1 Key Policy Insights

Following the outbreak of Russia's war of aggression against Ukraine, sizeable measures were implemented by the government to cushion the inflationary shock and to support the economy, and economic growth held up remarkably well in the second half of 2022 and the first one of 2023. Going forward, public policy should continue to address Spain's structural weaknesses. First, although the 2021 labour market reform has made it possible to reduce the high share of temporary contracts, unemployment remains the highest in the OECD and the integration of young people into the job market remains challenging. Second, income inequalities and poverty remain significant and poverty especially among young people. Third, Spain's growth potential is low and is expected to remain so, notably given the rapid ageing of the population. Stepping up the pace of fiscal consolidation should be a priority, given the demographic outlook and high public debt. Fulfilling Spain's ambitious objectives to fight climate change will require a strong commitment of all economic agents and a more environment-friendly tax regime.

Rising costs of living have brought new challenges since the COVID-19 crisis

Before the COVID-19 pandemic, the Spanish economy had experienced a period of sustained economic growth that was less dependent on the construction sector than the previous cycle. With the pandemic and Russia's war of aggression against Ukraine, the Spanish economy – like the rest of the world – has successively suffered two major shocks. Faced with these crises, the government took strong action to protect businesses and households. During the pandemic, the ERTE (Expedientes de Regulación Temporal de Empleo) short-time work scheme, guaranteed credits and various social measures limited the employment decline and made it possible to initiate a recovery, albeit at slower pace than in some neighbouring countries. Following the outbreak of the war against Ukraine, new measures were implemented to contain the inflationary shock and to support the economy. GDP growth held up remarkably well in the second half of 2022 and the first half of 2023.

Going forward, public policy should continue to address Spain's persistent structural weaknesses building on several major reforms undertaken since 2021 (Box 1.1). First, the recent labour market reform has made it possible to reduce the high share of temporary contracts from around 25% in late 2021 to around 17% in early 2023, and several recent labour market measures in terms of training contracts, active employment policies and hiring incentives should also support employment. Nonetheless, unemployment at 11.5% in August 2023 remains the highest in the OECD, despite having more than halved since 2013 and the integration of young people into the job market is still a challenge, as discussed in Chapter 2. Second, income and regional inequalities remain significant and poverty, despite coming down recently, is comparatively high, especially among the young. Third, Spain's growth potential is low and is expected to remain so, notably given the rapid ageing of the population. To reverse this situation, Spain will have to invest more, as capital intensity has been decreasing over the past few years (Figure 1.1), and must increase its total factor productivity, which is low compared to peer countries. This will require the continuation of the on-going reform efforts in many areas such as skills enhancement, dissemination of digital technologies, entrepreneurship and innovation. The investment and reforms under the national Recovery, Transformation and Resilience Plan (RTRP) will likely deliver higher potential growth (Box 1.1). The Government estimated that they can add around 2.6 percentage point of GDP per year on average between 2021 and 2031 (Ministerio de Asuntos Económicos y Transformación Digital, 2023[1]).

The deteriorated public finances reduce the leeway for future public policies. As a result of the pandemic, public debt, which was already high before, at 98% of GDP, increased considerably until the first quarter of 2021, even though it has been reduced to 111.2% in the second quarter of 2023. Spain will continue to benefit from the Next Generation EU programme, which provides for EUR 77.2 billion (5.7% of 2022 GDP) to be invested by 2026 under the RTRP. Spain has received EUR 37 billion so far, thanks to the fulfilment of 29% of the milestones and targets set with the European Union, making it one of the countries that have executed their plan fastest and had adopted 60% of the reforms by end-2022, several aligned with past OECD recommendations. Continuing with a rapid and effective implementation of the investments and reforms is essential to seize this unique opportunity to transform and strengthen Spain's economy and face the challenges ahead.

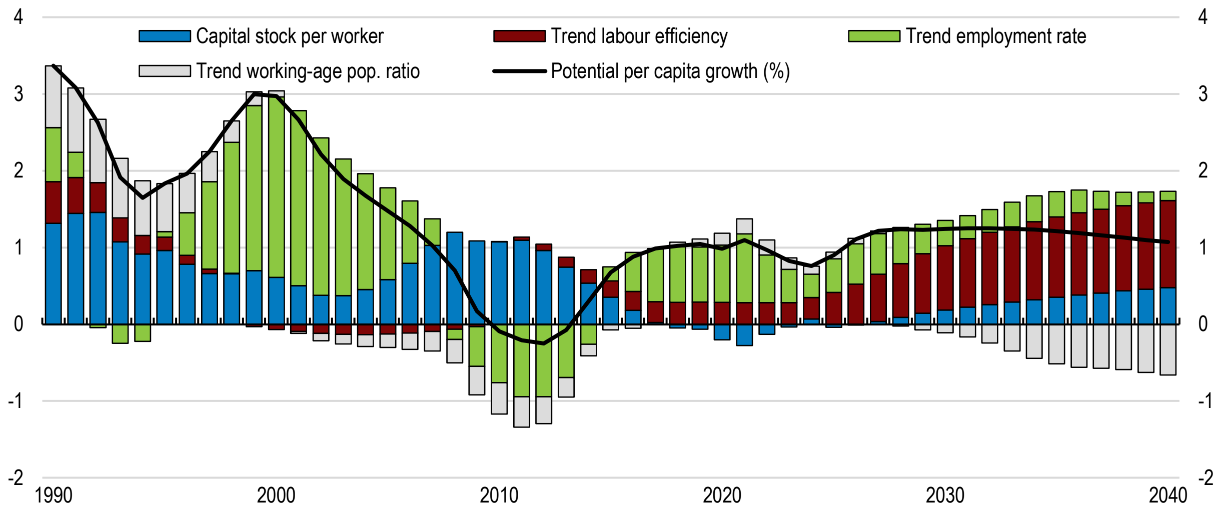
Foremost among the challenges facing Spain are climate change and other environmental issues, notably water scarcity and quality. Almost EUR 30 billion from the RTRP will be devoted to the green transition. The 2021 Law on Climate Change and Energy Transition sets the objective of carbon neutrality by 2050 and ambitious interim targets by 2030. To fulfil them, the 2020 National Energy and Climate Plan 2021-2030 will have to be fully implemented. Fortunately, Spain is well placed to confront this challenge with substantial technological capacity, the presence of leading companies and a consolidated value chain in key renewables sectors.

Box 1.1. Recent major structural reforms in Spain

- The **2021 labour market reform** restricts the use of temporary contracts and shrinks the menu of employment contracts. It also modifies the framework for collective bargaining and simplifies the procedure for companies to take advantage of the ERTE short-time work scheme. In addition, the new RED Mechanism for Employment Flexibility and Stabilisation will allow companies to cut working hours in case of cyclical downturn or difficulties specific to their sector.
- The **2023 Employment law** seeks to modernise active labour market policies, establishing a series of services to which all workers are entitled, and promotes the impact analysis of policies.
- The **2023 Royal Decree-Law on hiring incentives** aims to support employment via reductions in Social Security contributions or other instruments, with a focus on hiring vulnerable unemployed persons or those with low employability, and to encourage the transformation of permanent part-time and permanent discontinuous contracts into full-time and permanent ordinary contracts.
- The **2021 and 2023 pension reforms.** In 2021 the first part of the pension reform indexed benefits to consumer price inflation and eliminated the "sustainability" factor, which linked benefits to life expectancy, replacing it by an "intergenerational equity mechanism" relying on higher contributions. In 2022 legislation linked social contributions of the self-employed to their income. The second part of the reform agreed in 2023 will allow workers to choose between keeping the 25 years of contributions currently considered for calculating the pension benefit or retaining 29 years with the possibility of excluding two. Social security revenues will be strengthened by gradually increasing the maximum bases and maximum pensions. A "solidarity quota" will be phased in progressively, implying higher contributions for those earning the highest salaries.
- The **2022 Law on Business Growth** reduces financial and administrative barriers to the development of firms, while the 2022 **Start-up Law** introduces incentives for the creation of innovative companies.
- The **2022 Insolvency Law** reforms the framework for insolvency procedures and restructuring plans to favour out-of-court negotiations and swift reaction to financial distress situations.
- The **2022 Law on Science, Technology and Innovation** seeks to foster public research and promote the transfer of knowledge to firms.
- The **2022 Law on Telecommunications** includes measures to reduce administrative barriers to network and infrastructure deployment.
- The **2022 Organic Law on Vocational Education** introduces a single, integrated system of professional education.

Figure 1.1. On current policies, longer-run growth prospects are limited

Decomposition of potential output per capita growth, %



Source: OECD long-term projections based on (Guillemette, 2021[1]). The calculation of potential output incorporates the impact of investments only until 2024 but does not account for the long-term impact of policies and the structural reforms adopted as part of the Recovery, Transformation and Resilience Plan.

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The three main messages of this Survey are the following:

- It is imperative to step up the pace of fiscal consolidation, given the demographic outlook and high public debt. Enhancing Spain's growth potential and productivity will help to reduce public debt as a share of GDP. Policies to address the high cost of living should be phased out now that the recovery is firmly underway.
- Environmental challenges are immense. Spain's ambitious objectives to fight climate change can be reached only with a strong commitment by all economic agents. A swift implementation of the relevant RTRP programmes and adopting a more environment-friendly tax regime will be crucial to achieving them.
- Young people face important difficulties to fully realise their potential and contribute to the country's development. The 2021 labour market reform has led to a sharp decrease in temporary contracts for those under 30, significantly improving their situation. Further efforts are needed to offer young people access to training adapted to the needs of the job market, high-quality jobs, affordable housing, and better opportunities to set up their own business.

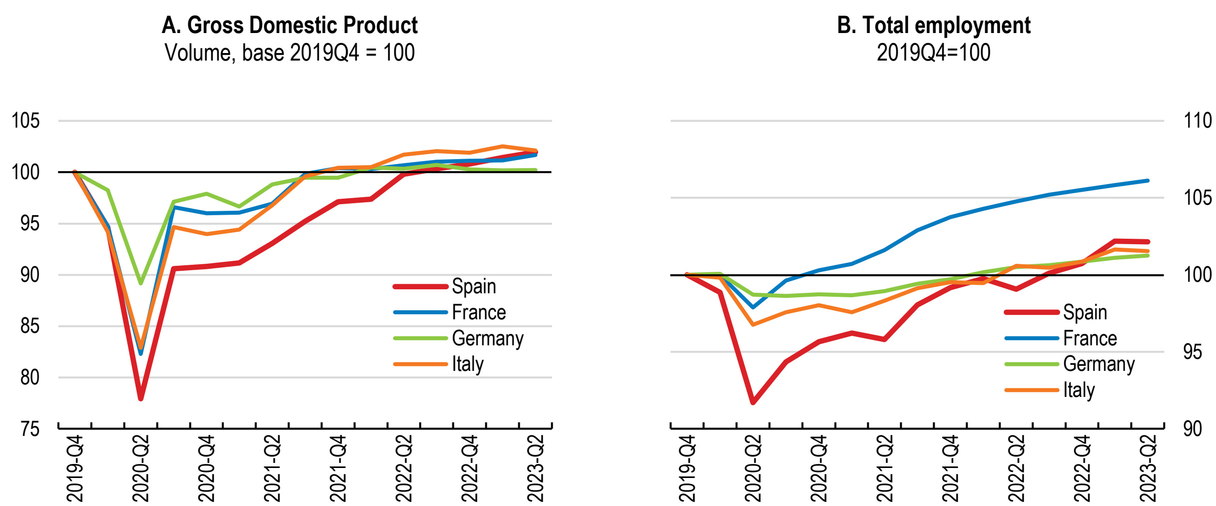
Spain has experienced a gradual but steady recovery

Government action has been decisive in shaping the recovery

With the gradual removal of COVID health-related constraints, activity increased markedly from the second half of 2020. However, the GDP recovery was slower than in the other major euro area countries (Figure 1.2, Panel A), with production lagging in construction and the automotive industry. The upturn in tourism, which provides 12% of total employment, was late, as in other popular tourist destinations.

From early 2021, the recovery was accompanied by inflationary pressures, in the context of a sharp rebound in demand and supply bottlenecks. Russia's war of aggression against Ukraine increased pressures considerably, causing a sharp rise in the cost of energy and some food commodities, and exacerbated uncertainties about the global economic outlook. The rise in consumer prices curbed household consumption, and the worsened outlook held back business investment. Higher policy rates also weigh on the cost of financing business and household investment and other durables purchases, thereby bearing down on inflation. Spain's bilateral trade flows with Russia and Ukraine are relatively small (less than 2% of goods exports and imports in 2021), but Spain is indirectly exposed via higher energy prices and reduced trading partners' growth.

Figure 1.2. The GDP recovery was slower than in the other main euro area countries



Note: Seasonally and calendar adjusted data; seasonally adjusted data, not calendar adjusted data for France in Panel B.
Source: Eurostat.

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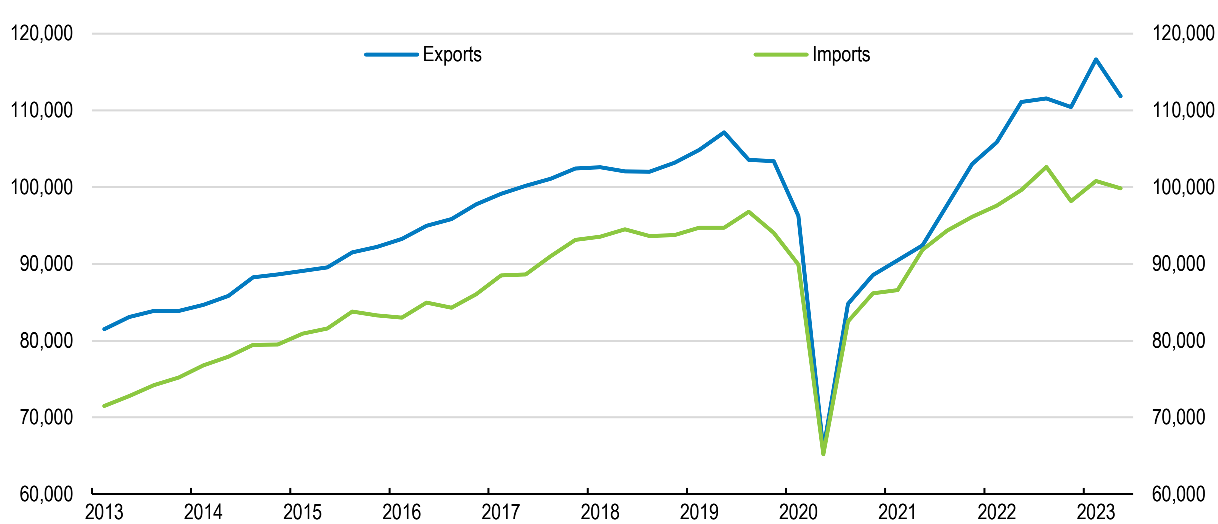
Figure 1.3. Exports have been particularly dynamic

Exports and imports of goods and services, chain-linked volumes (base 2015), seasonally and calendar adjusted data, EUR millions



Source: Eurostat.

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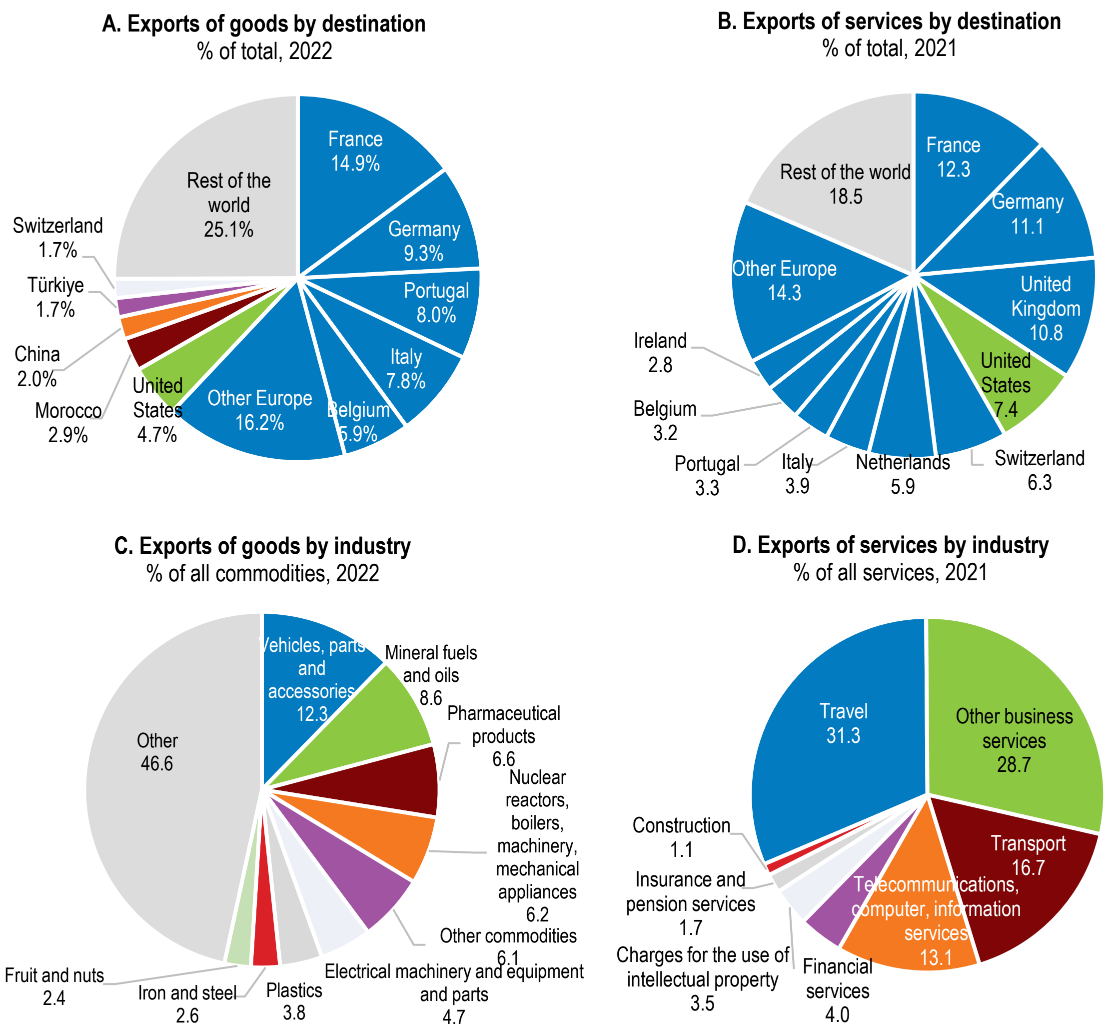
Faced with this challenging environment, the Spanish economy has held up remarkably well, posting GDP growth of 5.0% between the fourth quarter of 2021 and the second quarter of 2023, with significant gains across most sectors. Net exports proved particularly dynamic, accounting for almost two-thirds of the increase in GDP. Exports, which were hit hard at the onset of the COVID-19 pandemic, have been a key driver of Spain's recovery, as in the last decade (Figure 1.3). Spain's exports go mostly to Europe, though they are fairly diversified by product (Figure 1.4). Government measures to support businesses and households helped mitigate the inflationary shock (Box 1.2). Moreover, household income and consumption have continued to be underpinned by dynamic employment, which increased by 3.1% year-on-year in the second quarter of 2023 (Figure 1.2, Panel B). However, business survey data point to a slowdown in the second half of 2023.

Figure 1.4. Exports are diversified



Source: OECD International Trade Statistics.

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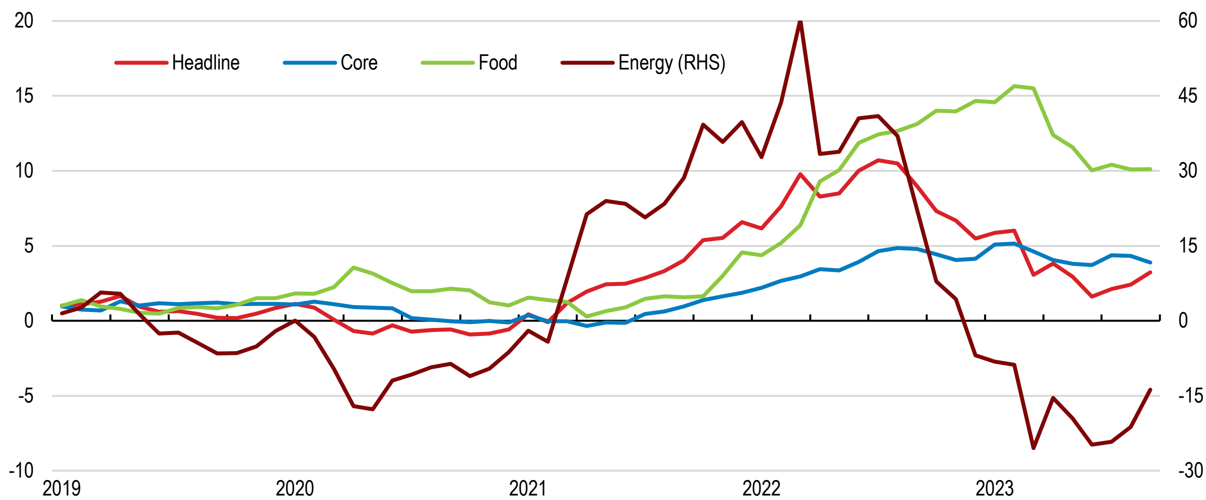
Inflation has moderated significantly but price pressures remain high. The decline in oil and gas prices, tax cuts and the implementation of the "Iberian exception" mechanism (see Box 1.2) have brought annual headline inflation down from a double-digit rate in the summer of 2022 to 1.6% in June. However, a recent rebound in energy prices pushed inflation to 3.3% in September 2023. The moderation in energy prices compared to 2022 has been larger than in other European economies; however, food and core inflation remain elevated (Figure 1.5). Some service prices continue to rise, fuelled by a lagged pass-through of past energy price increases and some wage pressures. Nominal wage growth is contained below headline inflation but has strengthened, with the year-on-year increase in compensation per employee reaching 5.4% in the second quarter of 2023. Firm managers expect further price increases in the short run, especially in services, although survey data show that inflation pressures are moderating. Core inflation is expected to recede slowly in 2024, with the growing impact of monetary policy tightening.

Figure 1.5. Food and core inflation remain high

Year-on-year increase in the harmonised index of consumer prices, %



Source: Eurostat.

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GDP growth is expected to slow after two years of strong growth in 2021-2022, in the context of the post-COVID-19 recovery, but will remain sustained, at 2.5% in 2023 and 1.5% in 2024. Domestic demand will moderate its pace but will remain the key driver of growth, amid weakened external demand (Table 1.1). Private consumption and investment will grow but less vigorously, limited by tight financial conditions and persistent inflation in 2024. GDP growth will benefit in the coming quarters from significant support from public spending linked to the RTRP. According to the government, the RTRP and associated reforms will boost GDP by 2.7 percentage points in 2023 and 3.1 percentage points in 2024 (Ministerio de Asuntos Económicos y Transformación Digital, 2023[2]). The Fiscal Council (AIReF) estimated the impact at 2.3% in 2023 and 1.9% in 2024 (AIReF, 2022[3]), while for the European Commission the RTRP will lift GDP between 1.8% to 2.5% by 2024 (European Commission, 2021[4]) According to the Bank of Spain, the funds associated to the RTRP could raise GDP by 1.3% to 1.75% in annual average terms over a five-year horizon (Fernández Cerezo, 2023[5]). In the short term the boost from the RTRP may reinforce upward pressures on prices, but eventually the added supply is likely to alleviate such stresses.

The outlook is overshadowed by significant uncertainties and downside risks. A further escalation of geopolitical conflicts could push up energy prices and inflation and worsen the economic outlook in Spain's main trading partners. A slow implementation of the RTRP could restrain growth more than expected. On the upside, a faster-than-expected improvement in the international environment would support activity, as would as a more rapid and efficient implementation of RTRP funds (Table 1.2).

Table 1.1. Macroeconomic indicators and projections

Annual percentage change, volume (2015 prices)

	2018 Current prices (billion EUR)	2019	2020	2021	2022	2023	2024
Gross domestic product (GDP)	**1,203.9**	2.0	-11.2	6.4	5.8	2.5	1.5
Private consumption	699.5	1.1	-12.3	7.1	4.7	1.7	1.6
Government consumption	225.3	1.9	3.6	3.4	-0.2	2.4	1.5
Gross fixed capital formation	234.0	4.5	-9.0	2.8	2.4	2.4	2.2
Housing	65.0	5.2	-9.7	0.9	1.4	1.7	1.6
Final domestic demand	1,158.8	1.9	-8.5	5.3	3.2	2.0	1.7
Stockbuilding[1]	12.4	-0.2	-0.8	1.4	-0.2	-0.2	-0.1
Total domestic demand	1,171.2	1.7	-9.2	6.7	3.0	1.7	1.6
Exports of goods and services	423.1	2.2	-20.1	13.5	15.2	3.3	2.1
Imports of goods and services	390.4	1.3	-15.0	14.9	7.0	1.5	2.6
Net exports[1]	32.7	0.4	-2.2	-0.2	2.9	0.8	-0.1
Other indicators (growth rates, unless specified)							
Potential GDP		1.5	1.3	1.2	1.3	1.3	1.2
Output gap[2]		2.2	-10.3	-5.7	-1.6	-0.5	-0.3
Employment		2.3	-2.9	3.0	3.1	3.4	2.4
Unemployment rate[3]		14.1	15.5	14.8	12.9	11.9	11.5
GDP deflator		1.4	1.1	2.7	4.1	5.9	2.4
Consumer price index		0.8	-0.3	3.0	8.3	3.5	3.7
Core consumer price index		1.1	0.5	0.6	3.8	4.0	3.0
Household saving ratio, net[4]		4.2	10.8	7.0	2.4	3.2	1.6
Current account balance[5]		2.1	0.6	0.8	0.6	2.4	1.8
General government fiscal balance[5]		-3.1	-10.1	-6.7	-4.7	-3.8	-3.5
Underlying general government fiscal balance[2]		-4.5	-3.0	-4.1	-4.6	-4.1	-3.9
Underlying government primary fiscal balance[2]		-2.4	-1.1	-2.2	-2.5	-1.9	-1.5
General government gross debt (Maastricht)[5]		98.2	120.3	116.8	111.6	109.4	110.0
General government net debt[5]		85.0	107.3	99.7	77.2	75.0	75.6
Three-month money market rate, average		-0.4	-0.4	-0.5	0.3	3.4	3.9
Ten-year government bond yield, average		0.7	0.4	0.3	2.2	3.6	4.5

1. Contribution to changes in real GDP.
2. As a percentage of potential GDP.
3. As a percentage of the labour force.
4. As a percentage of household disposable income.
5. As a percentage of GDP.

Source: OECD (2023), OECD Economic Outlook database, September.

Table 1.2. Events that could lead to major changes in the outlook

Shock	Possible impact
Intensification of geopolitical tensions	Higher energy prices would lead to a negative terms-of-trade shock, a rise in inflation, a fall in incomes and a worsening of the current account balance. Loss of confidence from investors would trigger a fall in global demand and lower Spain's growth.
Slow implementation of the RTRP	Lower public and private investment would slow the pace of the recovery. The disbursement of the Next Generation EU funds, which is conditional on the achievement of investment targets, would be delayed.
A wage-price spiral	Higher inflation would have a negative impact on demand, slowing economic growth. A wage-price spiral could lead to higher monetary policy rates, leading to tighter financial conditions, reduced borrowers' repayment capacity and more constrained fiscal space.
Extreme weather events associated with climate change., such as heatwaves, wildfires, or severe droughts	Lower production in agriculture. Worsened health, infrastructures, buildings and equipment and the destruction of wildlife.
More resilient domestic demand	More resilient private consumption supported by income and savings could lead to stronger than expected growth.

The labour market has recovered well, but challenges remain

The Spanish labour market has recovered well from the COVID-19 pandemic, and the unemployment rate stood at 11.5% in August of 2023, two percentage points below its pre-crisis level. Employment growth has been robust, and total hours worked have reached pre-pandemic levels. A large part of job growth since end-2019 is likely due to a strong rise in the formalisation of contracts by workers wishing to be eligible for pandemic-related social benefits. In addition, although the recovery has been associated with a rise in job vacancies, Spain has avoided the acute labour shortages seen in other European economies.

The labour market recovery has been underpinned by decisive policy action. Early evidence suggests that the 2021 reform to reduce over-reliance on temporary contracts is showing significant results, as discussed in Chapter 2. The share of employees with temporary contracts is rapidly decreasing, reaching 17.4% in the second quarter of 2023, down from 25.3% at the end of 2021, and narrowing the gap with the European Union average of 13.5%. The share of temporary contracts among those below the age of 30 fell from 55.4% end 2021 to 37.0% in the second quarter of 2023. Also, the recent improvement in the labour market is part of a deeper trend, with a continuous decline in unemployment since 2013, only interrupted by the COVID-19 crisis.

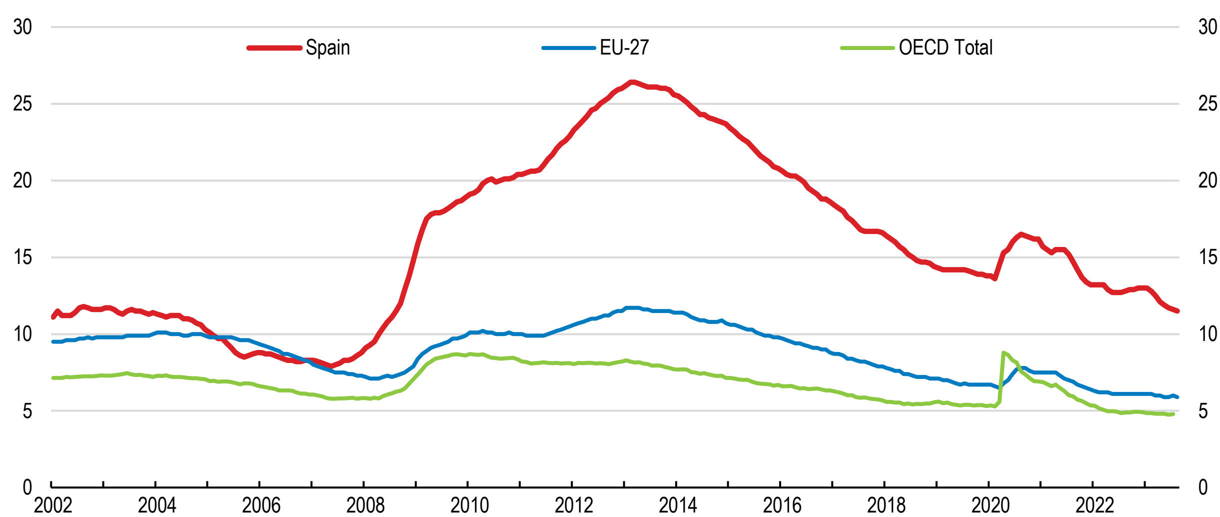
Despite this welcome progress, labour market challenges remain. First, the unemployment rate is still the highest in the OECD and more than double the OECD average (Figure 1.6). Second, the labour market remains especially difficult for young people (Chapter 2) and women. At 27%, youth unemployment is one of the highest in the OECD, though this is a considerable improvement compared to the pandemic high of 40% in June 2020. Third, average earnings are low compared to other OECD countries, reflecting low worker skills but also weak firm productivity. The rise in nominal wages in 2021 and 2022 was not enough to protect purchasing power in the context of high inflation, and real wages in Spain dropped by 1.4% between the first quarter of 2021 and the second quarter of 2023. Real wages for young people had been falling over the last couple of decades, unlike those of older workers.

High unemployment reflects structural issues to a large extent, including, low incentives to return to work for the unemployed skill mismatches and insufficiently effective active labour market policies, as discussed in Chapter 2. Recent reforms aim at reducing structural unemployment in various ways. First, the 2021 labour market reform is expected by reducing temporary work to create longer and more stable carriers and stimulate in-company training. Second, the *Expediente de Regulación Temporal de Empleo* (ERTE) scheme and the new scheme for the self-employed aim at reducing layoffs during temporary negative firm performance. Third, the investment and reforms under the RTRP are expected to increase output and, consequently, employment (AIReF, 2023[6]). Fourth, the new employment law aims at providing personalized support and guaranteed services in favour of re-employment, and upskilling and reskilling programs are part of the Recovery Plan.

To complement these efforts and to further reduce unemployment it will be important to provide better job-search assistance, career guidance and work-experience programmes, as well as up-skilling and re-skilling support, as discussed in previous Surveys and in Chapter 2. Moreover, it will be important to strengthen monitoring of the unemployed as well as to give greater incentives to the unemployed to return to work. Activation requirements for the unemployed are lower than in most other OECD countries (Figure 1.7), in terms of availability to work requirements, required job search activity and imposed sanctions. Moreover, while the generosity of unemployment benefits is like in other EU countries, the replacement rate declines more slowly through the spell of joblessness than elsewhere, reducing the incentives to get back to work. A further barrier to the reemployment of the long-term unemployed is that, given a sufficient contribution history, unemployment benefits can be collected until retirement for those aged 52 or older (Domènech-Arumí, 2022[7]). A welcome reform of the unemployment subsidies for those older than 52 years has been initiated to make it compatible with employment to encourage the reemployment of the older long-term jobless. Spain could follow in the steps of some OECD countries such as Italy and France to provide greater incentives to return to work by allowing combining unemployment benefits with work for some time (OECD, 2023[8]). As discussed, and recommended in Chapter 2, increasing access to quality childcare, especially for vulnerable children, could boost female labour force participation and productivity, besides improving education outcomes for children.

Figure 1.6. Unemployment has decreased but remains higher than in other OECD countries

Unemployment rate, seasonally adjusted, % of the labour force



Note: EU-28 prior to February 2020.
Source: OECD Labour Force statistics.

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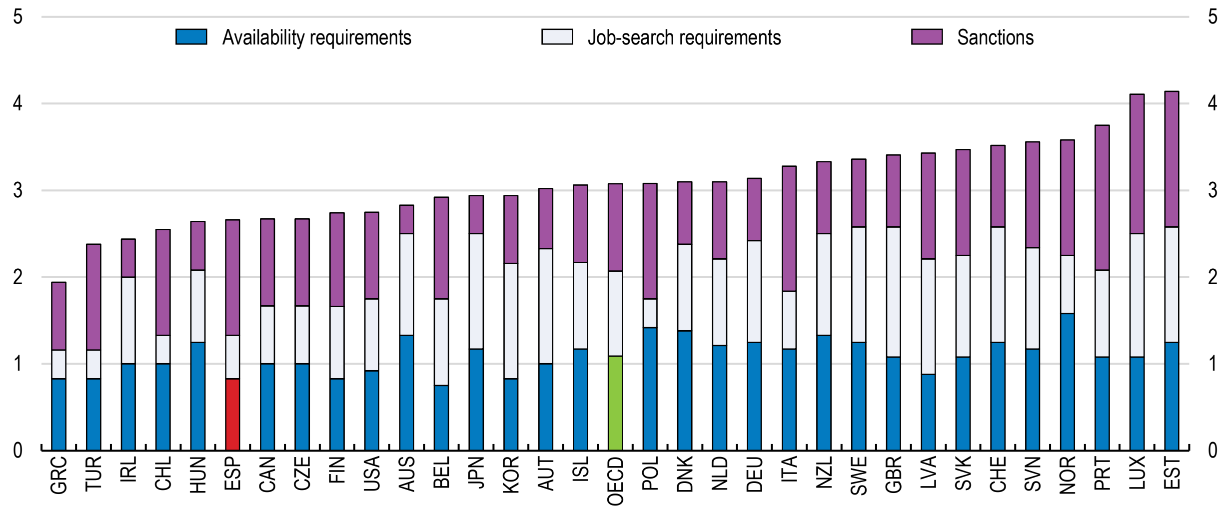
Figure 1.7. Activation requirements for the unemployed are lower than in most other OECD countries

Unemployment benefits strictness of activation requirements, index from 1 (least strict) to 5 (most strict), 2022



Source: OECD, Benefits and wages database.

StatLink https://stat.link/dpan05

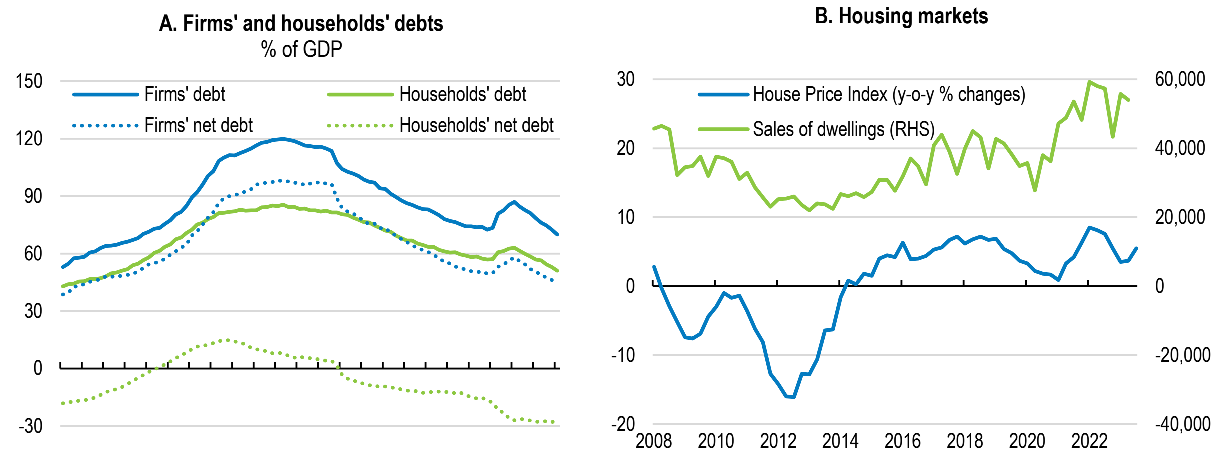
Table 1.3. Past recommendations on the labour market and actions taken

Recommendations in past Surveys	Actions taken since 2021
Simplify the menu of contracts firms can choose from.	The 2021 labour market reform streamlined the menu of temporary contracts available for companies.
Maintain a flexible labour market that allows firms to adapt to changing economic conditions, including through the priority of firm level agreements over sectoral and regional ones.	The 2021 labour market reform reinstated the priority of sectoral agreements over firm-level agreements for wage negotiations. It modified the ERTE short-time work scheme and introduced the RED Employment Flexibility and Stabilisation mechanism for particular macroeconomic or sectoral circumstances.
Establish a permanent commission to regularly evaluate the changes to the minimum wage.	A permanent commission was established in January 2021 to evaluate the changes and path of the minimum wage.
Target existing hiring incentives to specific vulnerable groups and link them to training programmes.	Royal Decree-Law 1/2023 reformed hiring incentives, targeting vulnerable groups and linking the incentives to training.
Ensure that workers on short-time work schemes are effectively prioritised for training.	The RED and ERTE schemes include training since 2022. The 2021 labour market reform increases incentives for training of temporary workers.
Increase spending on training and job-search assistance.	The allocation to finance employment promotion policies increased by 7.8% in 2022 and is being raised by 10.2% in 2023.
Remove barriers to competition of training centres across regions.	No action taken.
Introduce a single point of contact for social and employment services.	The 2023 Employment law clarifies responsibilities, promoting the role of Public Centers.
Introduce the use of profiling tools to identify job seekers at risk of becoming long-term unemployed and their training needs. Provide tailored guidance to workers.	The SEND@ digital tool provides guidance on the best-suited training programmes according to the characteristics of the job-seeker.

Financial risks have risen with higher interest rates, but private-sector finances have improved

Rising interest rates have increased financing costs for businesses and households, alongside financial risks due to persistent inflationary pressures and higher uncertainty. However, households' and firms' debts are now lower than in 2007 (Figure 1.8, Panel A), which implies that the weight of these additional costs relative to their income is lower than it was 2007. Also, firms and households have accumulated liquidities in the few past years, especially during the pandemic, which can serve as buffers and limit the economic impact of the rise in interest rates (Ministerio de Asuntos Económicos y Transformación Digital, 2023[9]). The consolidated debt of financial corporations, which had increased following the outbreak of COVID-19, has returned to its end-2019 level. Firms have received state guaranteed loans since the beginning of the pandemic for a total of about 8% of GDP. As support measures are gradually unwound, an increase in non-performing loans (NPLs) is possible, and close monitoring is warranted, but so far NPLs are still declining (Bank of Spain, 2022[10]).

Figure 1.8. The private-sector financial situation has improved



Note: Panel A: data on firms' debt refer to consolidated debt.
Source: Bank of Spain; Eurostat, House Price Indices; and INE.

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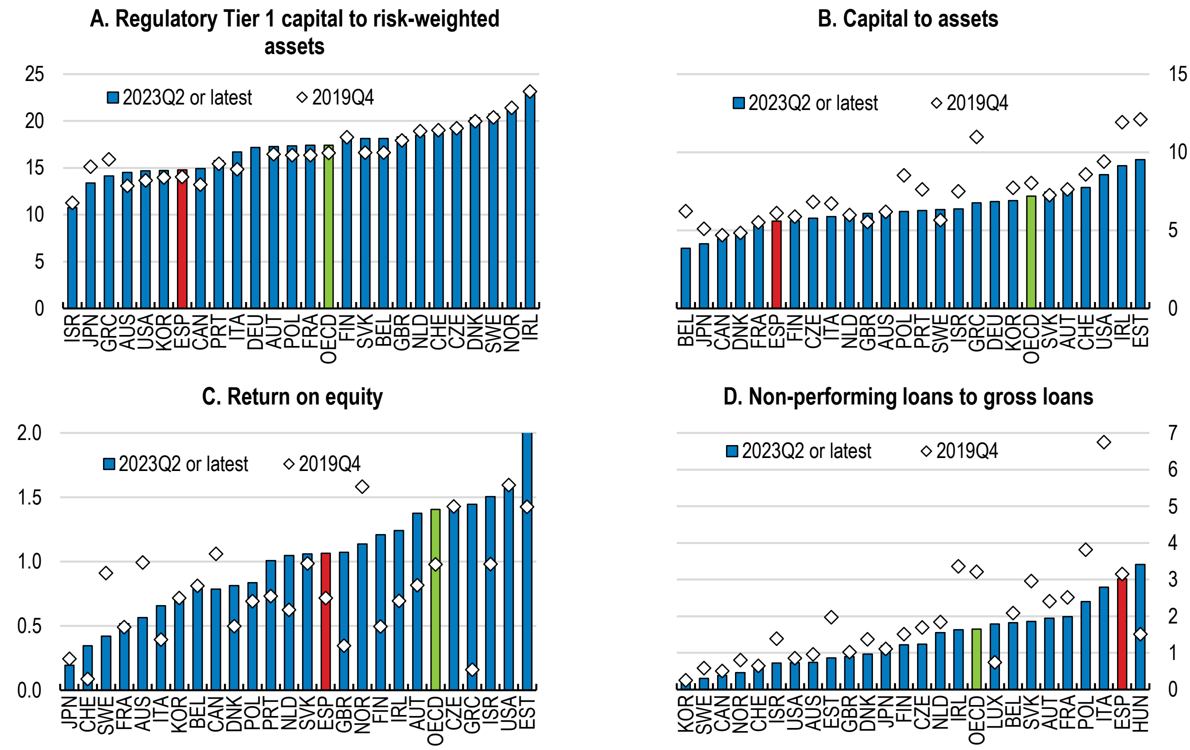
Spanish households are highly exposed to rising interest rates, given the heavy concentration of variable-rate mortgages (70% of the stock), even if in recent years most new mortgages have been extended at fixed rates, and despite measures in 2022 to cushion the increase in financial costs for debtors, notably by facilitating the extension of the repayment period and the conversion of variable rate loans into fixed rates. For banks, this entails a risk of sizeable impairment losses, which calls for prudent lending and close monitoring. Tighter financial conditions are cooling the housing sector with prices and sales starting to decelerate from mid-2022 (Figure 1.8, Panel B). Before that, housing price increases had been strong in some regions (Madrid, coastal regions and the islands). However, analysis by the Bank of Spain suggests that housing overvaluation is moderate overall, especially in comparison with 2007-2008, and that risks for banks' balance sheets related to real estate are contained so far (Bank of Spain, 2023[11]).

Spanish banks face the uncertain macroeconomic environment with higher levels of solvency than before the pandemic and lower NPL ratios (Bank of Spain, 2023[11]). Their return on equity ratios have increased in 2022 and remain above the average cost of equity and their CET-1 capital ratio are above minimum requirements, but below the OECD average (Figure 1.9). Financial-sector direct exposures to Russia and Ukraine are negligible. The turmoil in the financial markets that followed the Silicon Valley Bank's bankruptcy in early 2023 raised fears of a generalised banking crisis and contagion to Europe. This risk has not materialised, and the direct exposure of Spanish banks appears limited, but caution is still warranted. Also, a deterioration of the macroeconomic outlook and further increases in interest rates will likely erode borrowers' repayment capacity. Therefore, close monitoring is needed, and banks should keep prudent provisioning and capital policies. Stress tests conducted by the Bank of Spain suggest that Spanish banks would be solvent in a scenario of prolonged high inflation, a sharp slowdown in GDP and significant tightening of financial conditions (Bank of Spain, 2022[10]). However, there would be some heterogeneity in the resilience of individual banks. Against this background, the Bank of Spain has maintained its macroprudential stance by keeping the countercyclical capital buffer (CcyB) rate at 0%, which seems appropriate, given the prevailing downward risks for the economy.

Figure 1.9. Financial stability indicators are weaker than the OECD average

Financial stability indicators for deposit takers, %



Source: IMF Financial Soundness Indicators Database.

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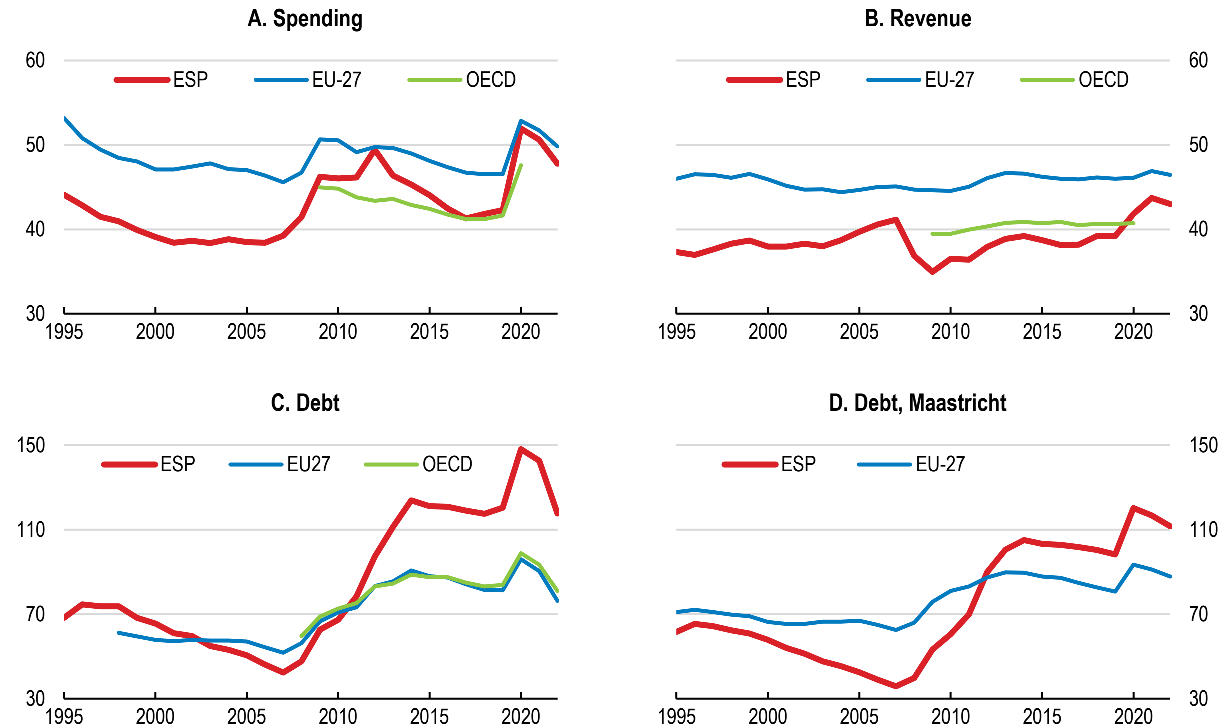
Public finances have improved, but government debt remains high

Spain has long had moderate government spending and revenues, but budget balance has been elusive. Public debt (Maastricht definition) reached over 100% of GDP following the Great Financial Crisis and 113.2% of GDP in 2022 (Figure 1.10). Gross public debt is even higher at 117.7% of GDP. Spending as a share of GDP is close to the EU-27 average (though well above the OECD mean), but revenue is several percentage points lower, making for a large structural deficit.

As outlined above, the government's fiscal response to the pandemic succeeded in limiting its impact but has taken a toll on public finances. Nevertheless, the headline fiscal deficit has more than halved in the last two years, to 4.8% of GDP in 2022, below the target set in 2021, driven by strong revenue growth and the withdrawal of COVID-related measures. The fiscal improvement more than offset the cost of measures taken in response to the surge in energy and food prices since the second half of 2021 (Box 1.2). Strong revenues have been underpinned by the recovery in activity, high inflation (the government attributes to inflation 5 percentage points of the 14.4% revenue gains in cash terms in 2022), a buoyant labour market, growing formalisation thanks to better law enforcement and an unusually high elasticity of revenue to output. Overall, while recent government deficits have been shrinking, closely in line with the euro area average, this has been mostly for cyclical and one-off reasons, and the underlying deficit has been largely unchanged at near 3% of GDP (Figure 1.11).

Figure 1.10. Spain has moderate government revenue and spending but also a large debt

General government, % of GDP, 1995-2022



Note: Debt for EU-27 is based on the average of 22 OECD-EU countries; debt for OECD average excludes Colombia, Iceland, New Zealand, and Türkiye.
Source: OECD (2022) National Accounts database; OECD Economic Outlook database.

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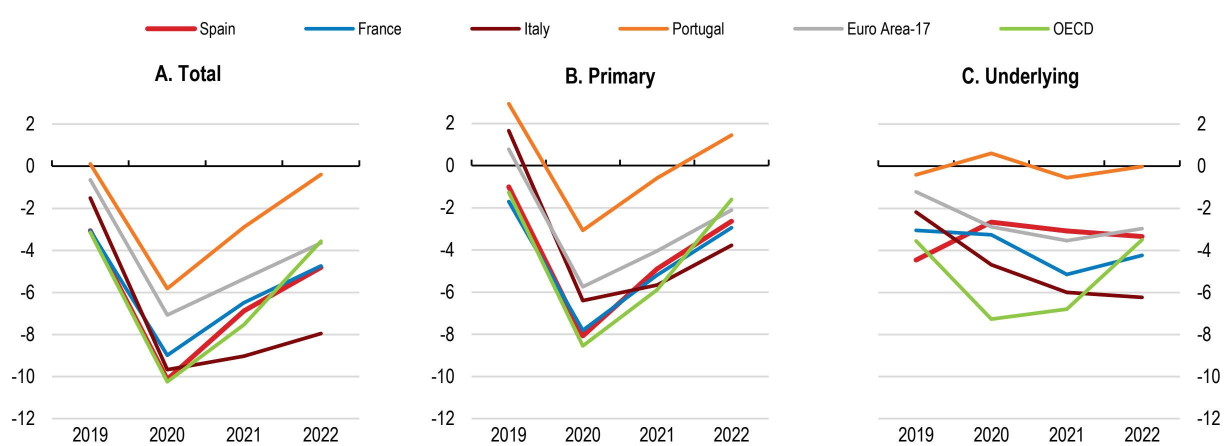
Figure 1.11. Spain's recent government deficits have been shrinking but for mostly cyclical reasons

General government balances, 2019-2022



Source: OECD General government deficit (indicator) and OECD Economic Outlook database.

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The government deficit is projected by the OECD to decline to 3.8% of GDP in 2023 and 3.5% in 2024 (compared to the government forecast of 3.9% and 3.0% published in the October 2023 Stability Programme), driven down by new temporary taxes, the wind-down in emergency measures and the non-neutral effects of still high inflation. The budget for 2023 features a 10.5% rise in social spending, a 11.4% increase in pension spending (including 8.5% for inflation compensation, something that other demographic cohorts have clearly not benefitted from to such an extent), and a 25% increase in military outlays, following the commitment to reach the NATO standard of defence spending of 2% of GDP in the next five years. New temporary tax measures targeting some firms and higher-income households are expected to increase tax collection by over EUR 11 billion cumulated over 2023 and 2024.These include one-off taxes on large banking and energy companies, a cap on large business groups' corporate tax deductions and a temporary increase in taxes on wealth and personal and corporate income, mostly affecting richer households.

The authorities have acted promptly to mitigate the impact of high food and energy prices, implementing various policies (Box 1.2). The fiscal cost of the measures at more than EUR 38 billion (about 2.9% of single-year GDP, excluding loan guarantees of a further EUR 10 billion) has been high. The bulk of support in 2022 was untargeted, such as electricity tax reductions, fuel excise rebates and cuts in the VAT benefiting in many cases the better-off (García-Miralles, 2023[12]). The measures have evolved since to target more households and vulnerable business sectors. According to the Bank of Spain the measures have reduced consumer prices by some 3 percentage points for the affluent, 4-5 points at the median income level and as much as 9 points for those at the bottom of the income distribution, though some of the effect is temporary (García-Miralles, 2023[12]). Spain has gone from having one of the highest inflation rates in the European Union to one of the lowest. Fiscal support to mitigate the high cost of living should now be fully and rapidly phased out to help to limit fiscal costs, preserve incentives to lower energy use and limit additional demand stimulus at a time of high inflation to support monetary policy. If further assistance to the poorest is needed, that should come through the new minimum income guarantee (see below).

Sustained fiscal consolidation will be needed to reduce the ratio of public debt to GDP and create space for needed spending and responding to future shocks. The government projects that the deficit will fall only by a quarter percentage point per year in 2025-26, with Maastricht debt still in triple digits throughout, ending the period at 106.8% of GDP. Given the poor demographic outlook, and resulting ageing-related spending pressures, as well as the need to spend more on the green transition, it would seem prudent to step up the pace of fiscal consolidation to restore pre-COVID levels of debt in the coming few years. The government predicts an increase in ageing-related spending of around 3 percentage points of GDP by 2050, with about 1¾ points each from pensions, mostly concentrated in the 2030s and early 2040s, and health/long-term care. Failing fiscal consolidation, according to OECD estimates, public debt may follow an upward trend in the coming years (Figure 1.12, blue line), even in the case of a faster-than-projected growth (Figure 1.12, brown line). Higher interest rates on government debt (orange line) would lead to a more substantial albeit lagged increase in debt ratios, given an average maturity of debt of eight years. Even if ageing-related costs are offset, the current stance of government fiscal policy would not be sufficient to achieve a significant reduction of public indebtedness (green line).

Box 1.2. Measures taken to offset the effects of the recent energy and food price shocks

Since 2021 several measures have been taken.

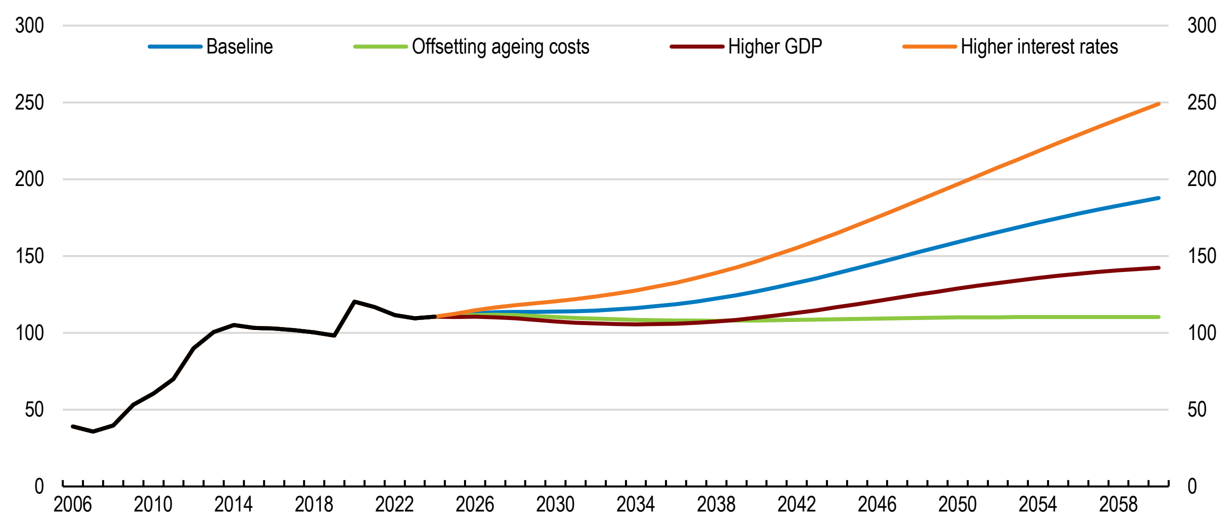
- A temporary cut in VAT on natural gas and electricity from 21% to 5% and an exemption on tax on the value of electricity produced. Basic food items are also temporarily subject to a zero rate of VAT (rather than 4%), and some other food items benefit from a halving of the VAT rate from 10 to 5% in 2023.
- Transport fuel excise rebates worth around EUR 6 billion have been curtailed for most users in 2023.

- One-off payment of EUR 200 targeted at 4.2 million households not covered by the minimum income guarantee scheme nor receiving a pension with annual incomes below EUR 27 000, subsidies to natural gas bills, a rise of EUR 100 for all monthly payments of scholarships for students above 16 years old and some direct compensation to promote public transportation. Overall support to households reached EUR 4.3 billion by end 2022, most of which was to subsidise household gas bills.
- Direct support to firms in the transportation, agriculture, fishing and energy-intensive sectors totalling EUR 1.8 billion to end-2022. In addition, a new public loan guarantee line (EUR 10 billion) for firms was created, and a six-month extension of the interest-only periods on COVID guarantees was granted to the most affected corporations.
- A 15% increase in non-contributory pensions and the minimum income guarantee.
- In June 2022, Spain and Portugal adopted a temporary cap on the price of electricity generated using natural gas ("Iberian exception"). According to the government, this scheme was expected to lower household electricity bills by 15-20%. It will end in December 2023.

In 2021, a cap was introduced for the uprating to the regulated tariff of natural gas, known as the "last resort tariff", for customers that have annual consumption of less than 50 MWh and are not in the liberalised market. The cap was extended to cover multiple-owner buildings with natural gas central heating.

Figure 1.12. Fiscal consolidation efforts are necessary to set public debt on a downward trend

Public debt, % of GDP



Note: The baseline scenario consists of the ongoing Economic Outlook projections up to 2024 and the long-term projections of the Economic Outlook No. 113 database afterwards, except for the primary balance, which is projected to improve gradually until 2029 and then to be equal to 0.5% of GDP minus net total ageing costs (net increase in public pensions, long-term care and health costs compared to 2022, adding 0.65 percentage points of GDP to annual government spending in 2029 and up to 3.0 percentage points in 2050). The estimates for ageing costs are mainly based on the projections of the 2021 European Commission Ageing Report. These projections include estimates for the cost of the indexation of pension benefits on the Consumer Price Index and for the suppression of the sustainability factor. Estimates for the other measures of the 2021 and 2023 pension reforms are based on AIReF. The "offsetting ageing costs" scenario does not include these estimates of ageing costs (i.e. the primary balance is equal to 0.5% of GDP after 2029). The "higher GDP" scenario assumes higher real GDP growth by 1 percentage point each year compared to the baseline scenario. The "higher interest rates" scenario assumes higher interest rates by 1 percentage point from 2024.
Source: Adapted from OECD (2023) Economic Outlook: Statistics and Projections (database); Long-term baseline projections; European Commission (2021), *The 2021 Ageing Report – Economic and Budgetary Projections for the EU Member States* (2019-2070); and AIReF (2023), *Opinion on the Long-term Sustainability of the General Government: The impact of demographics.*

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Given the magnitude of the longer-term public finance challenges, a medium-term plan to step up the pace of deficit reduction should be adopted. Fiscal consolidation will probably need to rely on both enhancing spending efficiency and mobilizing additional revenues. Besides lifting output by an estimated 2.2% on a ten-year horizon (Box 1.3, Table 1.4), the policy changes recommended in this *Survey* would lead to a net budgetary gain of 0.5% of GDP per year (Box 1.3, Table 1.5).

Box 1.3.Quantifying the impact of some recommendations

This box summarises potential long-term impacts of selected structural reforms included in this *Survey* on GDP (Table 1.4) and on the fiscal balance (Table 1.5). The quantified impacts are merely illustrative. The impact on GDP is estimated using historical relationships between reforms and growth in OECD countries. The estimated fiscal effects include only the direct impact and exclude behavioural responses that may occur due to policy change. Table 1.5. is not intended to provide a full description of the policy measures that the future evolution of public finances may require.

Table 1.4. Illustrative GDP impact of selected recommendations

Effect on the level of GDP

Policy	Scenario	5-year effect	10-year effect
Increase funding for early childhood education and care	Increase spending on early childhood education and care by10% from 0.5% of GDP.	0.2%	0.3%
Link retirement age to life expectancy	Increase the effective retirement age by 1.5 years.	1.0%	1.6%
Reduce regulatory barriers	Lower the OECD Product Market Regulation index related to barriers to trade and investment by 10% from 0.48.	0.2%	0.4%
Total		1.4%	2.2%

Note: Changes in regulatory barriers proposed in the Survey correspond to fostering the mutual recognition of regulations by regions and the implementation of the Market Unity Law. The scenario proposed in this box is purely illustrative, as the Product Market Regulation index used here has not been designed to correspond exactly to these reforms.
Source: OECD calculations based on B. Égert and P. Gal (2017) *The quantification of structural reforms: A new framework*, OECD Economics Department Working Paper, No. 1354.

Table 1.5. Illustrative fiscal impact of selected recommendations

Recommendations	Budgetary effect in EUR billions	Budgetary effect as a % of GDP
Eliminate some reduced VAT rates	5.0	0.4
Increase taxes on alcohol and tobacco	1.3	0.1
Raise green taxes notably on carbon	5.0	0.4
Lower non-recurrent taxes on property	-1.5	-0.1
Lower the tax burden for low-income households with children	-3.0	-0.2
Total revenue measures	6.8	0.5
Link the retirement age to life expectancy at the age of retirement	1.5	0.1
Increase social rental housing	-1.0	-0.1
Increase cash benefits for poor families with children.	-1.0	-0.1
Implement the recommendations in the fiscal council spending reviews	2.0	0.2
Increase funding for early childhood education and care	-1.5	-0.1
Total spending measures	0.0	0.0
Net budgetary effect	6.8	0.5

Note: Some of the estimates in this table were taken from the White Book (see Box 1.4). The increase in “funding for early childhood education and care” corresponds to the scenario in the previous table. In this table “Link the retirement age to life expectancy at the age of retirement” is considered equivalent to reinstating the sustainability factor.
Source: OECD calculations.

The tax burden has risen but without much attention to efficiency considerations

Government revenue was 3.8% of GDP higher in 2022 than in 2019, and tax compliance has improved recently, increasing revenues, but there is scope to further cut down on tax evasion by providing the Tax Administration Agency (AEAT) with more resources, to make the tax system more efficient and to raise still more revenue following the last major tax reform in 2014 (OECD, 2017[13]). In April 2021 an expert group comprising 15 members was established by the Minister of Finance to propose a broad-based tax reform. It reported in early 2022 in a detailed White Book (Institute for Fiscal Studies, 2022[14]), but the economic context in general and the government's revenue situation had changed so much since the authors' deliberations that its impact was diminished (Box 1.4).

Box 1.4. Recommendations from the expert group on tax reform

The government commissioned an expert group to make recommendations to reform Spain's tax system as it applies to the environment, corporations, digital activities, and regional harmonisation. It reported in 2022 in a "White Book" (*Libro blanco sobre la reforma tributaria*).

The most important recommendation was to remove the reduced VAT rates of 10% and the super-reduced rate of 4%. This would generate over EUR 17 billion (about 23% of its current yield), though offsetting compensation for the poor would lower the net gain to EUR 14.5 billion (20%) (IMF, 2022, p. 13[15]). The group also recommended eliminating the VAT exemption of financial and insurance services, which could raise a further EUR 2.8 billion. However, the group argued that it would seem necessary to combine that with the removal of the current 8% insurance tax and possibly the financial transactions tax of 0.2%, which was introduced in 2021 and has yielded about EUR 300 million per year, far less than had been expected. As well, a series of detailed recommendations pertained to digital services taxation in the wake of the January 2021 imposition of a 3% digital services tax and in conjunction with recent proposals from the European Commission.

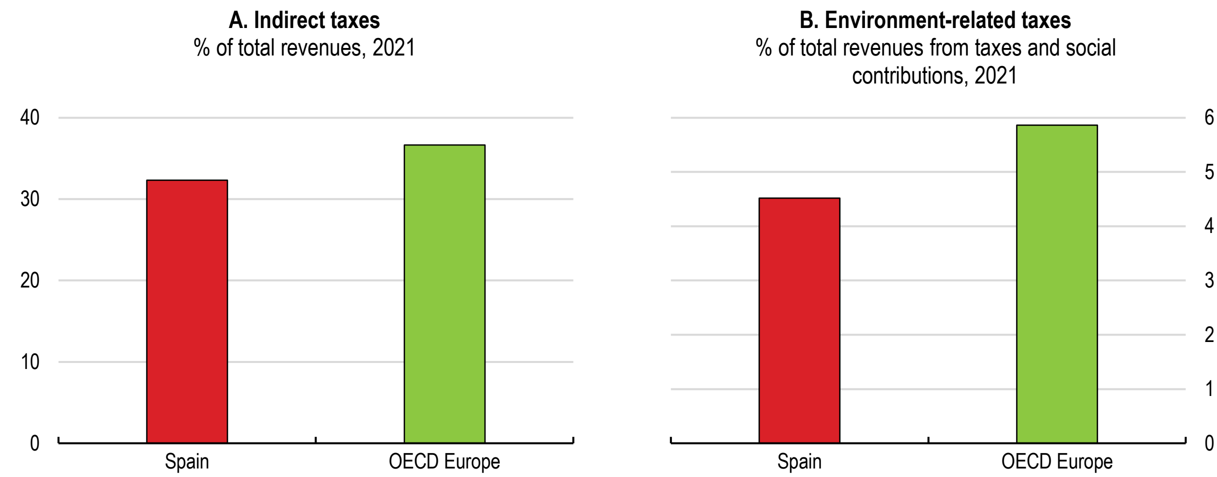
The group also suggested raising environment-related taxes, with estimated net revenue effects of EUR 5.9 to 15.0 billion. It called for higher rates on car registration, diesel, natural gas, fuel used in agriculture and new taxes on airplane tickets, use of road infrastructure (road pricing), extractive industries, and aviation and maritime fuels, as well as a lower electricity consumption tax and a repealing of the energy production tax.

In the area of wealth and inheritance taxation the committee recommended harmonising the systems across the Autonomous Communities by setting boundaries. For example, on the progressive net wealth tax (currently imposed only by Norway and Switzerland in Europe), it suggested a higher threshold of EUR 1 million (up from the current 0.7 million) and a narrower rate range from 0.5-1.0%, compared to the current 0.2-3.5%. As regards inheritance tax (which generates only 0.6% of total tax revenue), it advised a cut in the top rate (which is currently as high as 81.6%) to no more than 25% for close heirs and an increase in the threshold from EUR 16 thousand to EUR 250 thousand, although Andalusia and Galicia have already got thresholds of EUR 1 million.

The government has been deliberately making the tax system more redistributive: for example, about 60% of personal income taxes are paid by the top income decile. Greater efforts have also been made to shrink inter-regional per capita income differences (the current system eliminates about 60% of such gaps). As well, the government is making the tax system slightly greener by implementing new taxes on single-use plastics and, in 2023, on municipal waste.

Despite this progress, Spain still has a tax-to-GDP ratio that is below average EU levels and room to raise some additional revenues, notably from the VAT, environmentally-related taxes and other excise duties, which are lower than those raised by their OECD European counterparts (Figure 1.13), as recommended in past *Economic Surveys* (OECD, 2021[16]). Relying more on these tax bases would limit distortions to economic growth. On the other hand, some taxes seem unusually high, notably non-recurrent taxes on property (which amount to 0.2% of GDP, whereas they round to zero in the average OECD country). Also, a recent OECD report found that well-designed inheritance taxes can raise revenue and enhance equity, at lower efficiency and administrative costs than other alternatives (OECD, 2021[17]).

Figure 1.13. A small share of public revenue is raised from indirect and environment-related taxes



Source: European Commission; Eurostat.

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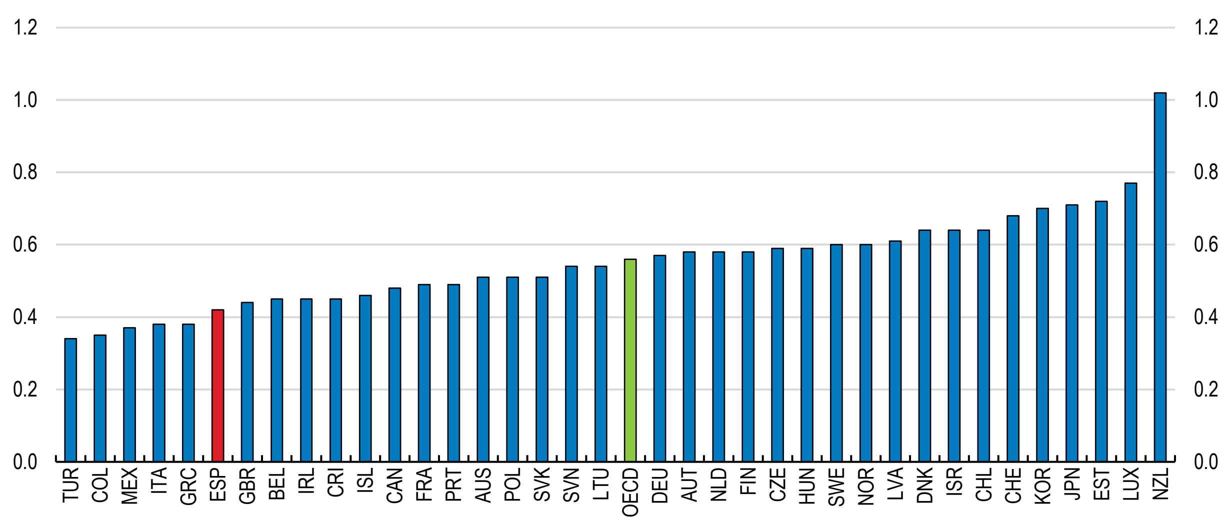
Figure 1.14. The VAT is underutilised

VAT Revenue Ratio, 2020



Note: Data for Türkiye refer to 2019.
Source: OECD (2022), Consumption Tax Trends 2022.

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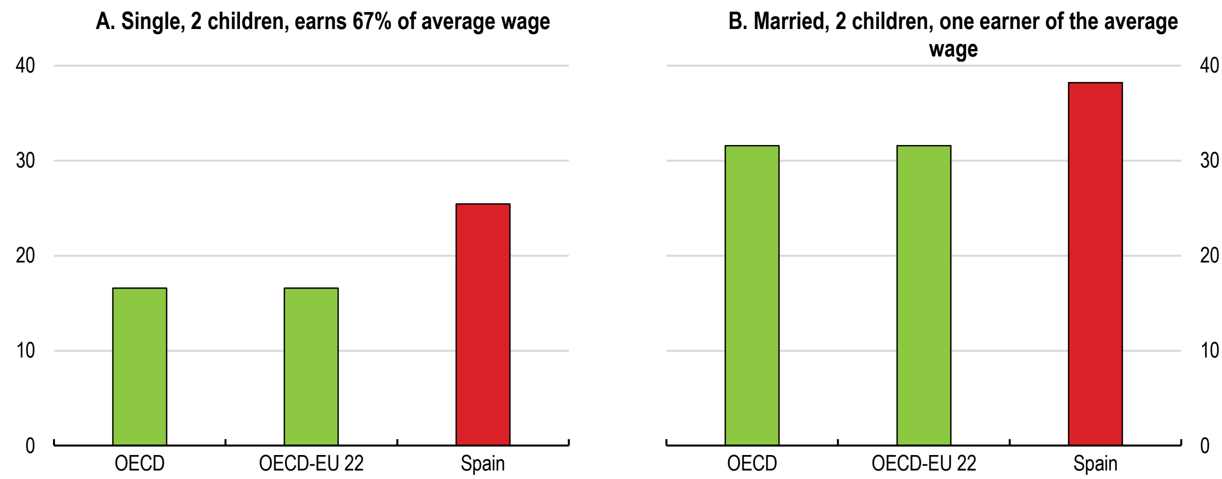
VAT exemptions and reduced rates (notably on hotels and restaurants) significantly reduce VAT revenue and contribute to Spain's poor efficiency in VAT collection (Figure 1.14). The reduced VAT rates disproportionally benefit higher-income households (OECD, 2021[16]). The government could consider moving towards a single uniform VAT rate in the medium term by gradually broadening the VAT base and compensating lower income groups through targeted spending to reduce distortions and achieve greater equity. The 2022 "Create and Growth" law made electronic invoicing mandatory for operations between companies and freelancers, and a preliminary draft regulation seeks to extend electronic invoicing to all operations between companies. This is welcome, as such initiative could help to reduce tax avoidance and enhance tax collection, and efforts to promote electronic invoicing should be continued.

The personal income tax schedule rises steeply already at modest levels of earnings, discouraging labour supply. Work incentives are diminished for people earning less than the median income because of high marginal rates and large tax wedges (OECD, 2022[18]). The average tax burden including all social contributions less cash benefits as a share of total labour costs (the "tax wedge") is higher than the OECD average for all household situations. But, more importantly, it is significantly above the OECD-Europe average for the categories of single parents with two children earning 67% of the average wage (24.4% compared to 19.6%) and couples with one earner earning the average wage with two children (33.8% compared to 29.9%) (Figure 1.15). More effort to ease the tax burden on such households would be advisable to improve their work incentives and horizontal equity and fight poverty.

Figure 1.15. Average tax burdens are high for low-income households with children

% of labour costs, by household type and wage level, 2022



Source: OECD (2023), *Taxing wages.*

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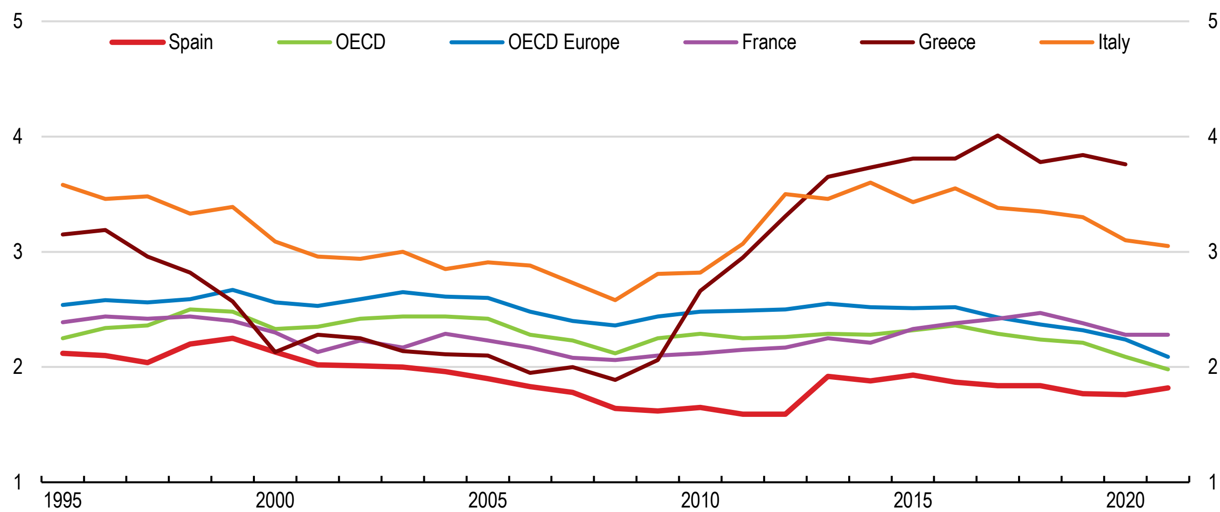
Spain has considerable scope to make the tax system more environmentally friendly. Environmental tax revenue as a share of GDP is low compared to most OECD European countries and has fallen over time from a peak of 2.25% in 1999 to 1.75% in 2021 and an expected 1.25% in 2022 (Figure 1.16), as against an OECD-Europe average of 2.27%. Spain's implicit tax rate on energy in 2019 was just over EUR 200 per ton of oil equivalent, the sixth lowest among 17 EU countries (IMF, 2023[19]). And its net Effective Carbon Rate in 2021 was only 20th in the OECD at less than half Switzerland's leading rate (OECD, 2022[20]). Several proposals to raise energy/environmental taxes were made in the recent experts' White Book (Box 1.4), but few have been acted on, though an in-depth review of environmental taxation is underway.

Remaining environmentally costly features of the tax system include a tax advantage given to diesel over petrol in road transport, zero rates on fossil fuels used off-road (such as in commercial navigation, and aviation and rail transport) and particularly low rates on fossil fuels used in industry (notably zero in the fisheries sector). Moreover, several tax-related actions taken during the ongoing energy crisis have been detrimental to long-term environmental goals by suppressing price signals, notably the petrol tax breaks.

Most of these were eliminated at the end of 2022, but some were extended to the first half of 2023. It would have been preferable and less costly to resort rather to cash transfers or block tariffs – where a basic amount of energy is provided at a low price with a much higher tariff applied above that rate to encourage energy frugality – or social tariffs where low prices are offered only to low-income groups. More generally as environmentally related taxation increases, adequate compensation measures for lower-income groups must be provided for social equity reasons and to ensure the necessary public support for climate change mitigation.

Figure 1.16. Spain raises little environmentally related tax revenue

Environmentally related tax revenue, % of GDP



Source: OECD (2023), Policy Instruments for the Environment (PINE) Database.

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Improving spending efficiency

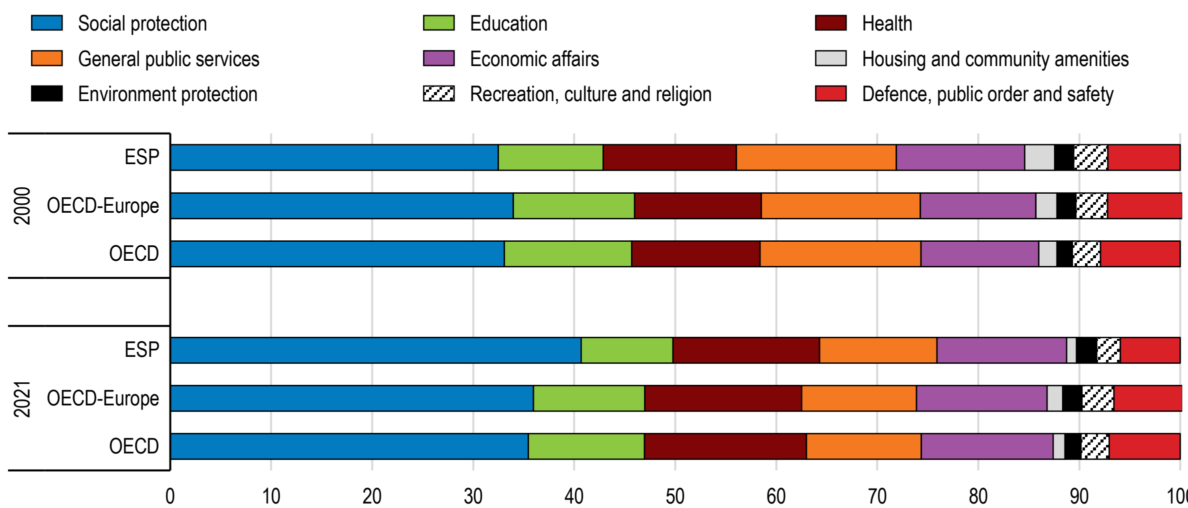
At 50.6% of GDP in 2021, Spain's public spending is relatively low compared to EU peers (though in the last year before the pandemic, i.e. 2019, slightly greater than the OECD average), but less of it is devoted to growth-enhancing spending, including education, training, and public investment, and relatively more to social protection, notably pensions and unemployment compensation (Figure 1.17). Some shift would seem appropriate in the medium term to strengthen growth.

Improving the quality and efficiency of public spending is appropriately becoming more of a focus. Since 2017, 11 spending reviews have been completed, and four are underway. Mandatory reports on measures taken in response to previous Fiscal Council recommendations have been part of the budget cycle since 2022. The latest March 2023 report credits the government with at least partial implementation of 184 of the 296 recommendations made by the Council. Proper follow-up is crucial to the success of this worthy endeavour. Following an RTRP commitment, the government is developing a strategy to reinforce the evaluation of public policies that will allow for ex ante, intermediate and ex post evaluation.

Significant efforts are also being made to improve transparency and integrity in the public sector through several open government initiatives under the Fourth Open Government Plan. They cover access to information, open data, citizen participation, regulatory footprints, a register of lobbyists, whistle-blower protection, open government inclusive communication, awareness-raising and training programmes, as well as an Observatory to promote best practises and 53 projects at regional and local levels.

Figure 1.17. The structure of government expenditure is weighted towards social spending

General government expenditure by function, % of total, 2000 and 2021



Note: OECD averages exclude Canada, Chile, Colombia, Costa Rica, Japan, Mexico, New Zealand, and Türkiye, for which data are not available on both periods.
Source: OECD Statistics on National Accounts.

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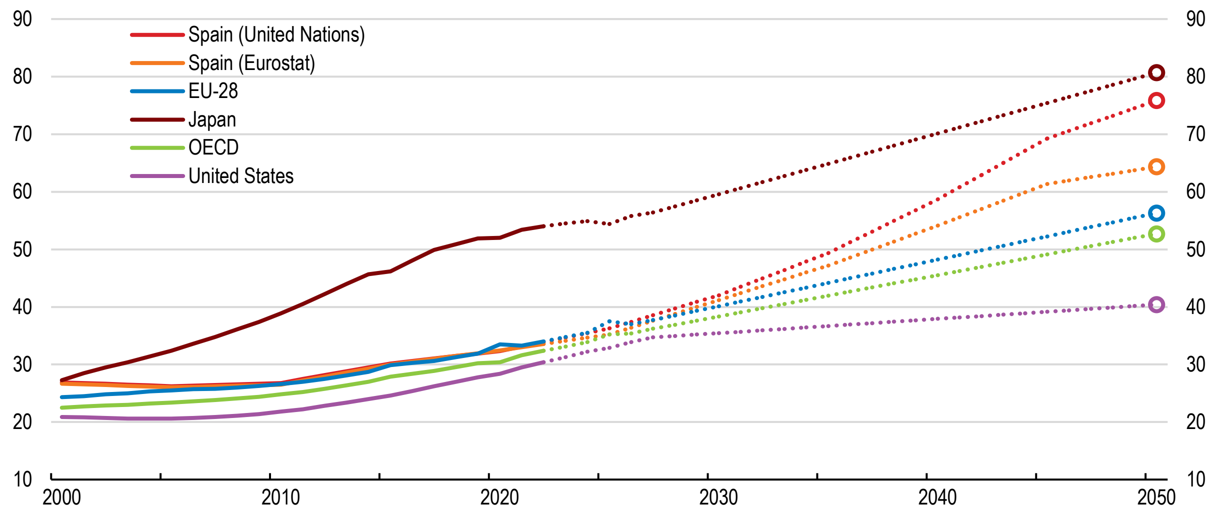
Longer-run spending pressures are significant in several areas

Given projected demographic trends (Figure 1.18), upward public spending pressures in the longer term will come notably from ageing-related items (pensions, health and long-term care), even if those related to pensions will begin to reverse somewhat after 2050. However, the green transition will also doubtlessly require extra government outlays. Moreover, the government is committed to raising the share of military spending in GDP from 1% to 2% of GDP by 2029 in line with its NATO commitments. The minimum income guarantee and extra grants to disabled and low-income university students are also adding to outlays and could do so more in the future if more of those eligible apply. Draft legislation on universities could push up that sector's claim on resources by about a quarter of a per cent of GDP on top, though that would merely bring Spain to around the OECD average share of GDP (based on 2019 data).

Less certain are the spending effects of employers potentially shifting seasonal workers to unemployment benefits under the revised labour-market legislation (see Chapter 2), the need for more social housing (see Chapter 2) and better pay for generally fewer numbers of public-sector workers, notably for those in the education and health sectors. There is a strong case for more funding for the public employment service to properly implement active labour market measures (see Chapter 2). In any case, some further priority setting will be required: while OECD and other estimates are that the structural deficit is over 3% of GDP in 2023, it could move up to closer to 5% of GDP in the coming years without some further consolidation effort.

Figure 1.18. The ageing of Spain's population is about to accelerate

Old-age dependency ratio, %



Note: The old-age to working-age demographic ratio is defined as the number of individuals aged 65 and over per 100 people of working age defined as those at ages 20 to 64.
Source: OECD Pensions Statistics.

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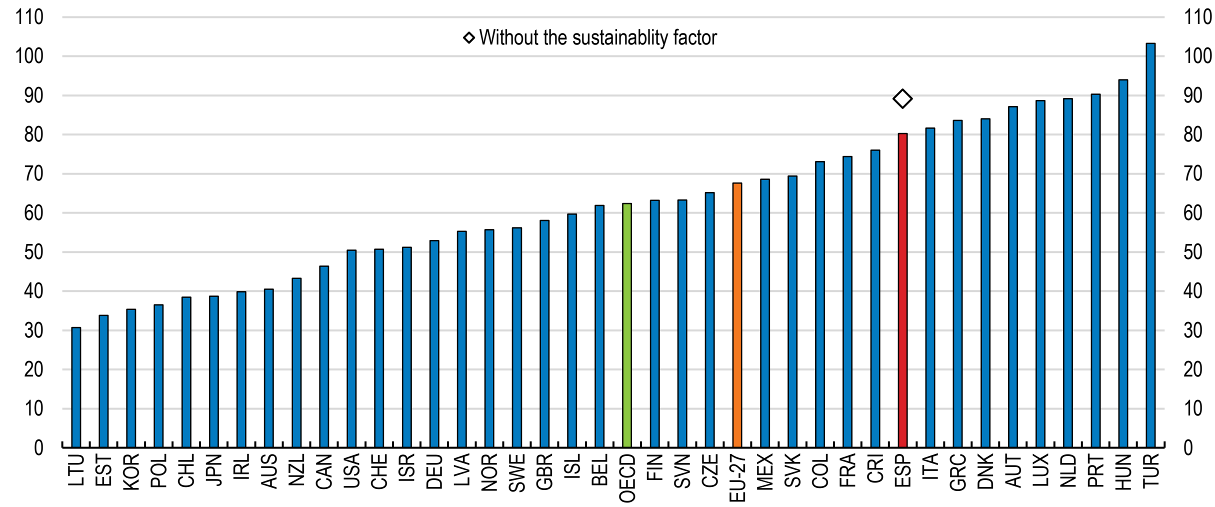
Addressing the rise in pension spending

The Spanish contributory pension system has so far offered high replacement rates (Figure 1.19) at reasonable pension-spending to GDP ratios (11.3% of GDP in 2019), resulting in low old-age poverty (Figure 1.20). But population ageing is projected to increase long-term fiscal sustainability pressures, with a large rise in the old-age dependency ratio by 2050 (Figure 1.18 above). To address those pressures, the government undertook important pension reforms in 2011 and 2013. These notably included a gradual increase in the pension age to 67, which will be achieved by 2027, and a reduction of the replacement ratio. Full implementation of the 2011 and 2013 reforms would have led public spending outlays to rise by 1.7 percentage points of GDP by 2050 and then fall by 1.5 points through 2070 compared to 2016, according to the 2018 Ageing Report (European Commission, 2018[21]). But it would have implied a significant reduction in the benefit ratio (average benefit payment in relation to the average wage), particularly affecting younger generations, even though it would have remained higher than in most other EU countries. Social pressure mounted after the reforms and led to a renewed linking of pension increases to inflation as of 2018 and a delay in implementing the sustainability factor that linked initial pension benefits to changes in life expectancy. These deviations from the reforms were estimated to result in additional pension spending of about 3-4 percentage points of GDP by 2050. But they also led to a short-term imbalance that is estimated at 2.2% of GDP in 2023 and that has resulted in rising debt in the social security system, which reached EUR 106 billion (7.9% of GDP) at end-2022.

Figure 1.19. Spain's pension system offers the average worker a high replacement rate

Net old-age pension replacement rate for workers with average wage, % 2020



Note: The net replacement rate takes account of personal income taxes and social security contributions paid by workers and pensioners. Replacement rates are slightly lower for women in Poland, Chile, Australia, Israel, Mexico, Colombia, Hungary and Türkiye, for which the male replacement rate is shown. Note that the estimate for Spain includes a sustainability factor that has since been removed, raising its rate.
Source: OECD Pension at a glance database.

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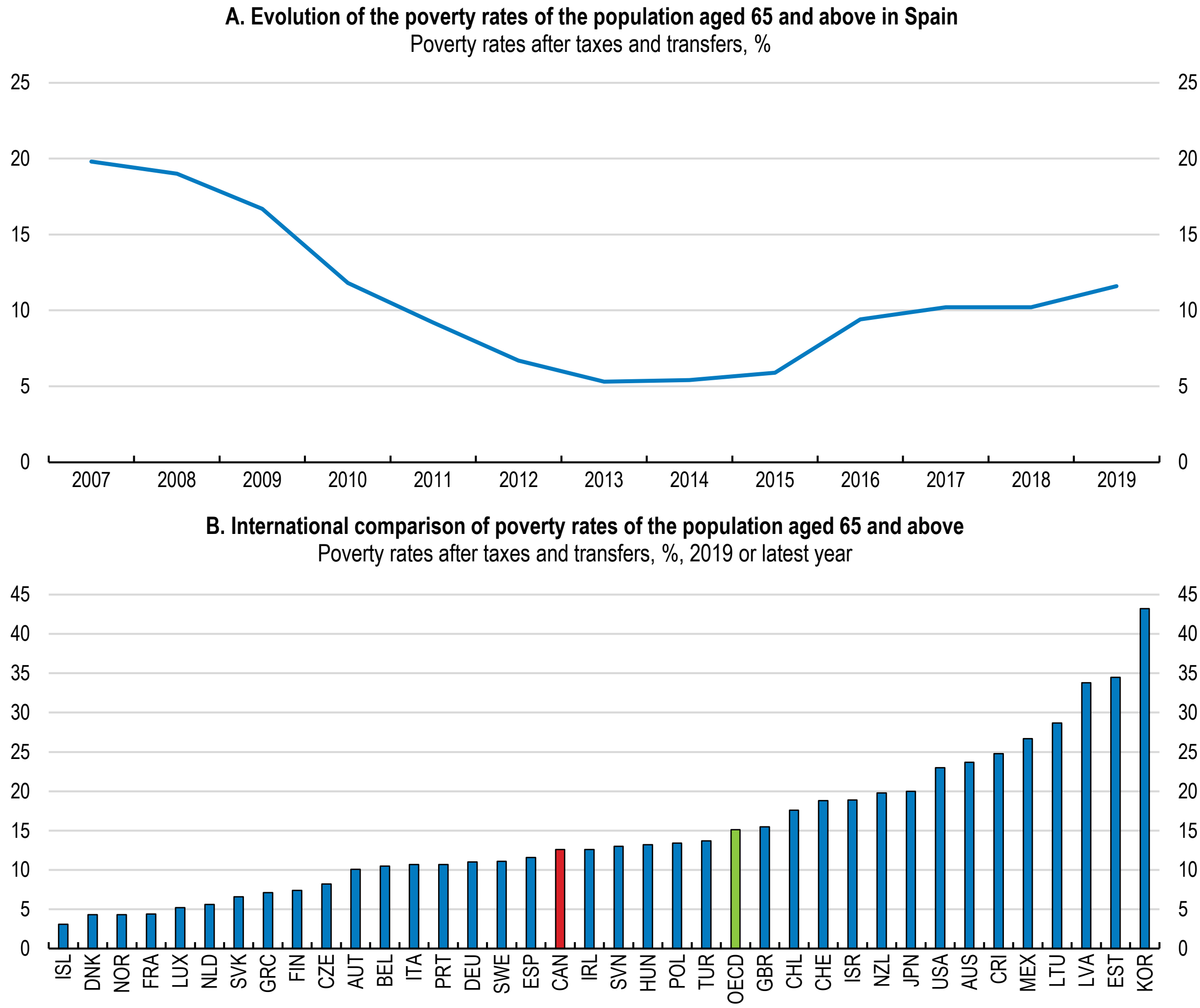
In 2021, the first part of a pension reform indexed pension benefits to consumer price inflation and eliminated the "sustainability" factor, which linked benefits to life expectancy. Revenues will be strengthened by gradually increasing the maximum bases and, later, maximum pensions. A "solidarity quota" will be phased in progressively, implying higher contributions for the highest salaries. And an Intergenerational Equity Mechanism will add an initial 0.6 percentage point (1.2 points in 2029) in contributions, mostly on employers.

Spain's workers stop working comparatively early and enjoy an extremely long retirement (including both periods with a retirement pension and others on other forms of benefits). In 2020 the effective labour market exit age was only 60.7 years, and the average period of retirement exceeded 25 years, almost four years more than both the EU27 and OECD averages. Financial incentives to delay effective retirement have been enhanced by offering a choice of either a lump-sum payment upon retirement of around EUR 12 000 per extra year of work beyond the statutory retirement age (65 with 38.5 years of contributions; otherwise 67) or a 4% increase in pensions or a combination of both. In 2023, from January to May, 8.1% of pensioneers retired one year later than their statutory retirement age, compared to 5.4% in 2021, according to the Ministry of Inclusion, Social Security and Migrations. There are also larger discounts for early retirement, heftier penalties on employers for laying off workers within two years of the legal retirement age and the prevention of labour agreements that force retirement for those beyond an agreed age. These are laudable measures, but they are unlikely to prove sufficient to fully balance the system, which will likely require some further changes in pension accrual rates.

Finally, in the same vein and in recognition of the fact that careers are now less linear and to remove gender biases, pensioners will be able to choose (until 2044) whether to set their initial pensions based on the best 29 years of contributions but with two low-earnings years excludable or to stick with the current 25 (lowest in the European Union, along with France and Slovenia). The self-employed, who typically had low pensions because 85% of them chose the lowest permissible contribution rate, will fully transition to the general regime based on actual incomes by 2032. Indeed, the fiscal council estimates the compensatory offsets (i.e. not including the impact of measures on increasing voluntary effective retirement age) at 1.3% of GDP.

Figure 1.20. Old-age poverty rates have risen somewhat but remain below the OECD average



Source: OECD Income Distribution Database.

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The new pension system's financial sustainability is to be examined by the Ministry of Inclusion and then re-examined every three years (starting in March 2025) by the Fiscal Council (AIReF) by agreement with the European Commission. AIReF has already made such an analysis, based on its latest demographic projections but excluding the growth impact of the RTRP reforms and associated spending. It shows that the pension reforms approved between 2021 and 2023 represent an increase in the deficit of 1.1 percentage point of GDP in 2050 and debt trending higher and reaching 186% of GDP by 2070. Legally such a scenario would be headed off by a rule that would trigger an automatic increase of pension contributions to correct 20% of the estimated gap every year beyond any corrective measures the government might otherwise decide, but the Fiscal Council judged the mechanism to be too imprecise to include in their baseline scenario.

New measures may be needed. Rather than impose extra contributions on the generation of active workers, the government should lengthen working lifetimes by linking the statutory retirement age to life expectancy at retirement, as recommended in the 2021 *Economic Survey*. But it should also look to accrual factors in the system, which allow a half pension after merely 15 years of contributions and a full pension after only 37 years (to be raised to 38.5 years), much less than corresponding periods elsewhere.

Furthermore, the reference period for the computation of pension rights should be extended, most likely to at least 40 years to ensure financial sustainability. Otherwise, if pension deficits continue to be met by general revenues, maintaining pension benefits will come at the expense of other priorities and to the detriment of the already disadvantaged younger generation (Chapter 2).

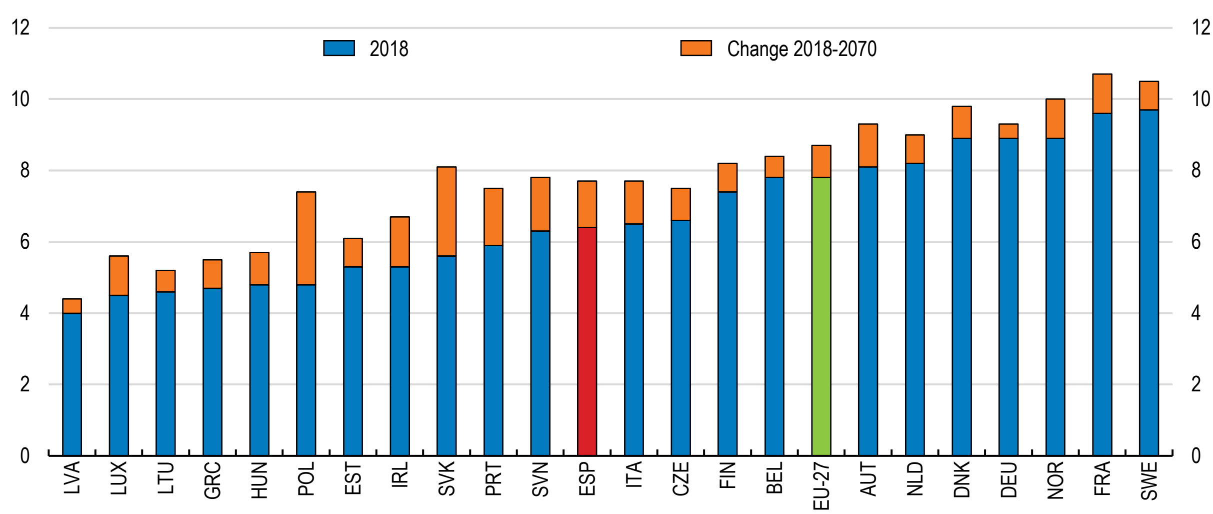
The health-care system will become more costly

The health-care system provides equity in access and delivers acceptable outcomes with moderate levels of spending (Figure 1.21). However, in the future, like other countries, Spain will face higher health spending as a result of population ageing, changes in relative prices and technological advances. Broader provision of active ageing services (which are available in only a minority of the autonomous communities and guaranteed in even fewer) would be helpful.

The COVID-19 pandemic and its aftermath ("long COVID" and the delays and lack of treatment provided) have put extraordinary demands on the health system. Human resources in the sector seem to be used at or near full capacity, and shortages of nurses are severe, numbering only 6.1 per 1000 population (Figure 1.22, Panel A). Spain should consider increasing the number of health professionals. This might mitigate the problem of many workers being unable to work because of illness (Figure 1.22, Panel B).

Figure 1.21. The share of GDP devoted to health care is still moderate but will rise somewhat

Public health and long-term care expenditure, % of GDP, 2018 and 2070 projection



Note: The "Ageing Working Group reference scenario" is used as the baseline scenario. In this scenario, health care expenditures are driven by the assumption that half of the future gains in life expectancy are spent in good health and an income elasticity of health care spending converging linearly from 1.1 in 2019 to unity in 2070.
Source: European Commission (2021), The 2021 Ageing Report, Economic and budgetary projections for the EU Member States (2019-2070), Institutional Paper 148.

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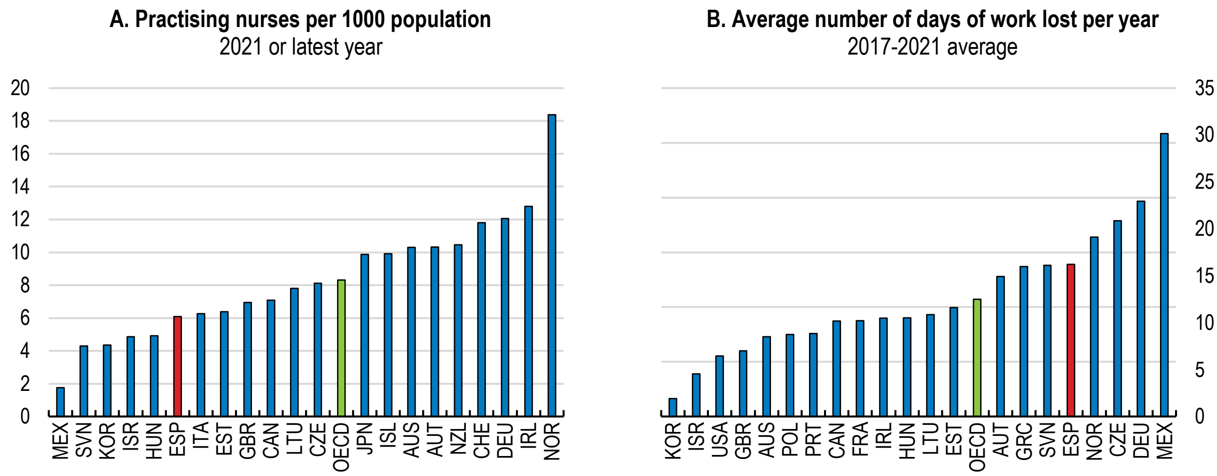
The RTRP includes measures aimed at purchasing new equipment, strengthening the health workforce and retaining talent. A reform to enhance professional skills and reduce temporary employment of nurses and doctors aims to address shortages by reducing temporary contracts; shifting their deployment towards under-served geographical areas; and improving their working conditions by supporting their professional development. The RTRP also contains reforms to broaden the portfolio of services covered by the national health system to new types of interventions, such as dental care, preventive care for children, genomics and orthopaedic and prosthetic care.

Taxes to discourage certain unhealthy behaviours could be used more intensively to improve health outcomes. In 2021 the VAT on sugary beverages was raised from 10% to the standard rate of 21% after Catalonia had implemented a regional excise tax on such drinks in 2017, which seems to have had a favourable effect (Puig-Codina, 2021[22]).

Figure 1.22. Spain has a lack of nurses and too many workers off work sick



Note: Panel B: Compensated or self-reported absences.
Source: OECD Health statistics 2022.

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Spain's taxes on distilled spirits, beer and wine are among the lowest in the European Union (Table 1.6) and could be raised. More fiscal and non-fiscal actions (e.g. advertising restrictions, packaging rules, age limits on vaping) could also be taken to discourage smoking. Spain's taxes on cigarettes are in line with those of comparator countries in the European Union. But, even with a fall of over 30% since 2010, Spain places fifth out of 22 OECD countries in terms of per capita tobacco consumption and eighth of 38 by share of adults who are daily smokers (Figure 1.23).

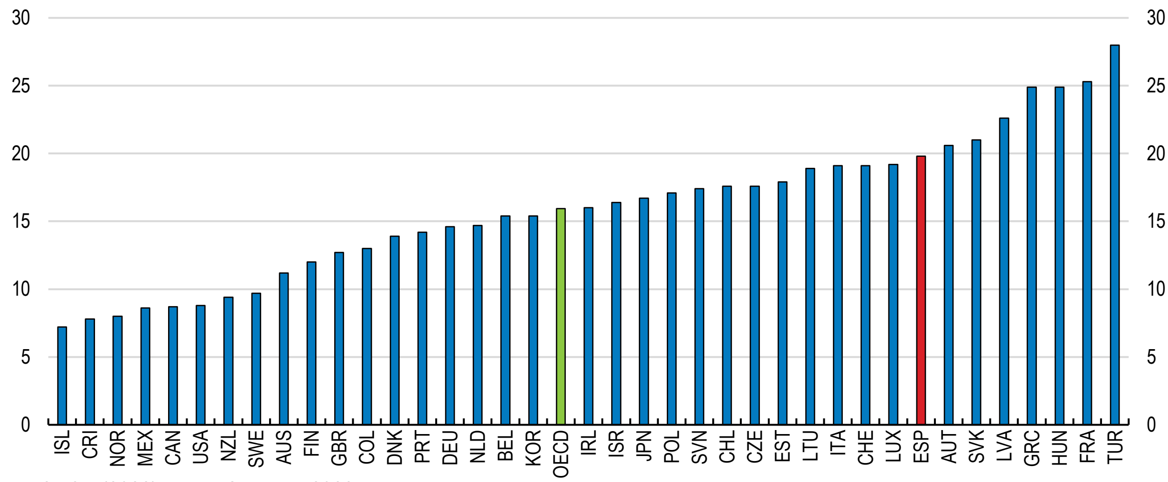
Table 1.6.Spain's alcohol taxes are low

	Beer		Wine		Other alcoholic beverages	
	Excise rate per hectolitre per % abv (USD)	VAT rate (%)	Excise rate per hectolitre (USD)	VAT rate (%)	Tax per hectolitre of absolute alcohol (USD)	VAT rate (%)
France	9.06	20	4.61 to 11.41	20	2,125	20
Italy	8.65	22	0	22	1,218	22
Portugal	9.81 to 34.47	23	0	13 to 23	1,632	23
Spain	0 to 15.95	21	0	21	1,128	21

Note: % abv = percentage of pure alcohol by volume at 20°C. Lower excise rates for small independent breweries and on low-alcohol beer may apply.
Source: OECD (2022), *Consumption Tax Trends 2022: VAT/GST and Excise, Core Design Features and Trends*.

Figure 1.23. Spain has a high share of daily smokers

% of the population aged 15 and over, 2021 or latest year



Source: OECD (2022) Health Statistics 2022.

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Table 1.7. Past recommendations on fiscal and pension policies and actions taken

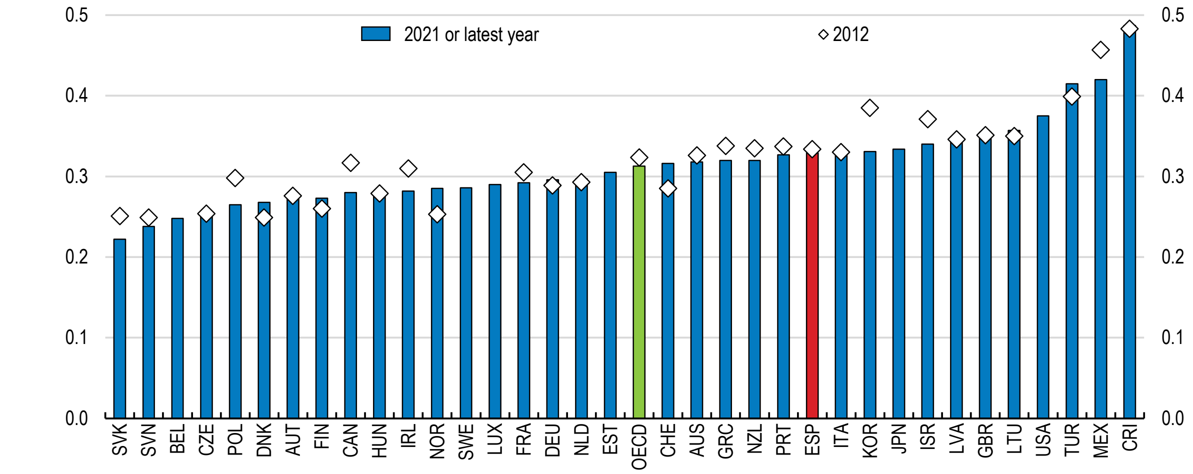
Recommendations in past Surveys	Actions taken since 2021
Keep fiscal policy supportive until the recovery is firmly underway, by prolonging support measures while making them more targeted.	The 2022 budget was supportive, and the 2023 budget curtailed support measures. New support measures have been taken in the context of the war in Ukraine.
When the recovery is firmly underway, announce a multi-year path for fiscal consolidation strategy, which includes all levels of government.	No action taken.
Increase systematic evaluation of policies at every level of government.	Policy evaluation is becoming more common. See text for further details.
Ensure efficient coordination and governance of the recovery plan by ensuring transparent procedures and criteria for investments.	With the requirements of the European authorities the Plan's investments have been treated efficiently and transparently.
Abolish reduced value-added tax rates that are regressive.	No action taken.
Increase taxation of fuels to better reflect emissions of CO_2 and other pollutants.	No action taken. Taxes on fuels were temporarily lowered in 2022 to deal with the fallout from the energy cost increases.
Make the expenditure rule the main rule and link it to the debt ratio targets.	Both national and EU fiscal rules were suspended again for 2023. Negotiations are ongoing as to what rules will be applied from 2024.
Take adequate and socially acceptable measures to ensure the long-term financial sustainability of the pension system.	The pension system has been overhauled, and the Fiscal Council has quantified the effects, judging the reform to be not fully financed.
Link the statutory retirement age to life expectancy at retirement, discourage early retirement, for example by increasing the number of years of contribution to gain a full pension.	New system of adjustment coefficients to discourage early retirement established in the 2021 pension reform.
Further extend the pensionable earnings reference period and the number of years of contributions required to gain a full pension.	An option to extend by two years the pensionable reference period has been introduced in the 2023 pension reform. No change has been made for full pension qualification.
To increase the flexibility of combining work and pensions, do not reduce pension payments & allow additional pension entitlements to be earned.	The Royal Decree-Law 1/2023 on incentives for hiring and the social protection of artists establishes the compatibility between retirement pensions and artistic activities.
Facilitate greater choice of both pension scheme providers and investment options available through employers.	No action taken.

Reducing poverty by enhancing redistribution

Despite improvements in recent years, Spain is still characterised by marked income inequalities compared to European peers (Figure 1.24) and over one quarter of the Spanish population was at risk of poverty and social exclusion in 2021 (Figure 1.25). Disparities across regions are large, with poverty concentrated in the south. The risk of poverty is particularly prevalent among those under 25 because of high unemployment, low wages and higher costs of housing, calling for specific policies targeted towards youth (Figure 1.26 and Chapter 2). Spain has the highest child (0 to 17 year-olds) poverty rate in Western Europe, at 21.8%. The poverty rate is low for those aged 65 or over, although it has risen to near the EU average in recent years.

Figure 1.24. High income inequalities remain after redistribution

Gini income coefficient, 2021 or latest year



Note: Data for Spain refer to the year 2020. The Gini coefficient is based on the disposable income, post taxes and transfers.
Source: OECD Income Distribution Database.

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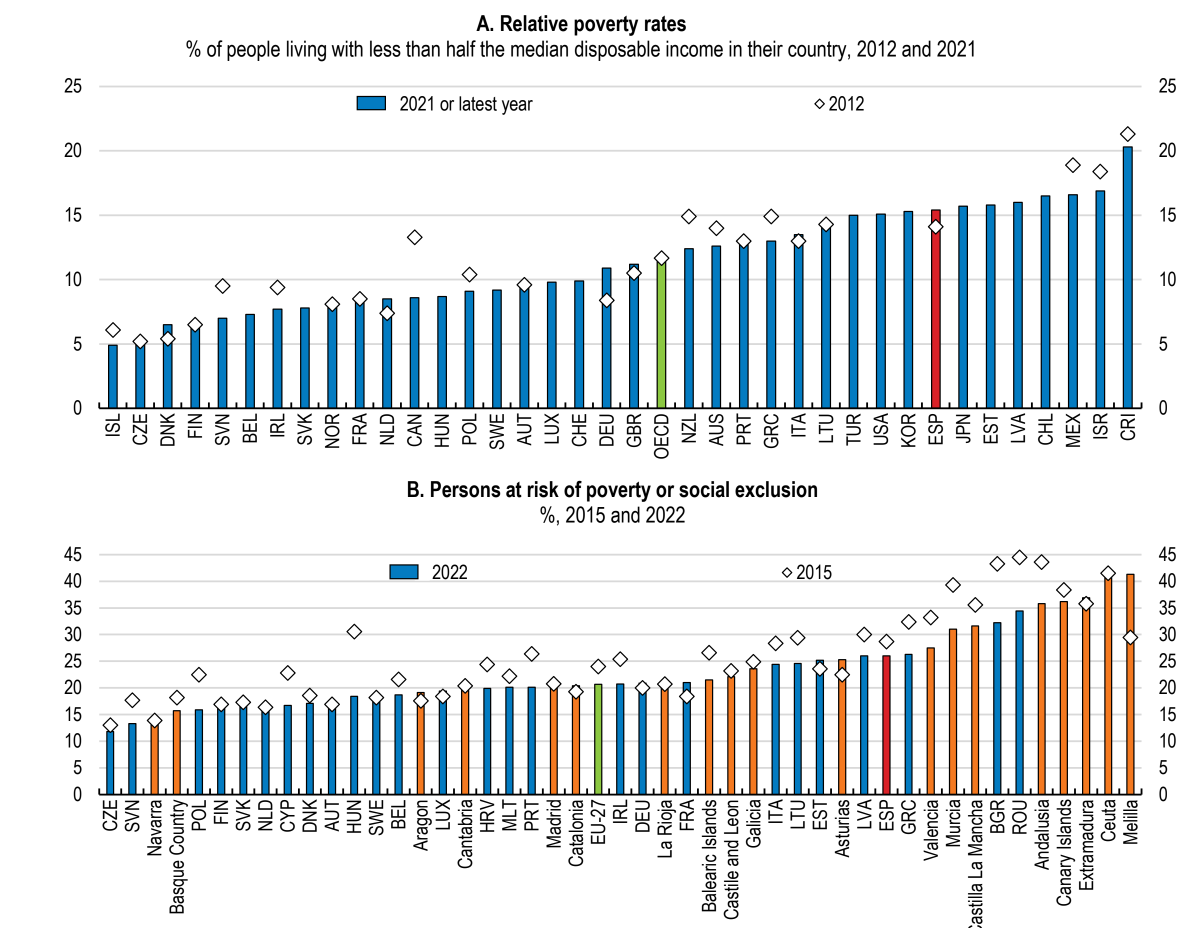
Figure 1.25. Poverty remains high



Note: Panel B: Persons at risk of poverty, or severely materially and socially deprived or living in a household with a very low work intensity. Persons at risk of poverty have an equivalised disposable income (after social transfer) below 60 % of the national median equivalised disposable income after social transfers. Details on the indicator are available at: https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Glossary:At_risk_of_poverty_or_social_exclusion_(AROPE).
Source: OECD Income Distribution Database; Eurostat, Income and living conditions database.

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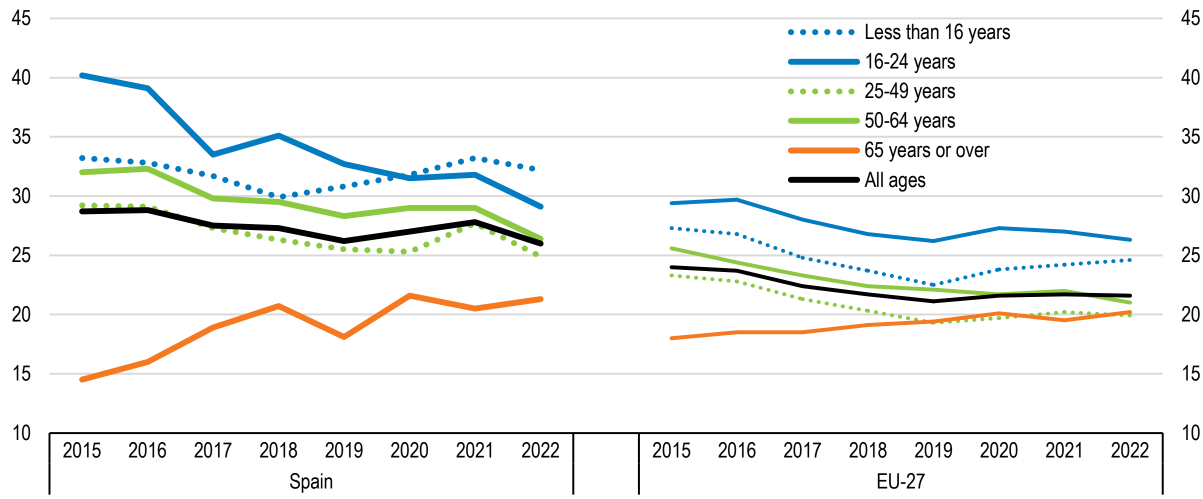
Figure 1.26. The risk of poverty is particularly high among young people

Persons at risk of poverty or social exclusion by age, %



Note: Persons at risk of poverty, or severely materially and socially deprived or living in a household with a very low work intensity. Persons at risk of poverty have an equivalised disposable income (after social transfer) below 60 % of the national median equivalised disposable income after social transfers. Details on the indicator are available at: https://ec.europa.eu/eurostat/statistics-explained/index.php?title=Glossary:At_risk_of_poverty_or_social_exclusion_(AROPE).
Source: Eurostat.

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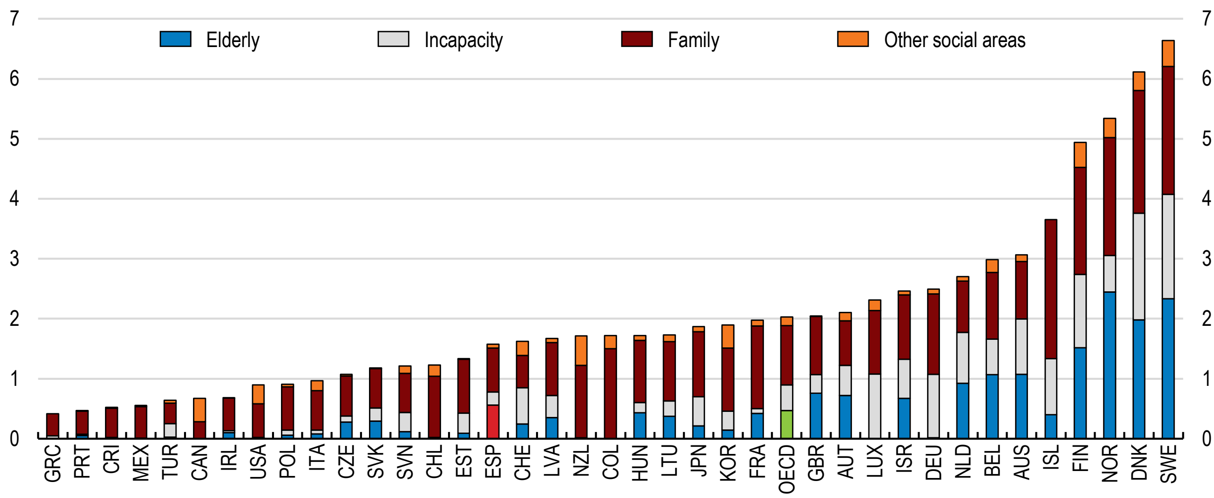
Spain's spending on social services is below the OECD average (Figure 1.27). Spending on people with disabilities, family (including child benefits), and the elderly stands at about 1.6% of GDP, well below the European average. However, total public social expenditure, including benefits, is much higher than the OECD average, at 28.1% of GDP in 2022 against 21.1%. Hence, there should be some room for a reduction in total spending. Social expenditure is heavily centred on cash contributory benefits (e.g. pensions and unemployment benefits) (Figure 1.28). This leads to a bias in the selection of recipients in favour of people able to contribute and may not adequately protect vulnerable groups, such as people out of work (Levy, 2022). Furthermore, in Spain a larger proportion of cash social benefits goes to higher-income (30%) than lower-income households (e.g. 12% for the poorest quintile), in contrast to most EU members (Figure 1.29). Moreover, social assistance programmes are not fully effective at reducing poverty, due to several policy weaknesses, including insufficient adequacy and coverage, inefficiencies in the administrative systems, and lack of coordination. But social spending alone cannot reduce inequalities, and efforts should also be directed to making the labour market more inclusive, as discussed above and in Chapter 2.

Figure 1.27. Public spending on social services is below the OECD average

Public expenses for benefits in kind by target group (% of GDP), 2019 or latest year



Note: The benefits selected are benefits in kind for older people (residential care, home care and other benefits), people with disabilities (residential care, home care, rehabilitative services and other benefits), families (other benefits) and other social areas.
Source: OECD (2023) Social Expenditure Database.

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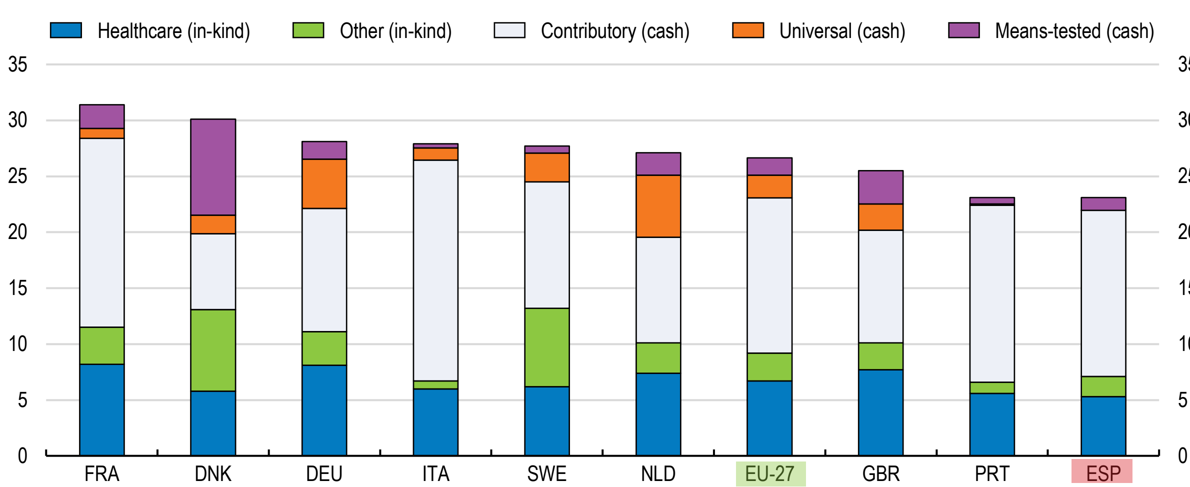
Figure 1.28. Social expenditure is centred on cash contributory benefits

Social protection expenditure as a percentage of GDP, 2018



Source: Levy, H. (2022), "Social welfare systems and inequality in Europe, Closing Spain's social protection gap", *Inequality and social contract outreach report,* OECD and "La Caixa" Foundation.

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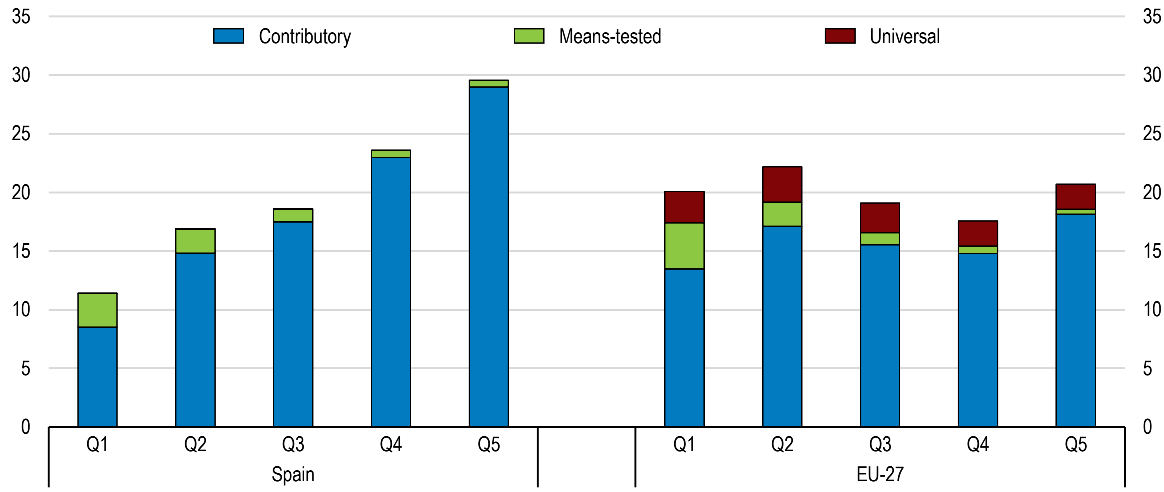
Figure 1.29. The distribution of social benefits favours wealthier people

Share of total social cash benefits received by quintiles of household disposable income, %, 2018



Note: Data for the EU-27 exclude the Slovak Republic. Data refer to year 2018, except for Ireland (2016) and Italy (2017).
Source: Levy, H. (2022), "Social welfare systems and inequality in Europe, Closing Spain's social protection gap", *Inequality and social contract outreach report,* OECD and "La Caixa" Foundation.

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Given the high level of decentralisation, a first step toward improving the effectiveness of social assistance would be a more coordinated approach. There is generally no single point of contact or one-stop shop to coordinate income support, social and unemployment services to offer a joint response to the challenges derived from lack of employment or other situations that push people towards social exclusion. These single locations grant users access to the services of social workers, health professionals (including mental health experts), employment specialists and legal advisors, among others. Spain could consider the experiences of Finland, where multi-sector services centres provide employment, social, health, rehabilitation and social security services to vulnerable people, or France where multiservice information and mediation points facilitate access to various public services and sources of social assistance, including legal assistance (OECD, 2022[23]).

Reducing overlapping benefits and improving the transferability of social and housing rights across regions would also make the system more efficient, ensure continuity of care for citizens and facilitate their mobility and participation in the labour market, as stressed in the 2018 *Economic Survey* (OECD, 2018[24]). Most regions do not have formal coordination mechanisms with other regions, and each has its own social services legislation. When citizens move between regions, they must reinitiate all the procedures to obtain services; moreover regions require residents to have been registered there for some time before receiving services. Lowering the complexity of the administrative processes and the bureaucratic hurdles to increase participation in the existing programmes is needed. As a result of the different regional regulations, there are important differences in the availability of social services across regions and high administrative complexity. Setting up a minimum guaranteed level of social services would help to reduce geographic inequities in access to services (OECD, 2022[23]). A law is currently being drafted to establish common minimum services across the country, reduce barriers to access social protection and facilitate mobility.

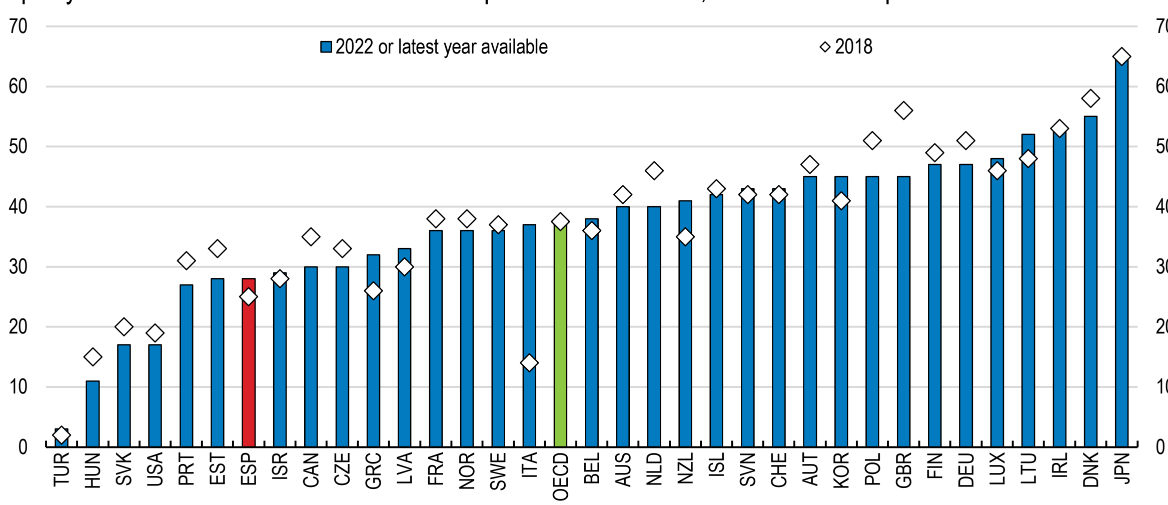
Beyond this, the central government can support the regions and the local entities in improving service quality. Although the statistics are not complete or fully comparable, the number and diversity of profiles of social services professionals appears to be insufficient, undermining the efficiency of the service and generating a heavy workload and stress for workers (OECD, n.d.[25]). Options to increase staff-to-population ratios and for continuous staff training and development should likewise be explored, leveraging European funds when possible. Finally, there is a need to bolster evidence-based policies in social services, starting by using the evidence collected by the 34 experimental studies conducted in 2022 and 2023 on the impact of different inclusion itineraries for beneficiaries of the minimum income guarantee scheme across the country. Greater integration of information systems and enhanced data sharing between social services providers would help assess needs and improve quality. Strengthening impact evaluations would allow a better knowledge of which interventions are working and which are not. Better data can also contribute to the dissemination of best practices and improve future policy design.

To address extreme poverty and complement the inadequate social assistance programmes administered by regional governments, a new nationwide means-tested minimum income guarantee scheme (Ingreso Minimo Vital, MIS) was introduced in May 2020. Moreover, a child support benefit exists since 2021. This is a step in the right direction, and indeed, the share of persons at risk of poverty or social exclusion decreased markedly in 2022, from 27.8% to 26.0%, around 850 000 fewer people. Nevertheless, there is scope for improvement. So far, the MIS has not reached as many households as it was meant to. By end-2022, close to 550 000 households had received the MIS, corresponding to 65% of the eligible households., For the year 2022, 82.2% of the planned budget was spent (EUR 2.5 billion out of EUR 3.0 billion).

Non-take-up is common and Spain does not differ from other countries in this regard. To increase take-up of the MIS by eligible households, the government has put in place a promotion campaign. Communication efforts should continue as, according to the limited available data, many potential beneficiaries are not aware of the benefit, especially among families in extreme poverty (Ayala Cañon, 2022[26]). These efforts could also help reduce the large number of unsatisfied requests because of non-compliance with the eligibility criteria. Monitoring, identifying, and removing unnecessary barriers to access should be reinforced.

Figure 1.30. The minimum income appears relatively low by international standards

Adequacy of minimum income benefits for a couple with two children, % of median disposable income



Note: The indicator measures the income of jobless families relying on guaranteed minimum income benefits as a percentage of the median disposable income in the country. Housing supplements are included subject to relevant eligibility conditions. Families considered are a couple with 2 children aged 4 and 6 years old where both the principal and the spouse are unemployed. Data for Spain refer to the national minimum income scheme at the end of 2022 without any regional supplement. The methodology of the indicator is available at: https://www.oecd.org/social/benefits-and-wages/OECD-TaxBEN-methodology-and-manual.pdf.
Source: OECD, Benefits and wages: Adequacy of Guaranteed Minimum Income benefits.

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Furthermore, it will be important to assess the adequacy of the MIS to effectively reduce extreme poverty as it appears relatively low by international standards (Figure 1.30), even if support has increased compared to many regional schemes. While the MIS is recent and its implementation has progressed noticeably since it came in force, there is still room to enhance complementarities between the MIS and the regional minimum income support schemes and coordination between the central administration and regions (AIReF, 2022[27]). In particular, the complexity for users and the administrative costs induced by the coexistence of the MIS with regional minimum income schemes should be reduced. The law that introduced the scheme included an obligation to develop work incentives and the incentives entered into force in early 2023. The benefits are gradually phased out as earned income rises. This may have a larger budgetary cost, but it ensures that incentives to work are not compromised.

Table 1.8. Past recommendations on social policies and actions taken

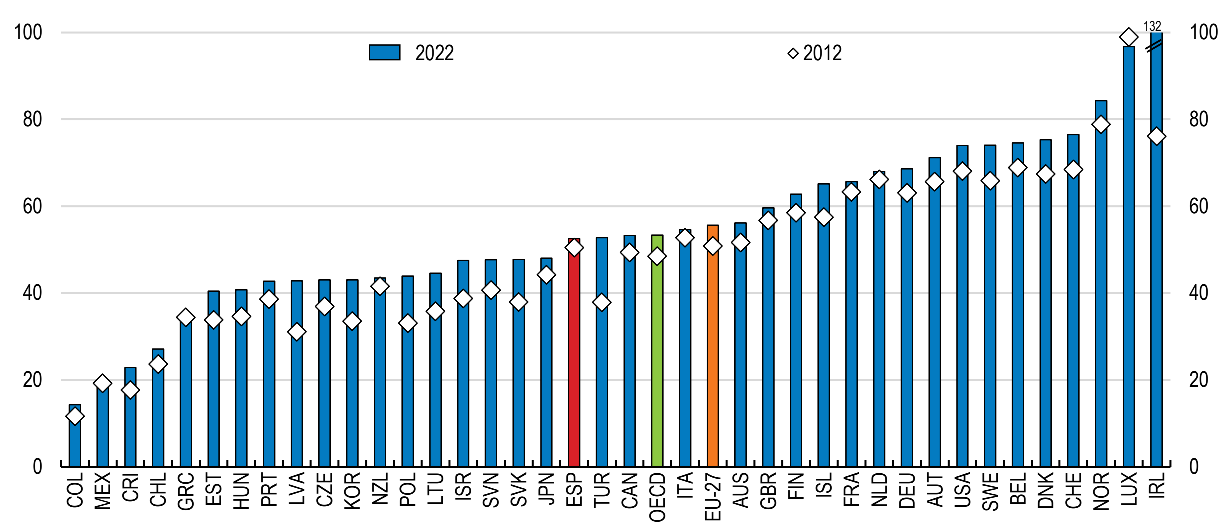
Recommendations in past Surveys	Actions taken since 2021
Ensure full portability of social and housing benefits across regions, by providing temporary assistance either by the region of origin or the central government.	The Housing Plan 2022-2025 and the Young Rental Voucher includes coordination mechanisms among regions to ease the portability of the housing subsidy.
Clarify and strengthen the role of regions in the implementation of the national minimum income guarantee scheme.	Law 19/2021 clarified the subsidiary role of regional income schemes and created mechanisms to share information between regional administrations and the Social Security.
Continue to expand early childhood education for those aged 0-3, targeting low-income households and disadvantaged areas.	The programme for the Promotion of the creation of public places of Early Childhood Education aims to create more than 65 000 places for children aged 0-3 in public schools.

Efforts to raise productivity must be pursued more vigorously

Continuous efforts are needed to improve Spain's productivity and innovation performance. Labour productivity is close to the OECD average, but far below some neighbouring countries (Figure 1.31). Between 2010 and 2022, Spain's labour productivity growth averaged only 0.6% per year, compared to 0.9% on average for the OECD and 0.8% in the euro area. The share of innovative companies is also low (Figure 1.32). Weak productivity performance has severe implications for future improvements in material living standards, given that ageing will soon become a larger drag on growth. Without vigorous efforts to boost productivity, the scope for further economic and social progress, to finance the needed policies and to help rebuild fiscal buffers, will be severely limited.

Figure 1.31. The level of productivity is relatively low and has grown little over the past decade

GDP per hour worked, USD, constant prices, 2015 PPPs



Note: The value for the OECD is the weighted average of the 38 OECD countries in the chart.
Source: OECD Productivity statistics.

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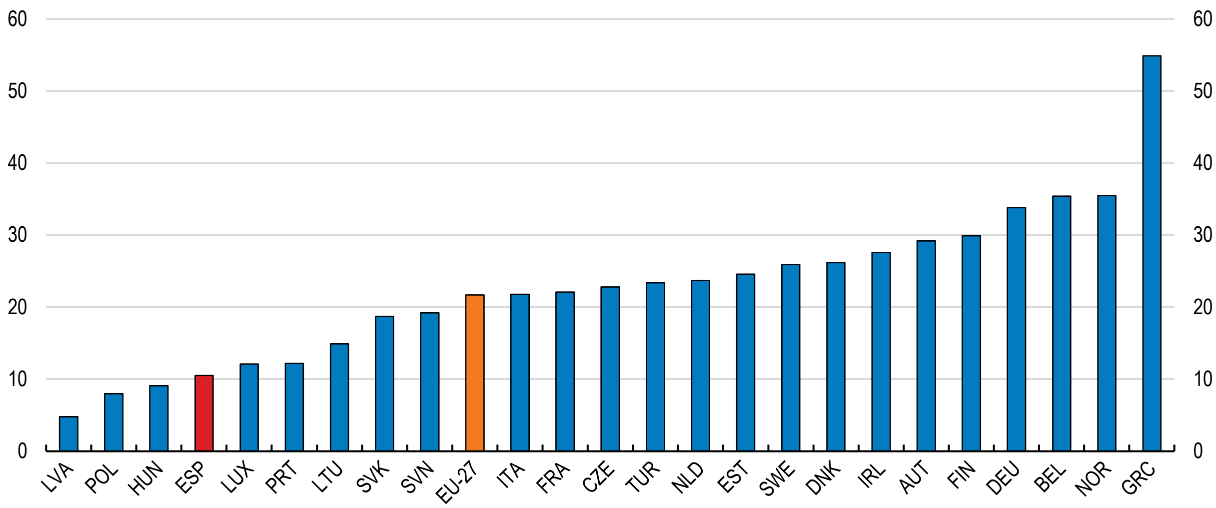
Figure 1.32. Innovative firms are few

Enterprises with on-going innovation activities, % of all enterprises, 2020



Source: Eurostat Community Innovation Survey 2020.

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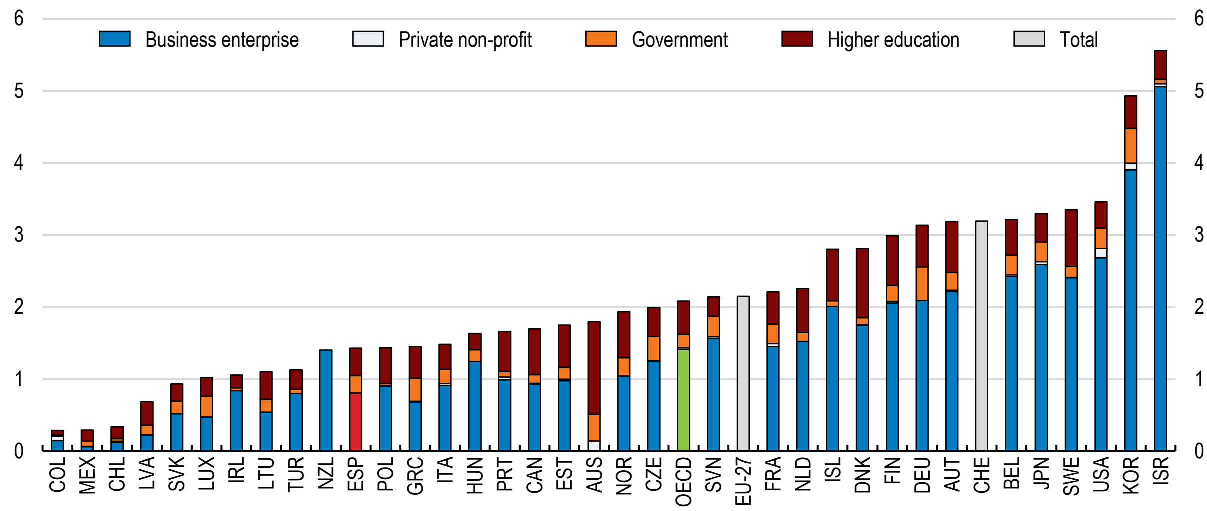
As discussed at length in previous *Surveys* (OECD, 2017[13]) (OECD, 2018[24]) (OECD, 2021[16]), several factors explain weak productivity and its persistence over time, notably a poor allocation of production factors between companies (Gopinath, 2017[28]); insufficient public spending on education and training; low R&D investment (Figure 1.33); and an insufficient stock of ICT capital (Maudos, 2021[29]). Productivity could be raised by reducing regulatory barriers (García-Santana, 2016[30]) or size-related financial constraints and regulations (Arregui, 2023[31]). Also, the 2021 *Economic Survey* (OECD, 2021[16]) highlighted the need to reinforce the dissemination of innovation and digital technologies to companies to increase productivity (Table 1.9). Spain does not currently have a productivity board or commission. These bodies are common in OECD countries to propose independent recommendations for productivity-enhancing reforms. The European Council issued a Recommendation to this effect in 2016, and, to date, 18 countries of the European Union have created such a board (Lehofer, 2023[32]). Creating such a body contributes to producing objective evidence and data on productivity trends and growth drivers and helping inform pro-productivity policies and interventions, and contributing to assessing and communicating the benefits of pro-productivity policies (OECD, n.d.[33]).

Broader dissemination of digital technologies can further enhance productivity. Spain performs well overall in digitalisation, ranking 7th on the European Commission's Digital Economy and Society Index, with high scores regarding connectivity and the digitalisation of public services. However, there is room for improvement in some dimensions. First, ICT specialists are too few: they represent 4.1% of employment against an EU-average of 4.5%. Second, only 9% of firms use big data and 27% cloud technologies, against 14% and 34% on average in the European Union, respectively (European Commission, 2022[34]). Leveraging the RTRP and its focus on digitalisation, with close to 30% of the total investments initially envisaged for digitalisation, including digital skills training (EUR 3.6 billion), the digitalization of public administrations (EUR 3.2 billion) and the digitalisation of businesses (EUR 3 billion), will help.

Figure 1.33. Spending on R&D is low

Gross domestic expenditure on R&D, % of GDP, 2021 or latest year



Note: The value for the OECD is the GDP weighted average of the 37 OECD countries in the chart.
Source: OECD Main Science and Technology Indicators Database.

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Table 1.9. Past recommendations on digitalisation and actions taken

Recommendations in past Surveys	Actions taken since 2021
Continue to reduce excessive regulatory burdens to develop communication infrastructure while reducing regulatory differences across regions, through the consultation mechanism in place.	The 2022 telecommunications act includes provisions to reduce restrictions on network and infrastructure deployment, including rights of use for the public domain and the obligation for public authorities to provide local urban planning of the necessary telecommunications infrastructure.
Fully roll out the National Plan for Digitalisation of Public Administration.	Ongoing. The“citizen folder” has been released. This digital tool allows people to receive notifications from the public administration and consult their personal data.
Strengthen Technology Centres’ capacity to effectively conduct R&D through partnerships between firms, especially SMEs, and research institutes.	PERTEs bring together different types of actors, including technology centres and SMEs.
Shift job training subsidies to individuals at least partially, or develop public job training programmes targeted to low-skilled and older workers for specific purposes, such as promoting ICT skills.	The National Digital Competences Plan, included in the Digital Agenda 2026, has a funding of EUR 3.75 billion. It aims to improve digital competences in the population, with emphasis on groups at risk of social exclusion.

The RTRP provides a unique opportunity to promote long-term growth, without further constraining Spain’s public finances. Spain’s overall envelope of Next Generation EU (NGEU) grants was expanded from EUR 69.5 billion to EUR 77.2 billion (5.7% of 2022 GDP) in June 2022, following a recalculation of allocations to reflect GDP developments in 2020 and 2021. Additionally, EUR 83 billion in loans have been made available, as well as an additional EUR 2.6 billion in grants from the Re Power EU Initiative. Both elements are currently under negotiation. Spain is making progress in the execution of the investments. By early March 2023, authorized spending amounted to EUR 58.0 billion. A new IT management tool (“COFFEE”), developed by the Ministry of Finance, allows officials to monitor progress in satisfying the 416 milestones and targets (of which the European Commission has signed off on 121), helping implementation. The degree of success in the use of the funds will depend on effective implementation based on transparent procedures and criteria for prioritisation of projects and commitment to sound cost-benefit analysis, so Spain gets the most out of them.

Strengthening public-private cooperation to boost productivity growth

Public-private partnerships are rare in Spain, as highlighted in the OECD's last *Economic Survey* (OECD, 2021[16]). Public-private partnerships in strategic sectors funded by the RTRP (known as PERTEs) target areas where private investment is insufficient and aim at accelerating Spain's digital transformation and its environmental transition. Twelve PERTEs have been created to date, with a total projected investment of EUR 40 billion, excluding the likely effects from the Re Power Initiative.

Fostering stronger collaboration among businesses and universities or public research organisations could support productivity. The 2022 reform of the Law on Science, Technology and Innovation should help in this regard, with its provisions to promote transfer of knowledge and innovation generated by the public sector and to facilitate cooperation between public administrations and companies. Notably, the reformed law stipulates that knowledge transfer activities carried out by public research staff must be considered for remuneration and promotion purposes. Further progress could be made by implementing the following recommendations as soon as possible (OECD, 2021[35]):

- encouraging a systematic evaluation of science, technology and innovation policies;
- enhancing the participation of industry and civil society in the university governance system, to raise accountability vis-à-vis stakeholders and avoid having strategic decisions guided only by academic considerations, ignoring the needs of companies and citizens. This could be achieved by increasing the number of external stakeholder representatives in the university governing councils (currently limited to only three) or by broadening the role of social councils, in which civil society is traditionally represented.
- promoting performance-based contracts between regional governments and universities, with incentive mechanisms related to collaboration and knowledge transfer. The Basque government's University System Plan provides a good example in this regard (OECD, 2021, p. 210[35]).
- offering "one-stop-shop" digital platforms to firms to inform them about existing public innovation support opportunities, building on existing but dispersed information; and
- increasing business incentives to recruit doctoral graduates.

Recent regulatory reforms should help, but there is still room for improvement

The predominance of small and micro firms is one of the reasons behind Spain's low aggregate productivity. There are several factors that could limit the growth of firms, including access to finance, regulatory barriers, and inadequate managerial skills. Differences in regulatory frameworks across regions hamper firms' growth and business competition. Several recent measures are welcome. The 2022 Law on Business Growth includes measures to eliminate financial and administrative barriers to firm creation and growth, amends the Market Unity Law notably to strengthen inter-administration cooperation and facilitates the right to complain about the non-respect of freedom of establishment or movement. The sectoral conference for Regulatory Improvement and Business Climate, established in 2021, aims to enhance cooperation and sharing of best practices among different levels of government to foster business activity and evaluates and promotes the implementation of the Market Unity Law. In 2017, a decision of the Constitutional Court limited the scope of this law by declaring unconstitutional the principle of "national effectiveness", which stipulated that companies would not be subject to any other requirements than those imposed in their region of origin. However, it is still possible for regions to incorporate this principle into their own legislation, which would be welcome.

Several recent initiatives to support firms' growth are welcome. The 2022 start-up law aims to encourage the creation of innovative companies and to promote youth entrepreneurship, which remains low (Chapter 2). The law offers tax incentives for companies and investors, in particular those based abroad, and creates a new visa with favourable tax conditions for international teleworkers. Further efforts are needed to reduce the number of size-related regulations because of their growth-inhibiting effects, as discussed in the 2018 *Economic Survey* (OECD, 2018[24]). More than 100 regulations of this type have been identified, related to taxation, labour, accounting or financing (Arregui, 2023[31]). They should be removed as needed, at least the most binding ones, or replaced by thresholds based on the age of the company.

An efficient insolvency regime encourages entrepreneurs to take the risk to start a new business and is positively associated with entrepreneurship development and productivity growth. The 2022 reform of the insolvency process is welcome, as it should help firms to restructure more smoothly and successfully, and favour a better allocation of capital by limiting the emergence of "zombie" companies (Adalet McGowan, Andrews and Millot, 2017[36]).The reform gives a more prominent role to the pre-insolvency stage, with a broader coverage and new instruments, to allow firms in financial distress to act swiftly. The framework for restructuring has been overhauled to favour out-of-court negotiations and minimise judicial involvement. Under certain conditions, creditors will be granted the power to impose restructuring plans. Also, the law provides specific, simplified and quicker procedures for micro-enterprises. Moreover, it enhances the “second chance procedure” by expanding the possibilities of exoneration for debtors, to facilitate the continuation of their entrepreneurial activity. Finally, the process of selling business units is being expedited to avoid them losing value during the process.

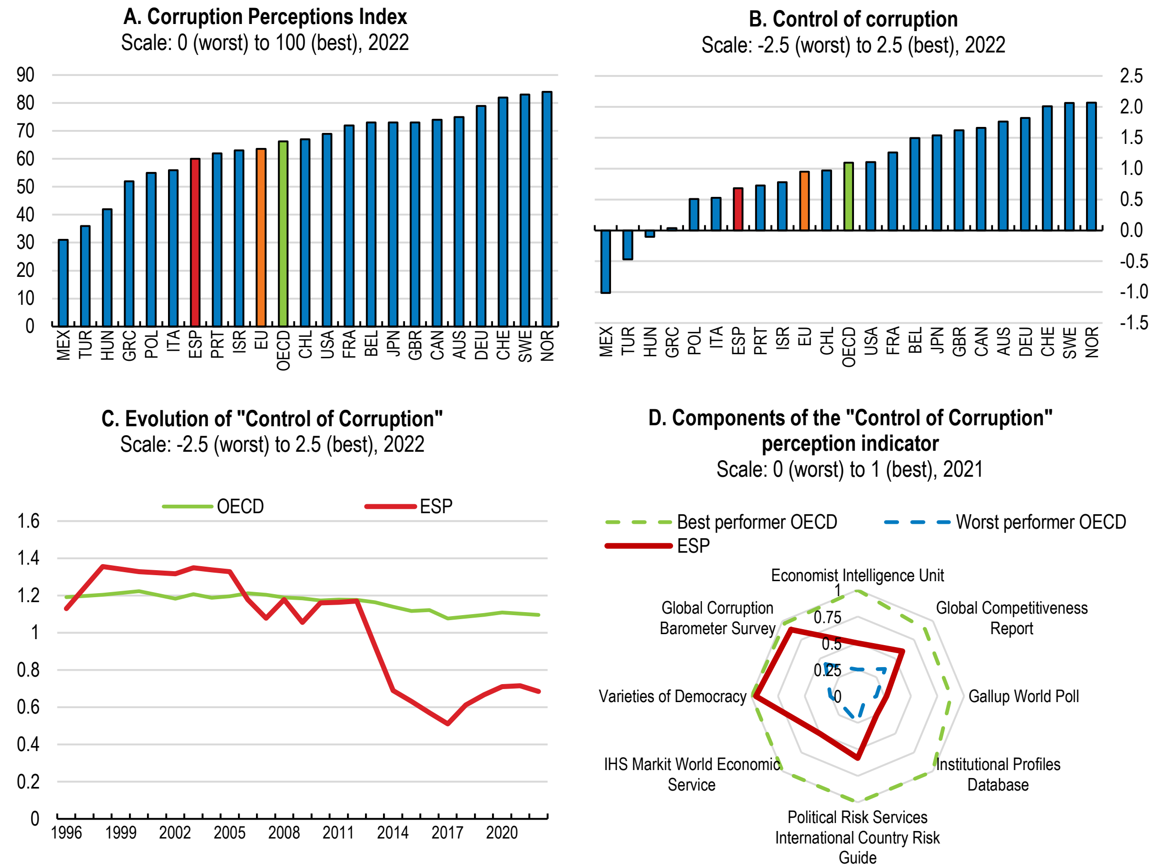
The fight against corruption should be strengthened

Fighting corruption is crucial to creating an economic and social environment based on trust and fair competition, conducive to investment and to productivity growth. In terms of perception, the level of corruption in Spain is seen as rather high by citizens, and increasingly so since 2013 according to the World Bank’s “Control of corruption” perception index (Figure 1.34). Nevertheless, this indicator shows some improvement since 2016. Moreover, the legal framework to fight corruption has been strengthened over the past decade and notably in 2023 with the adoption of a law on whistle-blowers.

The prevention of corruption in the public administration, notably conflicts of interest, could be reinforced (GRECO, 2022[37]). The adoption of the Law on Transparency and Integrity in the Activities of Interest Groups, which will regulate the activities of lobbies and force them to register is a step in the right direction. Also, the strong commitments in the 4th Spanish Open Government Plan 2020-2024 are welcome (Ministerio de Política Territorial y Función Pública, 2020[38]). Their implementation is well under way and should be continued. As indicated in the 2021 *Economic Survey* (OECD, 2021[16]), the recommendation of the OECD Council on public integrity can be used as a reference for future action. This recommendation provides policy makers with elements to build a public integrity strategy based on a comprehensive risk-based approach (OECD, 2017[39]) and the government has recently published a draft following up on this recommendation.

Fair competition in public procurement can reduce fiscal costs and enhance the quality of public investment. Progress could be made in this area, notably by increasing the calls for bids, which are relatively infrequent and, when they do take place, are slow (Figure 1.35). About 11% of the communications or complaints received in 2021 by the Anti-Fraud and Corruption Offices and Agencies are related to public procurements. As stressed in the 2021 *Economic Survey* (OECD, 2021[16]), electronic contracting should be systematically used, as it can raise both the efficiency and the transparency of public procurement procedures. However, the effective implementation of the legal obligation of electronic contracting is lagging (Comité de cooperación en materia de contratación pública, 2022[40]). Also, creating a single repository of open and harmonised data for all existing procurement platforms could help increase transparency and prevent corruption (Independent Office for Procurement Regulation and Supervision (OIReScon), 2022[41]).Regular use of electronic contracting and improving access to quality data are among the objectives of the National Public Procurement Strategy 2023-2026, which will need to be fully implemented (Comité de cooperación en materia de contratación pública, 2022[40]).

Figure 1.34. Corruption is perceived as high



Note: Panel D shows individual indicators, which underlie the "Control of Corruption" indicator by the World Bank.
Source: Panel A: Transparency International; Panels B & C: World Bank, Worldwide Governance Indicators; Panel D: World Bank, Worldwide Governance Indicators; Economist Intelligence Unit; World Economic Forum; Gallup World Organisation; French Ministry of the Economy, Industry and Employment and the Agence Française de Développement; Political Risk Services; IHS Markit; Varieties of Democracy Institute; Transparency International.

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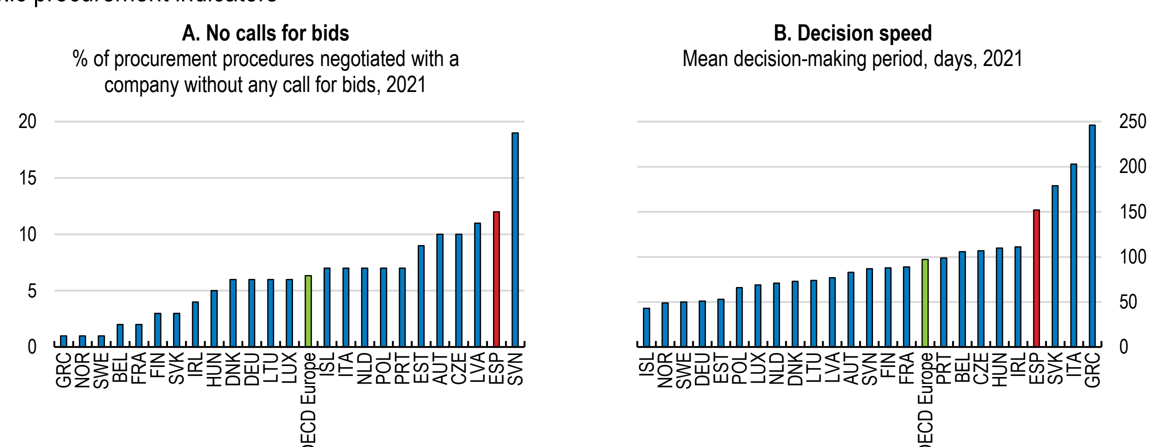
Figure 1.35. Public procurement could be better handled

Public procurement indicators



Note: Decision speed refers to the number of days between the deadline for receiving offers and the date the contract is awarded. The European Commission indicates that these indicators “are affected by country-specific factors” and “should be interpreted carefully, ideally in the light of additional quantitative and qualitative information”. More details on the methodology are available at https://single-market-scoreboard.ec.europa.eu/business-framework-conditions/public-procurement_en.
Source: European Commission.

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Spain should continue implementing the OECD Anti-Bribery Convention and follow the recommendations of the OECD Working Group on Bribery in this regard, as indicated in the 2021 *Economic Survey* (OECD, 2021[16]). The OECD Working Group on Bribery highlighted the substantive 2015 reform of the Penal Code that consolidated the foreign bribery offence and further aligned relevant provisions on legal persons' liability with the Anti-Bribery Convention and Recommendation. In addition, it considered that the efficiency of anti-bribery efforts would be enhanced by ensuring that prosecutors have sufficient time to conduct investigations and that the amount of evidence needed for opening a judicial investigation into foreign bribery does not hinder effective investigation and prosecution of offences. The statute of limitations for pursuing a foreign bribery case against legal persons should be aligned with that applicable to individuals. Introducing a system of non-trial resolutions for foreign bribery cases should be considered. Also, authorities should seek to raise awareness of foreign bribery issues among companies and actively promote anti-corruption compliance, in particular among SMEs (OECD Working Group on Bribery, 2022[42]).

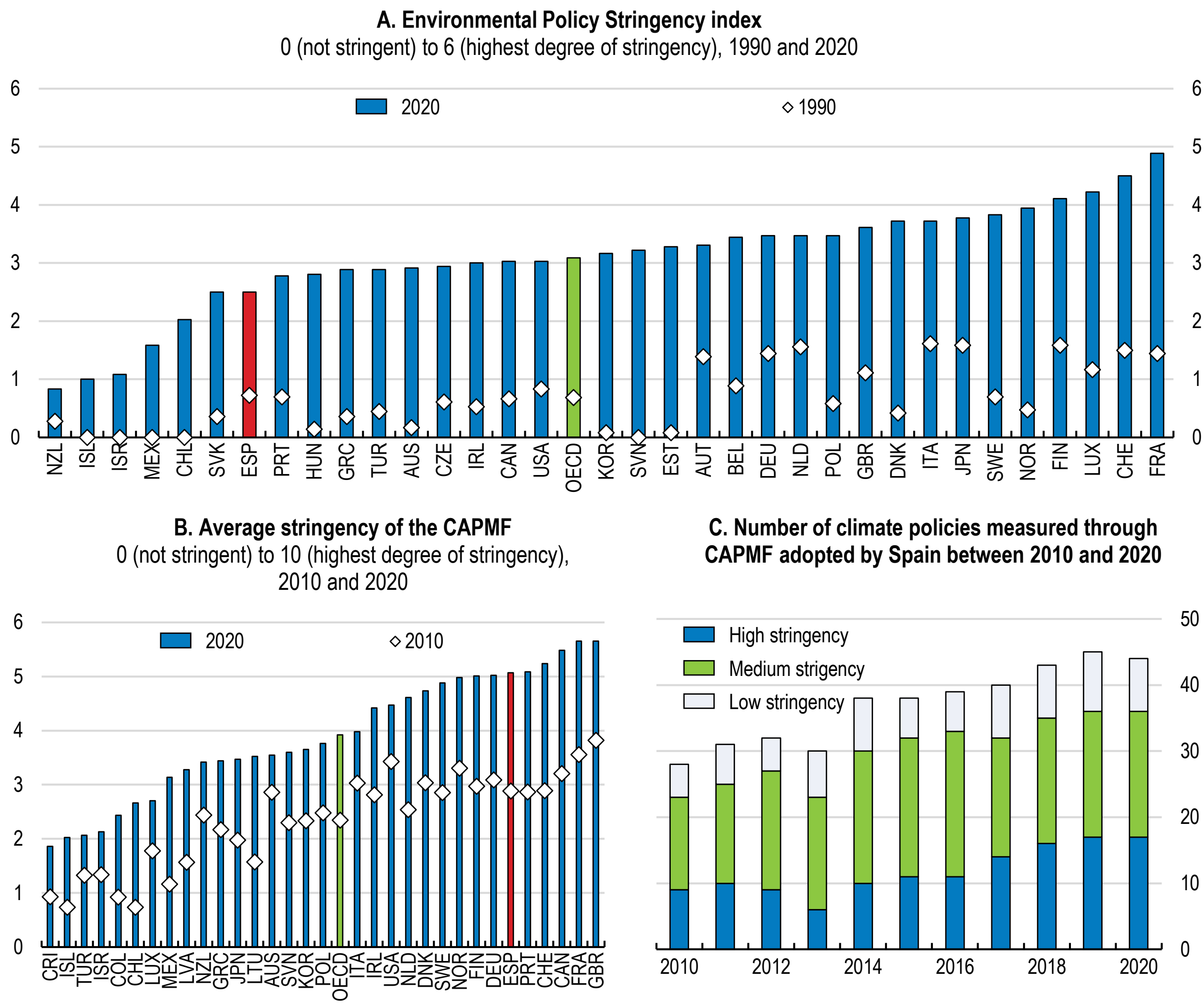
Table 1.10. Past recommendations on other productivity-related policies and actions taken

Recommendations in past Surveys	Actions taken since 2021
Ensure the swift disbursement of the new direct aid measures and increase the allocated funds, if needed.	Public aid in the context of the war in Ukraine followed that decided in the context of the pandemic. Notably, in total, over EUR 100 billion in loans have been guaranteed.
Promote out-of-court restructuring procedures, especially for small and medium sized enterprises.	In the 2022 reform of the insolvency process, the framework for restructuring was overhauled to favour of out-of-court negotiations.
Eliminate the existing regulations that depend on the size of firms, as needed.	No action taken.
Prioritise reforms that enhance long-term growth, while ensuring swift implementation to also support the near-term recovery.	The RTRP appears to be on track according to the European Commission. Budget commitments of EUR 42 billion were signed in 2021-22. Reforms implemented include the labour reform, the first phase of the pension reform, the Law on Creation and Growth of Companies, the law on start-ups, the bankruptcy reform, the Telecommunications Law, the Science Law and the reform of Vocational Training.
Regions should include the principle of national effectiveness of the Market Unity Law in their legislation.	Madrid, Murcia and Extremadura have included the principle of national effectiveness in their regulations. Their respective regulations have been added to a catalogue of best practices elaborated by the Sectoral Conference for Regulatory Improvement and Business Climate.
Assess the compliance of new legislation at all levels of government with the principles of the Market Unity Law.	The sectoral conference for Regulatory Improvement and Business Climate, established in 2021, oversees the evaluation and promotion of the implementation of the Market Unity Law.
Strengthen the ex-post evaluation framework of innovation support and consider increasing performance-based funding.	The reformed Law on Science, Technology and Innovation states that the Science, Technology and Innovation Advisory Board will be in charge of promoting the introduction of evaluation mechanisms.

Spain faces a range of environmental challenges

Spain has several areas of concern in the environmental domain. While it has reduced its energy and carbon intensity over the past decade, emissions from sectors not covered by the EU-wide emissions trading system (EU-ETS), including agriculture, transport and buildings account for 60% of Spain's greenhouse gas emissions. Water quality is poor and securing sufficient supplies of water is also a worsening problem in some parts of the country because of persistent drought. Spain uses a lot of fossil fuels, especially in road transport, in part because of a low car acquisition tax, and modest fuel tax and duty rates, notably on diesel. However, the higher fossil fuel prices induced by Russia's war against Ukraine will help to push down demand in the medium term. While environmental protection expenditure as a share of GDP was comparatively high in the decade ending in 2019 (D'Arcangelo, 2022[43]) and has been trending up in recent years, Spain ranks relatively low on overall environmental policy stringency (which covers water and air quality as well as climate change) (Kruse et al., 2022[44]). Over the years it has trended up, but it remains below its historical peak from 2011-12 and in 2020 was seventh lowest in the OECD (Figure 1.36, Panel A). However, Spain has made good progress since 2010 on climate change policies according to the OECD's recently developed Climate Action Policy Measure Framework (CAPMF) (Nachtigall, 2022[45]), having adopted 44 policies by 2020 many in high-stringency form (Figure 1.36, Panels B and C).

Figure 1.36. Environmental policy is not very stringent compared to other countries



Note: Panel B shows the percentage share of policies covered in the Climate Action Policy Measure Framework (CAPMF). Stringency is defined as the degree to which policies enable or incentivise GHG emissions reductions. It is operationalised by assigning for each policy a value between 0 (no policy in place) and 10 (highest value) based on the in-sample distribution across all countries and years.
Source: Kruse, T., et al. (2022), "Measuring environmental policy stringency in OECD countries: An update of the OECD composite EPS indicator", *OECD Economics Department Working Papers*, No. 1703, OECD Publishing, Paris, https://doi.org/10.1787/90ab82e8-en; Nachtigall, D., et al. (2022), "The climate actions and policies measurement framework: A structured and harmonised climate policy database to monitor countries' mitigation action", *OECD Environment Working Papers*, No. 203, OECD Publishing, Paris, https://doi.org/10.1787/2caa60ce-en.

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The Spanish government has made addressing climate change one of its priority areas and should continue to leverage its RTRP funds, of which EUR 27.8 billion is allocated to the green transition. Achieving the 2030 targets in the 2020 National Energy and Climate Plan (reducing greenhouse gas emissions (GHGs) by 23% compared to 1990, reaching a 42% share of renewables in energy use and 74% renewable energy in electricity generation, and making a 39.5% improvement in energy efficiency) are estimated to require EUR 241 billion in investment by 2030, with 80% coming from the private sector.

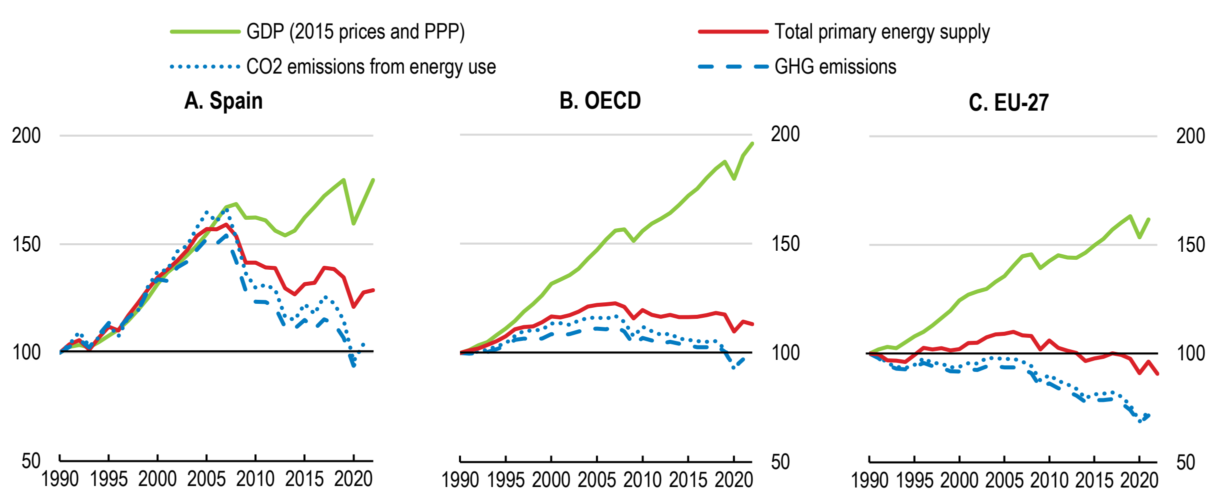
Much progress has been made in fighting climate change

Much progress has been made since the mid-2000s in the fight against climate change. CO_2 emissions have been decoupled from output growth both by cutting the energy intensity of GDP and using less emissions-intensive forms of energy, though the improvements have only recently begun to match or exceed those elsewhere in the OECD and especially in the European Union (Figure 1.37). Spain's success in decarbonisation owes much to the development of its renewables sector, which has been effectively supported by feed-in tariffs and auctions. In 2021, Spain's GHG emissions represented approximately 1.9% of the combined GHG emissions of OECD countries. In per capita terms they have fallen by 20% since 2010, and Spain is less emissions intensive per capita than most OECD countries (6.1 tonnes compared to an OECD average of 10.9 tonnes). Currently, transport is the first source of emissions (29.6%), followed by manufacturing and energy industries.

Mitigation efforts have been successful. The significant fall in emissions is due to the decarbonisation of manufacturing and construction (-33% since 2005) and of energy industries (-67%), driven by the phasing out of coal from the energy mix. It has been replaced by natural gas and renewables, the latter of which today represent 16.7% of total energy supply, compared to 5.9% in 2005. As a result, the energy industry accounts for only 14.3% of GHG emissions, down from 28.7% in 2005, which is far lower than OECD average of 27.6%. In any case, the challenges that remain to achieve the longer-run goal of net zero emissions remain considerable. Spain needs to accelerate mitigation efforts significantly, particularly in the transport sector, where emissions rose by 7.5% between 2012 and 2021. It has also failed to make any headway in cutting its emissions from agriculture, which have increased by 8.7% since 2012, primarily because of rising methane emissions from livestock herd expansion.

Figure 1.37. Decoupling of energy use and GHG emissions from output has continued

Index 1990 = 100



Note: GHG emissions excludes emissions/removals from land use, land-use change and forestry.
Source: OECD Economic Outlook: Statistics and Projections; IEA (2022), IEA Greenhouse Gas Emissions from Energy dataset; IEA (2023), IEA World Energy Statistics and Balances (database).

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Spain's set of policies designed to reach net zero by 2050 is a good start

The 2021 Spain 2050 Strategy aims to transform Spanish society to be carbon-neutral, sustainable and resilient to climate change. The Strategy sets the ambitious target of reducing gross emissions by 90% relative to 1990.

The National Energy and Climate Plan 2023-2030 (NECP) needs to be efficiently implemented and then monitored. While instability in the policy framework should be avoided, the Plan was revised in June 2023 to be consistent with the European Union's recently agreed more ambitious 55% cut in carbon emissions by 2030 compared to 1990 levels. The revised Plan's proposed target for 2030 implies a 32% reduction compared to 1990 levels, a significant increase from the previous version of the Plan but still less than the EU average abatement objective. It is also lower than the 43% net reduction relative to 2019 estimated by the Intergovernmental Panel on Climate Change to limit warming to 1.5°C with no or limited overshoot. A royal decree is expected to help address the expected coordination challenges, which have already been mitigated through sectoral conferences and the Ministry of Finance's recently developed COFFEE model of tracking projects and spending.

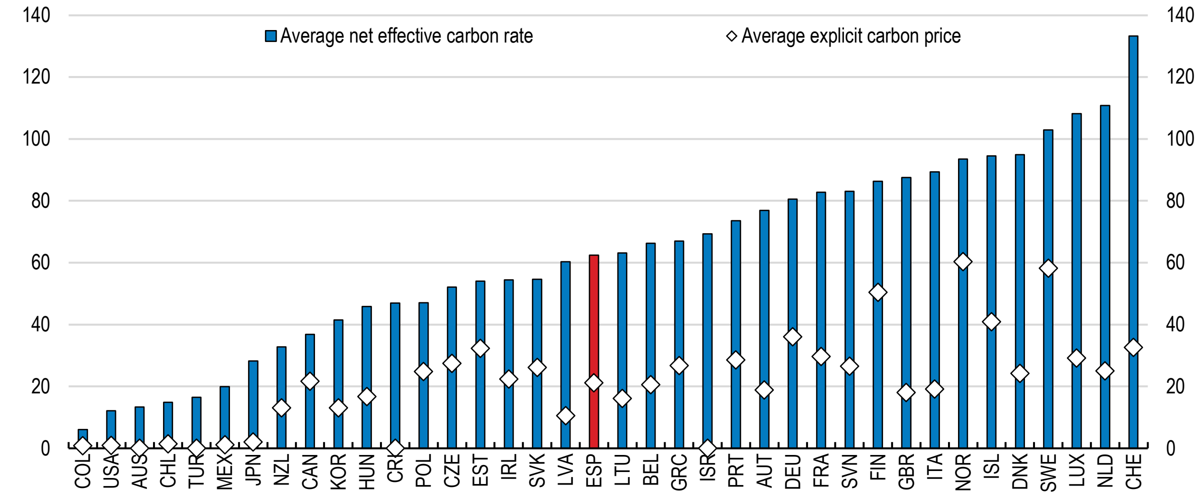
In Spain, the EU-ETS covers approximately 32% of total emissions. To reach the 2030 target, ETS sectors are expected to contribute to decarbonisation with an emissions reduction of 61% compared with 2005. Spain's NECP aims at deep emission reductions in electricity generation. This should result, firstly, from measures to deploy renewable energy, in particular solar and wind power. It should also result from the gradual phasing-out of coal. Most recently, the process has been supported by the closure of all coal mines by 2019 and of almost all coal-fired power stations by 2022. Discussions are also taking place regarding a faster withdrawal of free permits for the carbon-trading scheme through auctioning. However, there is still no carbon pricing in non-ETS sectors, other than a tax implemented in 2014 on fluorinated gases (which account for 3% of total emissions), which has succeeded in lowering such emissions by 65%. It is now urgent for non-ETS sectors to be tasked with a greater contribution to decarbonisation efforts.

The European Union is moving towards adopting a so-called ETS2 to cover emissions from fossil fuel combustion in the buildings, road transport and fuel distribution sectors from 2027 (OECD, 2023, forthcoming[46]). Once ETS2 is in place all sectors except agriculture, fishing, waste, land use, land-use change and forestry (LULUCF) and emissions other than from fossil fuel combustion would be covered by a carbon pricing system. The goal of ETS2 is to cut sectoral emissions by 43% compared to their 2005 levels without offering any free allowances. The expected permit price is lower than for the existing ETS, but some sort of convergence could be considered in the future. A substantial mitigation facility (the so-called Social Climate Fund) is to be established as from 2026 with funding of EUR 86.7 billion, three-quarters of which generated by the associated auction proceeds, with the remainder from Member state co-financing. While this is a laudable proposal, and is deserving of strong Spanish support when Spain assumes the EU Presidency at mid-2023, Spain should act more quickly by making fuller use of both price and non-pricing measures to raise the effective price of carbon until the ETS2 is in place.

Spain has eliminated all its explicit subsidies to fossil fuels in recent years and has stringent non-carbon-pricing mitigation policies. However, it continues to offer some substantial implicit subsidies in the form of exemptions, particularly to its farmers and fishers. OECD estimates for 2018 point to a middling "carbon pricing score" (a measure of the share of emissions exposed to carbon priced at a given price or more) for Spain at EUR 60 per tonne (46%). While this is above the OECD average (41%), it is lower than for many of its European neighbours, notably Switzerland and Luxembourg (69%) (OECD, 2021[47]). In all cases Spain's scores are essentially 100% for road emissions, much lower for others and lowest for agriculture and fishing. More recent OECD work for 2021 shows that Spain's average net Effective Carbon Rate rose by more than 30% since 2018, but that nearly a quarter of all emissions were still not subject to any positive carbon price (no change since 2018), while another quarter (road transport) faced carbon pricing of some EUR 150 per tonne. By way of comparison, Spain's average net Effective Carbon Rate per tonne is the eighth-lowest in the OECD-Europe (Figure 1.38). Bank of Spain modelling work shows that extending the ETS scheme to the entire economy would cut emissions by 14.5% and combining that with raising the rate by EUR 75 per tonne to EUR 100 would raise the estimated cut to 31.1% (Aguilar, 2022[48]).

Figure 1.38. Net Effective Carbon Rates are only moderate

Average effective carbon prices by country, EUR/tCO_2e, 2021



Note: The net Effective Carbon Rate (net ECR) is the sum of permit prices from emissions trading systems, carbon taxes and fuel excise taxes minus fossil fuel subsidies that decrease pre-tax fossil fuel prices. The explicit carbon prices include emissions trading systems and carbon taxes. Effective carbon prices are averaged across all GHG emissions, excl. LUCF, of 71 countries, including those emissions that are not covered by any carbon pricing instrument. Fossil fuel subsidy estimates (component of net ECR) are based on data for 2020.
Source: OECD (2022), *Pricing Greenhouse Gas Emissions: Turning Climate Targets into Climate Action*, OECD Series on Carbon Pricing and Energy Taxation, OECD Publishing, Paris, https://doi.org/10.1787/e9778969-en.

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Regarding industry, the NECP proposes incentives for incorporating renewables – in particular, biomass, biogas and solar – in industrial processes and intensifying research and innovation in low-carbon technologies, such as waste heat recovery and carbon capture technologies. The energy RD&D budget could be increased, as it has shrunk noticeably since 2012 and is now one of the lowest among IEA-member countries. Energy audits for large firms, which have been mandatory since 2016, could be made more effective by boosting penalties for non-compliance, as well as by requiring follow-up by firms if the implied investment payback period is reasonable. In addition, while publicly traded (large) firms have had to report annually on their environmental impact, a draft government regulation would require more firms to publish data on their carbon footprint.

Spain has committed to reducing emissions in non-ETS sectors such as transport, buildings, agriculture and waste by 26 % by 2030 compared with 2005. The NECP envisages significant reductions because of measures promoting a modal shift towards low- and non-emitting modes of transportation and, in particular, less need for trips by private cars. Measures foreseen include the creation of low-emission zones in cities over 50 000 inhabitants (from 2023), and the use of renewables, whose share in the sector is expected to reach 28% by 2030, by means of electrification and the use of advanced biofuels. More recently, the EU decision to ban the sale of vehicles powered by internal combustion engines as from 2035 will help to lower emissions. However, more support from the RTRP could be given for the installation of electric vehicle charging points, which are already mandatory in large petrol stations, as Spain has been lagging in this area (OECD, 2023, forthcoming[46]). Additionally, offering lower registration taxes for electric vehicles could allow a faster shift to non-emitting forms of mobility. Ending the tax benefit in the form of lower fuel excise duty offered to drivers of diesel-powered vehicles would help cut both carbon and particulate emissions.

In the building sector, the government intends to reduce emissions by improving energy efficiency, as Spain's homes are less energy efficient than those of many other European countries. In addition to a recent increase in the personal tax incentive for housing insulation and to the EUR 6.8 billion in RTRP funds allocated for rehabilitation of housing and urban renewal, more efforts will be needed for retrofitting and to make greater use of solar panels in the housing sector. However, these will have to confront energy poverty and affordability barriers, possibly through an enhancement of the thermal social bond subsidy measures for natural gas and electricity available to poor households that have existed since 2019. While temporary, many eligible households have not accessed these schemes. They may need to be made permanent in some form to handle affordability challenges.

Electricity accounts for about 19% of total energy supply in Spain, largely unchanged in recent years and below the OECD average of 22%. The government called for fundamental reform of the electricity market even before the war in Ukraine, not only because its structure is a barrier to decarbonisation but also because of the role of high prices in overall well-being and widespread energy poverty. Greater flexibility is being sought throughout the energy sector through new incentives and plans for storage (of liquified natural gas, for example, even though Spain is already the best endowed EU country in that regard) and auctions for long-term capacity and for so-called “active demand response” (for power interruptions in times of peak demand).

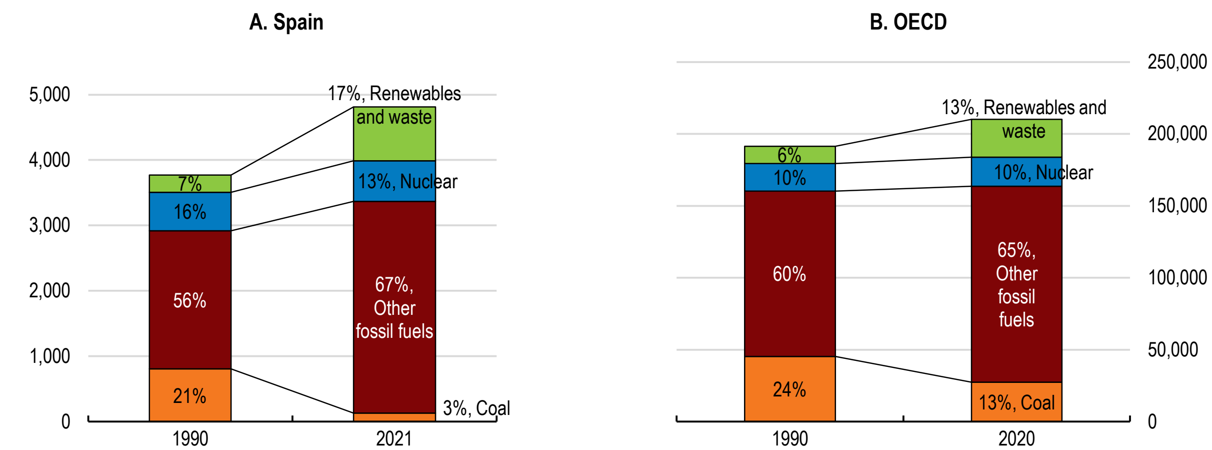
Over the medium term, continued efforts to overcome fossil fuel dependence will be necessary (Figure 1.39). Solutions include promoting investments in low-carbon alternatives, storage, and interconnections. A continued expansion of the renewables sector will be required to meet the government’s ambitious target of it accounting for 74% of electricity production by 2030 and 100% by 2050 (compared to a recent peak of 47% in 2021), especially because electricity demand will grow strongly because of electrification of other sectors, notably transport. Though the pace of installation of solar photovoltaic has jumped since 2019, the latest data show Spain to have been only near the IEA median for the share of electricity generated from renewables (International Energy Agency, 2021[49]), and it appears that a fairly sharp fall occurred in this share in 2022 because of the drought’s effects on hydro power. In addition, green hydrogen for large off-grid needs based on both solar and wind energy will also benefit from an allocation of EUR 1.5 billion in RTRP funds. The greatest hurdles to renewables penetration are permitting barriers for new energy projects (for example, the time needed to get a permit for an onshore-wind farm, at around 85 months, is much greater than most EU countries for which data are available (OECD, 2023, forthcoming[46]) and spreading NIMBY (not in my backyard) attitudes in some areas. However, a new law from March 2022 sets out streamlined procedures for approving renewable energy projects. Planned closure of some of Spain’s nuclear generating capacity (scheduled to take place between 2027 and 2035) will make the challenge of curbing GHG emissions more difficult.

Spain’s offshore wind and sea energy potential could be exploited following a December 2021 roadmap that pointed to the need to ensure that the relevant ports have the required infrastructure to absorb the power into the national grid. Spain, Portugal and France also agreed last December to move ahead with a sub-sea hydrogen pipeline connecting Barcelona with Marseille, which is expected to be operational by 2030, and thereby partially address poor energy interconnections between the Iberian Peninsula and the rest of Europe.

Spain faces multiple climate-related hazards that will increase in the coming decades, especially related to increasing temperature and drought. Based on 2016-2020 data, extreme heat (over 35°C) affects most residents, with 83.1% of the population exposed; wildfires are also a very real danger. On average, there are 6.3 additional extremely hot days per person compared to the 1981-2010 average. This underscores the need for targeted adaptation policies and for all nations to promote the global commitment to mitigation, something that Spain can take the lead on when it assumes the Presidency of the European Union in July 2023. The south of Spain is especially affected both by increased heat stress (up to 20 more hot days per year compared to 1981-2010) and drought. Moreover, average cropland soil moisture, an indicator for drought, has declined by 1.4% compared to 1981-2010, with particularly sharp declines of more than 10% in southern Spain. Spain released its latest climate-change adaptation plan in 2020 to cover the 2021-2030 period. It defines as key instruments for adaptation a programme of work with a clear timeline and milestones, together with sectoral and regional plans. In response to worsening drought conditions, the government also just announced an emergency spending package comprising EUR 1.4 billion to increase the availability of water and EUR 784 million to help farmers maintain production and avoid food shortages.

Figure 1.39. Like other countries Spain has shifted its energy supply towards gas and renewables

Total energy supply by source, PJ and %, 1990 and 2020-21



Note: Coal comprises coal, peat and oil shale. "Other fossil fuels" comprises oil products, natural gas, crude oil, natural gas liquids and feedstocks. Renewables and waste comprises hydro, geothermal, solar, wind and tide/wave/ocean energy and the use of these energy forms for electricity and heat generation, as well as solid biofuels, biogases, industrial waste and municipal waste.
Source: IEA (2023), IEA World Energy Statistics and Balances (database).

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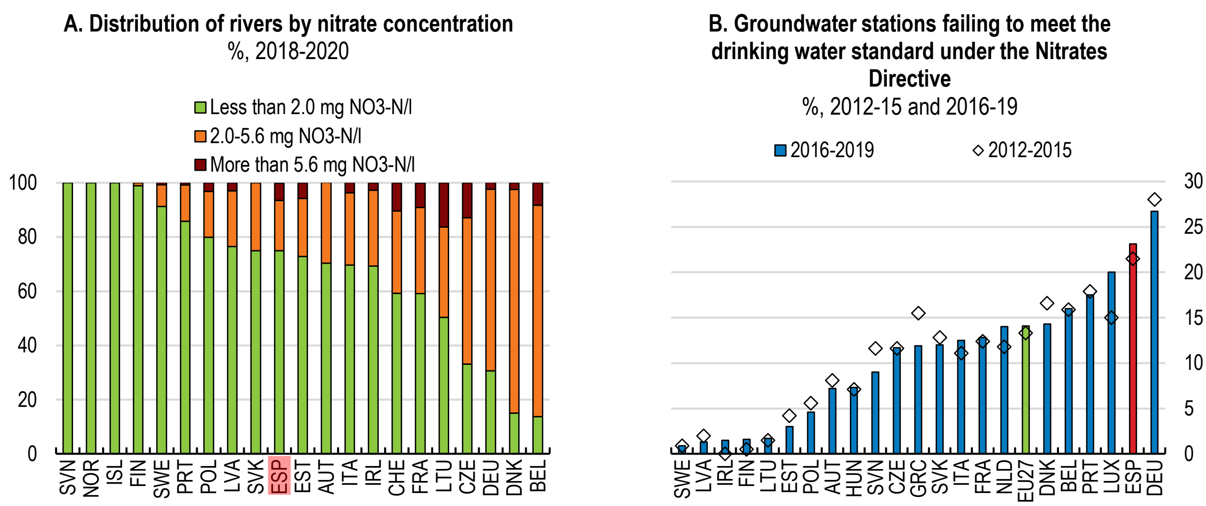
Water scarcity and quality issues remain significant

The historical and growing challenge of water scarcity due to insufficient rainfall exacerbated by climate change, widespread and increasing irrigation and other external pressures has important implications for the resilience of the water system, for personal welfare and ultimately for potential GDP as well as its sectoral composition. Since 1980 available water has declined by 12%, and projections call for further falls of 14-40% by 2050. Fortunately, the latest OECD data (up to 2020) show water stress (measured by gross water abstractions as a share of available resources) to have been falling, though it remains in the medium-high range. However, soil erosion already afflicts almost a quarter of Spain's land area, overall vegetation and especially forests, which have been suffering from the increasing frequency of large and intense fires. Water problems have been magnified by coordination issues between the central government – responsible for most water investment – and the relevant local authorities, though the 2021 National Climate Change Adaptation Plan is expected to improve matters.

In 2022 the government approved the "Strategic orientation on water and climate change", which includes the guidelines and lines of action to increase water security, better adapt to the consequences of climate change and increase resilience. The main lines of action focus on: demand reduction; the efficient use of water resources; recourse to non-conventional sources (such as water reuse and desalination); and the promotion of environmental recovery of water bodies. Investments within the Spanish RTRP, accounting for more than EUR 1250 million, will be used to achieve these goals.

The main challenge for water quality – arguably the only area where Spain suffers from a lower environmental quality of life than its EU neighbours (Eurofound, 2017[50]) – is nitrate pollution (and the ensuing eutrophication) that results from inappropriate fertilizer use on croplands and intensive livestock raising, especially of pigs (Figure 1.40). The situation is worsening steadily: the nitrogen balance per hectare was 39kg in 2015 but jumped to 49kg in 2017, surpassing the latest EU-wide figure for the first time. From 2015 to 2019 nitrogen use rose by 4.5%. This picture is consistent with Spain's increasing importance as a pork producer: the country is now the world's largest exporter of frozen pig meat and has the European Union's largest herd (over 34 million animals) (OECD, 2022[51]), which also brings with it additional emissions from slurry. Nitrogen from animals also pollutes the air in the form of ammonia, for example. Spain failed to meet its national ceilings on ammonia air emissions every year from 2010 to 2019, one of only two EU countries with that outcome (OECD, 2022[37]), though more recent national data show that targeted reductions have been met, following a decades-long stagnating trend in contrast to the cuts already achieved by most other EU Member countries. The phosphorous balance has also increased sharply and is now the highest in the OECD: in the four years to 2019, its use rose by 21%. Late in 2022 the government approved a royal decree that aims to improve fertilizer use to lower nitrogen pollution of water through various regulatory requirements.

Figure 1.40. Nitrates are a problem in drinking water



Source: Waterbase, Water Quality, European Environment Agency (EEA).

StatLink https://stat.link/r6p1w0

Late in 2021 the European authorities decided to take Spain to the European Court of Justice for not having done enough to combat nitrate pollution, which is estimated to afflict nearly a quarter of Spain's water (surface and groundwater). Wastewater treatment is also incomplete, resulting in legal actions by the European authorities. To its credit the government has started to deal more decisively with water-quality issues. In 2021, a ministerial order promulgated a National Plan for Purification, Sanitation, Efficiency, Savings and Reuse (DSEAR Plan) to overcome administrative coordination problems. In March 2022, the Strategic Project for Economic Recovery and Transformation (PERTE) for the digitalization of the water cycle was approved by the government, with an expected budget of more than EUR 3 billion from the RTRP. In August 2022, a proposed revision of the Water Law was released for public consultation, which would include an increase in the wastewater discharge control fee in line with the polluter-pays principle. Likewise, it is also worth noting the approval in 2022 of two Royal Decrees that include measures to protect water against diffuse pollution produced by nitrates from agricultural sources and that establish standards for sustainable nutrients in agricultural soils. Most recently, the government approved the Third Cycle Hydrological Plans that will govern the regulation of water resources until 2027. Over 6500 measures were enumerated with a budget of EUR 22.8 billion covering sanitation and purification, modernisation of irrigation systems, improvement of supplies, flood-risk management, restoration of the public hydraulic domain, construction of infrastructures and digitisation of the water cycle to ensure more efficient water use. This is slightly less than the EUR 28 billion in investment needs by 2030 estimated by the OECD (OECD, 2022[52]) to ensure adequate supplies and to treat contaminants of emerging concern so as to maintain drinking water standards, even assuming a reduction in leakages.

In sum, the authorities are taking appropriate measures but may need to step up their efforts to ensure a more frugal use of water. Given that 63% of its consumption is for farmland irrigation, encouraging a better use of water through more efficient irrigation, reusing and recycling water or increasing water pricing for irrigation reflecting water scarcity is key. A reduction of irrigation is achievable only if a robust water allocation scheme covering return flows is implemented to prevent the materialisation of the well-known "rebound effect", whereby water saved is used to extend irrigated land or grow more water-intensive crops. In any case, more should also be done to support innovation in irrigation and to encourage farmers to invest in water-saving equipment and households and other businesses to economise on their use of water both through price and non-price means. Comparing water prices across countries is difficult, but one recent private initiative found that households in Almeria, Barcelona, and Madrid paid less in 2021 per cubic metre than in most other European cities.

The OECD Council's recommendation on water does not endorse the use of desalination where shortages exist. Rather, demand should be thoroughly managed through robust water allocation regimes, and better use of alternative water sources (rain water, reclaimed water) should be made before desalination is considered. In Spain's case multiple desalination plants already exist. A step forward is a very recent not-yet-finalised compromise to set the price of desalinated water with a floor of EUR 0.35 per cubic metre; in any case more desalination capacity will almost certainly be required, even if that will be costly and energy intensive (at least the energy should be provided in renewable, carbon-free form) and will result in brine release. Similarly, much greater policy effort must be expended to safeguard water quality. That too has been damaged mainly by agricultural activities, both in the form of crop cultivation and livestock rearing. Steps need to be taken to restrain the use of fertilizers either by taxing or more severely regulating their use, at least in sensitive areas. In addition, much stricter standards should be applied to livestock slurry, even if that leads to smaller herds. Spain cannot afford to maintain such environmentally damaging activities.

Table 1.11. Past recommendations on environmental policies and actions taken

Recommendations in past Surveys	Actions taken since 2021
Over the medium term, increase taxation of fuels to better reflect emissions of CO_2, together with redistribution towards poorer households.	To protect poorer households from the effect of higher energy prices, fuel taxation was temporarily lowered in 2022.
Improve the use of water price signals and water governance by widening participation of stakeholders in river basin authorities to include more scientists and improving the efficiency of water supply and treatment services by benchmarking regulation of water utilities.	No action taken.
Increase the share of R&D in water-related technologies.	No action taken.

Table 1.12. Macroeconomic and structural policy recommendations (Key recommendations in bold)

MAIN FINDINGS	RECOMMENDATIONS
Addressing medium-term fiscal challenges	
Support measures to alleviate the impact of high energy and food prices have been sizable and only partly targeted towards the most vulnerable.	**End the support measures that were put in place to alleviate the impact of high energy and food prices.**
Higher interest rates could spark disruptions in financial markets and erode borrowers' repayment capacity.	Supervisory authorities should closely monitor banks and encourage prudent provisioning and adequate capital policies.
Public debt, at 113% of GDP is high, the fiscal deficit is still sizeable and pension and health-related expenditures are set to rise in the longer term.	**Adopt a medium-term fiscal plan, step up the pace of deficit reduction from 2024, and ensure all extra spending is fully financed over the medium term.**
Spending is tilted towards social spending, mostly pensions and unemployment benefits, with too little allocated to growth-enhancing items including education and training. Young people benefit less from public spending than others.	**Based on spending reviews and sound cost-benefit analysis, set longer-term spending priorities more geared to growth-enhancing items, notably skill-building measures such as education.**
The pension reforms approved between 2021 and 2023 represent an increase in the deficit of 1.1 points of GDP in 2050. Debt could trend higher and reach 186% of GDP by 2070 according to the fiscal council.	Link the retirement age to life expectancy at the age of retirement. If this, together with the latest reforms, does not ensure sustainability of the system, modify the pension accrual factors and extend the reference period to compute pensions to at least 40 years.

The health-care system has been delivering reasonable value for money. However, some parts have been heavily squeezed.	Consider hiring more health workers.
Tax revenues are low by EU standards, and there is scope to improve the design of the tax system: the value added tax base is narrow; marginal personal income tax rates climb quickly already at modest levels of income, discouraging labour supply; and the tax system is not well geared to achieving environmental goals.	**Mobilise additional tax revenues by gradually broadening the value added tax base, imposing higher excise duties on alcohol and tobacco and raising environment-related taxes, while reducing some capital taxes and the tax burden on labour for low-income households with children.** Reduce tax avoidance and enhance tax collection by continuing to promote the use of electronic invoicing.
Promoting strong, inclusive and sustainable growth	
Long term unemployment affects over 40% of the unemployed. Activation requirements for the unemployed are lower than in most other OECD countries. Few unemployment benefits are compatible with employment.	Give greater incentives to work, by making activation stricter and by allowing the combination of unemployment benefits with work to some extent.
Social expenditure is tilted towards contributory benefits favouring people with a job and a stable financial situation. Social assistance programmes do not adequately protect vulnerable groups. Child poverty is high.	**Increase the amount and coverage of cash benefits for poor families with children.**
The lack of transferability of social rights between regions is an obstacle for people moving between regions.	Ensure the transferability of social and housing rights for individuals moving between regions.
Inefficiencies in the administrative systems, complex rules and lack of coordination mean that social assistance programmes are not effective at reducing poverty.	Set up one-stop shops to coordinate income support, social and unemployment services for vulnerable people. Develop permanent coordination mechanisms between administrations for social services to reduce administrative complexity for users.
Information regarding social services is fragmented, hampering the assessment of needs, of service quality and of policy effectiveness.	Integrate information systems, enhance data sharing between social services providers, and evaluate the impact of social policies regularly.
The coverage of the minimum living income scheme is much lower than the eligible population, and income levels it guarantees are relatively low by international standards, despite recent temporary increases.	Assess the adequacy of the national minimum income scheme in reducing poverty. Simplify access to national and regional minimum income schemes.
Despite improvements, Spain remains heavily reliant on fossil fuels, favoured by tax-exemptions, modest fuel taxes and considerable subsidies in agriculture and fishing.	**Broaden the base for environment-related taxation including by phasing out exemptions and gradually increasing the tax rate on non-ETS emissions, and compensate partially and temporarily the most vulnerable.**
Current policy efforts are unlikely to be sufficient to reach stated goals, notably net zero carbon emissions by 2050 and a cleaner energy mix through greater renewables.	**Install more electric vehicle charging points and provide more support for the retrofitting of buildings.** Speed up permitting procedures for new renewables capacity.
Water quality is poor with toxic levels of nitrates concentration spreading because of intensive agriculture production. Securing water is also a worsening problem in parts of the country afflicted by persistent drought.	**Promote a more efficient use of fertilizers by increasing taxes or improving their regulation.** **Encourage a better use of water through more efficient irrigation, reusing and recycling water or increasing water pricing for irrigation.**
Pursuing efforts to raise productivity and fight corruption	
Collaboration between the business sector and researchers is weak. Innovative companies are too few and private-public partnerships rare.	Promote collaboration and knowledge transfer between businesses and universities through performance contracts that reward collaboration and participation of businesses in university governance.
Differences in regulatory frameworks across regions hamper firms' growth and business competition.	Continue to incentivize the reduction of regulatory barriers and better regulation of economic activities by fostering the mutual recognition of regulations by regions and the implementation of the Market Unity Law.
The legal framework to fight corruption has been enhanced over the past decade, but the level of corruption is still perceived as rather high by citizens.	**Continue efforts to reduce corruption in the public sector.**
According to the OECD Working Group on Bribery, Spain continues to close foreign bribery cases prematurely, and prosecutors have insufficient time to conduct their investigations and face challenges in deploying adequate investigative measures.	Continue to implement the OECD Anti-Bribery Convention.
Information on public procurement is not easily available.	Create a single repository of procurement-related data.

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