

## Assessment and recommendations

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### *The recovery from a deep recession is set to be slow*

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After a decade of rapid growth, Spain entered a recession of unprecedented depth and length in 2008. While the size of the contraction of output was broadly similar to that of other European economies, it has resulted in a massive rise in unemployment. The recession accelerated the adjustment of the current account deficit built up as a result of dynamic growth of private sector indebtedness, which had funded strong business and residential investment. The economy resumed slow expansion in the first half of 2010, but growth is expected to remain subdued owing to the necessary further adjustments in the housing sector and a high degree of private indebtedness. As a consequence, unemployment is expected to remain high. While fiscal consolidation will put an additional drag on the recovery in the short term, it is crucial to improve confidence among domestic and international economic agents.

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### *Addressing investors' confidence on fiscal sustainability is essential to foster the recovery*

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Owing to relatively prudent fiscal policy prior to the crisis, the government had fiscal space to allow the automatic stabilisers to operate fully and to support the economy through significant discretionary fiscal measures. These countercyclical policies account for around 40% of the deterioration of the fiscal position from a surplus of 1.9% of gross domestic product (GDP) in 2007 to a deficit of 11.1% in 2009. The remainder was structural, mainly reflecting a long-lasting decline in tax-rich domestic demand and lower potential GDP growth associated with the rise in structural unemployment. This deterioration in the structural fiscal balance combined with the expected increase in ageing spending, which will accelerate around 2030, has raised concerns in financial markets regarding fiscal sustainability. Sovereign spreads reached a peak in May 2010, prompting the government to take additional fiscal consolidation and structural reform measures. These measures, combined with the effect that the launch of the European Central Bank Security Market Programme to buy government debt and the announcement of the European Financial Stabilisation Mechanism had on euro area government bond markets, provided some relief. After the adoption of these measures, funding costs for the government fell and funding conditions for banks eased. While perceived uncertainty with regard to the exposure of banks to the residential housing sector contributed to a temporary increase in interbank funding costs relative to other euro area countries, the banking sector as a whole

has withstood the crisis well, emerging from it with abundant capital and provision buffers, owing notably to prudent financial supervision.

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### *The government has adopted a wide-ranging policy response*

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Investors' risk assessments of bank and government debt remain well above pre-crisis levels. In particular, if the high sovereign spreads persist, funding conditions in the private sector could be affected. The government has responded to this challenge with a wide range of ambitious measures, including a substantial, front-loaded budgetary consolidation programme. Steps to improve transparency of the financial position of banks with the detailed release of the banks' stress tests, as well as restructuring and reforms to strengthen the resilience of the savings banks, which are particularly exposed to the housing sector, have also helped allay risk perceptions. Reforms in product and labour markets are critical to rebalancing the economy. The measures taken so far in these areas are important and welcome steps but will need to be deepened and complemented by further steps, as discussed below and more in detail in this Survey.

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### *Budgetary consolidation is advancing*

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The government consolidation measures are set to lower the government deficit from 11.1% of GDP in 2009 to 6% of GDP in 2011, with the aim of reaching a deficit of 3% by 2013. Measures already implemented include value added tax (VAT) and personal income tax increases, an average 5% cut in public sector wages this year and large cutbacks in public investment. Public wages and most pensions will be frozen in nominal terms in 2011, and only one out of ten jobs in the government sector falling vacant will be filled. These measures are reflected in the central government budget for 2011 which foresees a reduction of spending by 7.9%. It is important that a permanent improvement in the budget balance is achieved. The government will fully spell out spending cuts announced for 2012 and 2013 in future budgets. Specifying these spending cuts earlier could help improve confidence further. *The consolidation measures should be strictly implemented. As announced, the government should stand ready to take further measures if needed, as some measures will be quite challenging to implement over time, such as the replacement of only one in ten government posts falling vacant. Priorities need to be clearly identified where government employment can be cut while preserving quality of service provision.*

If further consolidation measures are needed to meet the fiscal targets, tax increases could also complement expenditure cuts as the overall tax burden in Spain remains relatively low in comparison to other high-income European economies. Well-selected tax increases could also have a relatively more benign impact on activity than some expenditure cuts. *Applying the higher VAT rate to more goods and services would be one possibility to raise revenues, as indirect taxation has a smaller adverse impact on economic activity than many other taxes. Using environmental taxes, rather than subsidies to encourage environmentally friendly behaviour would achieve the same internalisation of social costs, but at a much lower budgetary cost. This principle needs to be applied, inter alia, in water policies (see below). Selective increases of these taxes could also fund a reduction in some employer social security contributions. Such a step could help reduce labour costs and improve competitiveness. Lowering the taxes on housing transactions would help remove barriers to the mobility of workers and would create*

room for raising more revenues from taxing real estate property, which would generate relatively little distortion to economic activity.

### *Pension reform must address ageing expenditures and improve work incentives*

Spain faces a dramatic increase in ageing-related public spending between 2030 and 2060. Spain's old-age pension benefits offer a more generous return on contributions than those of many other OECD countries. As more workers with full career records will enter retirement and the dependency ratio will increase, pension costs will increase sharply. *The proposal for a phased increase in the statutory retirement age for a full pension from 65 years of age to 67 years would generate a significant decline in future pension spending. It should therefore be a high priority and be combined with other measures to contain spending. In the longer term, pension entitlement parameters, for example the statutory retirement age or pension benefits, should be indexed to changes in life expectancy. The government should phase in a revised pension benefit calculation formula that reflects the full working life of participants.* The latter would increase the linkage between contributions and pensions. Survivors' pensions make up a substantial share of pension spending. As young and middle-aged women increasingly participate in the labour market, *eligibility requirements for combining survivor benefits with other pensions should be tightened, for example by means-testing.* The government is envisaging reform along these lines.

Workers exit the labour market on average about one year before they begin to receive pension benefits and extended unemployment benefit payments for older workers are used in the transition period to retirement. Though modest, these benefits can be paid for up to nine years until early retirement is reached, raising reservation wages and lowering employment of older workers. *The extended unemployment benefit payments for older workers should be gradually shortened and eventually phased out. Subsidies to the partial retirement scheme should also be phased out.* An increase in the minimum period of contributions required to reach a full pension, currently set at 35 years, would also improve work incentives, especially if the period of earnings assessed for pension benefit calculation is lengthened.

### *Domestic stability rules need to be reinforced*

Regional governments account for 35% of total government spending, although thus far they have contributed little to the national debt, reflecting the relatively recent completion of decentralisation of spending powers. In the recent boom years, the central government built up considerable surpluses in its own and in social security budgets, while regional governments ran small deficits. While the central government has strong powers, which have recently been enhanced, to intervene when regional governments do not meet deficit targets set in the *Budgetary Stability Law*, current regional funding and domestic stability rules could be improved to ensure that regional governments do not spend windfall gains in boom years. *The domestic stability rules limiting budget deficits of the different levels of government should be reformed to require larger surpluses when activity is above the domestic potential level.*

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### *Fostering the rented housing market can help absorb excess supply and ease labour market adjustment*

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The housing market remains characterised by large oversupply. At the same time, a large number of young adults live with their parents and some low-income households remain poorly housed. Housing policies can influence the speed with which the empty housing stock is reabsorbed and can foster geographic mobility, especially by removing hurdles to the development of the rental market. Some welcome steps have been taken: judicial procedures for the eviction of tenants have been simplified; tax allowances for housing purchases have been eliminated except for low income earners; and the tax treatment of owners and tenants has been equalised. At the same time, the government subsidises social housing. Social housing is comparatively low but poorly targeted and reduces mobility because of waiting lists. *Government subsidies for the construction of social housing should be reconsidered. Support for low-income families should be provided through means-tested cash benefits towards housing costs instead of housing-related income tax allowances.*

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### *Progress with product market reform is substantial but further steps would strengthen the recovery in the medium term*

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Progress in product market regulation can improve competitiveness, both by strengthening productivity and lowering prices. This could allow a faster reallocation of resources to the most efficient and fast growing sectors. Over the past decade, Spain has undergone widespread reforms that have made many markets more open to competitive pressures. Reforms are continuing, for example, in the draft *Ley de Economía Sostenible*. In retail trade, a recently passed law has removed the national requirement for a license for opening an outlet, although regional governments may require an authorisation under overriding reasons relating to the public interest. Scope for improvement remains. For example, some regional governments are making use of their powers to restrict entry of large-surface outlets. Besides, in professional services, qualification-related entry barriers are higher than elsewhere in the European Union. *Entry barriers for large-surface retail outlets imposed by regional governments should be lowered. In addition, shop opening hours should be liberalised in those regions where restrictions remain. Some qualification-related entry barriers in the liberal professions should be reviewed.*

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### *Reducing duality in the labour market*

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The massive increase in unemployment, especially among the young and unskilled, has made the structural weaknesses in the labour market evident. Structural unemployment is high and is likely to have increased during the current crisis. Furthermore, employment reacts in a very volatile fashion to the cycle, amplifying welfare, output and budgetary costs of fluctuations in activity. High protection of permanent contracts contributes to these structural problems. Firms have been reluctant to convert temporary contracts into permanent ones, and this increases turnover as well as encourages a dual labour market. High protection of workers on permanent contracts has also contributed to making wages less responsive to labour market conditions and has made the integration of young people

into the labour market more difficult. Finally, dual labour markets harm labour productivity, reducing job mobility and the incentives of individuals and firms to invest in human capital. The labour market reform legislation, approved by Parliament in September 2010, is expected to make it easier for firms to have dismissals accepted as “justified” which reduces their costs. However, the law still leaves much room for judicial interpretation, so that it is not clear to what extent the legislation will change the practice whereby firms prefer to pay upfront the highest severance payment in order to avoid going to court. Making it easier for firms to have dismissals accepted as “justified” would affect all existing contracts, not only new ones, hence reducing insider forces in wage setting and fostering mobility, with significant benefits for productivity and the integration of young workers. If these measures fail to make it significantly easier for firms to have dismissals accepted as “justified” *further progress in easing the burden on businesses to prove that dismissals are justified may be needed. Steps to reduce the duration of judicial procedures would also help.* The reform package also foresees the replacement of part of accrued dismissal pay entitlements by mandatory contributions of businesses into blocked accounts, which would be made available to workers upon dismissal or retirement as well as for training or mobility purposes, for newly signed contracts from 2012 onwards (the so-called “Austrian-model-type” part of the reform). This measure should reduce dismissal costs further, which is welcome.

The reform package also widens the types of workers who are eligible to be hired on permanent contracts with somewhat reduced dismissal pay. However, different permanent contracts, some of which stipulate high dismissal pay for unjustified dismissal, continue to exist side-by-side. Hence, even with the recent reform, severance pay may still be excessively large, making firms reluctant to transform temporary contracts into permanent ones. *The reform would be more effective if these two types of contracts converged. This could for instance be achieved by introducing a single contract with severance pay which is low initially, but gradually increases with seniority.* If designed like this, it could even replace the current system of temporary and permanent contracts. The convergence towards a single contract should not lead to unnecessarily stricter regulation of temporary contracts, however. In fact, the current reform package tightens the regulation of temporary contracts. This is risky in the current situation, even if the law foresees phasing the tightening in between 2012 and 2015. *Restrictions on temporary contracts should be avoided. As a minimum they should only be introduced if the reform succeeds in lowering dismissal pay for permanent contracts and improves hiring on such contracts markedly.*

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#### *A more far-reaching reform of collective bargaining is necessary*

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The wage bargaining system has several drawbacks. *First*, collective bargaining takes place predominantly at the sectoral and provincial levels and hence at an intermediate level of centralisation which is unfavourable for the flexibility of wages both to aggregate and firm-specific shocks. *Second*, bargaining outcomes are extended to all firms of the same sector or region by law even if they do not participate in the agreement. *Third*, it used to be very difficult for firms to opt out from collective agreements. The 2010 reform substantially eases the conditions for firms to opt out from collective bargaining agreements as regards wage and other work conditions, although the statutory extension of collective bargaining remains in place. *Abolishing the legal extension principle may be desirable* although such a step may be difficult to reconcile with constitutional law. In any case, *it should be ensured that employers and*

*workers can freely agree to opt out from collective bargaining agreements at the firm level as intended in the new legislation. Moreover, the system of collective bargaining could be simplified and give more room for wages and other work conditions to be decided at the firm level. Reforms along these lines would help to curb the widespread indexation of collectively bargained wage increments to past inflation, which is typically triggered when inflation exceeds 2%. This could be harmful, for example, should prices of imported commodities rise.*

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#### *The employability of young and low-skilled workers needs to be raised*

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Reducing the very high unemployment of young workers is a priority. In the current situation, reducing the number of pupils leaving school without upper secondary education would have a double dividend: it would raise human capital for the long term and would postpone entry of young and unskilled workers into a depressed labour market. The government has presented plans for wide-ranging reform of compulsory education, which will include steps aimed to reduce school drop outs. *In compulsory education, steps should be taken as soon as possible to focus the conditions for granting pupils promotion to subsequent grades on those core competencies needed to advance to any type of upper secondary education, as argued in the 2008 Economic Survey. This would lower drop-out rates and increase access to upper secondary vocational education.*

Middle-aged and older workers tend to be even less skilled than the young. Wider participation in continuous training could help improve skills. The current compulsory payroll contribution for the funding of continuous training seems to generate poor results, as investment into continuous training is low, while at the same time raising the tax wedge on employment. *The institutional setting of continuous training should be made less complicated and access of small firms to subsidised continuous training should be improved. Firms should also have more options as to the choice of training to ensure that the training meets the firms' needs, hence rendering the subsidies more effective. The government may also consider introducing training grants to individual adults, for instance in the form of vouchers covering course fees or allowances to cover indirect costs such as foregone wages. Such schemes facilitate targeting and stimulate competition among training providers by giving individuals greater choice. For such systems to be effective, though, it is important that provider quality is guaranteed, for instance by ensuring that accredited training providers meet strict quality standards.*

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#### *The matching process needs to be improved*

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The separation of responsibilities for the funding of unemployment benefits and active labour market policies, set at the national level, from responsibilities for the managing of placement services, set at the regional level, may distort placement incentives for regional employment offices. *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). If this is not possible, comprehensive monitoring and evaluation of employment services at the regional level should be introduced, based on quantitative output indicators or targets. This could be combined with qualitative studies of placement successes and their impacts on job-seekers' employability by following former unemployed over time. The reform according to which private firms (not only non-profit as previously) can provide placement services if*

authorised by public employment services is welcome as it could improve the effectiveness of overall placements of workers to jobs.

Spain follows a mutual obligation approach where, in return for benefits, recipients are required to engage in active job search activities, but the incentives of unemployment benefit recipients to search for a job could be further improved. *Benefit payment should not be paid retrospectively for the period prior to registration and the first full interview should be mandatory at the time of registration. Furthermore, Spain should increase the frequency of reporting of job search activity.*

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#### *The limits to more intensive use of natural freshwater resources have been reached*

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Water scarcity needs to be taken into account in economic decision making in order to preserve resources for the future and for natural habitats. Natural water resources are used intensively and scope for further raising the use of natural water supply, for example through increasing dam capacity, is limited. Climate change is expected to continue reducing supply, and make droughts more severe, especially in those river basins already most affected by water scarcity. Expansion of “non-conventional” resources – notably desalination and recycling – is still limited, as costs are often much higher than current prices paid by farmers. Irrigation accounts for around 65% of water consumption. But the range of water productivity observed in irrigation is large, with low value added production consuming a substantial share of water, even in basins most affected by scarcity. Government policy has responded to these challenges: achieving water savings, especially by modernising irrigation infrastructure, and support for “non-conventional” water resources were key measures taken, following the 2004 revision of the National Hydrological Plan.

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#### *The assignment of responsibilities according to river basins must be preserved*

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Public competencies for the management of water resources are assigned to river basin authorities, which are subordinated to the central government if river basins cover the territory of more than one autonomous community. This arrangement is appropriate. Recent amendments to some regional statutes lay claim on water resources management, for example, of river flows that are shared among several regions. *Competences over water resources that are shared to a significant extent across regions should remain clearly assigned to river basin authorities. In order to ensure a proper co-operation between the different levels of government in the management of water resources, the constitution of the Committees of Competent Authorities should be accelerated.*

River basin authorities have considerable budgetary and managerial autonomy, for example, in the assignment of water concessions or decisions on public infrastructure. Their work builds on the involvement of stakeholders in water use, especially through representation of users, who typically contribute a third of the members in decision-making bodies. In several river basin authorities, irrigation associations dominate user representation, generating risks of regulatory capture. *Risks of capture of regulatory authorities should be reduced by widening the participatory approach in water management to a broader set of stakeholders, such as scientists, or representatives of institutions protecting local*

ecosystems and the leisure services these provide. This enhanced participation should take place through the appropriate institutions, including in the river basin authorities.

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### Water prices need to fully reflect all costs

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Legislation on water pricing limits cost recovery to operating and capital costs in the provision of water services and hence prevents opportunity costs related to the scarcity of water and environmental costs from being included in water prices. A recent study estimates that a significant proportion of capital costs are not recovered, while pointing to lack of transparency and availability of relevant data. River basin authorities typically cannot fund investment from revenues obtained from water charges and have to rely on government funding instead. Higher revenues from improved cost recovery would in turn leverage substantial additional private funding for investment, providing benefits for water savings as well as economic stimulus. *Prices should more fully reflect all the costs involved in the provision of water services. The law should allow the inclusion of environmental and scarcity costs in water prices. Transparency in water charging should be improved, so as to provide information on the different costs involved in the calculation of tariffs. The provision of data on costs of water services should be made easily accessible nationwide. For example criteria on the attribution of costs to services with public goods characteristics, such as flood control, should be harmonised according to transparent criteria. Economic instruments, including tenders or auctions, could be used for the assignment of new water concessions instead of granting them for free.*

The government has provided substantial subsidies for the modernisation of irrigation techniques. Higher water prices may reduce the need for such subsidies. However, in the context of low prices, there is the possibility that water saved through modern techniques is being used to extend irrigation or for more water-intensive crops. In a recent programme to subsidise water-saving irrigation techniques (*plan choque de regadíos*), the government appropriately required the amount of water granted in concessions to be reduced for the beneficiaries of these subsidies, but the overall impact of the programme on water consumption is not clear. *In the short term, it must be ensured that subsidies for irrigation modernisation are conditioned on reductions in the amount of water that is designated in concessions to ensure that water savings resulting from the modernisation are made available to environmental flows or other economic use.*

Comprehensive water markets, including for the transfer of long-term water rights, have delivered efficiency gains worth several billion dollars in Australia and the United States by allocating increasingly scarce water supplies among competing agricultural, urban, and environmental uses. *Restrictions on the trade of water concessions should be eased. For example, caps on sales established on the basis of past consumption could be reviewed and the participation of dealers could be allowed. The requirement not to sell water to users considered to be of lower priority in the law should be reconsidered. Water banks could be extended to more river basins.*

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### Management of groundwater resources needs to improve further

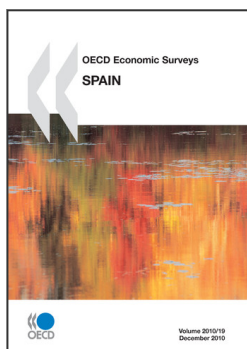
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A substantial share of groundwater resources is at risk of being overexploited and water quality is an issue. The management of groundwater resources in Spain faces a number of particular challenges: since most groundwater is used in agriculture, abstractions occur in



a highly decentralised fashion, making monitoring particularly difficult. The large value added gains from groundwater use in agriculture, compared to surface water, generate incentives for overexploitation. Although river basin authorities have received powerful instruments to halt excessive abstractions and much progress has been made in registering groundwater abstraction rights, several observers have noted that this framework has not yet been sufficiently effective. *The monitoring of groundwater abstractions should be reinforced. To this end river basin authorities should be endowed with the necessary financial and human resources. The sanctioning regime could be reviewed by making it more transparent for water users and by ensuring that sanctions are graded and proportionate to the offence. Legislation should be introduced to allow the introduction of a charge for groundwater abstractions to cover both the cost of administering and enforcing the groundwater rights and the cost of internalising the common-resource externality.*

Many associations of aquifer users have been created, with government support, but they do not appear to have internalised the common resource externality associated to decentralised groundwater extractions effectively. Few are oriented towards the sustainable use of a common resource. Most limit their activities to the joint use of infrastructure. On the other hand, there are notable examples of successful resource managers, who have set up internal mechanisms of abstraction controls and fines, without requiring the authorities' intervention. *To create incentives for user associations to manage groundwater resources sustainably, a charge could be introduced for users of aquifers which are persistently not managed in a sustainable fashion.*



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