ISBN 92-64-02920-6
OECD Economic Surveys: Spain

Chapter 3

Medium and long-term fiscal issues

Budget outcomes have steadily improved in the last decade, as Spain has continued its fiscal consolidation process. Several forces could make it more difficult to maintain the current prudent medium-term fiscal policy, which is needed both to provide room to manoeuvre in case of an economic downturn and to prepare for the budgetary effects of the predictable sharp deterioration in the age structure of the population that will take place in the coming decades. Against this background, the authorities have signalled their commitment to maintain a sound fiscal policy. They have also adopted a series of reforms that aim to increase public-sector efficiency and prepare for the long-term fiscal effects of the ageing process and the resulting rise in demand for health and dependency care. This chapter aims to analyse the forces acting on both the revenue and expenditure sides of the budget in the longer term and the authorities' strategy to address them. It also provides some advice, in light of the previous analysis, to ensure that the medium- and longer-term fiscal objectives are jointly consistent.

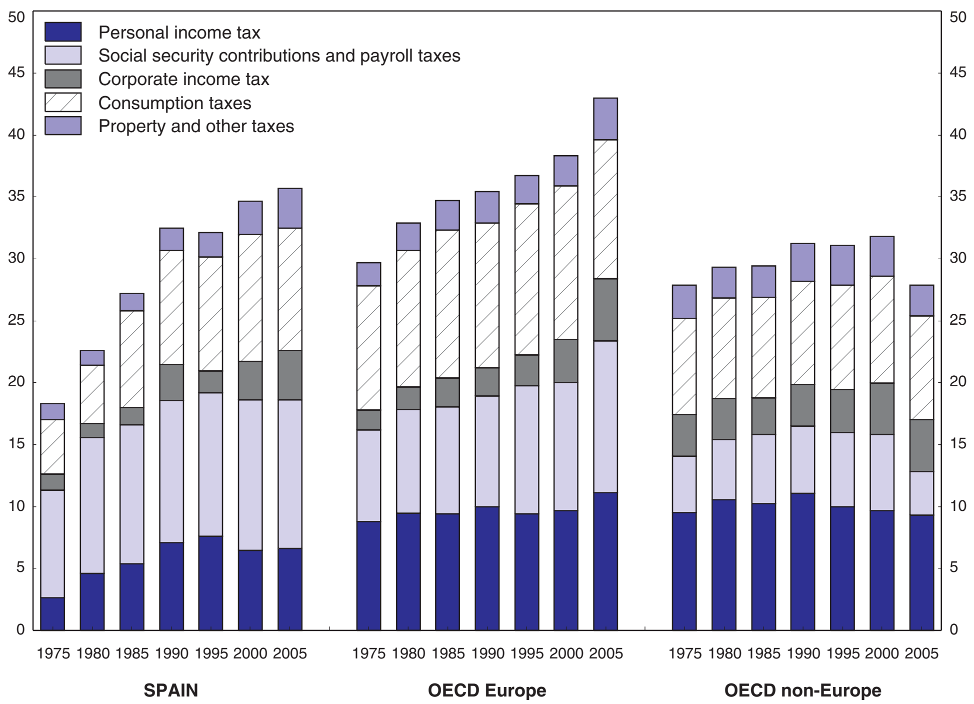
The authorities have achieved sound public finances over the last decade in a context of rapid economic growth. However, sound economic policy is as much about capitalising on good times as avoiding bad ones. The time is ripe for the authorities to develop a comprehensive strategy to deal with the most pressing issue affecting public finances in the long-term: the foreseeable increase in expenditures stemming from the ageing process. Before approaching the question of dealing with spending pressures, the revenue outlook will be discussed.

Forces acting on the revenue side

Since the mid 1970s and until the beginning of the 1990s, taxation in Spain rose sharply: the tax burden as a per cent of GDP rose from around 18% in 1975 to close to 33% in 1990 (Figure 3.1). Until then, tax reforms[1] were aimed at creating a modern tax system that would allow the authorities to finance an increasing demand for public services (OECD, 2000). Since the early 1990s taxation has increased only slowly (the tax burden has risen to close to 35% of GDP, not far off the European average), as second-generation tax reforms have aimed at simplification, promoting neutrality and enhancing incentives for

Figure 3.1. **The tax burden**

Per cent of GDP[1]



1. Data for 2005 are estimates.

Source: OECD, Revenue Statistics.

work, savings and investment. At the same time, additional pressures have been created in the tax system by a process of decentralisation of spending and taxing powers to regional communities (OECD, 2005a) and to some extent by foreign tax competition.

While recent reforms have been successful in simplifying the tax code, reducing compliance costs and rectifying previous distortions, the tax system still contains imbalances. These are reflected in the relatively high tax pressure on labour income (Table 3.1), insufficient neutrality in the taxation of savings and shortcomings in tax decentralisation which have allowed regional governments to rely – probably excessively – on transfers from the central government (Joumard and Giorno, 2005). In response to this, a new tax reform has been put in place for 2007, which includes changes to the personal income and corporate taxes, a uniform treatment of savings and additional incentives to work. The fight against tax fraud and money laundering has intensified. A new framework to coordinate the fiscal relations between the central and regional governments is under discussion, which will likely follow at least in part the path of the recently approved statute of autonomy for Catalonia. The new framework should have as its priority an increase in the accountability of regional governments by creating a stronger link between regional levels of spending and revenues. Citizens should be able to see clearly the link between the taxes they pay and the level of services they receive in exchange. Only by bearing the full marginal cost of increases in spending will regions decide efficiently on the optimal level of expenditures.

Table 3.1. **Average tax wedge in Spain and other OECD countries**

	2000	2001	2002	2003	2004	2005
Spain	**38.6**	**38.8**	**39.1**	**38.5**	**38.7**	**39.0**
OECD-Europe	41.2	40.7	40.4	40.2	40.5	40.2
OECD-Non Europe	21.4	21.2	22.6	22.1	22.0	22.6
OECD average	37.9	37.5	37.4	37.2	37.4	37.2

1. The tax wedge is calculated as the average personal income tax and social security contribution rates for a single person without dependents at 100% of the average wage.

Source: OECD Tax Database.

A new fiscal reform aims to reduce the tax burden and rationalise and simplify the tax code

In several respects, the new reform of the personal income tax goes in the same direction as the two previous overhauls (in 1999 and 2003; see Annex 3.A1). It simplifies the tax code by reducing the number of tax brackets to four,[2] and, in order to lower the tax burden, the top marginal rate[3] is cut from 45 to 43%. Neutrality is to be enhanced by a uniform tax treatment of savings, as the liability on income from all instruments will accrue at the same rate, 18%, rather than as a function of whether they are short- or long-term investments; the only exception will be the treatment of the income from dividends, as the first € 1 000 will be exempt. The favourable treatment of lump-sum withdrawals of private retirement savings is eliminated, although the maximum annual tax-free contribution is increased. The favourable treatment of housing purchases is curtailed, although only very marginally. The new reform places a stronger emphasis on increasing tax progressivity than its predecessors (Lagares, 2006). Personal and family allowances are increased, and are now included in the first income segment, which is taxed at a zero rate.[4] Concerning the taxation of labour income, allowances are being increased by between

8 and 14% (depending on the level of earnings). Official estimates suggest that personal tax payments will be reduced by 6% on average and 17% for the 60% in the lowest income brackets. Lower-income wage earners will benefit from the increases in work-related deductions, while tax savings will be modest for single and married people with no children; families with average incomes will be among the few negatively affected by the reform.

In addition to the revision of the personal income tax, the corporate tax is being reformed for the first time since 1995.[5] The new reform, also put in place in 2007, will focus on increasing firms' competitiveness by reducing their tax burden and simplifying the tax code. The rate is to be lowered from 30 to 25% in 2007 for small- and medium-sized enterprises, and from 35 to 30% over two years for larger firms. On the other hand, all the tax credits available to firms will be gradually phased out by 2011, with the exception of the deduction for research and development expenditures (which had an estimated budget cost of € 261 million in 2006) and the reinvestment of profits in productive investment (whose estimated budget cost was more than € 2 600 million in 2006). This will not only greatly simplify the tax code, eliminating distortions and the use of creative accounting to reduce tax liabilities, but it will also broaden the tax base.

The fiscal cost of the reforms to the personal income and corporate tax is estimated to be around € 2 billion and € 2.5 billion, respectively. However, efforts by the authorities to increase the use of permanent work contracts in the economy[6] will result in a further fall in revenues, estimated to be around € 425 million in 2006 and € 849 million in 2007. While the fiscal cost of the personal income tax reform is moderate when compared with previous changes,[7] the overall tax cut is projected to be of a similar order of magnitude as those in 1999 and 2003. This tax cut, amounting to around 0.4 percentage points of GDP, might however be partly offset by an increase in revenues brought about by the fight against tax fraud that the authorities are also intensifying (see below).

The reform will result in a more efficient tax system and is likely to decrease the tax burden, complementing other actions taken by the authorities to increase the economy's competitiveness. There are, however, several areas where it could have been more ambitious. *First*, tax brackets have been indexed since 2005 to the official inflation projections, which – being normative – have consistently underestimated actual inflation. The increases in the personal and family allowances and the tax brackets included in the reform do not even compensate for the past inflation effect.[8] Thus, it would be advisable, as has been suggested before (OECD, 2003) to incorporate a more systematic inflation adjustment of the tax brackets and allowances into the tax code to avoid both accumulating distortions until they are updated and relying on periodic fiscal reform to make the adjustment. This would also help to stop the slow up-creep in the tax burden observed in recent years. *Second*, although very slightly modified, housing purchases continue to receive a favourable tax treatment, which will continue to hinder the development of the rental market, thereby hindering labour market mobility in the event of regional shocks. *Third*, the large difference between the still relatively high top marginal personal rate (43%) and the low corporate tax rate on SMEs (25%) is likely to cause tax evasion to persist, as individuals in high tax brackets form small companies in order to lower their tax payments. Moreover, the persistently lower tax rate benefiting SMEs is a disincentive to the growth of firms near the threshold – as it is believed to be in Canada (OECD, 2006b). It is likely to continue favouring an industrial structure with a high proportion of small firms, whereas the development of bigger firms would be beneficial to the Spanish economy (see Chapter 4). *Finally*, while some of the tax incentives for contributions to private retirement savings plans have been cut back, the increase in the maximum contribution could be costly, as the net revenue cost of contributions to the plans[9] is likely to be high (OECD, 2005a; Antolin *et al.*, 2004).

By its very nature, it is hard to quantify the extent of tax fraud and the size of the underground economy, and the authorities provide no official estimate of either. However, the abnormally high number of € 500 bills in the economy,[10] public opinion polls[11] and various studies on the size of the underground economy[12] all seem to confirm the suspicion that tax fraud is considerable. In 2005, the government adopted a comprehensive plan to fight tax fraud and money laundering, with a bigger emphasis on real estate transactions, VAT schemes and the use of fiscal havens. In addition, more investigative tactics are being used, and more resources are being allocated to identifying suspicious patterns, rather than to the more time- and resource-intensive audits of individual tax returns. While the plan resulted in considerable increases in the amounts recovered in 2005 (€ 4.6 billion; almost 13% more than in 2004, although total revenues increased by more than 14% that year), and the streamlining and simplification of the tax system will help to contain tax evasion as compliance is made easier and loopholes used to reduce tax liabilities are closed, there is room for further improvement. In particular, cooperation between fiscal and police authorities, through the appropriate channels, should be improved to avoid cases where the former harbour suspicions of illicit behaviour but lack the power to investigate them.

The fiscal framework between the central and regional administrations is being reformed

Since the creation of autonomous communities by the 1978 Constitution, Spain has become one of the most decentralised OECD countries. Regional governments have progressively taken on more spending responsibilities, so that, with the devolution of education and health care spending completed by 2002, regional governments are now responsible for about 42% of total public spending (excluding spending on pensions; one third when such outlays are included). However, regional and local governments have relied heavily on transfers from the central government to finance spending increases. Taxing powers have been progressively devolved to regional governments, but they have been reluctant to fully exploit them (see below). The recent increases in health care spending, due only in part to the immigration boom (see below), have not been financed by increases in regional taxes, but rather by larger central government transfers (of around 0.2 percentage points of GDP in 2006 and 2007). The equalisation and solidarity mechanisms among regions have not been successful in pooling resources across regions and redistributing them among poor regions, as in recent years, only two regions (Madrid and the Balearics) have been net contributors. Rather, they have been a source of transfers to even relatively rich regions. The existence of two distinct financing arrangements, the Foral (that includes only Pais Vasco and Navarra) and the Common regime (which includes the remaining regions) has increased demands to address the inequality in the fiscal treatment among regions in the two systems.

As a result, central and regional governments have agreed on the need to update the financial framework to better reflect the regions' increased taxing and spending powers and increase their fiscal responsibility, through a reform of the *Ley Orgánica de Financiación de las Comunidades Autónomas* (LOFCA). Negotiations are underway between the regions in the common regime and the central government, although an agreement before the end of the current legislature in 2008 does not seem likely. New autonomy statutes for several regions, some still in the approval process, contain provisions that significantly alter the fiscal framework for the regions involved, although they will not be applicable until the LOFCA is reformed. While the statute of each region will be negotiated separately, it is likely that the new regional financing model will incorporate some of the changes in the new Catalonia statute, so as to achieve a symmetric financial mechanism with all regions (except those in the Foral regime) as sought by the central government.

The Catalonia statute introduces several relevant changes in the fiscal area, although most of them won't be implemented until the new LOFCA is in place. A greater share of taxes is ceded to it: in the case of the value-added tax and the personal income tax the share will increase from 33 to 50% and in the case of excise taxes (tobacco, alcohol, beer, wine, mineral oil and intermediate products), to 58%. A new semi-autonomous office within the regional government, the Agencia Tributaria de Cataluña, will be created and will be responsible for the collection of both own and totally ceded taxes in Catalonia,[13] which is currently the responsibility of the regional office of the central tax authority (except for the tax on electricity). The management of the partially ceded taxes, on the other hand, will still be the responsibility of the central tax authority; however, powers can be shared with the regions, and this is expected to happen. It is important to point out that the creation of the new agency will not expand, by itself, the competencies of the region. The statute also contains two principles that the region's net contributions to the equalisation and solidarity funds must satisfy. *First*, transfers from Catalonia must not change its ranking in regional *per capita* GDP. *Second*, the fiscal effort of receiving regions is one of the factors to be considered in the equalisation system. These two principles will be interpreted in the LOFCA. However, care must be exercised to ensure that their interpretation and implementation are not unduly complicated and do not lead to disputes.[14] .

As taxing powers are further devolved, it is important to stress that the new financial framework should provide good incentives for regional communities to maintain sound finances and rely more extensively on their own sources of financing, exploiting the powers to determine tax rates they already enjoy. Under the current financial arrangements regional governments have had normative powers over partially ceded taxes, but only one region intends to modify the rate of the personal income tax. Although comparing the differences in effective tax rates between tax systems is difficult, a recent study (Durán-Cabré and Esteller-Moré, 2006) suggests that regions might have induced, using tax credits, some variation in their effective income tax rates.[15] The overall impact of the new financing mechanism on the central government's tax revenues is unclear, as increases in regional tax revenues will be at least partially offset by decreases in transfers from the equalisation schemes. However, it is unlikely that any region will accept a decrease in revenues in the new system. As no new competencies or spending powers are being devolved, care should be exercised not to go too far in granting regions further revenue concessions, thereby creating undue stress on the central government's finances. The creation of the tax office within the Catalonia regional government[16] may increase efficiency in tax collection, but attention should be paid to not duplicate tasks and resources.

Negotiations are under way to reform the local government fiscal framework

Negotiations between the central government and municipalities have started with the aim of reforming the financing arrangement for local governments. As has already been suggested in previous *Surveys*, the property values used to compute real estate taxes are well below market prices, as they are not re-evaluated frequently enough (OECD, 2005a). The significant housing price increases in recent years have probably increased this gap, also raising questions about the equitable tax treatment of older versus newer housing. Local governments in Spain appear to rely less on user fees or charges than in other countries (OECD, 2003) and the further diversification of sources of revenues would be desirable.

Forces acting on the expenditure side

In the medium- and long-term, public expenditures will be subject to significant upward pressures. These include the significant efforts under way by the authorities to steer the economy onto a more sustainable growth path based on productivity increases, as summarised in the National Reform Programme, through an ambitious infrastructure programme and considerable increases in R&D spending (the authorities' objective is raise public R&D spending from 0.5% to 0.9% of GDP by 2010 – see Chapter 4). Regional governments are also insisting on more investment from the central government to correct perceived historical imbalances. In the long-term, upward pressures will also come from the ageing process. This section reviews the different sources of stress on spending and assesses the main measures the government has adopted to maintain sound public finances and prepare for the long-term fiscal costs of the ageing process.

An ambitious plan to transform the economy is underway

Significant improvements in Spain's transportation infrastructure have been made since it joined the European Union. Helped by EU funds, infrastructure spending as a per cent of GDP has been consistently above the EU average, but a sizable deficit in physical infrastructure *vis-à-vis* other EU countries still remains, especially in terms of railway infrastructure (Table 3.2). High-capacity roads still exhibit a hub-and-spoke model, which limits accessibility across regions; quality and safety standards are uneven across the rail network; and the demand for transportation services is predicted to grow considerably in the future (Ministerio de Fomento, 2004). To address these challenges and as part of the government's overall plan to meet the Lisbon Agenda goals, an ambitious infrastructure plan was launched by the government in 2004. Called the Plan *Estrategio de Inversion y Transporte* (PEIT) it involves total spending of € 250 billion over 25 years, or roughly 1¾ per cent of GDP a year until 2020, to be financed 60% from the general budget and the rest from other public entities and public-private partnerships.[17] Around 50% of total investments will be spent on the railroad network, 25% on highways and the rest on air, sea and urban and metropolitan transport systems.

As part of the negotiation of the new autonomy statutes, several regions have asked for increased spending on infrastructure by the central government to correct a perceived underinvestment in the past. In the case of Catalonia, for example, the central government agreed to increase the share of total investment in the region to an amount equal to the share of the region's GDP in the national GDP for the next seven years. The Andalusia statute, on the other hand, contains a request to raise the share of investment to the share of the region's population in the national total, while in the Balearics statute, a fixed

Table 3.2. **Transportation infrastructure density in Europe**

2004[1]

	Total motorway length		Total railway tracks		Electric tracks		Non-electric tracks	
	Km per thousand km^2	Km per million people	Km per thousand km^2	Km per million people	Km per thousand km^2	Km per million people	Km per thousand km^2	Km per million people
Belgium	57.2	167.8	206.1	604.3	179.6	526.7	26.5	77.6
Netherlands	56.4	142.3	67.7	173.3	..	..	..	..
Germany	33.7	146.0	198.5	859.5	126.2	546.3	72.4	313.3
Denmark	23.4	187.9	..	..	14.5	116.9		
Spain	**20.3**	**240.9**	**25.4**	**300.7**	**14.9**	**176.2**	**10.5**	**124.5**
Austria	20.0	205.1	67.3	697.9	..	..	..	..
Portugal	19.9	176.8	30.4	269.9	11.4	100.9	19.0	169.0
France	19.1	172.5	90.2	810.7	56.3	505.8	33.9	304.8
United Kingdom	15.1	61.1	136.1	551.5	49.5	200.6	86.6	351.0
Czech Republic	6.6	50.8	206.6	1 596.7	82.1	634.5	124.5	962.3
Hungary	6.1	56.3	136.9	1 260.0	63.1	582.8	73.8	677.3
Sweden	3.5	177.6	34.1	1 714.6	23.7	1 191.3	10.4	523.2
Finland	1.9	124.9	25.4	1 644.2	12.1	783.3	13.3	860.9
Poland	1.8	14.5	124.0	1 015.7	80.6	660.3	43.4	355.4
Norway	0.6	42.0	13.4	943.8	8.5	600.0	4.9	343.9
Average	18.7	127.0	97.3	888.8	59.0	542.4	43.3	421.9

1. Data are for 2002 for Germany, Denmark and Portugal, and for 2003 for France, the Czech Republic and Sweden.
Source: Eurostat, Transport statistics.

amount of € 3 billion over seven years was asked for. While some regions might have suffered from underinvestment by the central government in the past (see Garcia-Milà and McGuire, 2002; de la Fuente, 2001), future negotiations should avoid spawning additional pressures on public spending for political reasons as regional governments compete for further spending commitments from the central government.

While investments in infrastructure can eliminate bottlenecks and increase competitiveness, the benefits of a programme of this magnitude should be clearly weighed against other possible uses so as to assess if they are the most efficient use of available resources. The central government has already announced spending on education to be one of its priorities in the National Reform Programme. Given the high rate of return to education in Spain, estimated at between 7.5 and 12.2% (de la Fuente and Jimeno, 2005), questions can be legitimately raised concerning the most profitable use of public spending. More intensive investment in education might improve the efficiency of government spending and allow a faster convergence in *per capita* income levels with the rest of the euro area. In this regard, a too narrow interpretation of the clause in the new Fiscal Stability Law described in this Chapter, allowing all levels of government jointly to exceptionally exclude increases in public investment (including for R&D and innovation) up to 0.5% of GDP, would create the risk of biasing spending away from education. To avoid this, when implementing the exclusion, human capital outlays should receive the same treatment as other productivity-enhancing measures.

Efforts to rationalise spending have increased

Having committed itself to maintaining a prudent fiscal policy, the government has also made efforts to rationalise public spending and raise its efficiency. As mentioned in the National Reform Programme, the efforts include a significant financial restructuring and reorganization of RTVE, the public radio and television entity, the creation of a public policy evaluation agency, the increased use of e-government and the creation of a statute governing public employees.

The rationalisation of spending includes decentralised entities like RTVE, which has been a big drag on public finances for a long time. It has incurred losses of at least € 500 million in each of the last five years and has accumulated debts of upwards of € 7.5 billion, equivalent to around 0.7% of GDP, which the government has recently assumed. The welcome reform includes a corporatisation and reduction in the number of employees, from more than 9 000 to around 6 200, although negotiations with the labour unions are still not complete. Even though it will still be possible to be partially funded by public transfers, the change in structure is likely to prevent a repeat of past underperformance.

To raise the efficiency of public spending, a new framework for public entities has been created to increase their accountability and foster a culture of results-based administration. A new legal form, the "agency", will provide an organisational modality that gives more flexibility and autonomy to public entities to pursue their previously determined objectives, while making it easier to be evaluated. In tandem, a public policy evaluation office, the *Agencia Estatal de Evaluación de las Políticas Públicas y la Calidad de los Servicios*, has been created and is expected to be operational by the end of 2006. Initially, one of its main roles will be the assessment of the National Reform Programme. The office will need to collaborate with other sectoral and regional agencies (as there will be no hierarchical relationship among them) that are also being created in order to agree on a set of indicators to follow, for example in education, employment policy and health care. This reform could potentially provide a useful evaluation of public policy and institutions that will aid in maintaining the objectives of budget stability as waste and duplication is reduced. The competitiveness of the whole economy can be increased if the office helps to optimise the use of public resources at all levels of administration. However, it could see its scope to engage in benchmarking and other comparative studies constrained by the resistance of other public entities, especially at the regional level. To ensure its effectiveness, the new institution must have a high degree of independence, and its findings should be readily and easily available to the general public so as to help promote reforms.

The government has also taken several steps to increase the use of e-government. A new, electronic form of universal ID is being introduced that can not only significantly cut red tape in official procedures but can also provide a boost in e-commerce and other Internet-related operations as the new card can be used to store and retrieve customers' information. Through the *Ley de acceso electrónico de los ciudadanos a la administración,* the government will try to streamline interactions with citizens and move to electronic rather than paper-based administration. In fact, citizens will now have the right to conduct all of their interactions with the central government via electronic format. Efforts in this direction will not only save on public administration but can also be a much needed boost for members of the public to get used to electronic operations.

Following the decentralisation process, public employment rose considerably, particularly at the regional and local levels, which by the first quarter of 2006 accounted for around 70% of total public employment, up from around 45% in 1987 (Figure 3.2). The need to provide a homogeneous framework for all public employees across regions and modernise the management of public employment, as the current framework dates from 1965, is being addressed through the creation of a public employee statute. It sets out the rights and responsibilities of all 2.3 million public employees across the three levels of government.[18] Basic compensation will be the same among all governments, while complementary remuneration will be determined by each administration taking into account a series of measurable criteria. Employees' performance will be subject to regular evaluations, which will be used to determine vertical mobility. They will have the right to engage in collective bargaining agreements with the government, and the high share of temporary workers[19] will be tackled by limiting the share of temporary contracts to 10% of total employment in any administration and the conversion of 650 000 of them into permanent positions. By tying more closely remuneration and vertical mobility to employee performance, the statute is a positive step to foster productivity in the public sector. There is a risk, however, that it could provide a relatively rigid framework for all public employment, making regional adjustments more difficult. The move towards a more results-based evaluation of public entities requires that they have the flexibility to adjust their labour costs to changing conditions in order to reach their goals at least cost. Other decentralised countries, like Switzerland, have moved in the opposite direction by eliminating public servants' status at the regional level, thereby giving them more freedom in managing their workforces (OECD, 2002).

The ageing process will add to spending pressures

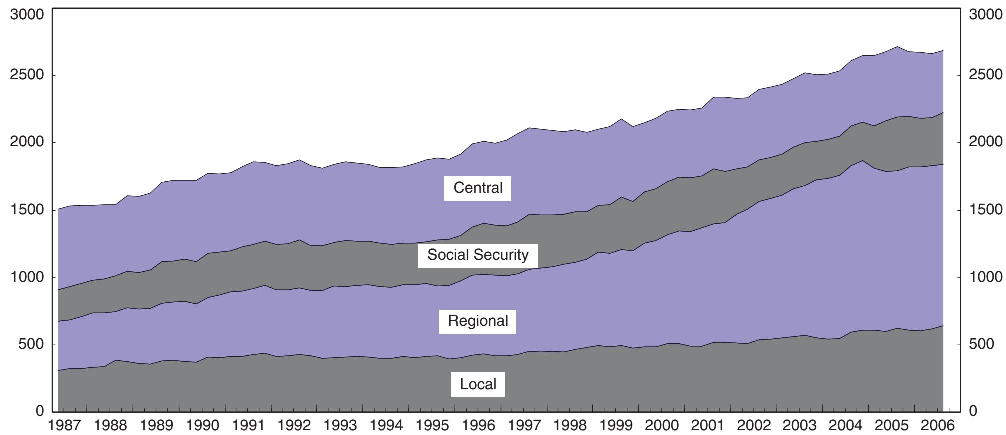
While countries across Europe will also face an ageing process, it is expected that the effects will be felt later but be more pronounced in Spain. Coupled with relatively generous parameters underlying pension calculations – even though the average level of pensions is lower that the euro area average – spending on pensions (as a share of GDP) is expected to increase more than in other countries. Health and dependency care spending can also be expected to increase in the medium- and long-term.

A new dependency law is to provide assistance to an estimated 1.1 million people by 2015

There is strong evidence that Spain lags substantially in expenditure on long-term care for the elderly (OECD, 2005a) and lacks sufficient facilities to provide care for elderly dependents, which is usually (in more than 70% of the cases) provided by unpaid female family members (Costa-Font and Paxtot, 2003). This has probably limited the female participation rate, even though it has increased rapidly in the current decade (from 41.4% in 2000 to 47.8% in the third quarter of 2006) and has been an important factor, along with immigration, in sustaining high GDP growth.[20] Currently, formal assistance falls well short of demand and is provided, on a decentralised basis, by regional and local governments through the health care system, resulting in sometimes inefficient use of acute care services when it would be both less expensive and preferred by patients for assistance to be provided, when possible, at home (OECD, 2005a). As the population ages, the demand for dependent care will increase, and the absence of a properly organised system of dependent care might make further increases in the female participation rate difficult and add further pressures to health care spending.

The Dependency law, which comes into force in 2007, will create the *Sistema de Dependencia*, which aims to progressively expand coverage, with the goal of reaching all the 1.1 million estimated dependents in 2015, when the system is expected to be fully operational. Coverage is beginning in 2007 for the 200 000 with the highest degree of dependency, according to an assessment made in 2006. The central government will

Figure 3.2. **Employment by level of government**
Thousand persons



Source: INE.

provide a basic package of benefits, so as to guarantee a minimum level of assistance across regions. Regional governments can then offer augmented packages, which they will need to co-finance (as is the case with the basic coverage) along with the central administration. Finally, beneficiaries will face a co-payment, which will be a function of their income. This setting can allow regions to offer coverage packages that are more closely tailored to their citizens' preferences, while providing a minimum level of care that is the same across all regions, ensuring both equity and flexibility. The total cost of the system is expected to be € 1.6 billion in 2007 (around 0.17% of GDP), rising as both coverage and demand are increased, to € 9.5 billion in 2015 (close to 1% of GDP).Regarding the financing of the costs, the draft bill that was approved by the government in April estimated that around 47% of the total cost will be financed in equal parts by the central and regional governments, 34% directly by beneficiaries through the co-payment and the remaining19% will be borne by reallocating current spending on dependents through the health care system. However, as the final version of the law, adopted in December, includes several modifications to the initial draft, new estimates of the total cost and its financing will be required.

The inclusion of a co-payment is a welcome feature that can effectively rationalise demand and help curb overall costs. However, there is still a high degree of uncertainty regarding the financing of the system. The central government has pledged a significant part of the financing, and the system is expected to provide clear guidelines as to how to determine the co-payment.[21] There are not yet any specific mechanisms through which regional communities can cover their projected part of the costs, which could lead to coordination problems. Some regional political parties opposed this reform, as they interpreted it as interference by the central government in regional competencies. Coming up with the promised funding might prove to be more difficult, especially in light of the problems that regional governments have faced in financing health care in recent times.

Spending on health care is likely to keep on rising

Total spending on health care continues to be below the OECD average, despite having grown by almost 1 percentage point of GDP to 8.1% from 2000 to 2004. Public spending, which is now the responsibility of regional governments, has been relatively well contained, as it has grown by only 0.5 percentage points of GDP, slightly less than the average across European countries (Table 3.3). However, public spending on pharmaceuticals[22] has grown steadily in recent years and is now almost 25% of public health spending, a significantly higher share than in most other OECD countries.[23] This increase appears to be caused more by the growth in the number of prescriptions than by any increase in spending per prescription. Also, spending pressure from in-patient care has been relatively strong of late, which might reflect to some extent a coordination problem between hospital and ambulatory care. Patients apparently prefer to go to a hospital in order to receive routine care, rather than to their primary care provider, as this allows them to choose when to receive treatment and avoid having to come back for more analyses (OECD, 2003). On the other hand, public spending on prevention and public health is well below the OECD average.

Table 3.3. **Evolution of health expenditure**

	Spain			OECD-Europe			Japan			United States		
	Change over period[1]		Level	Change over period[1]		Level	Change over period[1]		Level	Change over period[1]		Level
	1995-2000	2000-04	2004	1995-2000	2000-04	2004	1995-2000	2000-04	2004	1995-2000	2000-04	2004
In % of GDP												
Total spending	–0.2	0.9	8.1	0.2	0.9	8.8	0.8	0.4	8.0	0.0	2.0	15.3
Private expenditure on health	–0.1	0.4	2.4	0.1	0.2	2.2	0.2	0.1	1.5	0.1	1.1	8.5
Public expenditure on health	–0.2	0.5	5.7	0.1	0.7	6.6	0.5	0.3	6.5	–0.2	1.1	6.8
of which:												
In % of public expenditure on health												
Investment	0.4	0.1	3.5	–0.9	–0.3	3.6	–3.1	–0.4	4.0	–0.2	–0.2	1.5
Current expenditure	–0.4	–0.1	96.5	0.9	0.3	96.4	3.1	0.4	96.0	0.2	0.2	98.5
of which:												
Pharmaceutical and other medical goods[2]	3.0	1.4	24.5	1.5	–1.9	15.5	–4.0	0.8	16.8	1.8	1.7	7.7
In-patient care[3]	–3.6	2.4	39.0	–1.6	–3.0	47.6	1.0	0.0	44.4	–5.1	–2.6	34.9
Out-patient care[4]	0.3	–6.1	29.8	0.2	5.1	30.2	2.3	–1.2	32.6	1.8	1.6	44.6
Prevention and public health	0.7	–0.2	1.5	0.4	–0.4	2.0	–0.4	–0.2	1.7	0.6	–0.7	7.7
Other	–0.8	2.4	1.7	0.5	0.4	1.1	4.2	1.0	0.5	1.1	0.2	3.6

1. Changes expressed in percentage points.
2. Including therapeutic appliances.
3. Including expenditures on ancillary services.
4. Including expenditure on health services.

Source: OECD Health Data 2006.

Even though cost pressures have not been stronger than in other OECD countries, recent developments have strained the model of health care financing that has been in place since 2002. Increases in immigration, benefits provided and prices of medical goods and services have resulted in higher expenditures for regional governments,[24] who have coped with these pressures not by raising their own sources of revenue, but rather by successfully lobbying for additional transfers from the central government (of around € 1.6 billion in 2006).[25] Regional governments have also increased the number of health-care facilities, especially in regions with previously low levels of sanitary infrastructure, although it is likely that there has been some degree of duplication. Pressures on public health-care spending are likely to continue in the medium- and long-term as demand increases both through the ageing process and as cost-increasing technologies develop. As mentioned in Chapter 1,OECD estimates show that public spending could increase from the current level of 5.7% of GDP in 2004 to between 9.6 and 12.1% of GDP in 2050 (OECD, 2006c).

The authorities have unveiled a plan aimed at increasing coordination among regions, promoting best practice in medical treatments and enhancing the transparency of the national health system. In response, the central and regional governments have agreed on a set of measures to rationalise and raise the efficiency of health-care spending. Purchasing systems will be updated, encouraging the centralisation (and homogenisation) within each region of purchasing decisions, including investments in medical equipment. Pharmacies will be able to sell over-the-counter drugs online, and more information will be made available on the proper and most efficient use of pharmaceuticals and on the use of generic drugs when available. Furthermore, restrictions are being placed on the pricing of approved drugs,[26] and the prices of older drugs will be reduced by up to 20%, with the objective of saving € 1 billion over five years. However, recent experience suggests that reductions in drug prices generate only temporary decreases in pharmaceutical expenditures. After price rebates in 2005 and 2006, expenditure decreased by 4.5% in April 2006 (month on month), only to rebound two months later (by June, expenditure had increased by almost 10%). Competition between drugstores is limited by restrictive licensing procedures (see Chapter 5), which are likely to drive up drug prices. While the need for greater use of benchmarking and coordination is recognised by the central government, regions have been reluctant to participate fully. For example, regional governments have been opposed to the publication of information across regions on waiting lists in hospitals.[27] Public access to such information would probably increase public pressure to improve service through clearer accountability.

As in other countries, spending on sickness leave and disability benefits has increased considerably in the last few years. While the population covered has increased by only about 4% from 2000 to 2005, benefit payments have increased by more than 40% over the same period. The cost to the social security system alone was around € 6.3 billion in 2005, while an additional € 3 billion was spent by firms. In general, good incentives to contain spending are created when the party that is responsible for providing the benefit is also the one determining the validity of the claims. The authorities are acting on two fronts in this direction. *First*, beginning in 2006 social security administration personnel have alone had the authority to periodically review sickness leave cases and, if needed, extend temporary invalidity benefits for additional six-month periods. Previously, doctors from the public health system in any region could rule on the matter, even though the benefit is provided by the central government via the social security system. The maximum period is reduced from 18 to 12 months (plus, in both cases, a six-month extension), and employers are now required to notify the social security administration of all cases of sickness. *Second*, negotiations are under way in order to increase incentives facing firms to contain spending on short-term sickness leave. Currently, benefits from the 4th to the 15th day of incapacity are authorised by the social security administration, but it is employers who are financially responsible.[28] After the 15th day, the benefit is again paid by the social security system. In this way, administrators do not have any incentives to control expenditures until the 15th day of incapacity, although the system of monitoring and reviewing sickness cases appears to be working effectively to reduce false claims. It is not clear what the best way is to provide the correct incentives to firms in order for them to invest in preventive measures (Rae, 2005). In some countries, social security provides the benefits from the first day of leave (*i.e.* France, Denmark, Iceland, Portugal, Ireland and Greece), while in others employers are responsible for a relatively long period (*i.e.* 12 weeks in Austria and Italy and 28 weeks in the United Kingdom).

The ageing process, along with generous system parameters, will significantly raise pension spending

The expected effects on pension spending caused by the ageing process have been increasingly recognised by the social partners as a serious issue. While the social partners and the authorities have met periodically under the *Pacto de Toledo* to discuss this issue, the reform process has been slow, and no sense of urgency about the need to embark on serious reform is yet apparent, especially after the recent sharp increase in immigration which has pushed back the onset of the ageing process (see below).

In 2005, immigrants represented around 9% of the total population as compared with around 2¼ per cent in 1999. The share of foreigners in total contributors to the social security system has similarly increased from 2.3% in 1999 to 9.3% (1.7 million people) in 2005. In 2005, more than 550 000 illegal immigrants were regularised in an exceptional process. There is of course great uncertainty about the level of future immigration flows, which seem more driven by "push" rather than "pull" factors (OECD, 2003). European Commission (EC) projections assume that net immigration inflows would stabilise from 2010 on at around 110 000 per year until 2050, while the authorities have developed an alternative scenario[29] under which annual net inflows would stabilise at around 275 000, more than twice the EC assumption. In the first scenario, the old-age dependency ratio[30] would increase from around 24% in 2006 to 66% in 2050, significantly higher than the 55% estimated for the whole euro area (Puente y Gil, 2006). Under the second, high immigration scenario, the dependency ratio would increase to around 57%, much closer to the euro-area estimate but still more than double its current level. It is also important to note that higher immigration will also mean higher pension claims in the future and higher spending on health care and education. Thus, immigration will not solve the long-term financial problems of social security; it merely delays them.

The ratio of contributions to the pension system to GDP in these scenarios is robust to different assumptions about macroeconomic variables and is also stable across time. For example, Alonso-Meseguer and Herce (2003) estimate it to hover around 10.5% of GDP over the projection period (ending in 2050) under even the most optimistic assumptions regarding immigration, the growth of productivity and the employment rate. In effect, this means that the balance on social security is almost completely determined by the evolution of spending. The parameters used to determine pension benefits are more generous in Spain than in other countries (OECD, 2001 and 2005a),[31] which has made the system actuarially unfair: the internal rate that equalises the discounted value of old-age pensions and the corresponding contributions is 4%.[32] This rate is considerably higher than estimates of the growth of potential output in the coming years (OECD, 2006a). The combination of the actuarial unfairness of the system and population ageing will result in a progressive increase in expenditures and thus in the social security deficit. What is more, the projected expenditure on pensions is also fairly robust to reasonable alternative scenarios (Table 3.4), so that even in the most optimistic scenario, expenditure will still increase to 14.3% of GDP by 2050, 6½ percentage points above recent levels. These estimates are confirmed by the more comprehensive exercise done by Jimeno *et al.* (2006), who model the increase in pension expenditures using the more optimistic demographic

Table 3.4. **Total pension expenditure in per cent of GDP**

	2005	2010	2020	2030	2040	2050
	Basic scenario					
Total Social Security	7.8	8.1	8.5	11.0	14.4	15.2
	Alternative hypotheses					
Low unemployment rate[1]	7.8	8.1	8.5	11.0	14.4	15.1
High life expectancy[2]	7.8	8.1	8.5	11.0	14.5	15.2
High productivity[3]	7.8	8.1	8.4	10.6	13.8	14.3
Low productivity[3]	7.8	8.1	8.7	11.4	15.1	16.1
High employment amongst older workers[4]	7.8	8.1	8.5	10.9	14.3	15.1

1. The employment rate increases by 1 percentage point over 2005-15 and remains thereafter 1 percentage point higher. The participation rate is unchanged over the period.
2. A linear decrease in age-specific mortalities is assumed so that by 2050 life expectancy at birth would increase by 1.6 years for males and 1.3 years for females and the dependency ratio would increase 2.8 points.
3. Labour productivity increases/decreases by 0.25 percentage points over the period 2010-2015 and remains 0.25 percentage points higher/lower thereafter.
4. The employment rate of older workers is assumed to increase by 5 percentage points over 2005-25 and remains 5 percentage points higher thereafter. The participation rate shifts in a parallel way.

Source: European Commission (2006), "Impact on Ageing Populations on Public Spending on Pensions. Health and Long-Term Care. Education and Unemployment Benefits for the Elderly", Summary Report, Economic Policy Committee.

scenario and a variety of different methodologies. Even under their most optimistic scenario regarding productivity growth and employment, they estimate the increase in expenditures to be around 7 percentage points of GDP by 2050.

The recently agreed reform, made by consensus among the social partners and the government, contains additional restrictions on partial retirement, as the minimum eligibility age is being pushed back to 61. The effective contribution period to acquire pension rights is being modestly increased, as overtime can no longer be counted towards the minimum 15-year period: in effect, heretofore a worker might have needed to work less than 13 years in order to acquire pension rights. Widows' pensions will now be recognised for survivors of unmarried couples and married ones without children who have cohabited for at least two years. In Spain, access to widows' pensions carries the easiest conditions of all EU countries, as a result of the historically low labour market participation rates of women, which made them highly dependent on their husbands' sources of income. As this trend has been reversed, the rationale for providing generous pensions to widows has decreased. Incentives to extend work beyond 65, the current age at which full pension rights can be acquired, are being increased via higher accumulation rates, while subsidies are being provided to the employment of workers aged 55 and over. However, pension rights continue to be accrued at a decreasing rate, as the first years of employees' careers give rise to disproportionately large pension rights, which might have a significant impact on retirement decisions (OECD, 2003). Overall, the reform is likely to have a limited effect, as the parameters of the system continue to be relatively generous. This shows that the sense of urgency for a more radical reform is lacking among the public, the politicians and the social partners. Regarding the civil servants' retirement scheme, previous OECD Surveys have already identified it as being overly generous as, among other things, the employee's age does not enter into the determination of the replacement ratio when early retirement is chosen. The new public employee statute could make early retirement even more attractive, as it allows ministries to establish special, and more generous, conditions.

The healthy financial situation of the social security system, resulting from the strong rise in employment due in large part to immigration growth, has allowed the authorities to accumulate surpluses since 2000 in the reserve fund in order to finance future pension spending; this might help explain the lack of a sense of urgency. The reserve fund was created with a contribution of € 601 million and, as of March 2006, it had a balance of € 42.1 billion, or 4% of GDP. According to official projections, the resources in the reserve fund will peak at around € 55 billion (in current prices) around 2015. However, it is expected to be completely exhausted around 2020. There are, however, due to its very nature heavy restrictions on the instruments the fund's resources may be invested,[33] which has resulted in a low rate of return on assets.[34] Negotiations are under way to provide more freedom in the management of the fund, and a reform that privatises the management of at least part of the fund and reduces the restrictions on investments is likely to be enacted.

As suggested in previous Surveys, a parametric reform of the pension system is the most obvious solution to the pension problem, since the system is not actuarially fair. Such a reform could however take various forms. The level of pensions is low in Spain: in 2003, pension expenditure per person aged 65 and older was € 10 200, around 54.4% of *per capita* GDP, a significantly lower level than the average across EU countries (€ 21 100 and 74.3%, respectively). Furthermore, it is expected to remain relatively low as a percentage of *per capita* GDP, which will greatly hinder agreeing on a parametric reform.[35] Options for reform focusing on increasing incentives for older employees to remain in the workplace could include basing pension benefits on lifetime earnings, rather than, as currently done, on the earnings of the last 15 years; modifying the benefit formulae which have higher pension accruals at younger ages; indexing the eligibility age to life expectancy; and, increasing the increments from deferring retirement (OECD, 2006d). However, other alternatives, which have already been discussed in previous surveys (OECD, 2003 and 2005a), could include measures that do not modify the pension level. Given the increase in life expectancy, one such viable alternative is to increase the contribution period needed to qualify for a full pension. This increase would need to be done in a gradual manner, so as to protect workers close to retirement. A reform along these lines could be complemented with the advanced financing of pensions via higher public savings, over and above the accumulation of the already foreseeable social security surpluses. Meanwhile, the government's strategy to increase productivity can also help to lessen the burden, especially since pensions are indexed to inflation, not to wages. While running large surpluses for a number of years could only be sustained with difficulty in the political arena, as calls for increasing spending or further tax cuts would be likely, trade unions appear to be aware of the problem and could be open to discussion. Also, the intergenerational equity considerations would need to be discussed.

How should fiscal policy be managed in a longer-term perspective?

The first version of the Fiscal Stability Law, which came into effect in 2003, aimed to maintain a balanced budget without regard to the position of the economy over the economic cycle. Since no penalties were imposed on non-complying governments, fiscal discipline hinged on peer pressure and monitoring. Individual regional governments were subject to a zero-deficit objective, but, even though the cyclical situation of the economy was not especially weak, some of them resorted to off-balance sheet operations. However, since the National Accounts system was used, in order to assess whether they were meeting the objectives, they were formally complying with the Law. The objective of maintaining a balanced budget, irrespective of the economic cycle, was perceived as too restrictive, and some local governments even sought legal recourse to avoid compliance. The authorities have updated the Fiscal Stability Law (the changes come into effect in 2007) to address these and other criticisms and improve the framework for fiscal stability.

The new Fiscal Stability Law aims for fiscal stability over the economic cycle…

The main objective of the updated law is to maintain fiscal balance over the business cycle. Every three years, the central government will publish two growth thresholds that will determine the required financial outcomes for central, regional and local governments. Growth above the higher threshold (initially set at 3%) will generate a requirement for surplus; growth between the thresholds will prompt balanced budget requirements; and, finally, growth beneath the lower level (initially set at 2%) will allow governments to incur deficits, which are bounded by a total deficit ceiling, allocated by level of administration. The maximum allowed deficit will be 1% of GDP, distributed as follows: central government, 0.2%, regional governments, 0.75% and local governments, 0.05%. However, a special allowance is made to exceptionally[36] exclude increases in investment in programmes for productive activities, R&D included, that are deemed to improve productivity from the deficit restrictions. This allowance can be up to a maximum of 0.5% of GDP, with the central, regional and local governments allowed 0.2, 0.25 and 0.05% of GDP, respectively. Individual regional deficits are to be negotiated on a case-by-case basis by the central government, so as to meet the total regional deficit. Overall, when growth falls below the 2% threshold, the total government (excluding social security) deficit can reach 1.5% of GDP. However, even if growth is above the 3% level, by excluding, on an exceptional basis, increases in productive investment programmes, a deficit of up to slightly less than 0.5% of GDP can be incurred. Although compliance will still hinge on monitoring and peer pressure, it will probably be enhanced by the obligation on non-complying authorities to negotiate three-year action plans to correct the situation and the more stringent restrictions set by the central government on raising additional debt. Other attractive features of the new law are that transparency requirements are made more explicit for all levels of government, and, perhaps even more importantly, the fact that required budget outcomes will be set individually for the central, regional and local levels of government as well as the social security administration. Previously, bad budgetary outcomes by the central government could be offset by good results in the social security administration, as they shared a common objective.

… but it can be improved upon

Although the new law improves upon several aspects of its predecessor, there are several areas where risks could materialise when the law is put into place. *First*, the growth thresholds should be based on potential growth in order to better reflect the position of the economy over the business cycle. Care should be exercised when the guidelines to compute the thresholds are specified so as to minimize the room for arbitrariness. A good idea would be to outsource the computation of the thresholds to a credible outside agency that has the required technical skills and is autonomous enough to avoid conflicts of interest. *Second*, as currently stated in the law, discontinuities in the stability objective are introduced when growth is close to the thresholds. For example, with the lower threshold currently set at 2%, a projected growth of 1.9% would allow a deficit of up to 1.5% of GDP (including the exceptional allowance for investments), while a projection of 2% would allow only a deficit of 0.5% of GDP. *Third*, even though the law has improved the stabilizing role of fiscal policy by taking account of the cyclical position of the economy and its expected growth rate, care should be exercised when applying this new budgetary rule so as to avoid a too mechanical implementation and a procyclical budgetary outcome.[37] These risks seem to be higher in the regional and local administrations, so good performance and monitoring early on will be important. In order to allow an appropriate functioning of the automatic stabilisers, the level of the objective balance should be linked to the level of the output gap. However, since the estimation of the output gap is difficult and could be a contentious issue, a simpler requirement would be to link the targeted *change* in the fiscal balance to the projected pace of growth.[38] *Fourth*, establishing the

Box 3.1. **Policy Recommendations for managing fiscal policy in the medium- and long-term**

Tax policy

- Incorporate a more systematic inflation adjustment of the tax brackets and allowances into the permanent income tax code.
- Reconsider the tax incentives for private retirement plans, as the net tax cost is likely to be high.
- Improve cooperation between fiscal and police authorities, through the appropriate channels, to increase the effectiveness of tax fraud investigations.

Decentralisation

- Ensure that the new regional financing mechanism does not unduly increase the central government's burden, and provide incentives for regional and local governments to rely increasingly on their own taxing powers.

Spending Commitments

- Grant the public policy evaluation agency a high degree of independence from the political process, and make sure its findings are easily available to the general public.
- Increase information sharing and the use of benchmarking among regional hospitals, so as to allow higher public pressure to increase spending efficiency.

Social Security

- Increase pedagogical efforts so the general public and the social partners become aware of the seriousness of the social security problem and the need to take action.
- Develop a comprehensive strategy to tackle the social security problem, which could include a combination of parametric reform (for example, increasing the contribution period needed to qualify for a full pension in a gradual manner) and increasing public savings.

Fiscal Stability Law

- Base thresholds on potential output, and have computations made by a reputable and impartial entity.
- Avoid creating an unjustified bias in favour of tangible over other forms of productivity-enhancing expenditure resulting from the exceptional exclusion of increases in public investment.
- .Avoid a too mechanical implementation of the law, which could result in a pro-cyclical budgetary outcome.

stability requirement for each autonomous region on a case-by-case basis can be inefficient, as the outcome will be decided through bilateral negotiations, with all the uncertainty that entails.

Medium term fiscal policy should be consistent with the authorities' strategy to face the fiscal costs of ageing

With a proper implementation of the updated Fiscal Stability Law, insufficiently ambitious targets in good times can be avoided, as a surplus is required when output growth is above the threshold. On the other hand, by exceptionally excluding spending on productive investment from the allowed budget outcome, the Law is actually softening the requirement of maintaining fiscal balance. Nevertheless, to the extent that these investments improve potential output, the sustainability of public finances might be improved. More importantly, the management of fiscal policy in the medium term should be more integrated with the long-term strategy of the government to face the fiscal problems of ageing. Unless an admittedly difficult pension reform that would fully address the financial imbalances of the social security system is implemented in the near future, given the insufficiency of the reserve fund to cover the expected shortfall, it will be necessary to accumulate public savings at a higher rate than at present in order to achieve long-term sustainability of the public finances. The authorities should work to increase public awareness of the problem and of the need to take action as soon as possible so as to minimise the costs of adjustment. They should present alternative scenarios with a more intensive use of statistical models that give an approximation to the effects of different policies. Developing and using such models should now be easier than previously, since the social security administration has recently made available large datasets to researchers.

Notes

1. Among the most important reforms are the 1978 personal and corporate tax reforms, the introduction of the VAT in 1986 and the 1991 personal income tax changes (OECD, 2000 and 2003).
2. The number of tax brackets was reduced from 10 to 6 in 1999 and to 5 in the 2003 reform.
3. The top marginal rate was lowered from 56 to 48% in the 1999 tax reform and by a further 3 percentage points to 45% in 2003. The lowest marginal rate was reduced from 20 to 18% and to 15% in 1999 and 2003, respectively.
4. Family allowances will therefore raise the level of income at which the first positive tax rate is applicable –the income levels at which higher rates apply are unaffected. This effectively limits the tax reduction that arises from these allowances to their amount multiplied by the lowest positive tax rate, even if households face a higher marginal tax rate (Lagares, 2006).
5. Reforms to the corporate tax have been less frequent than those to the personal income tax. In 1995, reform was directed towards increasing the neutrality of the tax system both with respect to different sources of income and different financing instruments (OECD, 2000).
6. The latest efforts include a reduction of 0.25 percentage points in contributions to the unemployment insurance scheme for permanent workers and a halving of contributions to the public entity that takes over private pension funds of bankrupt companies, from 0.4% of total wages to 0.2%.
7. The fiscal cost of the 1999 and 2003 reforms of the personal income tax were € 4.9 and € 4.0 billion, respectively.
8. For example, the floor of the highest tax bracket will increase by close to 12% (from € 46 818 to € 52 360) and the tax credit for labour income by between 9 and 12%, while the accumulated inflation rate from 2002 (when the last reform updated the income brackets and allowances) to 2007 is estimated to be around 13.6 per cent.

9. Since income from pensions is taxed like other household income, the net revenue cost is the difference between foregone revenues at the contribution phase and additional revenues created at withdrawal.
10. After the introduction of euro bills in January 2000, 13 million € 500 bills were introduced in Spain (3.5% of the total) and, by April 2006, the total number in Spain had grown to 101 million bills (26% of the total in circulation).
11. A survey by the Centro de Investigaciones Sociológicas in 2004 found that 87% of people polled thought that evasion in the personal income tax was significant. 60% thought that it had increased or was the same as five years earlier, with only 20% believing that it had diminished over the same period.
12. For example, Gómez and Añalón (2003), using the total quantity of money in circulation in the economy, estimate it to be between 23 and 24% of GDP in 2002. EU studies have estimated the underground economy to have been around 15% of the measured economy in 1998 and 22% in 2002, and around 10% of VAT revenues to be lost via tax fraud, which would amount to around € 4 billion per year in the case of Spain.
13. The wholly ceded taxes include the tax on wealth transfers, the inheritance, estate, wealth and gambling taxes and three excise taxes: on the retail sale of gasoline and diesel, on household electricity and on transportation. As regards the tax on retail sales of oil products and the tax of certain means of transport, the current financing arrangement stipulates that although they can be collected by the regional administrations, none has requested to do so until now.
14. . For instance, the Catalonia statute states that the transfers to the receiving regions must take into account its fiscal efforts. This text could lead to multiple interpretations.
15. The paper uses the "Taxing wages" methodology developed by the OECD. For example, the tax rate applicable to a single, 30 year-old taxpayer with a wage of 67% of the national average can vary from around 6% (in Andalucía) to almost 29% (in Madrid).
16. Several other regions have already stated that they are keen to create similar agencies.
17. The government expects that up to 20% of total investment will be done by the private sector.
18. If employees of the social security administration are included, total public employment is around 2.7 million.
19. The share of temporary workers is almost 30% in regional and local governments.
20. In addition, female participation in the labour market has also been made easier by the abundance of immigrants working in domestic services.
21. It will be important that the co-payment effectively reflects the beneficiaries' payment ability and is not easily circumvented: if wealth is not taken into account distributional concerns could arise if people with high wealth, but low income, receive benefits. For example, in the United States, Medicaid is supposed to provide health and long-term care to low-income segments of the population, but people have been successful in hiding their wealth (via trust funds or by gifts to family members) in order to become beneficiaries of the programme.
22. Total spending on pharmaceuticals as a per cent of GDP is also relatively high in Spain at 1.9% of GDP in 2004, higher than both the OECD-European and OECD-Non-European averages of 1.4 and 1.7% of GDP, respectively, and the same level as in the United States.
23. Only Greece spent more on pharmaceuticals in 2004 than Spain.
24. According to estimates by the Ministry of Health, in the period 1999 to 2003, the contribution of each of these factors to the total increase was 21, 46 and 33%, respectively.
25. Of the total, € 500 million was directed to compensate for population increases and € 500 million to compensate, as stated under the current financing mechanism, those regional governments whose resources grew in the last two years more slowly than nominal GDP. Additionally, this guarantee will be extended beyond its original timeframe of 2002-04 until the new financing model is in place. A series of measures to increase regions' powers over several taxes was adopted, which are expected to provide an additional € 227 million per year in financing, starting in 2006. The formula to calculate the advances in tax receipts was also updated to provide revenues to regional governments more quickly. Other measures include a € 55 million fund to compensate island regions, € 200 million to provide health care to immigrants and € 100 million to help cover work-related injuries and illnesses to professional workers covered only by Social Security.

26. For instance, for drugs whose patent has expired and for which there is a generic substitute, the price will be set at the average of the (up to) three least expensive substitutes. Patients wishing to consume a more expensive drug will bear the full price, while they are currently responsible only for the difference in the two prices.
27. Users rank reducing waiting times as the most pressing reform needed in health care provision.
28. Collective agreements can also increase the responsibilities of firms, so that, in practise, firms can cover 100% of wages and periods longer than 15 days.
29. The previous population projections were done by the statistical agency (INE) in 2001, and they implied an increase in the old-age dependency ratio to close to 53% by 2050, close to the level implied by the high-immigration scenario of the new projections.
30. The old-age dependency ratio is defined as the ratio of the number of people older than 65 to the number of people aged between 16 and 64.
31. For example, the rate of accumulation of pension rights is 2.5% per year for an average wage earner in Spain and less than 2% in Italy, the second highest in the OECD; pensions are computed in Spain on the basis of the last 15 working years, while in other countries it is usually on the basis of the whole career; the maximum replacement ratio is 100%, while in other countries it is 80%; and, after 15 years of contributions, people acquire rights to a pension based on 50% of the earnings base.
32. The internal rate for special schemes (farm workers', self-employed and domestic employees') is even higher, ranging from 5 to 6½ per cent per year (OECD, 2005a).
33. Funds can be invested in foreign-government bonds.
34. In fact, it decreased from 4.8% in 2000 to 3.4% in 2005. As a comparison, the New Zealand Superannuation Fund has averaged returns of over 14% p.a. in recent years.
35. Minimum pensions, however, have been increased and could help to reduce political resistance to such a reform. In 2007, expenditure on minimum pensions is expected to be around € 450 million, or close to 0.04% of GDP and the accumulated increase in pension expenditure would reach a not unreasonable 0.09% of GDP by 2050.
36. For regions, these exceptional increases in investments will need to be approved on a case-by-case basis by the Ministry of Economy and Finance, on the basis of criteria established by the Consejo de Política Fiscal y Financiera, the region´s debt level and the foreseen contribution of the programmes to productive improvements.
37. For instance, in 2007, with expected growth above potential (according to the OECD estimates), a reduction of the fiscal surplus is expected relative to the 2006 outcome. Such a policy complies with the new rule but is pro-cyclical.
38. More specifically, an improvement in the fiscal balance should be imposed if the projected growth is above potential, and a deterioration can be accepted when projected growth is below potential.

Bibliography

Alonso-Meseguer, J. and J.A. Herce (2003), "Balance del sistema de pensiones y boom migratorio en España, Proyecciones del modelo MODPENS de FEDEA a 2050", *Documento de trabajo* No. 2003-02, Fundación de Estudios de Economía Aplicada, July.

Antolín, P., A. de Serres and C. de la Maisonneuve (2004), "Long-term Budgetary Implications of Tax-Favoured Retirement Plans", *Economics Department Working Papers*, No. 393, OECD, Paris.

Costa-Font, J. and C. Patxot (2003), "Long-Term Care for Older People in Spain", in A. Comas-Herrara and R. Wittenberg (eds.), *European Study of Long-term Care Expenditure*, European Commission, Employment and Social Affairs DG.

De la Fuente, A. and J. Jimeno (2005), "The Private and Fiscal Returns to Schooling and the Effect of Public Policies on Private Incentives to Invest in Education: A General Framework and Some Results for the EU", *Working Paper* No. 0509, Banco de España.

De la Fuente, A. (2001), "Un Poco de Aritmética Territorial: Anatomía de una Balanza Fiscal para las Regiones Españolas", *FEDEA Estudios Sobre la Economía Española* No. 91.

Durán-Cabré, J. and A. Esteller-Moré (2006), "How Diverse is Personal Income Tax Policy Among Spanish Regions?", mimeo.

European Union (2006), “Impact on Ageing Populations on Public Spending on Pensions, Health and Long-Term Care, Education and Unemployment Benefits for the Elderly”, Summary Report, Economic Policy Committee.

Garcia-Milà, T. and T. McGuire (2002), “Fiscal Decentralization in Spain: An Asymmetric Transition to Democracy”, mimeo.

Jimeno, J., J. Rojas and S. Puente (2006), “Modelling the Impact of Aging on Social Security Expenditures”, *Occasional Paper* No. 0601, Banco de España.

Joumard, I. and C. Giorno (2005), “Getting the Most Out of Public Sector Decentralisation in Spain”, *OECD Economics Department Working Papers*, No. 436, OECD, Paris.

Lagares, M. (2006), “Una Nueva Reforma del IRPF”, *Cuadernos de Información Económica*, No. 106, Fundación de las Cajas de Ahorros Confederadas, Madrid, mayo-junio.

OECD (2000), *OECD Economic Surveys: Spain*, OECD, Paris.

OECD (2001), *OECD Economic Surveys: Spain*, OECD, Paris.

OECD (2002), *OECD Economic Surveys: Switzerland*, OECD, Paris.

OECD (2003), *OECD Economic Surveys: Spain*, OECD, Paris.

OECD (2005a), *OECD Economic Surveys: Spain*, OECD, Paris.

OECD (2005b), *Revenue Statistics*, OECD, Paris.

OECD (2006a), *OECD Economic Outlook*, No. 79, OECD, Paris.

OECD (2006b), *OECD Economic Surveys: Canada*, OECD, Paris.

OECD (2006c), “Projecting OECD Health and Long-Term Care Expenditures: What Are the Main Drivers?”, *OECD Economic Department Working Papers*, No. 477, OECD, Paris.

OECD (2006d), “Retirement incentives: Draft special issue of "Pensions at a Glance"”, DELSA/ELSA/WP1(2006)2, OECD, Paris.

Puente, S. and M. Gil (2006), “Una Comparación de las Proyecciones de Población para España, la Zona del Euro y Estados Unidos”, *Boletín Económico*, Banco de España, enero.

Rae, D. (2005), “How to Reduce Sickness Absences in Sweden: Lessons from International Experience”, *OECD Economics Department Working Papers*, No. 442, OECD, Paris.

ANNEX 3.A1

The main features of the 2007 tax reform

A. Personal income tax

- The number of income brackets is reduced from the current five to four. The top marginal rate is reduced to 43% (from 45%).
- Personal and family allowances are increased. Deductions for children range from € 1 800 per year for the first child (up from € 1 400, a 29% increase) to € 4 100 for the fourth (up from € 2 300, a 78% increase), while the additional deduction for children younger than three is increased by € 200 (a 17% increase). The deductions for elderly dependents is raised 12½ per cent (10%) to € 900 (€ 1 100) if they are older than 65 (75). Finally, deductions for the disabled are increased between 13½ and 38%, based on the degree of disability.
- Personal and family allowances are now included in the first income bracket, which is taxed at a zero rate. Before the reform, they were deducted from the tax base, which decreased the progressivity of the tax.
- The general tax allowance for net labour income, which is based on a non-linear formula, is increased 14.3% (to € 4 000) for those who earn less than € 9 000 and 8.3% (to € 2 600) for those earning more than € 13 000.
- Savings are taxed at a single rate of 18%. Previously, long-term savings (in instruments with a maturity of more than a year) faced a 15% rate, while short-term savings (in instruments with a maturity of less than a year) were considered as general income and thus faced the general tax rate (between 15 and 45%). The only exception provided is in the treatment of income from dividends, as the first € 1 000 will be exempt, while the rest will face the 18% rate.
- The maximum annual tax-free contributions to private retirement savings plans is raised to € 10 000, € 12 500 for people aged 50 and older. Additionally, they cannot be more than 30% of income (50% for those older than 50). Withdrawals from the savings plans can be made only at retirement, either through an annuity or in a lump-sum payment; if the latter is chosen, the previously available exemption (of 40%) from the proceeds is no longer available.
- The favourable treatment of housing purchases for the first two years is eliminated. Before the reform, in the first two years after purchasing a house, instead of the general deduction of 15% of payments (interest and capital) with a limit of € 9 015, 25 per cent of the first € 4 507 could be deducted and 20% of the rest up to the € 9 015 limit.

B. Corporate tax

- The tax rate is lowered, in 2007, for small- and medium-sized enterprises, from 30 to 25% and progressively over two years for larger firms, from 35 to 30%, with the rate falling 2.5 percentage points in both 2007 and 2008.
- On the other hand, all the tax credits available for firms, with the exception of the deduction for research and development expenditures and the reinvestment of profits in productive investment will be phased out by 20% a year until complete elimination in 2011.

Table of contents

Boxes

Tables

 OECD ECONOMIC SURVEYS: SPAIN – ISBN 92-64-02920-6 – © OECD 2007

Figures

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

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

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

The previous Survey of Spain was issued in April 2005.

BASIC STATISTICS OF SPAIN (2005)

THE LAND

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

THE PEOPLE

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

PRODUCTION

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

THE GOVERNMENT

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

FOREIGN TRADE

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

THE CURRENCY

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

From:

OECD Economic Surveys: Spain 2007

Access the complete publication at:

https://doi.org/10.1787/eco_surveys-esp-2007-en

Please cite this chapter as:

OECD (2007), “Medium and long-term fiscal issues”, in *OECD Economic Surveys: Spain 2007*, OECD Publishing, Paris.

DOI: https://doi.org/10.1787/eco_surveys-esp-2007-5-en