they mainly relate to the recapitalisation of banks by the government, some of which might count as expenditure, although they are one-off effects. The depressing impact of weakening domestic demand on tax revenues may in addition be underestimated. Some of the measures, notably the one-off tax amnesty, are uncertain in their budgetary effects. Additional measures are likely to be needed to meet the headline deficit target for 2014 according to OECD estimates. In any case, the measures need to be spelled out in more detail.

To improve confidence in government finances, further permanent deficit-reducing measures may need to be introduced, while minimising their regressive impact, if any, and, in any case, measures already planned specified in full, while paying careful attention to a fair burden sharing of consolidation efforts to maintain social support since fiscal consolidation episodes tend to be regressive (Ahrend *et al.*, 2011). To bolster confidence it will be important to rapidly stabilise the public debt to GDP ratio. Nevertheless, if output growth proves well below projections it would be counterproductive to offset such risks and the government should let automatic stabilisers operate, at least partially.

Ambitious budgetary rules have been introduced

National budgetary rules introduced in 2012 require the general government budget, as well as the budgets of each of the central government, the regions, the municipalities and the social security system, to be in balance structurally from 2020 onwards. They also limit the growth of government expenditure in line with recent EU rules (Box 2). The rules also strengthen central government oversight of regional governments and their budgetary reporting. The requirement to report regional budgetary data on a monthly basis will be effective from October onwards, improving rapid detection of changes in budgetary developments. Moreover, the government has set up a fund worth 18 billion euros which can lend to regional governments requiring official support to cover funding needs at their request. So far, six regional governments have announced that they will request to borrow from this fund. To avoid moral hazard, loans from the fund are subject to conditionality, along the lines of the budgetary rules described in Box 2, although regions will be subject to closer oversight by the central government and can be subjected more quickly to sanctions. It is critical that the new requirements on the publication and control of regional government budgetary policies are strictly implemented. Earlier in the year, the central government had also offered liquidity assistance for local and regional governments, subject to conditionality, to cover supplier payment arrears. Local governments have received 9.5 billion euros (0.9% of GDP) and the regions 17.7 billion euros (1.7% of GDP) under this programme.

Box 2. **New budgetary rules apply from 2012**

In April 2012, legislation came into force requiring a structural fiscal balance and limiting public debt to 60% of GDP in 2020 onwards. It also limits government spending growth to nominal national medium-term GDP growth at each level of government with immediate effect. A higher structural deficit of up to 0.4% of GDP would be allowed when structural reforms with a positive medium-term impact on the budget are implemented. The regional governments and the central government may also record a temporarily higher deficit in specific situations. By 2020 general government debt must be reduced by at least 2 percentage points of GDP per year if annual real GDP growth or net employment growth reach at least 2%, until debt falls to 60% of GDP. The general government structural deficit has to be reduced by an average of 0.8% of GDP per year, to which the central and regional governments contribute. Any administration exceeding these ceilings will be banned from issuing further net debt. The law puts stronger requirements on reporting. Budgets must be presented in national accounts terms. Budgetary outcomes have to be presented on a monthly basis by the regions and on a quarterly basis by municipalities. If the central government detects risks of non-compliance it can issue an early warning, after which the administration concerned has one month to take action. If actions taken are deemed insufficient, the central government can intervene by, for example, withdrawing the authorisation for the administration concerned to issue debt, or intervening in discretionary spending and revenue decisions.

If an annual target is not met a plan has to be developed to correct the deviation within one year. If that plan is not met, a sanction regime applies. The administration breaching the target will not have access to additional credit and will have to deposit 0.2% of its nominal GDP at the Bank of Spain. These funds can only be withdrawn once corrective measures are implemented. If this is not done within 3 months, the administration will have to pay interest on the deposit and after another 3 months it becomes a fine. Moreover, a “no bail out” clause applies, according to which higher-ranking levels of government may not assume the commitments of lower ranking ones.

The newly introduced fiscal rules have the potential to substantially improve the commitment to reach the target of a balanced budget and it is advisable to allow some experience to accumulate before considering substantial changes. In the meantime, the authorities could consider potential improvements to be introduced at a later stage. Steps can be taken to improve the design of budgetary rules by offsetting deficit overruns with additional consolidation measures in subsequent years. In the “debt brake” rules in Germany and Switzerland, such overruns are booked in a compensation account. If its balance exceeds a set threshold it must be reduced over time. Specific budgetary rules would be useful for the central and regional governments, where control of structural budget balances over the cycle is especially important.

As a complementary tool to the introduction of fiscal rules, the government should set up an independent fiscal council, as required in the recommendations adopted by the Council of the European Union. Such a fiscal council should notably provide the government and the public with independent analysis of the impact of fiscal policy, including through independent fiscal projections at all levels of government. It could also exercise more normative mandates so as to help reduce the pro-cyclicality of fiscal policy and reinforce fiscal discipline on all levels of government. Such a body could help “depoliticise” decisions to sanction regional governments that have not abided by the rules. For it to be effective in this role, the fiscal council needs to be designed as a truly independent body, which is unelected, but accountable, and with a term structure for its management board which does not coincide with the political cycle. It should be included in fiscal policy formulation and in the monitoring process. The government should be required to consider the recommendations by the agency and if it chooses not to follow the recommendations of the new fiscal council, the government should be required to publically justify its actions (Hagemann, 2010).

Pension reform has damped the expected increase in ageing-related spending but further reform is necessary

Pension spending as a share of GDP had been due to increase from 10% of GDP in 2010 to 16½ per cent of GDP by 2060. However, the pension reforms introduced in 2011 are expected to reduce the projected increase in annual pension spending from 6½ per cent of GDP to about 3% of GDP, in part by raising the legal retirement age to 67 for workers who have contribution periods shorter than 38.5 years (see MinEH, 2011a for more details). This estimate of future pension spending assumes that the parameters of the pension system will be adjusted in such a way as to offset the impact on pension spending of further increases in life expectancy from 2027 onwards. However, no specific adjustment has yet been proposed. Without it, pension spending is projected to rise by 3.6% of GDP by 2060. An indexation formula linking pension system parameters to changes in life expectancy should be introduced as soon as possible. The expected increase in health and long-term care spending, while subject to more uncertainty, is estimated at 2% of GDP. It is expected to be partly offset by a fall in education and unemployment spending of 1.6% of GDP. Savings in future pension spending can be achieved by reforming survivors' pension benefits in the light of high labour market participation of young women, by focusing such benefits more closely to cases of need, as recommended in the 2010 *OECD Economic Surveys*. Such steps would also improve the fairness of the pension system.

Despite the 2011 pension reform, the pension system continues to generate unnecessary disincentives to supply labour in the formal economy. In particular, in the reformed system, which applies to all workers entering the labour market, pension benefits are determined by the level of earnings in the last 25 years before retirement and the maximum pension entitlement is attained after 37 years of contributions. These settings do not sufficiently acknowledge long contributory careers, penalise people with stable earnings throughout their working lives and do not incentivise extending working lives after the relevant periods of contributions have been attained. These settings encourage workers and their employers to only partially declare earnings before they reach the last 25 years of the active working life, and not to declare any revenues in some years. The accrual rate in the pension system should be lowered so as to require a longer contribution record to obtain the full pension entitlement at the legal retirement age. Earnings throughout active working life should be assessed for the calculation of pension benefits. These steps would also help further moderate the projected increase in pension spending.

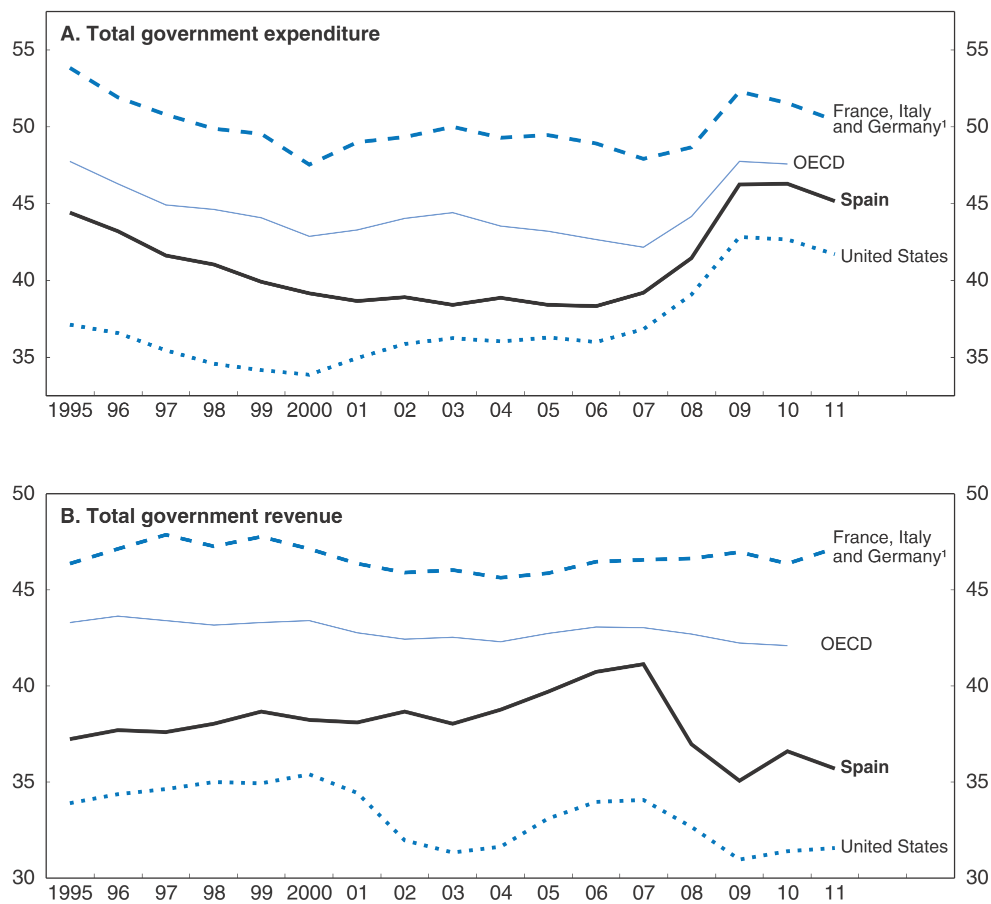
There is also scope to further reduce effective public subsidies to early retirement through extended unemployment benefit payments, although these measures should be considered as relatively low priority at present, in view of the difficult situation in the labour market, the low budgetary cost of the benefits concerned and the low educational attainment of many unemployed older workers, which limits the resulting loss in potential output. By contrast remaining partial retirement subsidies are paid to workers in employment who reduce their hours worked. These are costly to the budget so should be eliminated as soon as possible.

Budgetary consolidation should be combined with a reform of the tax system, notably to make it more green-growth friendly

Since 2010 substantial measures have been taken to reduce government expenditure. These measures have included reductions in government employment, wage cuts, and reductions in public investment and transfers. Most recently, they have also included cuts in education and health spending. Scope for achieving substantial and sustainable spending cuts within a relatively short period of time may now be reduced and the efficiency savings from public sector reform may take more time to materialise. Public spending is relatively low by international standards (Figure 5), despite high unemployment benefit spending. Government spending on health and education as a share of GDP is modest in international comparison, and OECD indicators of efficiency of health care systems across OECD countries (Joumard *et al.*, 2010) point to relatively efficient use of the public resources in health services. Public health insurance and policies to foster access to education are key instruments to reduce inequality (Joumard *et al.*, 2012). Cuts in the coverage provided by public insurance may result in the expansion of private health insurance without appropriate equalisation

Figure 5. **Government expenditure and tax revenue in selected OECD countries**

Per cent of GDP



1. Unweighted averages. For the OECD aggregate 2010 is an estimate and Chile, Japan, Mexico and Turkey are excluded.
Source: OECD (2012), *OECD National Accounts Statistics Database*, November.

StatLink http://dx.doi.org/10.1787/888932740271 mechanisms, which can result in higher total health care costs and inequality. Reducing inequality also calls for room to be made for expanding access to education (see below). In this context, the tax-raising measures announced on 13 July to achieve further budgetary consolidation are welcome. In the near term, tax increases are likely to have less negative impacts on activity than expenditure cuts. However, tax measures need to be designed in a growth-friendly way. While the government package appropriately relies mostly on consumption taxes, some further improvements could be made (see below).

The Spanish tax system remains relatively heavily geared towards the taxation of labour, notably through social security contributions (Table 5). A reduction of employers' social security contributions would be welcome. By contrast, indirect tax revenue has been

Table 5. **Structure of tax revenue**

In per cent of GDP

Tax revenue by sector as a percentage of total tax revenues, 2010[1]

	Personal income tax	Corporate income tax	Social security contributions	Property tax	Goods and services tax	Other taxes
Spain	**21.7**	**5.5**	**37.7**	**6.1**	**26.7**	**2.2**
Australia	37.4	18.7	0.0	9.6	29.1	5.2
Austria	22.5	4.6	34.5	1.3	28.0	9.1
Belgium	28.1	6.2	32.5	6.9	25.4	0.9
Canada	35.0	10.7	15.3	11.3	24.4	3.3
Chile[2]	38.4	. .	6.9	3.6	51.3	-0.3
Czech Republic	10.3	9.8	44.7	1.3	33.4	0.6
Denmark	50.6	5.7	2.1	4.0	31.7	5.9
Estonia	16.0	4.0	38.7	1.1	39.8	0.5
Finland	29.7	6.0	29.8	2.7	31.5	0.3
France	16.9	4.9	38.8	8.5	25.0	5.8
Germany	24.4	4.2	39.1	2.3	29.5	0.5
Greece[2]	22.3	. .	34.6	5.6	37.1	0.4
Hungary	18.0	3.3	30.7	3.1	42.8	2.1
Iceland	35.5	4.6	11.6	6.8	35.5	5.9
Ireland	27.0	9.2	20.3	5.6	36.9	1.2
Israel	19.1	9.0	17.2	9.6	40.0	5.1
Italy	27.2	6.5	31.5	4.7	25.8	4.2
Japan	20.0	9.6	40.9	10.1	19.1	0.3
Korea	14.3	13.9	22.8	11.4	33.9	3.3
Luxembourg	21.4	14.4	29.6	7.2	27.1	0.3
Mexico[2]	28.6	. .	16.7	1.7	50.2	2.7
Netherlands	22.7	5.3	36.1	3.9	30.7	1.2
New Zealand	37.5	12.4	0.0	6.9	39.3	3.9
Norway	23.8	22.6	22.8	2.9	28.0	0.0
Poland	14.6	7.2	35.7	3.9	37.0	1.6
Portugal	17.9	9.1	28.8	3.8	39.6	0.8
Slovak Republic	8.2	9.0	43.3	1.5	36.4	1.6
Slovenia	15.2	5.0	40.3	1.6	37.3	0.6
Sweden	28.0	7.6	25.0	2.4	29.5	7.6
Switzerland	32.3	10.8	23.3	7.4	21.8	4.4
Turkey	14.1	7.3	24.5	4.1	47.9	2.1
United Kingdom	28.7	8.7	19.1	12.1	30.9	0.5
United States	32.0	10.9	26.2	12.9	17.9	0.0
OECD	24.7	8.4	26.6	5.5	32.5	2.3

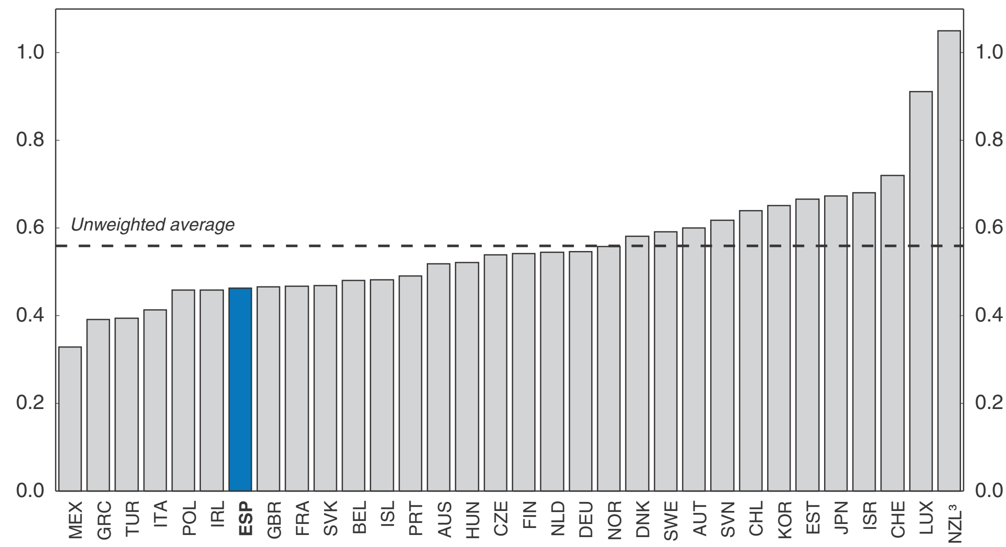
1. 2009 for Australia, Japan, Mexico, the Netherlands, Poland and the OECD aggregate.
2. Data shown in the first column covers both personal and corporate income tax.

Source: OECD (2012), "Revenue Statistics: Comparative Tables", *OECD Tax Statistics Database*, August.

relatively low so far. Taxation of personal income and labour earnings is more harmful for economic activity and employment than the taxation of the consumption of goods and services. Steps to broaden the VAT tax base are particularly welcome as VAT has been considerably less broad-based than in a majority of OECD countries (Figure 6), which tends to raise distortions. In 2012, several goods and services have been moved to the standard tax rate. However, a number of sectors continue to benefit from substantially reduced rates and the VAT tax base should be broadened further, moving most goods and services to the full rate. For example, tourism-related services and transport services are only taxed at 10%. Some paper products are only taxed at 4%.

Figure 6. **VAT revenue ratio**[1]

2010[2]



1. The VAT revenue ratio (VRR) is defined as the ratio between the actual value added tax (VAT) revenue collected and the revenue that would theoretically be raised if VAT was applied at the standard rate to all final consumption. This ratio gives an indication of the efficiency of the VAT regime in a country compared to a standard norm. It is calculated as: VRR = VAT revenue/([consumption – VAT revenue] × standard VAT rate). Consumption is final consumption expenditure from the national accounts (heading P3).
2. 2009 for Australia, Greece, Ireland, Netherlands and Poland.
3. New Zealand raised VAT from 12.5 to 15% in October 2010 which raises the average ratio in 2010 above 1.0.

Source: OECD (2012), *OECD National Accounts Statistics* and *OECD Tax Statistics Databases*, November.

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There is also room to remove exemptions and deductions in the taxation of personal income. These include significant deductions for contributions to personal pension plans. These deductions should be eliminated or reduced substantially. Tax deductions for pension plans, in particular, mostly benefit middle and high income households, up to a reduction of 10 000 euros of taxable income. Any positive impact of these deductions on private household saving is likely to have been more than offset by lower government savings and the rate of return on such pension plans may be significantly lower than the interest rate on government debt. Moreover, their elimination would not affect activity adversely. The government has decided to abolish the deductibility of mortgage payments for new mortgages, as required in the recommendations adopted by the Council of the European Union, which is welcome. It has also somewhat reduced tax subsidies for existing mortgages.

Environmental taxes raise revenue worth 1.5% of GDP, considerably less than in other European tax systems, where these revenues exceed 4% of GDP in some cases. Taxation of motor vehicle use is not sufficient to price in carbon externalities (OECD, 2012b) and tax advantages are granted to diesel-engines despite the risks they pose to human health. Agriculture is exempt from most environmental taxation. Introducing a national carbon tax should be considered, including on transport fuel. The government is planning to increase taxes on fuels, which is welcome. Other pollutants are only taxed in some autonomous regions although their environmental externalities extend beyond regional borders, such as sulphur oxides and nitrogen oxide. These should be taxed at the national level.

There is also scope for raising taxation of wealth, where tax rates are low and revenues raised modest (less than 0.1% of GDP). Moreover, inheritance taxes are a tool to make wealthy households bear a higher tax burden. In Spain some inheritance tax setting powers have been devolved to the regions. Since regions have competed for the richest households, tax rates are generally low and there is a risk that tax rates are lowest in regions with the highest concentration of wealthy households. Tax rates on relatively mobile tax bases with a marked redistributive objective are more appropriately set at the central government level, although, even then, tax rates must be limited to a level that is consistent with avoiding international capital flight. Inheritance tax setting powers should be attributed to the central government in full and tax rates raised. The rise in inheritance taxes could also reduce the frequent regressive impact of fiscal consolidations (Ahrend *et al.*, 2011), fostering its public acceptance.

There is also scope for reforming the tax system to make it more growth enhancing. Part of the revenues generated from a more wide-ranging reform of VAT, the elimination of tax deductions in personal income tax and from higher environmental taxation can make room for further reductions in social security contributions, provided the consolidation targets are met. These cuts in social security contributions could be targeted at low wage earners. Such a step could strengthen employment prospects and real incomes of low-skilled workers, whose employment prospects have deteriorated particularly markedly. Reductions of employer-paid social security contributions can improve competitiveness in the near term, notably in view of the inertia in the wage bargaining system. This inertia is likely to remain in the near term even after the reforms put in place this year (see below).

Part of the revenues generated by tax-revenue raising measures could also be used to pay higher child benefits to low-income families, with the benefits made conditional on attendance of continued full-time education when children reach the age of 16, when compulsory education ends. Such a step could help reduce early school drop-outs and help fight poverty, which is highly correlated with the presence of children in households, especially in Spain, where child benefits are low. Such a step could support activity, as the marginal propensity to consume of low-income households is likely to be relatively large, especially in deleveraging episodes.

Revenues from the taxation of immobile property depend heavily on the taxation of housing transactions, which discourages labour mobility, harming labour market performance (OECD, 2010a). By contrast, recurrent taxation of real estate has been found to be a relatively non-distorting tax. The increases in real estate taxes introduced this year should therefore be made permanent. Shifting towards taxation of real estate values would encourage the mobility of workers, fostering labour market adjustment. Moreover, the assignment of transaction taxes to the regions is particularly unsuited because of the volatility of revenues. Any remaining taxation of housing transactions should be assigned to the central government, which because of its size is better able to cope with the volatile revenue stream.

Box 3. **Key recommendations to put public finances on a sustainable basis and make the tax system more growth friendly**

- The government should aim at meeting its new headline deficit targets, unless growth is far lower than expected, in which case the automatic stabilisers should be allowed to operate, at least partially.
- Spell out the consolidation measures needed to reach the deficit target in 2014. Minimise their regressive impact, if any, to foster the social consensus around consolidation needs.
- Strictly implement control of regional government budget policies and the new requirements on the publication of regional government budget outcomes.
- Raise taxes on environmental externalities, including on transport fuels. Apply the standard VAT tax rate to more goods and services. Consider using some of the additional revenues raised though VAT and environmental taxation to further lower social security contributions for workers on low earnings. Make increases in the taxation of real estate values permanent and reduce taxation of housing transactions.

Progress in labour market reform is considerable but important challenges remain

In the context of a still weak outlook for output growth, Spain faces very high unemployment. Segments of the population that were already at a disadvantage before the crisis – young people, immigrants and temporary workers – have borne the brunt of rising unemployment. In April 2012, the unemployment rate of those aged less than 25 was 51.5%. The percentage of youth neither in employment nor in education or training (NEET) is close to 20%, one of the highest rates in the OECD. Moreover, the proportion of unemployed who have been out of work for more than 12 months rose to 43% at the end of 2011. The experience of previous severe economic downturns suggests that it may take a long time to absorb the large pool of unemployed.

The main challenges for the Spanish labour market are therefore to deal with very high labour market slack and to prevent unemployment from becoming permanent. At the same time, Spain is under significant fiscal pressure, making it important that measures are cost effective. Faced with this dilemma, it is key to:

- Implement reforms to address remaining structural impediments for firms to create jobs and improve competitiveness, notably as concerns employment protection and wage bargaining.
- Improve activation of the unemployed, by reforming placement services and scaling up of effective and well-targeted active labour market policies, especially for young workers.
- Improve relevant skills, notably for young people, by widening access to upper secondary education.

In February 2012, the government introduced a package of wide-ranging labour market measures. The measures took immediate effect by decree; the law has been in force since July 2012. In general, these reforms are a substantial step in the right direction. While it is still too early to assess the impact of the reform, there are areas where they need to be complemented so as to address these challenges, as described below.

Ensuring that employment protection is not a burden for hiring

Reform of employment protection legislation is key to reducing disincentives of firms to hire on permanent contracts. High dismissal costs on permanent contracts, as compared to temporary contracts, makes firms reluctant to convert temporary contracts into permanent ones, leading to a dual labour market (OECD, 2010a). High protection of workers on permanent contracts also reduces the responsiveness of wages to labour market conditions and makes the integration of young people into the labour market more difficult. Finally, it harms labour productivity by reducing the occupational mobility of workers with permanent contracts and the incentives of individuals and firms to invest in training on temporary jobs (Mora-Sanguinetti and Fuentes, 2012).

The 2012 labour market reforms aim at reducing duality. If a dismissal is judged unjustified, the maximum compensation is reduced to 33 days' wages per year of seniority (up to a maximum of 24 months), compared with 45 days (and a maximum of 42 months before). This applies to all new contracts and for future years of service on existing contracts. Justified dismissal carries severance pay of only 20 days' wages per year of seniority. A potentially important part of the reform is clarifying what justified dismissal means, as clarity will make it easier to use. This should help bring the reference down to 20 days wages per year of seniority. Firms no longer have to pay interim wages while judicial procedures are pending and collective dismissals have been made easier by doing away with the requirement of approval by a regional or the central government. All in all, employees have less incentive to go to court to claim that the dismissal would have been unjustified.

Under the new law, dismissal can be judged justified for economic reasons if the company faces a decline in revenues over three consecutive quarters as compared to the previous year. The possibility to shed labour in bad times should raise the incentive of firms to use permanent contracts and it should improve wage flexibility. In good times the reform should also facilitate restructuring and flexibility, but it remains to be seen how many dismissals will be judged as justified by the courts. In any case, severance pay for unjustified dismissal should be further reduced, as even at 33 days' wages, firing costs for unfair dismissals remain high in international comparison. In particular, the difference with respect to firing costs of workers on temporary contracts remains large. If the reform does not prove effective in reducing duality substantially, moving to a single contract with initially low but gradually increasing severance payments could reduce the difference in dismissal costs of temporary and permanent contracts.

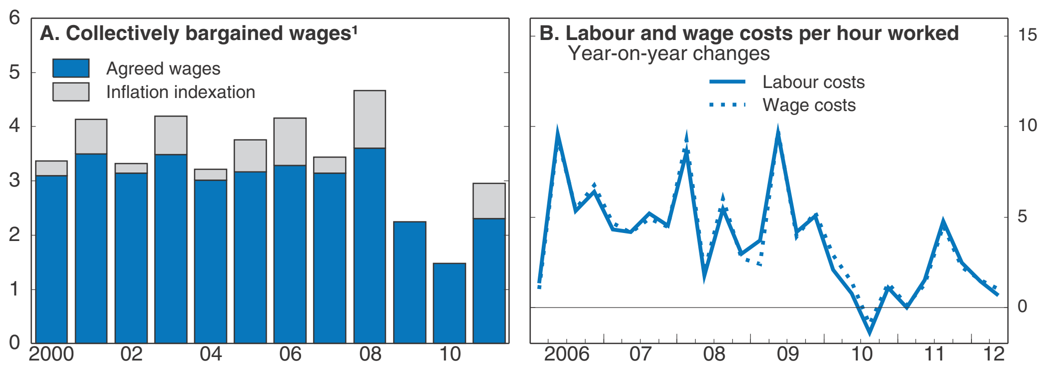
The 2012 reforms reinstate the limit of 24 months on the duration of fixed-term contracts, but this limit had little effect in the past. It can be circumvented by redefining the job and rehiring the same workers on another temporary contract after an unemployment spell. In the medium term, making employers' contributions to the unemployment insurance fund depend on the firm's dismissal history – such as the experience-rating of the unemployment insurance in the United States – could help reduce this risk and help reduce duality. It would, however, imply a *de facto* increase in employment protection, highlighting the need to revisit policy in this area.

Promoting job creation through more flexible adjustment of wages

Reform of collective bargaining is especially important to promote job creation through more flexible adjustment of wages and hours worked, thereby improving competitiveness. In Spain firms had limited leeway in adjusting working conditions to external or internal conditions, as reflected in collectively bargained wages that were increasing even in a situation of very high unemployment (Figure 7). This is due to a complex system of collective bargaining, predominantly at the sectoral or regional level, and the extension of such bargains by law to all firms of the same sector or region, even if they were not represented in the negotiations.

Figure 7. **Wage costs**

Per cent growth



1. Data for 2010 and 2011 are provisional.

Source: Ministerio de Empleo y Seguridad Social (2012), *Boletín de Estadísticas Laborales*; and Banco de España (2012), *Indicadores Económicos Database*, November.

StatLink http://dx.doi.org/10.1787/888932740309

The 2012 labour market reforms allow companies to reach firm-level collective agreements, removing the restrictions sector-level bargaining could impose on such agreements. Firms can more easily opt-out from collective agreements if employers and workers fail to agree; in this case, the reform introduced binding arbitration. Firms can unilaterally alter employment contracts. Finally, the reform limits to one year the maximum time period during which the conditions of a collective agreement remain in force beyond the period originally foreseen in the agreement.

These steps significantly improve flexibility of work conditions at the firm level, which is welcome. Nevertheless, some collective wage agreements may still apply up to 4 years as some are negotiated for 3 years and could be in force for another year following the foreseen end period. This could make wages less responsive to economic conditions, although the measures described above improve flexibility and nominal wage growth per worker fell to 0% in the second quarter. For firms failing to reach a firm-level agreement, legal extension will require them to apply higher-level agreements. The outcomes of new firm-level agreements are likely to remain conditioned by legally extended sectoral agreements, as these will in most cases provide the fall-back option if a firm-level agreement is not reached. However, high-level agreements may also become more flexible to changes in economic conditions in response to the implemented reforms. Moreover, individual firms cannot decide whether to participate in sectoral wage negotiations or not. Another option to avoid these drawbacks is to abolish legal extension and replace it by an opt-in system, where employers decide whether to be represented in sectoral wage bargaining.

Strengthening activation

Increasing job-search assistance for young people experiencing difficulties in finding a job has proven effective in other countries and is especially needed in Spain, in the light of the large share of young people who are neither in employment nor in education or training (OECD, 2010b). Also, in a recession, the lower opportunity cost of time spent on training makes it an especially opportune timing to increase them. Training would also help the unemployed acquire a different set of skills so as to prepare for a job outside their previous occupation. This is particularly important for Spain where the economic recovery requires significant structural change. The government is designing measures to address these issues.

While unemployment insurance has so far helped limit the social costs of the economic and financial crisis, rising long-term unemployment has lowered the coverage of unemployment insurance as benefits are being exhausted. Hence, effective placement services and activation of the unemployed are critical to lowering unemployment and avoiding it from becoming permanent. The 2012 reform authorises temporary employment agencies to act as placement agencies. This is welcome. However, requirements for benefit recipients to engage in active job search activities need to be better enforced, although some steps have been taken to make progress. The division of responsibilities may distort placement incentives for regional employment offices as regions do not receive the fiscal benefits of a reduction in unemployment. Comprehensive monitoring and evaluation of placement services and ALMP implementation at regional level, based on quantitative output indicators, help to improve incentives for regional employment services (OECD 2008, 2010a). Some steps are being taken in this direction.

While a wide range of hiring subsidies have been abolished in 2012, new subsidies were introduced for the hiring of vulnerable groups, including young people, by firms with fewer than 50 employees. The 2012 reform has scaled up subsidies for firms hiring workers on permanent contracts. The experience from previous downturns has shown that under conditions of very weak labour demand such incentives can jump-start job creation, in particular if targeted at vulnerable groups (OECD, 2010c). However, these subsidies should only be used as a temporary instrument while activity remains weak, and they should be applied only to most disadvantaged youth. Subsidies to private-sector employment otherwise have large dead-weight and substitution effects, which may increase with the recovery (De Serres *et al.*, 2010). Hence, as labour markets tighten, most schemes will ultimately yield little in terms of net employment gains, but will be costly for public finances. This indeed was the experience in Spain in periods of economic expansion (OECD, 2010a).

Ensuring that youth acquire the skills needed in the labour market

The share of the low-skilled among all young unemployed has been particularly high in Spain in international comparison and has increased drastically since 2007, reflecting weaknesses in the education system and a poor school to work transition. Policy makers should encourage youth to stay in formal or vocational education to boost their skills and longer term employability. Two priorities stand out: reducing the high drop-out rate and improving vocational education.

The graduation rate from lower secondary education has been very low and has barely increased during the crisis, reaching only 75% in 2010. Relatively strict requirements to pass compulsory (lower) secondary education have contributed to frequent grade repetition and eventual high drop out from compulsory education. Besides the adverse effects on employability of the student, grade repetition creates large costs for the society as a whole. The government should narrow criteria for granting pupils' promotion to subsequent grades, and hence access to upper secondary education, on those core competencies that are instrumental for following any type of upper secondary education. At the same time, efforts should continue to raise educational outcomes.

Improved vocational education is needed to provide youth at risk of dropping out with work-related skills and an alternative option to attain upper secondary education. In Spain, the incentives for young people to follow vocational streams have been weak, as reflected in relatively low graduation rates from vocational programmes. Moreover, the skills acquired do not match those asked for in the labour market (OECD, 2008), linked to the limited participation of businesses in school-based programmes. An alternative option to acquire practical skills, the training contract, has proven unattractive, too. The skills acquired through these contracts have not been formally recognised, making young people reluctant to take on such jobs (OECD, 2007). Training contracts have also been typically too short for firms to draw a net return from the investment in the training.

The government envisages improving school-based vocational education and the training contracts. These two elements should be combined within a single scheme, the period for which training contracts are signed extended, and work-based training provided through training contracts alternated with school-based training. These reforms would raise the attractiveness of vocational training for both young people and firms: students would receive a wage and the contents of work-based and school-based training would be more closely linked. By paying wages, firms would participate in the financing of the system, and are expected to be willing to do so because they receive benefits in terms of access to a better workforce. The government should concentrate mainly on the provision of the school-based part of the training, increasing spending efficiency.

Box 4. **Key recommendations on labour market reform**

- Further reduce compensation for unjustified dismissal. If the reform does not prove effective in reducing duality substantially, a single contract with initially low but gradually increasing severance payments would help reduce the still large difference in dismissal costs between temporary and permanent contracts. This would reduce duality effectively.
- An option to improve the flexibility to react to economic conditions, is to abolish legal extension of higher level collective bargaining agreements or replace it by an opt-in system, where employers decide whether to be represented in sectoral wage bargaining.
- Extend access to training and job-search assistance for unemployed youth. Introduce comprehensive monitoring and benchmarking of placement services and ALMP implementation at regional level.
- Widen access to upper secondary education by narrowing criteria for grade advancement in lower secondary education to core competencies. Combine the school-based vocational education system and training contracts into one single scheme.

Reforms to raise productivity can strengthen competitiveness

Structural estimates based on the 2008 sectoral PMR indicators suggest that aligning product market regulation in network and services sectors with international best practice could raise the level of labour productivity in Spain by up to 7% over ten years (Arnold *et al.*, 2009). Were Spain to adopt best-practice regulation in sectors that are important providers of intermediate inputs to the economy, average annual MFP growth could be around 1.6 percentage points higher for the manufacturing sector and 0.8 percentage points for the whole economy over a 5-year period (Bourlès *et al.*, 2011). Both results assume best practice in each single sector and quick phasing-in.

The Spanish economy has experienced significantly weaker labour productivity growth than other OECD economies since the mid-1990s. In recent years labour productivity growth has accelerated, but this recovery is likely to have been due to cyclical and to other temporary factors related to the destruction of low-productivity temporary jobs, notably in the construction sector (Mora-Sanguinetti and Fuentes, 2012). Total factor productivity growth has been low across a wide range of sectors (Mora-Sanguinetti and Fuentes, 2012), suggesting that broad-based policy action could strengthen performance. Labour market reforms have an important role to play in raising productivity performance.

Empirical evidence suggests that part of the weak productivity performance is related to relatively low firm turnover and the large size of a relatively low-productivity small business sector (Mora-Sanguinetti and Fuentes, 2012). This evidence indicates that the barriers to entry and to firm growth hold back advances in productivity. Onerous regulation of employment relationships can raise the cost of employment, relative to self-employment, and would, therefore, be expected to create barriers for successful firms to grow. Growth of successful firms is a key driving force of output and productivity growth (*e.g.* Wong and Autio, 2005, and references therein).

OECD product market regulation indicators show that the administrative costs of creating a business are relatively high. Moreover, licensing requirements on large retail surface outlets remain onerous. Some entry barriers in the professional services also appear unnecessary, as qualification requirements are more stringent than in other EU countries. Entry barriers to road transport could also be reduced further (Annex A1). While recent reform has reduced the costs of creating a business, the number of procedures necessary to register a business is still relatively high as compared to other countries. The government has raised the minimum number of weekly hours that regional governments must allow retailers to be open (regions are free to allow more extensive opening hours, but not more restrictive ones). This limit, which is now quite low, should be raised substantially beyond what is currently planned. The government should also eliminate restrictions on pricing below cost. The government also aims to limit the range of activities which are restricted to specific professional groups and to eliminate barriers that are deemed unjustified for the access and exercise of professional services. All these measures are welcome. In addition, the costs of creating businesses should be reduced and sector-specific entry barriers eliminated, including for professional services as well as road transport.

Policies to ensure sustainable and efficient use of natural resources are critical to ensure sustainable expansion of activity. Water policies are particularly important in Spain, as scarcity is marked and water resources are used intensively. As recommended in the previous *OECD Economic Survey of Spain* water prices will need to rise further so as to reflect costs in full. Higher revenues from improved cost recovery would generate private funding for investment, providing near-term economic stimulus. Further steps need to be taken to halt excessive groundwater abstractions. Risks of regulatory capture of regulatory authorities by large water consumers should be reduced by widening the participatory approach to a wider set of stakeholders, such as scientists or representatives of institutions protecting local ecosystems. Benchmark regulation of water utilities would contribute to more efficient water supply and treatment services.

Box 5. **Key recommendations on product market reform**

- Further reduce the costs and procedures necessary to create businesses and eliminate sector-specific entry barriers, including for professional services as well as rail and road transport.
- Entry barriers for large-surface retail outlets imposed by regional governments should be lowered, and shop opening hours should be liberalised in those regions where restrictions remain. Raise the minimum opening hours regional governments have to apply.

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ANNEX A1

Progress in main structural reforms

This table reviews action taken on recommendations from previous *Surveys*. Recommendations that are new in this *Survey* are listed at the end of the relevant chapter.

Recommendations in previous Survey	Action taken since December 2010
Improve Fiscal Policy across levels of government	
Budget outcomes of regional governments should be published in a timely manner.	Since 2012 quarterly data on national accounting basis are published for Autonomous Communities. First quarter data were published in June, complementing the quarterly releases on a cash-basis. Legislation has been passed requiring the provision of monthly data on cash and national accounts basis for Autonomous Communities and on a quarterly basis for municipalities. The first monthly release on a cash basis was published in October.
Ensure that the budgetary rules across levels of government require substantial surpluses in periods in which economic activity is above the national potential. Rules concerning budget balances for the regional governments could be set as a function of the national output gap, rather than growth rates of output.	The new Organic Law on Budgetary Stability and Financial Sustainability requires all jurisdictions of general government to be at least in structural balance from 2020 onwards, taking into account the national output gap.
Make stronger use of benchmarking of regional government services with respect to quality and cost of services they provide. For instance, link transfers to poor regions to education outcomes, such as graduation rates in upper secondary vocational education.	Benchmarking of local governments is envisaged in the draft Law for Rationalisation and Sustainability of Local Administration to evaluate efficiency of expenditure and quality of services.
Grant the public policy evaluation agency a high degree of independence from the political process and ensure its findings are easily available to the general public.	The draft Transparency Act sets up a Transparency Agency, replacing the public policy evaluation agency. The appointment of its president will have to be accepted by a parliamentary committee. All assessments reports are published on the website.
Reduce ageing cost and improve fiscal sustainability	
Implement the increase in the legal retirement age from 65 to 67 years and begin indexing the statutory retirement age to changes in life expectancy.	The legal retirement age will rise gradually to 67 years from 2013 to 2027 for workers with contribution records of less than 38.5 years. An indexation mechanism has not been defined but a legal obligation exists to introduce one by 2027 at the latest and may be introduced earlier if the pension system is in deficit.
Base pension entitlements on a participant's lifetime earnings rather than the final 15 years.	The assessment base will rise to 25 years from 2013 to 2022.
Reduce the average annual accrual rate sufficiently to lengthen the duration of the contribution record needed to obtain a full pension.	The number of contribution years to qualify for the full pension gradually increases from 35 to 37 years, from 2013 to 2027 and the accrual rates are adjusted accordingly.
Reduce the duration and gradually phase out supplementary unemployment benefits paid to older workers until they reach retirement. Consider increasing the "bonus" for postponing retirement beyond the statutory retirement age. Abolish subsidies for partial retirement.	The age for receiving the unemployment benefits for older workers has been raised from 52 to 55 years. Discount and bonus payments for retirement before and after the legal age, respectively, were raised. Subsidies for partial retirement were removed, but partial early retirement is not subject to discounts.

Recommendations in previous Survey	Action taken since December 2010
Continue tightening eligibility for survivors' pensions through closer scrutiny of employability of beneficiaries. Phase out benefits to non-immediate family beneficiaries, and integrate survivor benefits more closely with own old-age pension benefits.	None.
Phase out special schemes and integrate them into the general public pension system. Introduce discounts for pensions of all civil servants retiring before the legal retirement age.	The special regimes for civil servants has been abolished for new workers. The special regimes for agricultural workers and for workers in households has been abolished for all workers.
Make the tax system more growth friendly	
Consider shifting some of the burden of labour taxes to consumption taxes, e.g. by reducing the use of preferential value added tax rates.	The standard VAT rate was raised by 3 percentage points and the reduced rate by 2 in 2012. Some goods and services were moved from the lower to the standard rate. Increases of environmental taxes are planned.
Consider reducing taxation of corporations. Phase out preferential rates for small businesses.	None.
Improve local government's reliance on real estate tax and abolish the local business tax. Lower taxes on housing transactions.	Real estate taxes were raised temporarily in 2012 and 2013 nation-wide. Tax subsidies for the refurbishment of private homes will be eliminated in 2013.
Improve the functioning of the housing market	
Eliminate or further reduce remaining tax subsidies for housing and for rental properties. Replace them with a means-tested cash benefit for low-income households, earmarked to rent payments.	Tax deduction in house mortgages will be removed for purchases as from 2013.
Improving the functioning of the labour market	
Further ease the burden on businesses to prove that dismissals are justified. Steps to reduce the duration of judicial procedures would also help.	The labour market reform legislated in July 2012 eases the burden on businesses to prove that dismissals are justified and reforms the judicial procedures for dismissals (Chapter 2). The administrative authorisation for collective dismissals has been eliminated.
Consider the introduction of a single work contract with gradually increasing severance payments according to length of service.	Unfair dismissal compensation was reduced and causes for fair dismissal were clarified. A new contract with a one-year probationary period, during which no dismissal compensation rights accrue, was introduced for firms with fewer than 50 employees (see Chapter 2).
Ensure that firms and workers can freely agree to opt out of higher level collective agreements.	Implemented.
Consider abolishing the statutory extension principle. Or replace it with an opt-in system that allows employers the choice of whether to adopt the agreement.	The period of validity of collective agreements beyond their expiry date if renegotiation fails was reduced to one year and prevalence was given to firm level agreements.
Encourage the elimination of inflation indexation clauses in collective bargaining.	The social partners' agreement of January 2012 encourages fixing wages according to productivity.
Redirect subsidies for hiring unemployed on permanent contracts to better targeted active labour market programmes (ALMPs).	Most subsidies have been eliminated except those for young workers at SMEs and for people with disabilities.
Provide the most disadvantaged youth access to closely monitored early activation and job-search assistance programmes.	It is planned to focus a gradual reform of ALMPs on youth.
Ideally, the responsibilities for funding of unemployment benefits and for managing the public employment services should be assigned to the same jurisdictional level (the central government). At least, introduce comprehensive monitoring and evaluation of employment services at the regional level, based on quantitative output indicators or targets. Successful regional placement services should receive a financial reward.	A new co-ordination scheme is in force. Regional employment services will be monitored and funds distributed in part according to performance. Evaluation mechanisms are planned.
Do not pay benefit payment retrospectively for the period prior to registration and make the first full interview mandatory at the time of registration. Increase the frequency of reporting of job search activity. Consider reducing the duration of unemployment benefit entitlements.	The unemployment benefit has been reduced for workers who have been unemployed for more than six months. Conditions for receiving the benefit have been strengthened.

Recommendations in previous Survey	Action taken since December 2010
Improving the integration of immigrants	
Improve the recognition of foreign qualifications through bilateral agreements with originating countries and an on-the-job skill assessment programme.	The central government has transferred funds to the autonomous communities to facilitate the recognition of professional competences acquired through work.
Improve public language training. Adapt the national system of language certification to the needs of the labour market.	None.
Allow non EU immigrants (with a valid permit) to hold jobs in at least some parts of the public administration.	None.
Further improving access to and quality of early childhood education	
Disburse central government subsidies for accredited childcare facilities in the form of vouchers to low income households with children, covering the full cost of a place in accredited childcare.	The central government plans to offer funding to regional governments in 2013, yet to widen public provision for 0-2 year-old children, although the available amount is not decided.
Raising the share of students graduating from upper secondary education	
Enforce the prohibition of raising fees from parents in publicly funded primary and lower secondary schools as well as of selection criteria. Ensure a level playing field in the rules assigning resources to public and publicly funded private schools.	None.
Link the disbursement of subsidies to upper secondary schools to the obligation of offering schooling free of charge.	None.
Widen the choice of options at the final stage of compulsory schooling and focus the conditions for granting pupils promotion to subsequent grades and access to upper secondary education more narrowly on those core competencies that are needed to follow any type of upper secondary education.	The government intends to undertake a review of all Secondary Education. It will open the choice of options at the final stage of compulsory schooling and focus teaching more strongly on core competencies.
Raise child benefits and make them conditional on continued attendance in full time education.	None.
Extend external testing at the school level to all regions, and use this to benchmark performance against targets.	National external testing and assessment for primary and secondary education are undergoing a review processes.
Widen autonomy of schools, notably with respect to hiring decisions of teaching staff and curricular content and give schools powers to hire, reward and dismiss teachers.	Steps are planned in the new Law of Education.
Strengthen higher education	
Publish the results of the national quality assurance agencies' assessments on a regular and comprehensive basis.	All the quality assurance agencies for higher education publish the evaluation reports on all programmes offered by universities on the web. These reports contain suggestions for improvement which are later monitored.
Remove the obstacles to university teachers moving to the private sector and participating in spin-off firms. Increase the freedom of universities to recruit non-permanent professors and to adjust all professors' remuneration according to performance.	The Science, Technology and Innovation Bill in force since 2011 provides a legal framework for collaborative research projects (including intellectual property rights). It promotes the sharing of technology between teaching and research on one side, and businesses on the other.
Introduce loans with income contingent repayments for all tertiary education students. Increase fees at public universities and introduce fees for tertiary vocational courses.	No action on loans since the introduction of interest-free loans for master's degree courses in 2007. Fees were raised in many universities in 2012.
Link university funding more strongly to indicators of teaching output. Strengthen further the independence of universities, notably with regard to the setting of contract conditions and pay.	None.
Raising the attractiveness of vocational and continuous education	
Open up the teaching profession in vocational schools more widely to practitioners.	A pilot programme launched for 3 years in 2012 facilitates knowledge transfer between schools and enterprises and will be evaluated. Legislation is being prepared to regulate apprenticeship contracts and dual VET.

Recommendations in previous Survey	Action taken since December 2010
Make the system of continuous training less complicated and less stringent and facilitate the access of small firms. Improve the options of firms as to the choice of training in order to ensure that it meets the actual training needs of the firms.	The labour reform has introduced competition in the selection of providers and centralised priorities with the Employment annual Plan. Training contracts have been reformed (see Chapter 2).
Introduce training vouchers to individual adults covering course fees and indirect costs such as foregone wages. Guarantee provider quality by ensuring that accredited training providers meet strict quality standards.	The labour reform introduces a voucher (cuenta formacion) that still needs to be developed.
Improving the functioning of product markets	
Increase the independence of sectoral regulatory bodies and strengthen their powers.	The independence of sector regulators was strengthened in 2011. From 2012 a new multisector supervision authority, the Comisión Nacional de los Mercados y la Competencia (CNMC) a will enforce competition policy and supervise telecoms, transport and energy, replacing the competition commission and the sector regulators. The new authority will have full independence from public and private entities. The appointment of the counsellors will be ratified by Parliament with a fixed, non-renewable mandate of six years. However, the board members of the disappearing independent regulators will be removed before their term ends. In telecommunications, some competencies will be moved to the government.
Further reduce barriers to the establishment of new firms.	In 2010 and 2011 several initiatives were implemented to facilitate the creation of businesses including shortening procedures to create limited liability companies to between 1 and 5 days. Local licensing are required to be abolished except for well-defined exceptions. The use of electronic systems was fostered to reduce the cost and time taken to create a business. Limits on the duration and cost of the notary and the registry procedures were imposed. In 2012 local license requirement schemes for shops and other consumer services with a surface of less than 300 m^2 were eliminated.
Reduce the regulatory obstacles to institutional investors' participation in venture-capital companies.	None.
Energy markets	
Reform the current system of energy generation capacity payments by providing a variable payment that is linked to the use of capacity.	The regulatory authority is working on a proposal. Some regulated payments for distribution, transport, availability of generation capacity, insular generation and other were cut.
Phase out regulated retail gas and electricity prices.	Regulated retail tariffs were raised by 7% in 2012.
Post and telecommunications	
Give the telecom regulator responsibility for consumer protection.	None.
Allow the regulator, in an explicit manner, to mandate the functional separation of the incumbent as a measure of last resort.	None. The government takes such decisions on the basis of information received by the regulator.
Ensure an appropriate level of access of competitors to the public postal network and ensure access to the address databases of the postal services incumbent.	None.
Transport services	
Make the tender of regional passenger rail transport services compulsory. Require the incumbent to make its rolling stock available with non discriminating conditions.	Implemented by the end of 2012. Passenger rail services will be fully opened to market entrants in 2013. The incumbent operator has been split into 4 companies.
Remove the constraints involved in obtaining a road freight haulage operating license and reform the authorisation process to make consolidation of firms easier. Ensure that road passenger transport licenses are tendered on a competitive basis without favouring incumbents.	A modification of road transport legislation is planned to harmonise it with EU regulation and simplify administrative obligations for operators. It also aims at strengthening competition in services tendered publicly.

Recommendations in previous Survey	Action taken since December 2010
Retail trade and professional services	
In retail trade, regional governments should reduce entry restrictions of large retail outlets. Shop opening hours should be liberalised in those regions where restrictions remain. Consider raising the national minimum which applies to the limit that regions can impose when regulating shop opening hours.	The government raised the national minimum on the ceiling regional governments can impose on opening hours from 72 to 90 hours per week and on opening during public holidays from 8 to 10 days. Touristic areas have been defined for which opening hours regime has been fully liberalised.
Amend the excessive and sometimes discriminatory restrictions in the pharmacies sector.	Measures to facilitate entry in the sector are under consideration.
The range of professional services for which Spanish regulation requires specific qualification requirements should be reduced.	A new regulatory framework for professional services is planned aiming at limiting restrictions to those considered necessary and proportional.
Savings banks	
Further reduce the role of regional governments in business decisions of the savings banks. Remove the requirement for regional governments to approve mergers of cajas.	Almost all savings banks have transferred their activity to commercial bank subsidiaries. Some have raised equity from external investors and have been recapitalised by the central government. Reforms have been introduced to their governance (see Chapter 1).
Create independent selection panels supplying a list of possible candidates for management positions in the savings banks.	None.
Reducing greenhouse gas emissions	
Review tax subsidies for energy efficiency. Use the tax system to internalise externalities instead. Consider raising taxes on the use of fossil fuels further and introduce a congestion toll.	Incentives for renewable energy were abolished The government is preparing a draft law on energy market reform. To pay for cumulated deficits between regulated electricity prices and costs a 6% flat tax rate on electricity activity and specific taxes on different sources, including nuclear energy and coal combustion, were introduced.
Support the elimination of the EU rules that allow the sale of only up to 10% of the permits	Implemented.
Review the cost effectiveness of the feed-in tariff regime for renewable electricity sources.	Subsidies have been temporarily stopped for new renewable energy generation plants A review of the Renewable Energy Plan 2011-2020 is foreseen.
Managing water resources efficiently	
Ensure that competencies over water resources that are shared to a significant extent across regions are clearly assigned to the respective river basin authorities and the central government. Ensure a proper co-operation between the different levels of government in the management of water resources.	In 2012 steps were taken to preserve the principle of unity in water management and to promote greater co-ordination. The legislation to transpose of the EU Water Framework Directive in national law ensures administrative co-operation as regards the protection of water resources with the Competent Authority Committees (CACs) created for the river basins involving several autonomous regions.
Reduce risks of regulatory capture of regulatory authorities by large water consumers, by widening the participatory approach in water management to a wider set of stakeholders, notably in river basin authorities. Include scientists and representatives of institutions protecting local ecosystems.	The participation of different stakeholders has been strengthened following the transposition of the Water Framework Directive into domestic law.
Ensure that prices reflect more fully all the costs involved in the provision of water services, including environmental and scarcity costs. Develop methods to determine valuations for the environmental impact of water abstractions. In the short term, ensure that subsidies for irrigation modernisation are conditioned on reductions in the amount of water that is designated in concessions.	None.
Review the method of calculating capital costs and ensure full cost recovery. Consider allowing prices to generate sufficient revenue to fund replacement investment and to fully take into account administration and management costs. Harmonise criteria on the attribution of costs to services with public goods characteristics. Extend water pricing on the basis of volumes consumed, especially in irrigation.	None.

Recommendations in previous Survey	Action taken since December 2010
Improve the transparency of the costs of water provision services, making them comparable at the national level. Such data should be used to benchmark costs of service providers. Apply benchmark regulation to prices and quality of service.	Legislation in 2011 has clarified cost-based pricing in some cases, notably in private provision. The government has announced its interest in developing a National Water Plan that contributes to greater administrative co-ordination and greater consistency in water management.
Consider introducing a tax on the consumption of pollutants, for example on nitrogen or on phosphorus. Complement it with specific action programmes for designated areas vulnerable to nitrate contamination and by subsidies to support pollution minimising cultivation, especially in the driest water basins.	None.
Extend water banks to more river basins. Ease restrictions on the trade of water concessions. Introduce regulated third-party access to private infrastructure. Reconsider the requirement not to sell water to users considered to be of lower priority in the law.	None.
Use economic instruments, including tenders or auctions, for the assignment of new water concessions and for the replacement of expiring concessions instead of granting them for free.	None.
Reinforce the monitoring of groundwater abstractions. To this end, endow the river basin authorities with the necessary financial and human resources. Review the sanctioning regime by making it more transparent for water users and by ensuring that sanctions are graded and proportionate to the offence.	Monitoring is being reinforced in line with the provisions of EU law. The rules on penalties have been updated and powers to sanction have been reinforced.
Allow the introduction of a charge for groundwater abstractions to cover the cost of administering and enforcing the groundwater rights and to internalise the common-resource externality.	None.

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