Assessment and recommendations

Despite persistently favourable economic results in recent years, risks and important challenges remain

Spain's macroeconomic performance has remained remarkable: the country has experienced a 13th consecutive year of strong growth. This economic vitality has had the effect of narrowing the gap in *per capita* GDP with the euro area average from 20% to under 12% over the past decade and has also contributed to improved fiscal outturns. It has continued to be underpinned by buoyant domestic demand and spectacular employment growth based on substantial immigration, increased female labour force participation and a marked drop in unemployment. Taking advantage of still favourable cyclical trends, the authorities have rightly opted to tackle the economy's main medium-term issues:

- The stubborn inflation differential, which is continuing to erode competitiveness and helping to widen the trade deficit, highlights the need to improve the functioning of the labour and product markets so as to reduce the economy's nominal rigidities and thereby strengthen its resilience to shocks.
- The very rapid rise in household debt and property market prices, which could jeopardise macroeconomic stability, underline the need to stabilise the housing sector and correct its dysfunctional aspects.
- From a long-term perspective, reforms are still needed to ensure that the public finances remain sound, given the expected consequences of population ageing.
- Maintaining the process of income convergence with the most affluent countries will require a pick-up in productivity growth; this will involve improving the education system, catching up in terms of innovation and the use of new technologies and also eliminating the market distortions hindering the development of higher value added activities.

The National Reform Programme drawn up in 2005 by the authorities identifies these challenges and outlines a package of measures to meet them. However, in some cases the pace and ambitions of the measures introduced thus far do not appear commensurate with the problems to be overcome.

Growth has remained robust but unbalanced, despite some improvement

Economic growth has continued to edge up and is likely to have reached 3¾ per cent in 2006, over a percentage point more than in the euro area. As in previous years, the buoyancy of activity was based on very strong domestic demand underpinned by relaxed monetary conditions. The resulting substantial job creation has also been supported by real wage moderation. These trends helped not only to absorb the large numbers of immigrant workers and women entering the labour market, but also to reduce the unemployment rate to 8¼ per cent (from 19% in 1994). However, despite some progress, growth has remained unbalanced. First, although the upturn in the European countries has stimulated exports, the gradual tightening by the European Central Bank (ECB) since end-2005 has only slightly trimmed Spanish domestic demand. In particular, despite some signs of a property market slowdown, residential investment has reached 9.2% of GDP, real estate prices are still rising about 10% per year and household mortgage borrowing is growing excessively. Annual productivity gains remain modest, at no more than about 0.5%, and the inflation differential with the euro area has stayed at 1 to 1.5 percentage points, thus continuing to weaken competitiveness. While there is no problem financing the current account deficit, which may have reached about 9% of GDP in 2006, it is indicative of the scale of the strains in the economy.

Fiscal consolidation is proceeding at a good pace, although more ambitious budget targets would be desirable

For a number of years the authorities have been pursuing a fiscal consolidation policy that is more aggressive than those conducted by most other EU countries. This has partly counterbalanced the expansionary effect of the prevailing easy monetary conditions. Fiscal results have improved markedly, and in 2005, for the first time in 30 years, the public accounts showed a surplus of 1.1% of GDP, which was well above the target set. This performance will no doubt be bettered in 2006, with a projected surplus of 1.4% of GDP – again substantially above the official forecasts, largely for cyclical reasons. The more restrictive stance of macroeconomic policy in 2005-06 has, however, scarcely curbed domestic demand. Although the impact of the higher ECB interest rates could make itself felt more in 2007, such restraint will be partially offset by tax reductions of 0.4% of GDP for households and firms. Against this background, growth of activity could reach 3% or more both in 2007 and 2008, rates still in excess of the OECD estimate of potential growth. Without any residual spare capacity from the earlier slowdown, continuing demand pressures are likely to result in a slightly positive output gap, hindering any narrowing of the inflation differential. *It would therefore be appropriate to ensure that the fiscal stance remains as restrictive as it has turned out in recent years so as to alleviate domestic demand pressures and also meet longer-term imperatives. In this light, more ambitious budget targets are called for.*

More balanced growth requires measures to stabilise the housing market

Stabilisation of the property market, the prices of which have doubled in real terms since 1998, would also reduce macroeconomic and financial risks. This would be assisted by a decline in the inflation differential, which would allow for a rise in the currently very low level of real interest rates. It is also important, however, to correct the property market distortions that spur demand and make it more difficult for less well-off and younger households to enter the housing market. Many dwellings remain vacant and the rental sector is very limited, which also works against regional labour mobility, thereby hindering

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further falls in unemployment. These problems appear to have prompted the measures adopted recently to develop the rental housing market. However, until such time as the main property market dysfunctions have been overcome, these measures are likely to have only a limited effect. From this point of view, *it would no doubt be more effective and less costly to gradually do away with the various forms of assistance to home ownership that are still available so as to balance the incentives between renting and purchasing and moderate demand pressures*. On the supply side, *improved legal security of relations between owners and tenants would help to ensure that more effective use is made of the housing stock*.

But it also involves improving the functioning of product markets

Reducing the consumer price inflation differential with the euro area, which has reached a cumulative 10 percentage points since 1997, is a priority objective. The erosion of competitiveness that is implicit in this trend is worrying in that, *vis-à-vis* the countries of the Economic and Monetary Union (EMU), any depreciation in the real exchange rate that might be needed in order to make good this imbalance in the future risks a prolonged period of slow growth. While some part of the inflation differential can be associated with benign price-convergence mechanisms, the evidence is that these mechanisms account for only a small part of the total. More buoyant activity relative to potential than in the euro area is undoubtedly a significant part of the story. But just running a weaker economy is not a desirable solution. Rather, if Spain is to achieve continuing high resource utilisation with lower inflation, it must enhance the flexibility of product markets. The interaction between insufficient competition and the strong pressure exerted by domestic demand has in recent years prompted excessive increases in profits in the sheltered sector. Similarly, because of the relatively higher energy intensity of Spanish production and lower taxation of oil products, recent energy price rises have had a larger impact on underlying (and overall) inflation than in the euro area. *Tackling remaining market dysfunctions would reduce prices in the long run, as improved supply conditions lead to lower costs and mark-ups and higher productivity gains*.

The wage formation process needs to be reformed

The price increases generated at the sectoral level have been passed on and propagated by the wage formation system, even if the latter has not been the fundamental source of inflation. Real wages have fallen over the past few years, partly as a result of the strong rise in immigration, which has enhanced labour market flexibility. However, nominal wage growth has been systematically higher than in the euro area, even though wages have been initially negotiated on the basis of the 2% European Central Bank inflation reference rate. The reason is that an increasing number of collective agreements include inflation catch-up clauses. Moreover, these agreements, which are negotiated at intermediate (provincial or sectoral) levels, contain very broad administrative extension clauses that firms can evade only with great difficulty. On the one hand, such practices are unsuited to EMU membership, since they do not guarantee increases in unit labour costs similar to those in the rest of the zone. On the other, they restrict wage differentiation between firms with different productivity levels and reinforce nominal wage inertia. In a context of eventually weaker domestic and overall demand, such a wage determination process would hamper the resilience of the economy and its capacity to adjust by improving its competitiveness through a fall in relative unit labour cost. The social partners had earlier agreed to discuss wage bargaining reforms, but the prospects are poor. *Given the current framework, the best approach would seem to be to move the system towards greater decentralisation and flexibility. In particular, the conditions for firms to opt out of collective agreements should be relaxed.*

Fiscal policy still has medium-term challenges to face

The fiscal consolidation achieved over the past decade in a context of strong growth and substantial decentralisation has been remarkable, and the authorities have clearly indicated their intention to continue to pursue a prudent fiscal policy in the medium term. Reforms have been introduced with the object of improving the efficiency of budgetary management in terms of both resources and expenditure. In this regard, the spending caps, which in practice have consisted in limiting the growth of central government expenditure to below the projected rise in nominal GDP, have been an effective way to pursue a counter-cyclical fiscal policy and to use buoyant tax revenues to reduce indebtedness. However, further efforts are necessary, bearing in mind the pressures that will weigh on the public accounts in the medium term as a result, for example, of the gradual decrease in EU transfers and the ambitious public investment programme.

Budget efficiency can still be improved

Recent measures to simplify and reduce tax rates on households and businesses and bolster efforts to combat tax evasion will improve the effectiveness, equity and neutrality of the tax system. Furthermore, by increasing the regions' control over the taxes levied on their territory and limiting their dependence on central government transfers, the ongoing revision of fiscal federalism will better align their revenue-raising powers with their spending responsibilities, thereby enhancing accountability. *However, unless the regions are allocated more expenditure responsibilities, this revision of fiscal federalism must not entail any further reduction in central government resources.* With decentralisation leading to fragmentation and loss of information, setting up an agency to evaluate the quality of public policies is a promising idea for comparing the management methods of the various government agencies and boosting efficiency. *For this reform to succeed, however, the agency in question must be sufficiently independent and make its assessments widely available to the public so as to promote best practices. Publication of the results of comparative analyses, in particular, must not be hindered by opposition from the regions,* as happened in the case of hospital waiting lists.

A stabilising fiscal role with prudent economic assumptions is key

To ensure continuing sound fiscal management in a decentralised framework, while maintaining the stabilising role of public finance, the government has reformed the 2003 Fiscal Stability Law, which obliged each level of government to keep its accounts permanently in balance. The new rule retains its predecessor's simplicity and has fairly broad support from the regions because of its increased flexibility. More significantly, the law has improved fiscal policy's stabilising function by evaluating the cyclical position of the economy and taking into account its expected growth rate relative to potential. *However, care should be taken when implementing this new budgetary rule to avoid a procyclical budgetary outcome*. Equally important, *the authorities' use of prudent macroeconomic assumptions should continue and incorporate the risks of a slowdown in potential growth in the medium term,* given the persisting sluggishness of productivity growth and the uncertain trend in immigration. In this respect, according to OECD estimates, an assumption for potential growth averaging above 3% for the next few years may be optimistic. While the new law takes account of the economic cycle, it may exceptionally exclude increases in public investment (including for R&D and innovation) up to 0.5% of GDP. That said, *an unjustified bias in favour of tangible over other forms of investment resulting from this exclusion should be avoided*. *Moreover, any exclusion should be treated very cautiously so as not to weaken the rule itself. Hence, they should be granted only exceptionally — as foreseen by the law — and kept strictly under the ceiling, which should not be raised in the future*.

It is time to confront the budgetary implications of ageing

The time has come to develop a more far-sighted long-term strategy to deal with fiscal management in the context of population ageing. The social partners now broadly recognize the scale of the financial problems resulting from ageing: something on the order of 7% of GDP by 2050 merely for public pension spending, which is more than in most other EU members because of the larger, albeit later, demographic shock and the insufficient actuarial fairness of the old-age pension system. Indeed, its parameters provide pensions whose discounted value on average exceeds the sum of corresponding contributions. Also, according to OECD estimates, the rise in health spending by mid-century could exceed an additional 4 percentage points of GDP, while the average annual budgetary cost of the infrastructure needed to provide long-term care for the elderly – to be gradually developed between 2007 and 2015 – may ultimately reach as much as 1% of GDP. Confronting these cost increases will be difficult. Although the massive recent increase in immigration has improved short-term pension finances, it has reduced the public's awareness of how urgent it is to deal with the problem so as to minimise adjustment costs. As the present average level of pensions is low and is expected to rise only slowly, reducing the replacement rate may not be the right approach. Rather, the appropriate strategy might be to gradually extend the contribution period required to qualify for a full pension. Incentives to take early retirement should also be removed and working lives prolonged. Relying heavily on increased contributions to contend with growing expenditure would mean shifting more of the adjustment burden onto younger generations and would have negative effects on employment. Substantial debt reduction and building up the reserve pension fund before the demographic shock occurs is an appropriate part of the Spanish authorities' answer to the budgetary problems flowing from ageing; indeed, public debt has been reduced by about 20 percentage points of GDP since 2000. It should, however, be linked to the implementation of an ambitious reform of the parameters of the pension system. Some modest reforms have been recently undertaken but further progress is necessary. It follows that drawing up alternative, model-based scenarios, for example in the framework of the Toledo Pact monitoring commission, would have a useful educational role to play as regards building a consensus on the socially preferred strategy.

Increasing the economy's capacity to innovate will enhance productivity

The persistent weakness of productivity growth for over a decade is, quite rightly, one of the authorities' main concerns. Admittedly, it has not stopped the buoyancy of the economy or prevented it narrowing the gap with the most affluent countries, but the underlying increase in available labour is inevitably going to tail off in future with the achievement of full employment, the slowdown of immigration and the impact of population ageing. Accordingly, OECD long-term scenarios point to a marked diminution in potential growth over the coming years if there is no appreciable improvement in productivity trends, risking an interruption, or even a slight reversal, in the process of convergence with the euro area average in the course of the next decade. In response, the government is trying to ensure that the country catches up in terms of innovation, especially in the private sector, and enhances its capacity to absorb new technologies.

The reform of R&D and innovation policy appears well thought out

To develop the economy's research and innovation capacity the authorities have devised a comprehensive, three-part reform strategy whose aim is to step up the effectiveness of R&D and innovation policy proper, as well as its framework conditions, and to upgrade the quality of education. This multidimensional approach is welcome. The *Ingenio 2010* plan, which is the first part of this strategy, is particularly detailed and generously funded, with the civilian research budget set to double during the present parliamentary term. It proposes a number of instruments to increase the focus and funding of government research, stimulate technology transfers by encouraging public/private partnerships and enhance the incentives for private-sector research and the diffusion of new technologies. Because of the multiplicity of existing obstacles and the varying forms of innovation activity, this approach seems appropriate and it is already producing positive preliminary results. *Careful evaluation of the effectiveness of the different types of financial incentives employed is called for however. Promoting technology centres, which rely on demand by end users, is a useful way of encouraging a culture of innovation while simultaneously limiting the risks of wastage. Improved transparency and co-ordination of the programmes devised by central and regional governments would avoid duplication, make it easier for SMEs to access information and reduce the danger of these measures becoming nothing more than industrial policies favouring local firms.*

Efforts to improve the quality of education are timely

The reforms under way in education, which make up the second pillar of the strategy, involve improving schooling from early childhood right up to the tertiary level, not forgetting adult training. Generally speaking, these reforms go in the right direction. The recent revision of the compulsory school system increases schools' independence, so that they can adjust more easily to growing student diversity, and backs this up with significantly increased budgetary resources. This should lead to better results and to lower failure rates. The authorities also acknowledge the need to further develop the continuous training system and the skills in the use of new technologies among a substantial portion

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of the population. Recent changes have sought to strengthen the management of the relevant oversight bodies and to facilitate SME access to the funds set aside for this purpose. That said, the programmes offered are often too long and unsuited to firms' needs. *Joint employer/government financing of specific continuous training projects would no doubt help to ensure the efficiency of such spending. More generally, greater efforts are needed to improve the functioning of training markets by improving the system of recognition of skills and easier access to training leaves.*

An ambitious reform of the university system has been proposed

Measures reforming university education were also recently launched to boost Spain's relatively poor performance as exemplified by international rankings or, less directly, the lower-than-average private returns to higher education. *What is needed is to move from a system based on input regulation to one based on better output appraisal linked to funding mechanisms.* The government proposal rightly increases university independence, notably as regards staffing and curriculum planning, and aims at strengthening performance appraisal. For this purpose, the statistical information on the functioning and performance of universities is being reviewed in order to ease the evaluation process, while an extensive dissemination of this information is also planned. The research assessment system will also be improved, with a view to fostering applied research and transfers of knowledge and technology to firms through financial incentives. These proposals, which are awaiting examination by Parliament, are laudable. Evaluation is vital to encourage benchmarking, increasing the possibility of discriminating among university degrees and stimulating competition and student mobility. In this connection, the projected increase in grants and loans repayable on the basis of income is also welcome, but *it should be complemented by a rise of university fees, which would be a useful addition to the tertiary sector's rather limited resources.*

It will be necessary to overcome resistance to reform

This reform is likely to meet with opposition resulting first, from some insiders reluctant to the spread of a culture of appraisal. *Yet the universities have to look beyond the particular interests of the academic community and their own sphere and seek better to meet the needs of society, especially firms.* Second, it must be ensured that the decentralised framework of the Spanish system, with the regions controlling and funding universities, will not stand in the way of the development of a culture of nation-wide evaluation and competition. *Encouraging healthy emulation is however necessary for obtaining more from the investment in human capital and creating attractive centres – for foreign researchers and students too – as has happened in the case of business schools.* Finally, the widely held view that university is a public service to which everyone is entitled could also be an obstacle to higher tuition fees. *Yet increased charges can be justified on both equity and efficiency grounds.* Despite the aforementioned shortfall, tertiary education nevertheless yields significant private and social returns, and, as in other countries, few of those attending university come from underprivileged households. Moreover, higher fees should also prompt students to make the most of their studies and finish them sooner.

A more fluid labour market is needed for permanent workers

There has recently been progress in making the framework conditions for innovation – the third pillar of the strategy – more favourable. For example, measures have been adopted to stimulate business creation and facilitate initial funding, and efforts are ongoing to reduce those labour-market rigidities that hinder the business reorganisations often needed when adopting new technologies. The May 2006 plan to reduce the market segmentation between permanent workers – heavily protected against redundancy – and those with temporary contracts did so by limiting recourse to the latter and improving incentives for permanent contracts, mainly through higher budgetary support. Additionally, the access of a wider group of workers with temporary contracts to permanent jobs was made easier. However, these reforms in fact only slightly reduce the cost differential with temporary contracts and may therefore not do enough to make the market much more fluid for permanent workers, even if the share of temporary jobs does diminish. Yet greater flexibility with regard to permanent contracts is essential if such workers are to lose their reluctance to change employers, firms to become more open to technological change, innovative industries to emerge and better quality jobs to be created. *A single employment contract that gradually increases severance payments based on length of service would achieve this essential flexibility. In addition, as is done in Austria, employees could be provided with individual severance insurance accounts into which are paid contributions that the employee can use in case of dismissal.* This would remove the present uncertainty surrounding the application of employment protection legislation and increase the mobility of permanent workers. Performance would also be improved by effective activation measures to compensate for permanent workers' reduced protection. *In some fashion, a better balance has to be found between employers' need for flexibility, employees' goal of security and adequate protection against unemployment.*

Reform of the general competition framework is welcome

Strengthening product-market competition, which is another official priority, is crucial to achieving both static and dynamic efficiency gains. More vigorous competition increases price-setting discipline in the goods market, especially in the sheltered sector, stimulates innovation, new technology adoption and, ultimately, productivity growth. While regulation has become more pro-competitive since 1998, according to the OECD Product Market Regulation Indicators, the progress made has not been any more rapid than elsewhere, and hence there is still plenty of leeway for unleashing market forces. A commendable draft overhaul of the general competition-policy framework is before Parliament. The adoption of a leniency programme will have a useful deterrent effect. The new Commission will also be more independent *vis-à-vis* the political authorities, especially where mergers are concerned, and more accountable for its actions. *It should also achieve efficiency gains from synergies between investigations and enforcement actions. Enhanced independence would also be valuable for other sectoral regulatory bodies.*

But competitive forces ought to be freed up in some sectors

While these general measures will be beneficial, more should be done to increase competitive pressures in various individual sectors. Large-scale supermarkets suffer, for example, from unjustified barriers to entry imposed by the regions. *The authorities could make use of the future European directive on services to do away with these obstacles. In any event, despite the minor initiatives already undertaken in the retail sector, they should take more resolute action to reduce the plethora of regional regulations tending to fragment the Spanish market.* The electricity market is also hampered by major defects which the government is endeavouring to correct. *This means, inter alia, adjusting regulated electricity tariffs more rapidly and transparently on the basis of changes in input costs, thereby avoiding the distortions resulting from too low prices, which have increased the energy intensity of production with harmful consequences for the environment. Efforts to agree an inter-connection with the French grid should be redoubled so as to integrate Spain into the single European electricity market and to increase international competition in the Spanish market, which has been characterised by considerable market power wielded by dominant local firms. Recent improvements in telecommunications regulations should further strengthen competition in mobile telephony and broadband Internet services, which still suffer from comparatively high prices. Regulatory changes are also needed to remove obstacles to competition in many other sectors, such as heavy road haulage and cement. Finally, both legislation and conduct in sectors, for which not enough information is available but which appear to be suffering from a lack of competition, such as procurement contracts and certain professional services, need to be more closely scrutinised.*

Table of contents

Boxes

Tables

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Figures

This Survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

The economic situation and policies of Spain were reviewed by the Committee on 30 November 2006. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 13 December 2006. The cut-off date for information used in the preparation of this Survey is 21 December 2006.

The Secretariat's draft report was prepared for the Committee by Claude Giorno and Eduardo Camero under the supervision of Peter Jarrett.

The previous Survey of Spain was issued in April 2005.

BASIC STATISTICS OF SPAIN (2005)

THE LAND

Area (1 000 km^2)		Major cities (thousand inhabitants)	
Total	506.0	Madrid	3 155
Cultivated (1999)	183.0	Barcelona	1 593
		Valencia	796
		Seville	704

THE PEOPLE

In thousands		Employment (thousands)	18 973
Population	43 398	Employment by sector (% of total)	
Net natural increase	79	Agriculture	5.3
Net migration (2002)	460	Industry	17.3
Number of inhabitants per km^2)	85.8	Construction	12.4
		Services	65.0

PRODUCTION

Gross domestic product (GDP)		Gross fixed capital investment	
Million €	905 455	% of GDP	29.3
Per head in $	25 964	Per head in $	7 610

THE GOVERNMENT

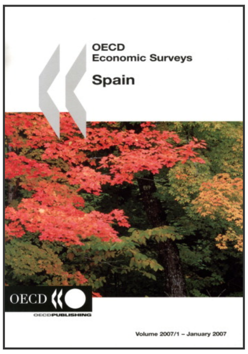
% of GDP		Composition of Parliament (seats in March 2004)	350
Consumption	18.0	Spanish Labour Socialist Party (PSOE)	164
Revenue	38.6	Popular Party (PP)	148
Surplus	1.1	Convergence and Union (CIU)	10
Fixed investment		Republican Left of Cataluña (ERC)	8
(% of gross fixed capital formation)	12.1	Basque Nationalist Party (PNV)	7
		United Left (IU)	5
		Other	8
		Next general elections: March 2008	

FOREIGN TRADE

Exports of goods and services (% of GDP)	25.5	Imports of goods and services (% of GDP)	30.9
Exports as a % of total goods exports		Imports as a % of total goods imports	
Foodstuffs	12.1	Foodstuffs	6.1
Other consumer goods	26.8	Other consumer goods	23.0
Energy	3.4	Energy	14.1
Other intermediate goods	48.1	Other intermediate goods	45.4
Capital goods	9.6	Capital goods	11.5

THE CURRENCY

Monetary unit: Euro		Currency units per $, average of daily figures	
		Year 2006	0.797
		December 2006	0.758



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