

ASSESSMENT AND RECOMMENDATIONS

Sustaining a strong performance over the medium term requires continuing the reform process

1. Spain's performance has remained remarkably strong thanks to the structural reforms implemented since the mid-1990s and the sound macroeconomic policy framework. Employment has expanded strongly, enabling the economy to grow more rapidly than the euro area average, even during the recent slowdown. To sustain this strong performance over the medium term, it is necessary to continue the reform process. *First*, the persistent inflation differential with the euro area is worrying as it erodes competitiveness progressively and could lead to a period of slower growth. This inflation differential, which is partly the consequence of exceptional factors, highlights the need for continuing labour market reforms, and for strengthening competition in certain sectors. Additional reforms in these areas would also help in bringing down unemployment, which is mainly structural and, in spite of its considerable reduction, remains among the highest in the OECD. *Second*, productivity gains have remained small, partly as a consequence of positive effects of strong employment growth. Accelerating real convergence requires removing the obstacles to the development of higher value added activities, promoting the improvement of human capital, reducing the innovation gap and stepping up the slow diffusion of new technologies. *Third*, a reform of the real estate market is desirable, to raise labour mobility, to improve resource allocation and to prevent the risk of a speculative bubble from developing. *Last*, reforms are needed to prepare against the consequences of ageing. They should be phased in now to ensure the sustainability of the public finances, which will be under threat from sharply rising spending on pensions and medical and social services as from 2020-25.

The slowdown was mild, but inflation remains high

2. Spain did not escape the economic slowdown that hit the OECD, but did perform better than most countries. Growth reached 2 per cent in 2002, the positive differential *vis-à-vis* the euro area average remaining at 1¼ percentage points. Housing investment has been the most dynamic demand component, while house prices have risen steeply. Job creation has been buoyant, increasing by nearly 1½ per cent, but productivity gains have remained small. Unemployment did, nonetheless, rise for the first time since 1994, reaching 11½ per cent in late 2002. Despite the easing of labour market pressures and a slightly negative output gap, inflation has not slowed – partly for exceptional reasons such as the euro changeover – and the differential with the euro area has not shrunk. This differential, which has been about 1¼ percentage points since 1999, tends to weaken international competitiveness.

The neutral stance of the 2003 Budget suits the economic situation and some slippage can be tolerated if downside risks materialise

3. Domestic liquidity conditions have become easier in recent years because the European Central Bank (ECB) has relaxed monetary policy. Monetary conditions remain accommodating despite the euro's appreciation since the second half of 2002. The expansionary effect has been limited, however, by fiscal tightening since 2000. Policy has, quite rightly, been more prudent than in most other European countries. Fiscal consolidation that began in the mid-1990s has led to the elimination of the general government deficit in 2001, despite the economic slowdown. The government account remained close to balance in 2002, even though activity was more sluggish than anticipated. The government aims again at a balanced budget in 2003 on the basis of an official forecast of 3 per cent, close to potential growth, implying a neutral fiscal stance following the tightening in 2001 and 2002. According to the OECD projections, gross domestic product (GDP) growth may be only marginally above 2 per cent in 2003 before reaching 3 per cent in 2004, maintaining the positive growth differential with the euro area, while inflation should progressively dip to 2½ per cent in 2004. These projections imply the persistence of a negative output gap and, given the relaxed monetary conditions, a neutral fiscal stance is appropriate. The stance also appears appropriate in view of the mainly negative risks surrounding the economic outlook, which largely concern international developments. A slight government deficit in 2003 cannot be ruled out, however, but should be tolerated, particularly if the outlook deteriorates further. Even though the inflation differential may decline, a permanent improvement in inflation performance requires tackling nominal wage and price rigidities rather than a tighter fiscal stance.

In the medium term, it will be necessary to steer a prudent fiscal course

4. Beyond the short term, the latest Stability Programme aims at maintaining the government accounts in balance or small surplus, which means adhering to a largely neutral policy stance through the period to 2006. The Programme includes the assumption that the inflation differential with the euro area will decline. If this were not the case, the effect on exports from the continuing loss of price competitiveness would be more than offset for a time by the impact on the domestic demand of lower real interest rates than in the rest of the euro area. This sort of situation would create an unbalanced policy mix. However, if the inflation gap is eradicated, the medium-term fiscal goals are appropriate and would allow a further reduction in debt or additional tax cuts. Fiscal policy faces, however, two main medium-term challenges.

In the context of decentralisation, the implementation of the new balanced budget rule should be flexible, as permitted by the law

5. The first medium-term challenge is to maintain fiscal prudence in the new, more decentralised way of organising the public finances. With health service management having been transferred to all the regions in early 2002, decentralisation of the largest spending areas is complete, making Spain one of the most decentralised OECD countries. In order to consolidate the fiscal progress made, the authorities have implemented two reforms. The first consists of increasing the regions' and municipalities' financial self-sufficiency and fiscal responsibility. The second is the adoption of a fiscal stability law that obliges all levels of government to balance their accounts as of the 2003 Budget. As regards the latter, it is important to ensure that the implementation of this fiscal rule, which takes no explicit account of the economic situation, does not engender pro-cyclical effects on activity. To avoid this danger, advantage should be taken of the flexibility built into the law. If deficits do develop, the law foresees that these need to be corrected only in the medium run, ensuring that fiscal discipline

and automatic stabilisers are fully compatible. Moreover, the law explicitly allows the possibility of nominal deficits in “exceptional circumstances”.

Improvements in the quality of the public finances need to be pursued

6. The second medium-term challenge concerns improving the quality of both taxation and spending. Decentralisation has the potential, in theory, to enhance the efficiency of public management. This, however, implies that the national authorities will have to re-think the way they act in a number of areas such as health, where their main role now is to co-ordinate the various regional systems. Co-ordination should stimulate the regions’ efforts to be efficient. Regular publication of indicators for the communities would make it easier to assess their performance and encourage them to adopt best practice. In this connection, the recent decision to publish homogeneous information on regional hospital waiting time is welcome. Ensuring an equitable provision of public services throughout the country should also focus more on assessing services and results rather than only imposing minimum expenditure criteria, as is planned in the case of health. Lastly, co-ordination between the regions should take into account economies of scale or spillovers. With regard to taxation, the rationalisation of the system has moved forward. Distortions due to certain local taxes will be reduced. More importantly, the personal income tax has again been cut in 2003, and work incentives have been raised for older workers and mothers with young children, while the unemployed face better incentives to be geographically mobile.

Pension reform is more urgent than generally perceived

7. In the longer term, the biggest challenge is to ensure fiscal sustainability in the face of population ageing. Recent reform efforts have improved the incentives for older workers to remain active. Moreover, the pursuit of a prudent fiscal policy has allowed the social security reserve fund to be raised to above 1 per cent of GDP in 2003 – a year earlier than planned – and to reduce public debt. Solving the pension problem, however, implies adopting measures that go much further than those already approved. The strategy of the authorities separates the long-term financing problem posed by ageing from medium-term fiscal management, which makes a reform of the pension system essential. However, the official analyses tend to emphasise the pension system’s present strong financial position, which should persist until 2015, whereas the uncertainty of the situation after 2015 is stressed. Nevertheless, even taking these uncertainties into account, the available studies point to the need for a prompt and ambitious reform. Further measures to promote a longer active life should be taken and, most importantly, a revision of the system’s parameters is necessary, since currently pensioners receive, on a discounted basis, more in pensions than they contribute. If the sharp rise in pension spending as from 2015-20 is to be mitigated, a reform that makes the system actuarially neutral cannot be put off any longer, as many changes will have to be phased in. A significant first step would be to calculate pensions on the basis of earnings over a whole career instead of the last 15 years. The gradual introduction of this measure, which would not affect the pensions of current retirees or of those who are close to retirement but would lower future pensions of younger workers, should be discussed at the tripartite negotiations, which will start soon. Undertaking a comprehensive reform would reduce the need to raise fiscal revenues in the future to cope with ageing.

***Labour market reform
has progressed...***

8. Structural reforms are needed to raise the employment rate further and to boost productivity growth. The remarkable labour market performance in recent years is attributable to the reduction in employment rigidities, highlighted by real wage moderation since 1995. Even so, there remain major distortions in the labour market. It is still very segmented, with temporary jobs in excess of 30 per cent. The flexibility of temporary jobs contrasts with the high level of protection enjoyed by workers on indefinite contracts, while the level and regional dispersion of unemployment also remain very high. A reform of unemployment insurance was adopted in 2002, enabling firms to slightly reduce their redundancy costs provided they agree to view dismissals as “unfair”. It reforms the special compensation scheme for Andalusian and Extremaduran farmers which was being abused, and increases the incentive to look actively for work by clarifying the concept of suitable work, *i.e.* work that cannot be refused without incurring a penalty. The reform is a further step in the right direction, even if redundancy costs still need to be reduced more sharply. Also, the public employment service (INEM) will have to function better in providing job placement services, while active labour market policies, which are not very effective, need to be reviewed.

***...but needs to be taken
further, primarily as
regards wage
formation***

9. Reforming the wage bargaining system is of crucial importance, even if difficult to achieve. The most urgent task is to reduce the strong nominal wage inertia caused by the widespread use of wage indexation clauses, which is one important reason for the inflation differential with the euro area. These arrangements provide workers with a guarantee against inflation surprises, but pose two major problems. First, they remove any responsibility for inflation developments from the social partners, whereas inflation in the short run is largely a consequence of their attitudes and the way they interact. The unions, in particular, are not concerned with nominal wage increases as long as they are guaranteed in real terms. Second, the indexation is based on overall rather than underlying inflation, reducing the economy’s flexibility to cope with exogenous shocks – oil price shocks, for example. This rigidity, which penalises Spain, is harmful in the present economic situation. These shortcomings need to be remedied by reforming the wage bargaining framework. In view of the difficulty of reforming the system, a new attempt could have more success – as in 1997 – if it were to combine a number of mutually reinforcing measures. In addition to abolishing the indexation clauses and reforming the INEM, the level of protection enjoyed by established workers should be reduced while at the same time stricter controls against the abuse of temporary contracts should be implemented, so as to reduce employment segmentation without penalising overall labour market flexibility. Segmentation is likely to foster unskilled work, encourage investment in less productive sectors and is a heavy burden on younger workers, who are increasingly well trained. It also may reduce incentives to strengthen human capital and to incorporate new technologies in production, which could well be one of the causes for low productivity growth.

***The reform of
education is welcome***

10. Education policy is also one of the areas with a big potential impact on future productivity growth. The shortcomings of the current system are highlighted by the high failure rate in secondary education and, recently, the OECD’s PISA report. Several reforms have been adopted with the objective of improving the quality of education. A new law broadens the range of free infant education services, which should raise female participation rates and help the

integration of the children of immigrants. It also extends schools' independence in a number of areas, which is positive from the point of view of increasing experimentation and helping schools to adapt to their social environment. This independence could be further enhanced by basing teachers' pay and career development on their responsibilities and performance. Concerning the universities, changes have made the appraisal of university departments and the appointment of professors more independent. However, the system of university financing has not been touched by the reform, and should be rethought. The system is regressive, with low enrolment fees for university education, mainly benefiting students from middle and high income families who will later enjoy high salaries and low unemployment. An increase in fees, partly offset by a greater provision of grants or subsidised loans for disadvantaged students, would make the system less regressive. It would also help to cut the present length of courses, which is excessive. Higher university fees would also free up resources for improving quality of secondary and tertiary education and for occupational training which is not well developed.

Competition has been strengthened but needs to be rigorously applied in certain sheltered sectors

11. In the product market, competition policy plays a key role in fostering an efficient resource utilisation and reducing inflationary pressures. Noteworthy progress has been made in this area. The competition authorities' resources have been substantially increased and new regional courts have been set up, which should relieve the national authorities from having to investigate regional cases. Even so, co-ordination is needed to ensure that the competition rules are applied homogeneously across the regions and to prevent the development of a culture of indulgence *vis-à-vis* local firms. In this respect, continued efforts need to be made in the distributive sector, which is prone to inflationary pressures and where hypermarket locations are often subject to regional restrictions. In the network industries, competition has been strengthened thanks to an ambitious privatisation and liberalisation programme. Progress is ongoing, for example, in fixed telephony, thanks in particular to competition being actively promoted by the industry regulator. In the electricity and gas sector, liberalisation will soon be complete. However, the highly concentrated nature of production and distribution of energy products has resulted in some instances in anti-competitive behaviour and a significant increase in profits in part of the energy sector. The efforts already under way to improve linkages with other countries' networks are set to continue, while thought will have to be given to splitting up big companies with considerable market power.

The real estate market needs to be reformed

12. Reforms should also focus on correcting the distortions in the real estate market. They have underpinned the very steep rise in house prices and led to a shortage of rental housing, while the share of real estate assets in households' wealth is very high. Housing policy encourages house purchases by tax deductions while regional and local governments limit the supply of building land. The authorities have introduced new incentives to stimulate the supply of rental housing such as the reduction of the taxable base by 50 per cent of the net rental income, while the many unoccupied dwellings can now also be taxed more heavily by the municipalities. This would foster the development of the rental market and should lead to a better use of the housing stock. This reform would be even more effective if accompanied by the phasing out of the tax deductions for house purchases to establish a balanced mix of incentives. While scaling back generous fiscal support for house purchases is politically difficult, experience in

some OECD countries shows that it is possible. Reduction of the incentives for future home buyers and introduction of rental subsidies for low-income households would be justified both from the standpoint of equity and by the now very low level of real interest rates. Such a reform would lessen the risk of a speculative bubble in the housing market. Homogeneous, transparent and more flexible management of the supply of building land by the communities and municipalities also appears necessary to damp house price increases. A reform of land management would require agreement among the different levels of government, that the central government has already started to promote. It would doubtless be easier to obtain an agreement if a reform of local finances were to reduce the heavy dependence of municipalities on resources derived from land zoning, which underlies their restrictive practices and could be offset, if necessary, by a more widespread recourse to user fees and charges.

Environmental policy should be strengthened, especially in response to climate change

13. As regards environmental policy, preference should be given to cost-efficient measures so as not to hamper growth. The delay in drafting a national climate change strategy and failure to implement cost-effective abatement strategies means Spain will have to rely on the flexible mechanisms allowed under the Kyoto Protocol to meet the EU Burden Sharing target. In addition, more should be done at the domestic level. Past policy has been of limited effectiveness and, therefore, needs to be reinforced. The climate change strategy should set more ambitious targets using measures that will equalise marginal abatement costs. The introduction of emission permits that can be integrated into an EU wide system should be the approach for achieving abatement targets. Where sector-specific targets are deemed necessary, care is required to prevent the emergence of undue abatement cost differentials. In this light, a green certificate market should be used to achieve the planned doubling of the share of renewable energy. Finally, the government should continue restructuring the coal industry and phase out coal subsidies.

More efficient water management requires better water pricing mechanisms

14. Pressure on water resources is serious, with agriculture representing the most important user. This pressure has led to the over-exploitation of ground water sources and environmental degradation in some areas. The water basin authorities should not let abstraction rates for ground water exceed those consistent with natural replenishment. The system of water allocation, including for agriculture, should, where appropriate, progressively move from an administered system to a marginal social cost system where supply and demand determine prices for each water basin, including a charge on the environmental externality of abstraction. Supporting legislation should be introduced to facilitate the operation of the recently allowed secondary market for water, and ensure that payment discipline is enforced vigorously, so giving all users incentives to use water sparingly. Getting the framework right for water management rapidly should complement the decision to invest in water transfer to ensure this resource is used efficiently.

The positive economic impact of immigration does not lessen the need for pension and labour market reforms

15. While many Spaniards emigrated in the past, immigration has surged in recent years. Despite the strong increase, the foreign population remains relatively small and has therefore had a rather limited macroeconomic impact so far. However, immigration is likely to continue, which makes it important to assess its economic effects in a number of areas. Immigration, which is the subject of the in-depth chapter of this *Survey*, has had a positive effect on growth,

largely by boosting employment, but the overall effect on labour productivity is less clear. Non-EU foreigners, who account for most of the immigrants, often occupy low-paid jobs refused by natives and have contributed to sustain or develop the activity of some low value-added sectors. Immigrants have raised the employment rate both directly through their high participation rate, and indirectly by facilitating female participation through domestic services, boosting incomes for the natives. But immigration has probably not contributed to reducing regional differences in unemployment rates. Moreover, most non-EU foreigners work on temporary contracts, which contributes to sustaining the high share of such contracts, highlighting the need for reform in this area. Legally resident foreigners are making a positive contribution to public finance in the short run. In the longer run, however, while increased immigration would mitigate the expected increase in the dependency rate, the relief would be only transitory under current pension rules and further measures, especially reforms of the pension system, remain necessary.

Migration policy still needs to achieve an appropriate balance

16. The task of migration policy is difficult. It has to reconcile the strong demand for workers in low-wage sectors with the policy aim of preventing illegal immigration. The migration policy framework has been reformed, but at the moment inconsistencies persist. For example, a large number of places in the quota scheme go unfilled, while at the same time a large number of undocumented immigrants have regular but undeclared work. In agriculture, the demand for low-qualified labour partly reflects the heavy subsidisation of the sector. Migration policy needs to be sufficiently flexible to allow the undeclared immigrants, whose presence is *de facto* accepted, to obtain work permits. If an appropriate balance between legal inflows, border controls and labour inspections to reduce undeclared employment is not found, illegal immigration will continue to undermine formal immigration targets. Regarding enforcement, measures to reduce undeclared employment, if necessary by strengthening labour inspections, would be a cost-effective complement to border controls.

The integration of immigrants should be improved

17. The integration of immigrants, which is important both for economic and social reasons is another challenge for migration policy. The new Immigration Act clarifies the rights of immigrants in terms of access to health and education, thus contributing positively to their integration. However, the difficulty to find adequate housing, largely due to a very limited supply of rental housing is an obstacle to integration. Recent steps taken to favour rental housing may help in this respect. Integration policy should also take more into account the specificity of immigrants depending on their origin country. Experience from other countries suggests for example that efforts to raise proficiency in the local language facilitate integration. On these issues, the autonomous communities and municipalities have an important role to play.

Summing up

18. Output growth has remained strong for a number of years, with robust job creation, despite the recent slowdown. But inflation has been higher than the euro area average, raising competitiveness concerns while – partly as a result of strong job creation – productivity has been weak. The prudent fiscal policy of recent years has resulted in balanced public accounts. Any cyclical slippage can thus be tolerated if the economic upturn in 2003 is weaker than expected, though a structural deficit needs to be avoided. Prudence also needs to prevail in the medium term. In this regard, the recent reforms aimed at maintaining fiscal

discipline in the context of public finance decentralisation are important. But the fiscal stability law, which requires all levels of governments to balance their budget, has to be applied with the flexibility embodied in the law. In the current situation the inflation differential with the euro area is worrying. However, it should be tackled by structural reforms, rather than a tighter fiscal policy. This implies elimination of the wage indexation clauses and stronger competition in certain sectors. In addition, labour market reform, which moved ahead in 2002, should aim to further reduce labour market segmentation and facilitate a pickup in productivity gains. While growth based on strong job creation can continue for a few years if wage moderation prevails, strengthening productivity over the longer term will be essential to ensure real convergence. In this respect, the recent reform of education will help, but it should be reinforced by an overhaul of the university funding system. Further efforts are also needed to reduce the innovation and research and development gap *vis-à-vis* the OECD average. Changing housing policy is essential for a better functioning of the labour market, a more efficient allocation of resources, and to reduce the pace of house price increases. In addition to a reform of land management, phasing out the fiscal incentives for home purchases would be a first-best approach. The authorities' choice of granting new tax deductions to increase the supply of rental housing is, in this perspective, a second-best solution. Many structural reforms necessitate active participation of the communities, whose responsibilities now extend to such crucial areas as land use and competition policy. They also have an important role to play in environmental policy, for example in water management, where efforts should focus on limiting water wastage through the introduction of adequate pricing mechanisms. In recent years, a notable development has been the steep rise in immigration, which has had positive effects on the economy. Nevertheless, reducing the number of illegal entries while responding to the needs of the labour market is a policy challenge, as is the integration of foreigners. The positive short-term impact of immigration on public finances will be temporary and does not lessen the need for pension reform to cope with population ageing. Guaranteeing the long-term viability of the public finances and the continuation of structural reforms are key to keeping Spain's growth and employment performance among the best in the OECD area.