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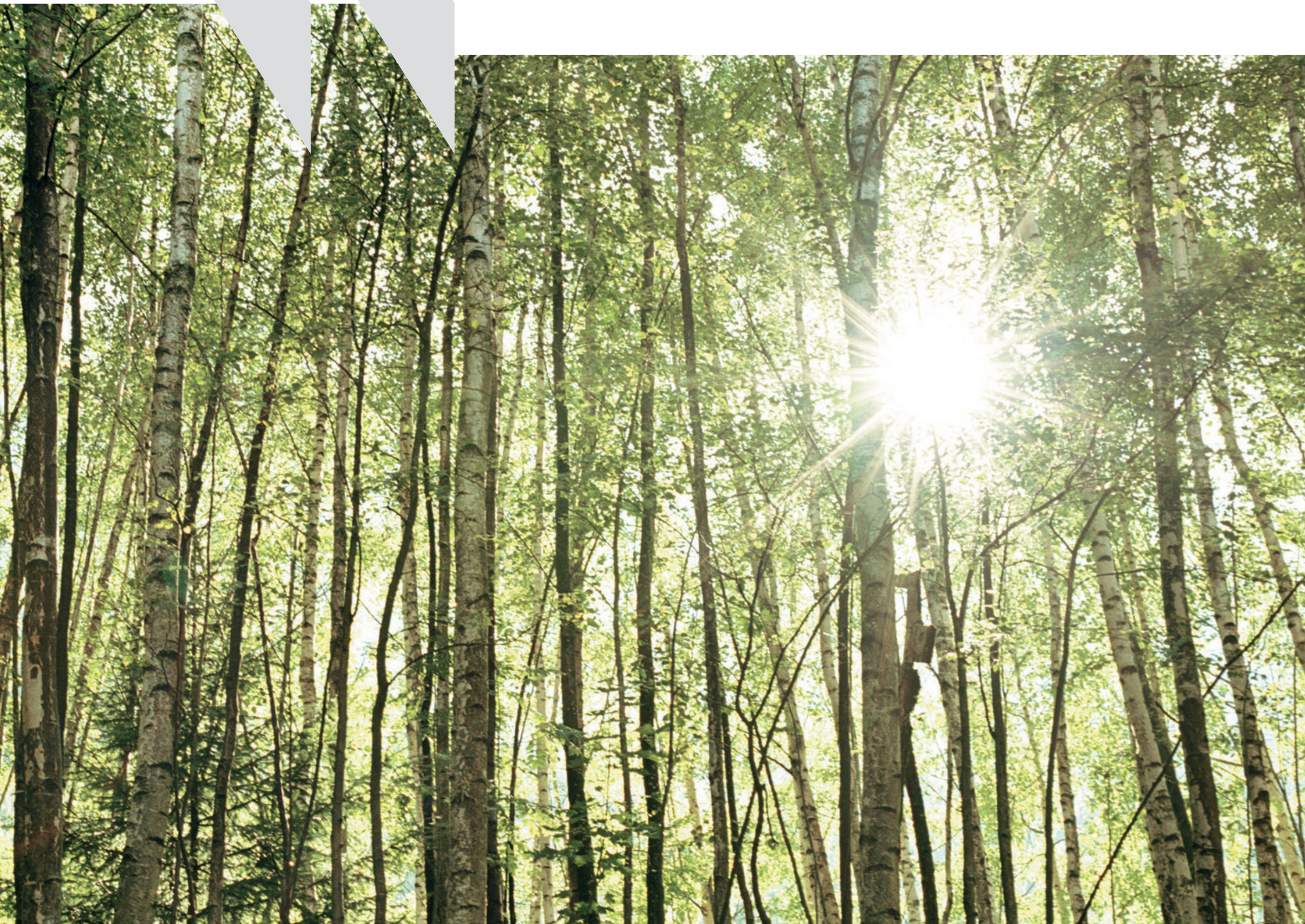

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This survey is published on the responsibility of the Economic and Development Review Committee of the OECD, which is charged with the examination of the economic situation of member countries.

Publié également en français

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BASIC STATISTICS OF SPAIN (2003)

THE LAND

Area (1 000 km^2)		Major cities (thousand inhabitants)	
Total	506.0	Madrid	3 093
Cultivated (1999)	183.0	Barcelona	1 583
		Valencia	781
		Seville	710

THE PEOPLE

In thousands		Employment (thousands)	16 695
Population	42 345	Employment by sector (% of total)	
Net natural increase	56	Agriculture	5.6
Net migration (2002)	470	Industry	18.7
Number of inhabitants per km^2	83.7	Construction	11.9
		Services	63.8

PRODUCTION

Gross domestic product (GDP)		Gross fixed capital investment	
Billion €	745	% of GDP	25.6
Per head in $	19 896	Per head in $	5 087

THE GOVERNMENT

% of GDP		Composition of Parliament (seats in March 2004)	350
Consumption	17.9	Spanish Labour Socialist Party (PSOE)	164
Revenue	39.2	Popular Party (PP)	148
Surplus	0.4	Convergence and Union (CIU)	10
Fixed investment		Republican Left of Cataluña (ERC)	8
(% of gross fixed capital formation)	13.6	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)	27.8	Imports of goods and services (% of GDP)	29.4
Exports as a % of total goods exports		Imports as a % of total goods imports	
Foodstuffs	12.6	Foodstuffs	6.8
Other consumer goods	28.6	Other consumer goods	21.5
Energy	2.7	Energy	10.3
Other intermediate goods	43.7	Other intermediate goods	45.4
Capital goods	12.3	Capital goods	16.0

THE CURRENCY

Monetary unit: Euro		Currency units per $, average of daily figures	
		Year 2004	0.805
		December 2004	0.745

Executive summary

The Spanish economy has enjoyed many years of brisk growth and has recovered swiftly from the recent international slowdown. Activity has been boosted by low interest rates and strong job creation, and underpinned by structural reforms and a sound fiscal policy. As a result, the income gap with the euro area steadily narrowed. However, tensions have arisen that could undermine the strong growth performance as inflation is relatively high, eroding competitiveness, while the surge in house prices does not yet show signs of abating. Also productivity gains have remained meagre and unemployment is still high.

Against this background, the new government has embarked on a strategy that aims at boosting productivity performance by raising spending on education and research and development activities, while pursuing a prudent fiscal policy within a more transparent framework. Also a plan has been adopted to alleviate the tensions in the housing market. These measures go in the right direction, but they need to be complemented by additional reforms to accelerate convergence with the best performing countries.

Maintaining macroeconomic stability and competitiveness: *narrowing the inflation differential with the euro area is key to avoiding a continuous erosion of competitiveness. Relatively high inflation is fuelled by rigidities in labour, goods and services markets. The wage bargaining system, for instance, leads to nominal wage inertia through catch-up clauses in collective agreements. Moreover, competition needs to be raised in several sheltered sectors. Cooling the housing market is also key for maintaining macroeconomic stability. Reforms should go beyond those already approved and remove the obstacles limiting the supply of building land. Tax incentives for house purchases should be phased out to lower demand pressures and to develop the rental market, which is too narrow.*

Combining higher productivity gains with rapid employment growth: *productivity growth is hampered by shortcomings in the education system, while R&D activities are low, despite recent progress. Policies that sharpen incentives should accompany the planned spending increases, including greater autonomy for schools, linking the financing of universities to their performance, raising university fees and fostering private R&D spending, mainly by improving framework conditions. Reducing labour market segmentation by lowering employment protection for permanent workers and applying current legal limits to the renewal of temporary contracts is also crucial as segmentation undermines productivity gains by weakening incentives for job training and work effort. Reforming active labour market policies together with unemployment benefits would help to reduce unemployment further.*

Preserving sound public finances: *aiming at a balanced budget over the business cycle rather than every year, as planned by the authorities, is warranted, but must not undermine fiscal discipline. This will require maintaining a fiscal surveillance system for the regions. The financing system for the regions should be improved by taking better account of the net fiscal effect of demographic developments linked to immigration and ageing, while regional authorities' incentives to act in a cost-conscious way should be strengthened. Better information systems would favour the* *adoption of best policy practices by the regions. In the long run, the financial viability of the pension system is threatened. Reforms should focus on revising the parameters for establishing pension rights, which are inconsistent with long-term solvency. The adjustments needed will be less far-reaching insofar as policies designed to boost productivity and employment, particularly for female and old workers, are effective and if the transient social security surpluses expected over the coming years are saved, which would imply a tighter fiscal policy than currently projected.*

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 31 January 2005. 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 14 February 2005.

The Secretariat's draft report was prepared for the Committee by Claude Giorno, Miguel Jimenez and Isabelle Joumard under the supervision of Peter Hoeller.

The previous Survey of Spain was issued in May 2003.

This Economic Survey may not include an examination of certain policies that are relevant to the country but fall within the competence of the European Community. While some of these policies may be examined in the Survey of the Euro area, other policies may not be examined by the EDRC, as the European Commission currently maintains that the Economic Surveys should be limited in their coverage. No limits apply to the policies that can be covered in the Economic Surveys of other OECD member countries.

The Commission and the member States of the European Union are working actively on ways of reviewing EC and EU wide policies within the context of the EDRC.

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Assessment and recommendations

Spain's economy has been performing very well but the pace of the reforms needs to be accelerated to foster continuing convergence

For a decade now, Spain's performance has been remarkable. Growth has been robust, allowing real convergence at a fairly brisk pace, with the standard of living differential with the euro area average shrinking from 20% to less than 13% between 1995 and 2003. Fiscal consolidation, the fall in interest rates due to the introduction of the single currency, structural reforms pursued since the mid-1990s and a surge in immigration have created a virtuous circle of rapidly rising activity sustained by strong job creation. But where there is much light, there is also shadow: unemployment is still widespread; productivity gains have remained meagre; inflation is relatively high, eroding international competitiveness; and the surge in house prices is a cause for concern. Against this background, it will be important to tackle the impediments to the continued dynamism of the Spanish economy by accelerating the pace of structural reform. Preserving conditions that will ensure that convergence continues at a rapid pace should involve:

- *Maintaining macroeconomic stability and competitiveness*. The inflation differential with the euro area has to be reduced. Actions should include improving the collective bargaining system and strengthening competition in the sheltered sectors. The real estate sector also needs to cool down. House prices have almost doubled in real terms since 1998, increasing the risk of a fall in the medium term, while the associated rapid increase in household indebtedness also makes domestic demand more vulnerable to higher interest rates. Reforms to housing policy should play a vital role.
- *Boosting productivity gains*. Stronger productivity gains are needed to raise the pace of convergence. Spain is lagging in human capital investment and technological development, while various market distortions may hinder the emergence of activities with higher value added. It is important for Spain to avoid being locked into a specialisation in relatively low-technology sectors where it is likely to face growing competition from countries with lower labour cost.
- *Keeping public finances sound*. To retain the benefits of fiscal consolidation, while providing quality infrastructure and public services, it will be important to improve fiscal management and, especially, relations between the different levels of government in view of the very decentralised institutional framework. In the longer term, one of the main challenges is to guarantee the fiscal sustainability of the pension schemes, which is threatened by population ageing.

In the absence of policy changes, the inflation differential and modest productivity gains will erode the competitiveness of Spanish firms

The factors underpinning strong growth in recent years continued to operate in 2004, but the accompanying strains persisted and this put a damper on the results. Interest rates remained low in real terms, immigration continued at a rapid pace and real wage gains remained moderate. The increase in activity, which has reached 2¾ per cent, continued to depend on solid growth in household spending, underpinned by strong job creation which has reduced unemployment to less than 10½ per cent. These positive developments have, however, been accompanied by productivity gains that are very modest, at just ½ per cent, as well as a surge in property prices and household borrowing. The inflation differential with the euro area of close to 1 percentage point has persisted. The positive growth differential with the euro area, which amounted to 1¼ percentage points on average between 1996 and 2003, narrowed to ¾ of a percentage point in 2004 because of less favourable foreign trade developments, despite the improvement of the international environment. Although the appreciation of the euro, coupled with the rise in relative labour costs, has weakened price competitiveness in recent years, industrial firms have been able to maintain their market share until 2003 either by reducing margins and, more recently, by adjusting the workforce. This situation, which shows up in a widening dichotomy between developments in the exposed and sheltered sectors, seems difficult to maintain over the longer term.

Prudence would argue for a somewhat tighter fiscal stance in the medium term

The policy of balancing the government account in structural terms, which the authorities intend to pursue over the coming years, could result in a slightly expansionary macroeconomic policy stance. For 2005, this poses no problem as the output gap is still slightly negative, while growth will probably be close to potential at 2¾ per cent. Though this projection is a little more pessimistic than that of the authorities, because of a somewhat higher oil price assumption, balancing the budget should be feasible because tax receipts are likely to remain buoyant since the nominal increase in GDP (Gross domestic product) could exceed the official projection. Looking beyond the short term, the persistence of low real interest rates and the property boom should keep domestic demand growing swiftly, but the resulting strains on capacity should be limited by a weakening export performance. *While fiscal policy should play some role in ensuring against the risk of excessive domestic demand pressures and be in line with long-term fiscal needs, reducing the inflation gap requires above all structural reforms.*

The narrowing of the inflation differential with the euro area requires structural reforms

Narrowing the inflation differential with the euro area, which has amounted to a cumulative 8 percentage points since 1997 and is threatening the robustness of growth, should be a priority. The differential is eroding competitiveness while it stimulates domestic demand by reducing real interest rates. This fosters strong growth of sheltered, often less productive, sectors. The persistence of this differential cannot be ascribed to price convergence that is driven by the catch-up process, a so-called Balassa-Samuelson effect. Demand pressures partly explain the inflation differential, though real wage gains have been moderate, and capacity constraints have been similar to the euro area. Another reason for the persistence of the inflation differential is related to a high degree of nominal price and wage inertia, due to insufficient product market competition in several sectors and to the existing wage bargaining system. Nominal wage increases have remained above the euro area average in a context of low productivity gains and, in several sheltered sectors, where demand pressures are stronger and effective competition is still relatively weak, enterprises are able to pass on relatively rapid labour cost increases into prices.

In several sectors, competition needs to be encouraged

Since the late 1990s, reforms of goods and services markets have been timid, even though competitive pressures appear limited in several sheltered sectors. *The numerous barriers to the establishment of new hypermarkets and shopping centres in retail distribution that have been put in place by regional governments should be dismantled*. The recent change in the framework law that regulates retail opening hours, although it has allowed the settling of an ongoing legal dispute, has been a step in the wrong direction as it allows regional governments to reduce maximum opening time for large outlets. This not only protects small, less-productive shops, but also impinges on welfare by limiting shopping time and thus reduces opportunities to reconcile work with family life. *In network industries, further reforms are necessary to reduce the still considerable market power wielded by a small number of firms*. Liberalisation of network industries has resulted in efficiency gains and important price reductions in recent years, but some segments of the energy sector are still *de facto* vertically integrated, with incumbents controlling prices and raising barriers to the entry of new competitors and there is little price competition in mobile telephony. *While the general competition authorities have handed down tough decisions in a number of high-profile cases, their effectiveness should be raised further by granting greater independence and by enhancing their advocacy role, which could be used to investigate service sectors where prices are high. Competition policy would also be strengthened by merging the Competition Tribunal and the Competition Service as this would lead to synergies in investigations. Leniency programmes have been successful in other countries and should also be introduced in Spain*. The government has adopted, after the finalisation of this *Survey*, a set of measures aiming at improving the functioning of the product market and strengthening productivity.

Reducing nominal wage rigidities calls for a reform of the wage bargaining system

Real wage gains have been broadly in line with aggregate productivity developments, thus underpinning job creation. But nominal wage growth has remained relatively high, partly reflecting catch-up clauses for inflation surprises in many collective agreements. *Ex post indexation should be eliminated, as it induces nominal wage inertia and inflation persistence*. Indeed, present levels of real wage growth should be compatible with lower nominal wage growth and inflation. *If catch-up clauses cannot be eliminated, they should be linked to core rather than headline inflation to avoid a price-wage spiral following an oil price hike. These changes should*

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be accompanied by other measures that would help to reduce inflation expectations, which are above the 2% reference value, including further liberalisation in some goods and services markets. Moreover, wage negotiations should take into account wage developments in the euro area. The present wage bargaining system is outdated and is too focused on intermediate level agreements at the sectoral and provincial level. As such, it does not allow for sufficient wage differentiation across firms, while the possibility of firms to opt out of sectoral wage agreements is very limited. *Greater decentralisation of bargaining, which has been debated but never implemented, is needed.* Higher level agreements could still play a role, as negotiations in small firms may be costly, but the *clause that obliges all firms to adhere to higher level agreements should be substituted by an opt-in clause. If this is not feasible, at least opt-out clauses should be made more flexible and not be limited to wages, but extended to other matters.*

Housing policy reform is needed to stabilise the property market

Cooling the property market is another important task. A narrowing of the inflation differential with the euro area would help, as it would lead to higher real interest rates. However, easing the pressures in this sector also means improving the way it operates, and this will first and foremost involve developing the rental market which is much too limited, whereas the proportion of unoccupied homes is very high. A plan has been adopted to alleviate the tensions in the housing market. These measures go in the right direction, but they need to be complemented by additional reforms. For instance, new tax incentives to encourage rental supply and demand were recently introduced, but *gradually abolishing the various forms of assistance to home ownership would be more effective as these tend to push up property prices, have a high budgetary cost and debatable redistributive effects. Improving the legal position of tenants and owners, and reducing the minimum 5-year duration of rental contracts would also contribute to a better utilisation of the housing stock and help to build up private rental supply in a less costly way than by means of the incentives adopted. Such measures should be accompanied by more flexible town-planning regulations at the local level, while the compulsory transfer of 10% of developable land sold to the municipalities should be abolished*, to do away with the incentives for these authorities to keep the price of land high. In addition, *the cost effectiveness of the present system of low-cost housing subsidies, which rests to a large extent on the sale of homes below the market price, warrants scrutiny*. Letting rather than selling low-cost dwellings could be envisaged as a way of solving access problems for a growing number of households because of increasingly unaffordable prices, but *it would probably be better to facilitate access to the private rental market for disadvantaged groups by introducing a system of housing vouchers for tenants.*

Improving productivity performance requires reforms in many areas

Improving the sluggish labour productivity performance is key for accelerating the pace of convergence with the leading OECD countries. Labour productivity growth has been dragged down by a composition effect as a large number of low-skilled workers entered the labour market. However, the slowdown is pronounced and suggests that other factors are at work, in particular labour market institutions, which do not provide strong incentives to raise productivity, and problems arising in the education and training system. These have adverse effects on R&D (Research and development) activities and the absorption of new technologies, and have also weighed on equipment investment, resulting in a lower capital-output ratio. In all these areas there is wide scope for improvement and the government's objective to raise performance in many of these domains is well placed, even though the results of such reforms will no doubt take time to be visible.

Reducing labour market segmentation is vital

Labour market reforms would have a positive effect on productivity performance. One of the most harmful features of the labour market affecting productivity is its segmentation between permanent workers, who are protected by very high severance payments, and a large number of temporary workers with little employment stability. This duality not only raises equity issues, but also limits productivity gains as both job training for temporary workers and incentives to become more efficient for permanent workers are low. Although fixed term contracts have contributed to job creation, segmentation also generates incentives for developing low-technology sectors, which are those that benefit most from temporary employment, and can discourage re-organisation within firms to exploit new technologies. Hence, *the long overdue task of reducing labour market segmentation by lowering the cost and uncertainty of employment protection for permanent workers remains crucial, and should be accompanied by efforts to apply current legal limits for the renewal of temporary contracts, which are abused in practice*. The existing subsidies for many new permanent contracts are expensive as they incur a high deadweight loss and should be seen, at best, as a temporary solution.

Enhancing the education system remains a priority

Human capital is also key for lifting future productivity growth. Educational attainment has improved dramatically over the past two decades, suggesting that the potential for higher growth is there. While rigidities in the labour market impede the full exploitation of human capital, there is also much scope for further improvement in several areas. *Early childhood education is limited for very young children and could benefit from additional public help in the form of fiscal incentives,* which would also encourage participation of women in the labour market and higher fertility rates. In compulsory schooling, poor quality has been highlighted by the OECD's international PISA tests. Addressing poor education outcomes is the main objective of ongoing school reforms. Apart from pedagogic changes, *priority should be given to measures that grant greater autonomy to schools, allowing them to experiment and adapt to local conditions and sharpening incentives, including economic incentives for teachers linked to training and performance*. Participation in upper secondary education is low, especially in low-income regions. *Lifting the liquidity constraint that affects the less well off students would help to raise participation and would accelerate convergence across regions. Vocational training is also underdeveloped and needs a decisive push to increase its prestige, while also raising resources, including more enterprise-based training.* In university education, there is little competition for excellence across university departments, while selection mechanisms for teaching staff tend in some cases to favour internal candidates. *Linking university financing to clear performance criteria instead of block grants should improve education and research quality,* and in this respect the newly created agency for the evaluation of universities could be a useful tool. *A sizeable rise in university fees, while providing flexible payment mechanisms for students with liquidity constraints, such as income-contingent loan repayments, would not only be justified by equity reasons, but would also provide more resources for universities and introduce incentives for students to make the most of their studies.*

Better framework conditions would boost the adoption of new technologies and strengthen the efficiency of R&D spending

Convergence would also be fostered by a more rapid take-up of new technologies. The share of output of high-tech sectors is low and the export structure of the new EU (European Union) countries is approaching that of Spain. Investment in ICT (Information and communication technology) equipment, which is a potent driver of productivity improvements within firms, is weak, while other ICT indicators are also relatively poor. Increasing the use of ICT in the private sector would probably require enhancing human capital and fostering R&D activities, which have complementarities with the use of new technologies. R&D spending and output indicators are well below those of the best-performing OECD countries, especially in the private sector. The authorities are aware of these shortcomings, and have programmed substantial increases in public funds for R&D for the coming years. However, it is also important to establish better framework conditions to make the most of public R&D spending:

- First, public funds for R&D should be scrutinised regularly to assess their potential social returns and to redefine priorities, so that public money funds R&D activities with clear and high externalities rather than providing mere industrial subsidies with weak links to R&D. An independent agency could play this role.
- Second, an adequate financial and tax framework for risky R&D projects has been implemented, but venture capital for technology start-ups has not taken off and requires the development of a better financial and management culture. Government equity programmes that allocate some public funds to these projects could help to develop this culture.
- Third, encouraging further the formation of clusters for technology firms as intended by the authorities, is a cheap and effective way of promoting R&D activities, especially for small firms.
- Fourth, the status and remuneration of young researchers should be raised, while job mobility and flexibility should be improved to increase the links between private and public research.

Other labour market reforms are required to raise labour utilisation further

Although job creation has been very rapid over the past ten years, the unemployment rate remains high and requires other labour market reforms. In this respect, *improving active labour market policies and the public employment service should become a priority. This should be accompanied by continuous efforts to provide adequate resources to employment services, improve the efficiency of counselling and training measures for the unemployed and undertake independent evaluation of different policies*. At the same time, *conditionality of unemployment benefits on* *participation in active job search, which is required by law but only loosely applied, should be enforced to reduce unemployment spells. To increase female participation, work schedules should be better aligned with family needs,* i.e. *by promoting flexibility in timetables, part time contracts and substitution of split-shifts by a continuous working day*. These reforms, together with those of the wage bargaining framework and employment protection, should be designed in a comprehensive way so as to take advantage of political economy aspects of reform. In this regard, the "Declaration in favour of social dialogue" signed in July 2004 by the government, employers and unions provides a window of opportunity to make further progress with labour market reforms.

Important fiscal challenges need to be addressed

Concerning the public finances, the authorities are confronted with three main challenges.

- First, the macroeconomic policy framework needs to ensure not only sound public finances, but also that a pro-cyclical fiscal stance is avoided.
- Second, good framework conditions need to ensure that the wide-ranging transfer of spending and tax responsibilities to the regions leads to a sound management of their resources, while balancing costs and benefits at the regional level when providing new services.
- Finally, a coherent strategy will need to be implemented to guarantee the long-term sustainability of public finances, with particular attention to the public pension schemes.

The fiscal consequences of ageing provide a strong reason for reducing public debt more quickly ahead of the ageing shock as a complement to a pension reform. This could be achieved by balancing the budgets of central and regional governments over the cycle, while accumulating the surpluses of the pension schemes.

Information systems should be developed to raise the effectiveness of public spending and to support fiscal discipline

Following the rapid decentralisation to the regions since the early 1980s, the sub-national authorities now have more staff to manage than does central government and have responsibility for spending on education, the social services and health. Decentralisation has not compromised fiscal stability, and has enabled regional governments to provide better-tailored services. Nevertheless, it has also resulted in a rapid increase in government employment, and has undermined cost-effectiveness in a number of domains, creating pressures on public spending. Rapid decentralisation has, for instance, been accompanied by a fragmentation and a loss of information. It will be necessary to *develop proper information systems on sub-national governments' policies and outcomes to foster fiscal discipline.* Sub-national government accounts are available only with a significant lag and the use of off-budget operations through public enterprises controlled by the regions or municipalities has expanded. In addition, although anecdotal evidence suggests that regional governments have implemented innovative policy options in some areas, in particular health care, there is a lack of consistent and reliable information on such policies and outcomes. Thus, the diffusion of best practice is limited, the lack of co-ordination between and across levels of government results in an inefficient use of public facilities, while citizens cannot easily benchmark their own governments against others and press for a more efficient public sector. *The government is committed to improving the quality of information for public services – a National Agency for the Evaluation of Public Services' Quality and Public Policies is to be created. To be effective, this agency, as others recently created* (e.g. *for health care or universities*)*, should have sufficient resources and be independent from the government so as to raise acceptance and credibility. Indicators, consistent for the whole territory, should be defined and made public so as to foster benchmarking.* In this context, central and regional governments' recent agreement within the *Consejo Interterritorial de Salud* not to disseminate regional data for hospital care waiting lists is a step in the wrong direction.

The ongoing examination of the new financial arrangements for sub-national governments should pay attention to demographic developments

The new financing arrangement for the regions is commendable in many respects. Most importantly, it has brought the regions' revenue-raising powers more in line with their spending responsibilities and intergovernmental transfers have been redesigned so as to mitigate moral hazard problems. It should thus contribute to secure fiscal discipline at the regional level. Although the new financing arrangement is rather recent, the government is currently assessing its implementation, and a discussion on some of its main features is underway within the Council for Fiscal and Financial Policy, where both the central government and the regions are represented. *To deliver its full benefits, the new financing model should make fully operational its mechanisms to make it sustainable in the face of demographic developments, in particular immigration and the prospects of population ageing. More specifically, the financial resources provided by the new financing arrangement should follow more closely the net fiscal effect of these changes. A careful examination of the best approach to finance the likely increase in regional spending over the long term because of population ageing should be carried out, with the objectives of: avoiding large distortion associated with labour taxes; underpinning regional governments' incentives to act in a cost-conscious way; and ensuring that regional governments' revenue raising powers are used and adequate to deliver a sufficient standard of public services to all citizens. In addition, the redistributive bias in allocating central government investment across the regions should be reconsidered, as distributive goals can be achieved by better instruments. At the municipal level, the existence of many very small municipalities argues in favour of a cautious approach to the transfer of new spending responsibilities. Their financing should however be improved by reconsidering the local business tax,* which is paid only by relatively large companies and could hinder the growth of enterprises or create a risk of tax avoidance, *while increasing local governments' reliance on the real estate tax. This would require upgrading the land and property register.*

Although warranted, the reform of the Fiscal Stability Law must not undermine fiscal discipline

To maintain fiscal discipline in the decentralised framework, a Fiscal Stability Law was implemented in 2003 with the objective of keeping the accounts of all levels of government, taken individually, permanently in balance. While it has the advantage of being simple and easy to convey, this rule is nevertheless formulated in too rigid a manner and could result in fiscal policy playing a pro-cyclical role. *The new government will amend the fiscal rule so as to maintain fiscal balance over the cycle, rather than in each year. Applying this principle seems relevant for central government and all the regions, given their tax and expenditure assignments. They will be allowed to post deficits during cyclical troughs but will be required to produce surpluses when activity is buoyant.* In the case of the local authorities, on the other hand, changing the present system does not appear necessary because their budgets are not very sensitive to the economic situation whereas maintaining structural surpluses would be preferable in the case of the social security system. *The specific sharing of overall fiscal targets between the different regions needs to be based on a consensual approach of collective surveillance so as to avoid having to resort to sanction mechanisms* which appear difficult to implement. *It would nevertheless be worthwhile continuing to require the regions to present a medium-term fiscal adjustment plan in the event that they significantly miss their targets. It is vital to ensure that the new norm does not* de facto *weaken fiscal discipline and that it is applied equitably to all the regions, whatever their size.*

A downward revision of the parameters underlying pension calculations is needed

While lower public debt and rising employment contribute to ensure sustainability of public finances, the sustainability of the pension system is not guaranteed over the long term. The impact of ageing will be felt later on but more acutely than in other OECD countries, because it will be more pronounced than elsewhere and because the parameters underlying pension calculations are more generous – even if the average level of pensions is low at present. On the basis of favourable assumptions of increased immigration and employment, pension spending could rise by almost 8 percentage points as a proportion of GDP by 2050 if the generosity of the system remains unchanged, *i.e.* if the number of pensions received per person aged over 65 and the average benefit relative to productivity remain stable. *Reforms are needed concerning both receipts and benefits.* This was acknowledged in the Toledo Pact, but little progress has been made with reforms in recent years. However, in the context of the "Declaration in favour of social dialogue" signed in July 2004 a negotiation process has already started that will tackle pending challenges outlined in the Pact. *Raising the level, or number of years of contributions to certain schemes, such as that for the self-employed, would be welcome.* However, the average level of pensions compared to per capita GDP will have to be lowered by some means to contain the rise in pension outlays. *The parameters underlying pension calculations will have to be revised to at least ensure that the discounted value of old-age pensions is not higher than the sum of the corresponding contributions, making the system actuarially fair considering that the revised parameters will only apply to future generations of pensioners affected by the demographic shock. This could mean basing pensions on earnings over an entire career instead of the last fifteen years, or reducing the average rate of accumulation of pension entitlements, but it may also be necessary to means-test revenues of those drawing on more than one pension.*

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Labour market and fiscal policies will be key to limiting the scale of pension reform

The need for such reforms in pensions will be more limited if the policies designed to boost productivity and employment are effective and fiscal management over the next few years is sound. *The employment rate could be raised by reconsidering the rate of accumulation of pension entitlements, which is lower at the end of the career than at the beginning, reducing the incentive to stay in the labour market. Increasing the number of day-care facilities for young children and of health and home care provision for dependent elderly persons, in addition to labour market measures, would also help to raise female employment further.* In view of the foreseeable rise in demand for long-term care, there is a need to organise efficient provision with the emphasis on enabling the elderly to remain in their own home. *Consideration should also be given to the possibility of running a significant budget surplus over the coming years. Reducing general government indebtedness more quickly and increasing social security assets ahead of the demographic shock in 2015-20 would help to limit the fall in the relative level of pensions so that it remains socially acceptable.* The temptation to lower social insurance contributions has to be resisted, despite the surpluses that the pension schemes have posted in recent years, and surpluses should be kept in the social security reserve fund in the years ahead. At the same time *the generosity of the tax incentives favouring private pensions should be reconsidered*. The net cost of these incentives is high as they appear to mainly affect portfolio allocation and generate little extra saving.

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Chapter 1

Maintaining a strong performance: the challenges ahead

The Spanish economy has performed well in recent years and has weathered the international slowdown in activity better than most OECD countries. As a result, real convergence with the area average has continued and the difference in living standards narrowed to 13% in 2003. Eliminating the remaining gap does, however, pose several challenges: i) Preserving macroeconomic stability and competitiveness. This requires eliminating the persisting inflation differential with the euro area, stabilising the housing market and stemming the sharp rise in household borrowing; ii) Boosting productivity gains which were very weak over the last years; iii) Guaranteeing the financial viability of public finances. Because of the decentralised institutional framework, this involves improving budgetary relations between the different levels of government so as to limit pressures on public spending. It will also be necessary to ensure the viability of government accounts in the face of population ageing.

Preserving macroeconomic stability and competitiveness

Convergence has been driven by employment growth…

Convergence in living standards has continued at a steady pace of 1% per year in recent years (Table 1.1), largely due to brisk employment growth (Figure 1.1). The positive effects of deeper integration and the labour market reforms in 1984 and then in the mid-1990s, which coincided with wage moderation, played a decisive role in increasing the employment rate. However, improved resource utilisation was accompanied by a marked slowdown in productivity gains, in contrast with developments in some other OECD countries.

Table 1.1. **Growth gap decomposition for selected OECD countries**[1]

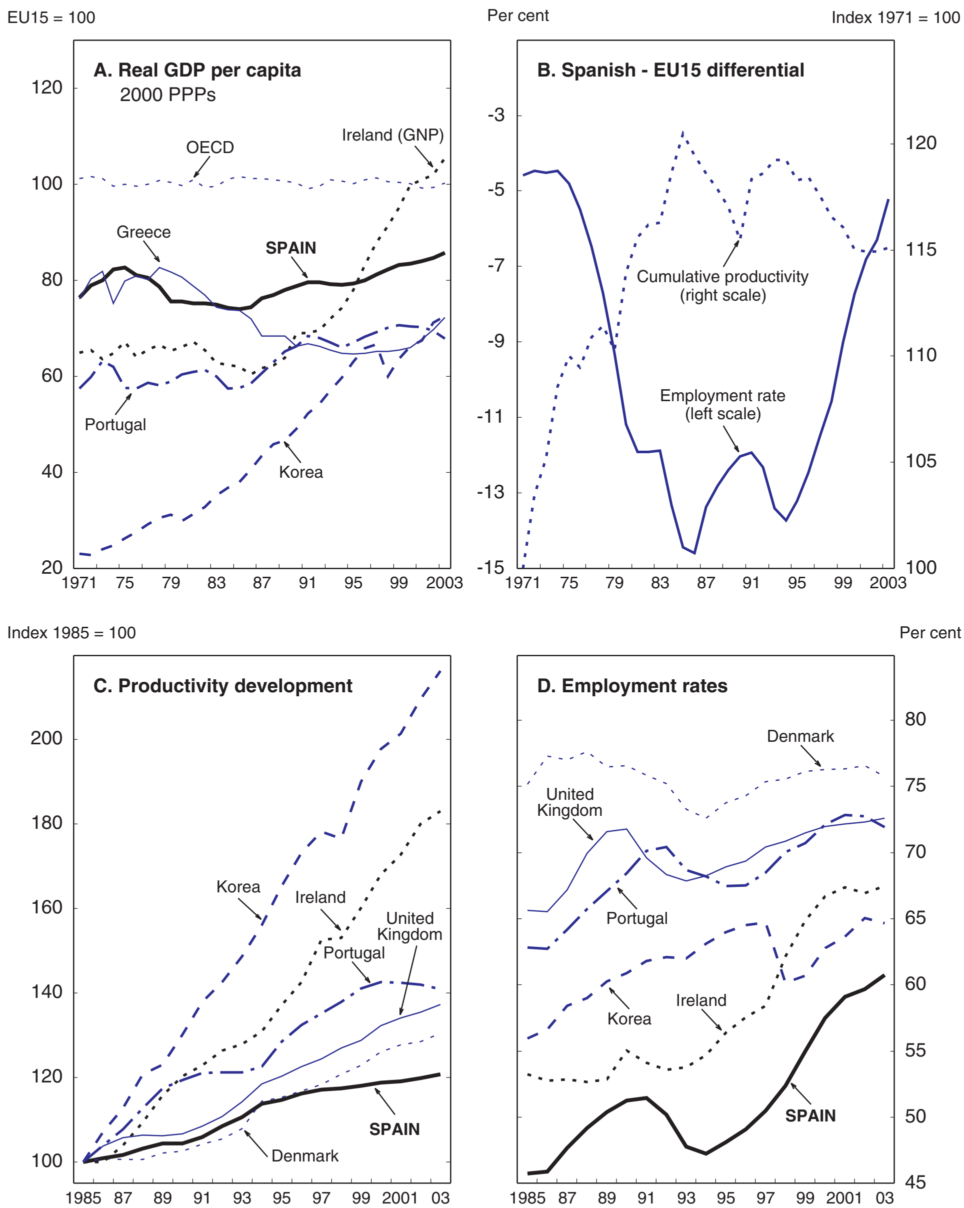
Average of the period, relative to the euro area

	1971-2003	1971-85	1986-94	1995-2003
Spain				
Growth per capita	0.4	–0.2	1.0	0.8
Productivity	0.5	1.2	0.0	–0.2
Employment rate	–0.2	–1.3	0.6	1.0
Demography	0.1	–0.1	0.5	0.1
Greece				
Growth per capita	0.1	0.1	–1.1	1.1
Productivity	0.2	–0.2	–0.9	2.0
Employment rate	0.0	0.5	–0.4	–0.4
Demography	–0.2	–0.3	0.2	–0.5
Ireland[2]				
Growth per capita	1.6	–0.3	2.3	4.1
Productivity	1.1	0.3	1.7	1.8
Employment rate	0.2	–0.4	0.1	1.4
Demography	0.3	–0.2	0.5	0.9
Korea				
Growth per capita	3.7	3.6	5.4	2.4
Productivity	2.6	2.0	3.5	2.7
Employment rate	0.5	0.8	1.2	–0.7
Demography	0.6	0.8	0.7	0.3
Portugal				
Growth per capita	0.8	0.3	2.0	0.5
Productivity	0.2	–0.4	0.8	0.7
Employment rate	0.5	0.8	0.7	–0.3
Demography	0.1	–0.1	0.5	0.1

1. Growth per capita is defined on the basis of GDP (volume) per inhabitant. The breakdown is calculated as follows: productivity is GDP (volume) per employed person, the employment rate is the ratio of employment to the active population and demography is the ratio of the active population to total population.
2. Gross national product (GNP) instead of GDP.

Source: OECD (2004), *Economic Outlook*, No. 76, and *National Accounts*.

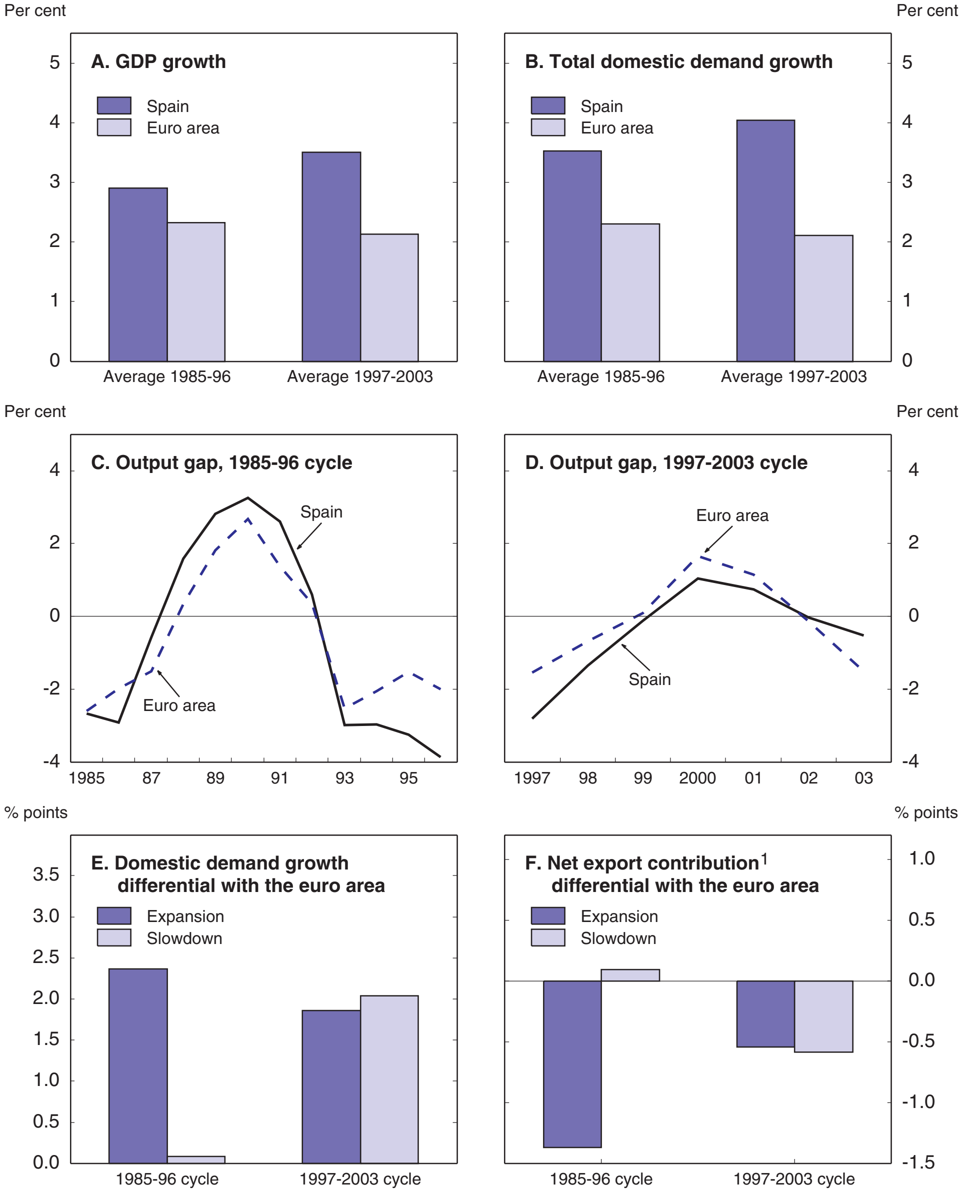
Figure 1.1. **The convergence process**



Source: OECD (2004), *OECD Economic Outlook*, No. 76; *National Accounts* and *Main Economic Indicators*.

Strong job creation has fuelled rapid domestic demand growth (Figure 1.2). Membership in the euro area and the steep increase in immigration in recent years have accentuated this characteristic of the Spanish growth pattern, and also its ability to weather the negative OECD-wide shocks. Between 1997 and 2003, cyclical fluctuations were shallower than in most other European countries, in contrast with the previous cycle. The fall in interest rates prompted by the adoption of the euro, and fiscal consolidation which was accompanied by tax cuts in 1998 and 2003, improved households' confidence and led to a reduction of their saving ratio. Lower real interest rates had an even more marked impact on construction investment, particularly residential, which remained the

Figure 1.2. **Growth comparison over the economic cycle**



1. Contribution to GDP growth.

Source: OECD (2004), *OECD Economic Outlook*, No. 76.

most dynamic component of domestic demand. It also cut companies' financial costs, increasing their profitability and stimulating capital expenditure. Meanwhile, the surge in immigration helped to preserve real wage restraint and fostered continuing brisk growth of employment, even during the slowdown that began in 2000. All in all, activity has grown by nearly 3½ per cent per year since 1997 and the growth differential with the euro area widened to 1¼ percentage points.

… but has been accompanied by strains undermining competitiveness

The robustness of growth is, however, under some threat from emerging macroeconomic strains. Since the introduction of the single currency, private borrowing has risen steeply, notably by households, while real estate prices have surged and inflation has remained above the euro area average. The inflation differential amounted to 1.2 percentage points per year since the creation of monetary union, giving a cumulative increase of almost 8 percentage points since 1997 (Table 1.2). The gap between inflation in the service sector and industry has been wider than elsewhere, which highlights a dual inflation problem.

Table 1.2. **Inflation differential between Spain[1] and the euro area**

Percentage points

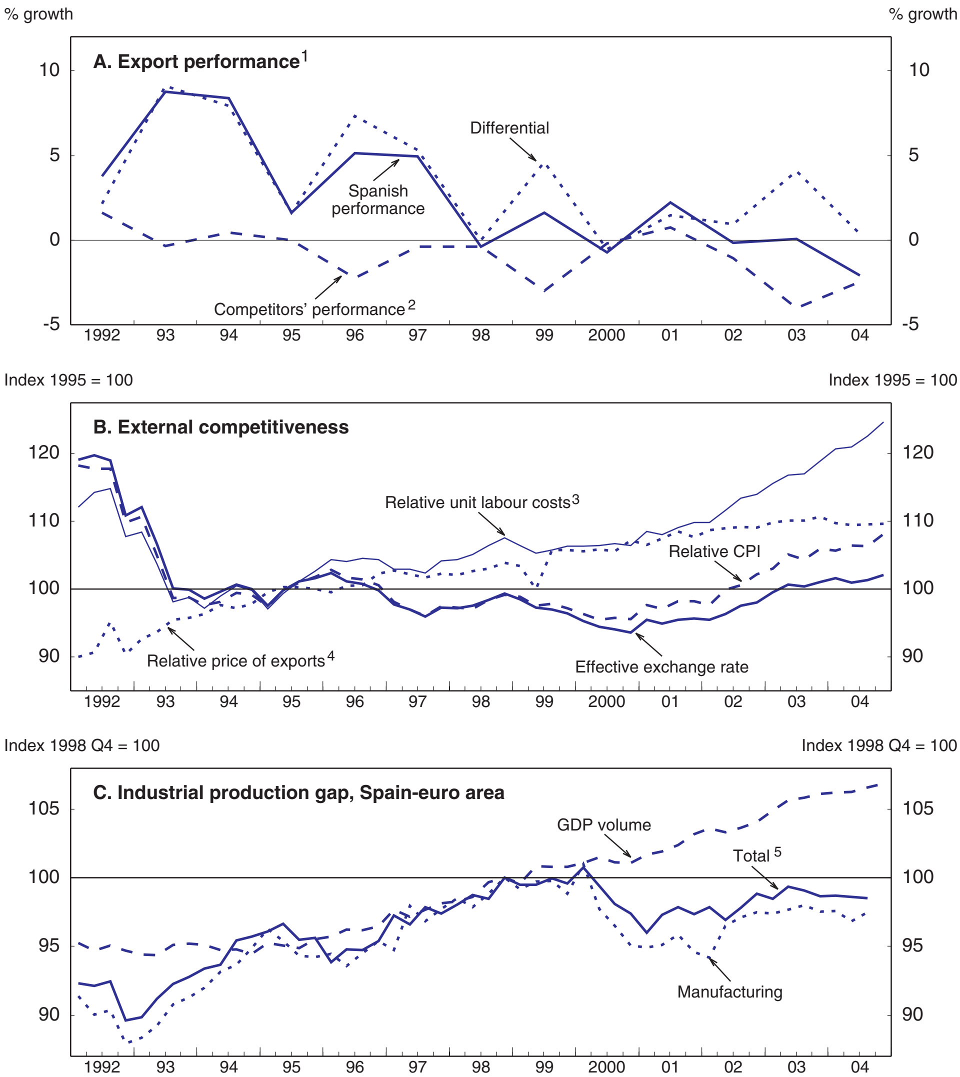
	Weight	1997	1998	1999	2000	2001	2002	2003	2004	Cumulative 1997-2004
Total	**100.0**	**0.3**	**0.7**	**1.1**	**1.4**	**1.2**	**1.3**	**1.0**	**0.9**	**8.0**
Food	25.1	–1.6	–0.2	1.2	1.1	0.1	1.9	2.0	2.8	7.3
Industrial goods	40.7	0.7	0.3	0.8	1.1	0.4	1.0	0.8	0.4	5.4
Industrial goods excluding energy	38.1	1.0	0.5	0.9	1.6	1.7	1.1	1.4	0.2	8.4
Energy	9.4	–0.3	–1.2	0.9	0.4	3.2	0.5	–1.7	0.4	2.1
Services	34.3	1.2	1.6	1.7	2.1	1.8	1.5	1.1	1.0	12.1
Memorandum item:										
Core inflation[2]	82.3	0.5	0.8	1.3	1.5	1.6	1.4	1.1	0.7	8.8

1. The break of the Spanish harmonised consumer price index (CPI) in 2001 has been adjusted using the national CPI as benchmark.
2. Total excluding unprocessed food and energy.

Source: INE and Eurostat, New Cronos database, February 2005.

The inflation differential with the euro area is pushing real interest rates below the euro area average and, while this is stimulating domestic demand, it is also undermining competitiveness, thereby creating a dichotomy between developments in the exposed and the sheltered sectors of the economy. Since 2000, industrial production has been less buoyant than in the euro area despite stronger domestic demand (Figure 1.3). The possibility that the inflation differential is being driven by a Balassa-Samuelson effect can be discounted because there is no catch-up in productivity. Even though price levels and labour costs in manufacturing are still short of the euro area average,[1] the capacity of Spanish firms to absorb higher underlying inflation is waning, as the increase in hourly labour costs in industry is not offset by more rapid gains in labour productivity. Despite an effective exchange rate that has remained relatively stable on average for the past ten years, relative unit labour costs expressed in a common currency have risen uninterruptedly to a level that is now higher than before the 1992 devaluation. While initially cushioned by the fall in firms' financial costs due to lower interest rates, the industrial sector's profit margins and profitability have suffered in the early 2000s. Although export prices have risen faster than in the euro area countries they have risen less than labour costs, even though industrial firms have reduced their workforce from end-2001 to limit labour costs and preserve margins. While these efforts prevented market share losses up until 2003, it would seem difficult to sustain a large cost and price differential over the longer term.

Figure 1.3. **Competitiveness indicators and export performance**



1. Change in export market shares for goods and services.
2. Represented by Belgium, France, Germany, Italy and Portugal.
3. In manufacturing.
4. Exports of goods and services, relative to the euro area.
5. Excluding construction; including mining, energy and water.

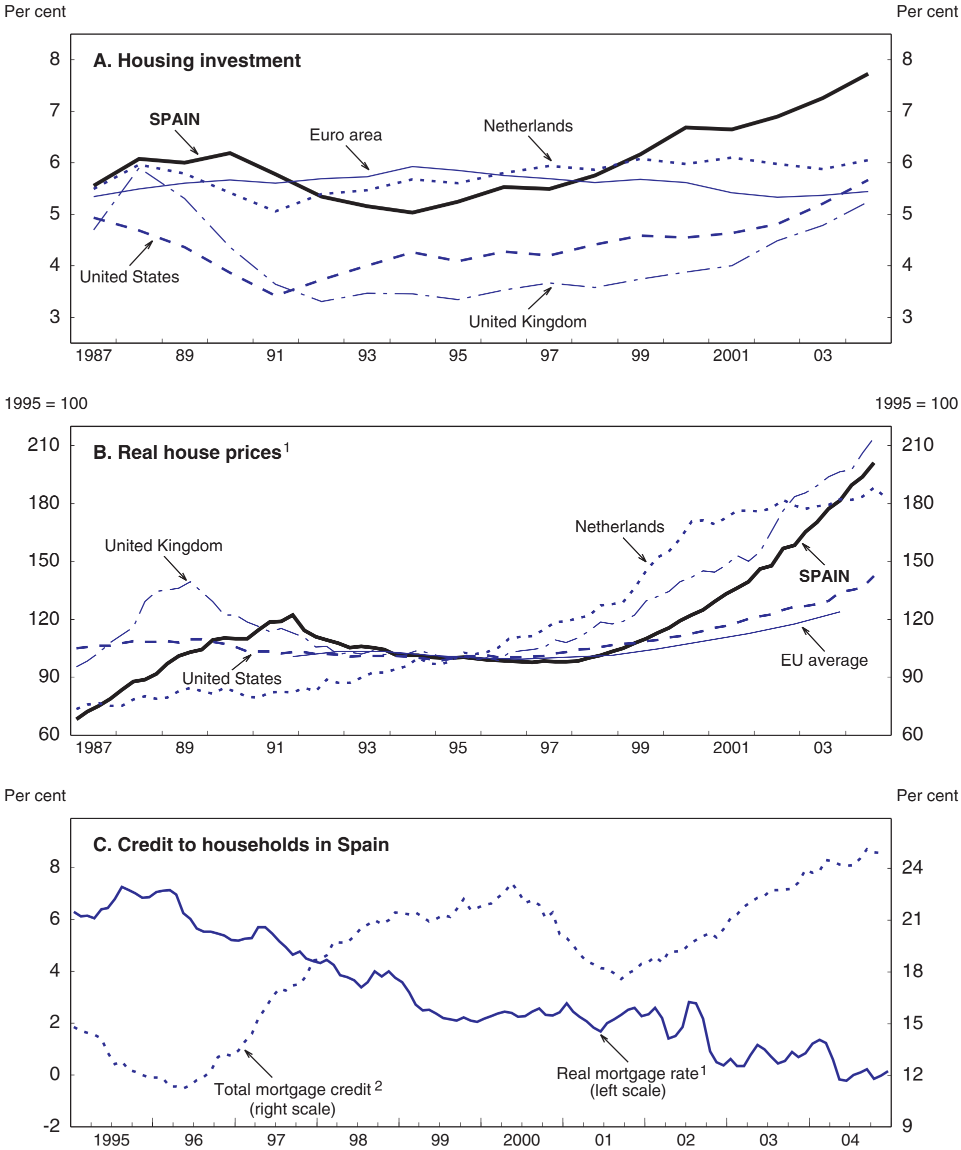
Source: OECD (2004), *OECD Economic Outlook*, No. 76, and *Main Economic Indicators*.

Housing market developments are a source of concern

The strong demand pressures in the real estate sector…

Since 1998, activity in the housing sector has grown at double the rate of the rest of the economy, and this sector accounts for about one-eighth of all jobs created since then, while the whole construction sector accounts for one-quarter of jobs created. Despite the swift expansion, real estate prices have risen by about 90% in real terms, which is more than in most other OECD countries (Figure 1.4). Households have increased borrowing sharply, debt as per cent of disposable income doubling since 1995 to 100%, thus exceeding the EU average. There is broad agreement that the surge in house building and in prices is due

Figure 1.4. **Housing market indicators**



1. Deflated by the consumer price index.
2. Year-on-year percentage changes.

Source: Bank of Spain; OECD (2004), *OECD Economic Outlook*, No. 76, and *Main Economic Indicators*.

both to demand and supply factors (Martinez Pagés and Llanos Matea Rosa, 2003). The increase in demand was underpinned by the fall in real interest rates, longer loan maturity and the large number of jobs created. Property purchases have also been boosted by strong demand for second homes by European citizens and the arrival of large numbers of immigrants. It was also stimulated by the low returns on financial investments and the expectation of rising house prices. As a result, the very high proportion of real estate in households' wealth compared with other countries reached 73% in 2001 (Naredo *et al.*, 2002), whereas it represents only around 35% in the major OECD countries. These strong demand pressures have been met only partially, even though housing construction is well above previous property market highs.

… have probably led to an overvaluation of house prices

It is difficult to judge whether the steep rise in household debt and property prices is sustainable. Recent empirical studies tend to show that prices are high in relation to their equilibrium value, even though the latter has also increased. According to Ayuso *et al.* (2003) and IMF (2004), for example, the persistent undervaluation of house prices in the second half of the 1990s gave way to an overvaluation of between 10% and 20% in 2003. Although the degree of such an overvaluation does not seem large, the surge in house prices, which continued at an annual rate of more than 15% in 2004, does not appear to abate. This has prompted the Bank of Spain to urge banks to exercise caution in their mortgage lending and to avoid granting loans amounting to more than 80% of the house value, even though solvency ratios and provisions in the financial sector remain high (Bank of Spain, 2004a).

Rising household indebtedness raises the vulnerability of the economy to a monetary tightening

Developments in the property market point to two main risks. The first relates to the steep rise in households' mortgage debt, usually contracted at variable rates, and the consequences of an increase in interest payments should interest rates go up. According to the Bank of Spain, the level of debt in 2004 does not appear excessive, when taking into account the changes in its long-term determinants, and that rising indebtedness has been accompanied by an increase in both real estate and financial assets. However, a continuing rise in indebtedness runs the risk of weakening consumption and loan demand in the medium term.[2] The consequences of a rise in interest rates should not be underestimated, even if the risk of any marked tightening is low. Because of the increase in mortgage borrowing, household savings not used for amortising debt have fallen from 8% of households' disposable income in 1996 to under 2% since 2000 (Bank of Spain, 2004b). This makes household spending more sensitive to interest rate fluctuations.[3] The behaviour of households also depends on their wealth situation which is not uniform across the population (Carrascal, 2004), even if the effort involved in financing an average mortgage loan is moderate in a historical perspective. To reduce the vulnerability of borrowers to a rise in interest rates, the Ministry of Economy and Finance has announced measures that will lower the conversion cost of a variable rate to a fixed rate loan.

The risk of a fall in house prices is a source of concern

A marked reduction in house prices is the second source of concern because of the adverse effects on private consumption and activity in the construction industry. Although this is not the most likely scenario, such an adjustment cannot be ruled out. The potential effect of a fall in property wealth on consumer spending looks similar in Spain to that of other OECD economies (Farré and Raymond, 2002). Real estate accounts for a large proportion of households' wealth, even though mortgage equity withdrawal to finance consumption is not as well developed as in some other countries (Marqués and Nieto, 2003). Furthermore, a big fall in demand would trigger a lasting decline in house building activity, which currently has a larger weight in GDP than in most other OECD economies. Such a negative and asymmetric shock might be difficult to cope with in the absence of an independent monetary policy.

A better functioning of the housing market is vital

A number of factors underpinning demand could persist in the future. These include purchases of second homes by non-residents, rising employment and immigration and an increase in the number of households for demographic and sociological reasons (Pareja and San Martin, 2003). This would limit the risks of a retrenchment, but raise the urgency of increasing the flexibility of supply. If the market were to function better, it would not only lessen the risks of a property sector slump, but would also ease the problems of access to housing experienced by a growing number of households. This means especially developing the rental market which is fairly limited, whereas the proportion of unoccupied homes is very high. To do so, however, would imply a profound reform of housing policy. Better utilisation of the housing stock and tilting the balance of the housing market in favour of rentals would reduce obstacles to labour mobility and help restrain residential construction whose strong growth may also have impeded the expansion of high value-added activities elsewhere. Chapter 2 will highlight the policy issues concerning the housing market together with those related to the problem of inflation.

Raising productivity growth while maintaining strong job creation

Weak productivity performance has been associated with strong job creation…

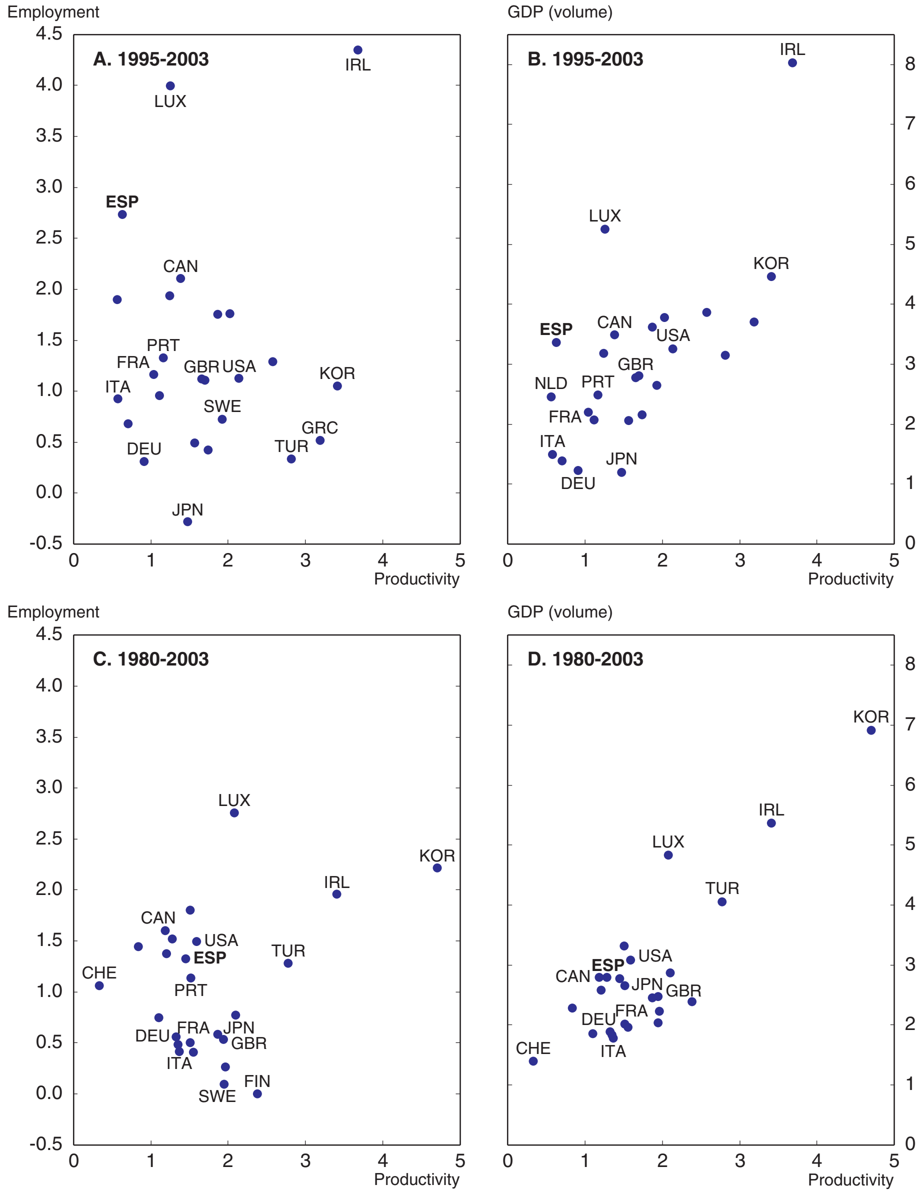
Over the past 20 years, growth has become increasingly driven by rising employment rather than productivity gains. However, in several countries, high productivity and employment gains have been achieved in tandem. While there is a positive cross-country correlation between productivity and GDP growth, the correlation between productivity and employment growth is weak (Figure 1.5), suggesting that there is not necessarily a trade-off.[4] Indeed, some of the best performing OECD countries, like Ireland or Korea, have had rapid gains in both dimensions. This suggests that Spain's catch-up process can be accelerated by improving productivity performance, a development that would be all the more desirable as the gap in the hourly productivity level with the most advanced economies is the main source of the gap in per capita GDP with these countries (Figure 1.6).[5]

There are reasons that may suggest that the recent productivity slowdown is not as deep as it seems:

- *First*, the massive arrival of workers with low productivity (young, immigrants or the long-term unemployed) has affected productivity growth through a composition effect. The increase in employment of marginal workers is positive as it raises per capita GDP, but it also partly reflects distortions in some low productivity sectors (agriculture, construction) that attract large numbers of low-skilled immigrants. However, this composition effect is likely to explain only a small part of the productivity downturn: if the sectoral shift of employment observed between 1995 and 2003 towards construction had not taken place, average productivity growth would be less than 0.1 percentage point higher than recorded (Table 1.3). The previous OECD *Survey* showed that the arrival of immigrants in low productivity sectors has supported this sectoral shift. Apart from the sectoral shift, the composition effect derived from the arrival of immigrants filling low skill jobs is also small. A simple accounting exercise shows that even assuming an average productivity level of immigrants equal to only 50-75% of native workers, they would only explain 0.1 to 0.2 percentage point of the productivity slowdown between 1995 and 2002 (OECD, 2003). As for the composition effect linked to new employees with little experience (young workers and many women), a similar exercise shows that in the extreme case where all new youth and female employment created since 1995 corresponded to workers with a lower productivity level than that of the average worker (20% lower), their impact on average productivity growth would have been 0.5 percentage point. However, this is an upper bound, since many of the young workers have a higher education level than the average worker, while inexperienced workers can raise their productivity level quickly.

Figure 1.5. **Productivity and employment**

Average percentage growth

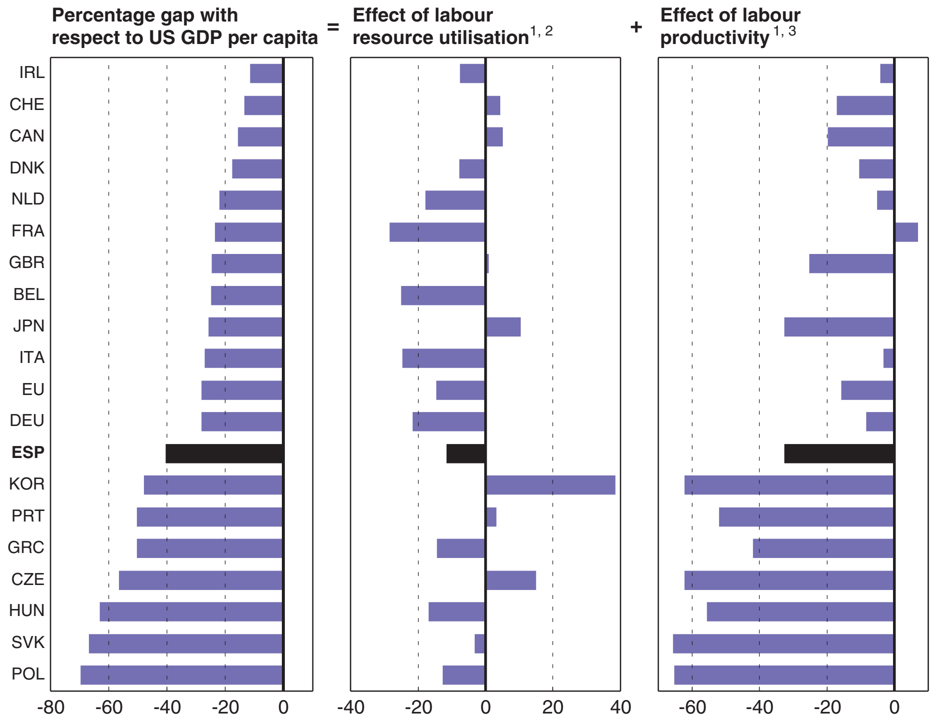


Source: OECD (2004), *OECD Economic Outlook*, No. 76.

- *Second*, productivity may not be well measured. However, it is not obvious that the national accounts overestimate employment growth, and it is more likely that some of the immigrants are not recorded (estimated at close to 1 million in 2003). As to the GDP level, the extent of miss-measurement is unknown. The National Institute of Statistics is likely to make an upward revision of GDP in 2005, but little effect on productivity growth is expected.[6] Overall, the under-recording of GDP growth in recent years (even if not recognized in the 2005 revision) would be to a large extent compensated by under-recording labour inputs. Other sources based on micro data, like the Bank of Spain's balance sheet sample, confirm the labour productivity slowdown between the first and the second part of

Figure 1.6. **The sources of income differences**

2002, in 2000 PPP terms



1. Percentage gap with respect to the level of the United States.
2. Labour resource utilisation is measured as total number of hours worked divided by working-age population.
3. Labour productivity is measured as GDP per hour worked.

Source: OECD, *National Accounts* and Labour Force Statistics database, December 2004.

Table 1.3. **The effect of employment shifts on labour productivity growth**[1]

Between 1995 and 2003

		Agriculture	Energy	Industry	Construction	Market services	Non-market services	Total economy: Index of cumulative gains	Total economy: Average annual rate (%)
Index of cumulative productivity gain between 1995 and 2003	(A)	1.301	1.549	1.106	0.980	0.998	1.076	1.055	**0.67**
Employment share in 1995 (%)	(B)	8.0	1.1	18.5	9.4	41.9	21.1	100	. .
Index of relative level of sectoral productivity in 1995 (%)	(C)	55.1	366.4	98.3	80.0	122.1	70.1	100	
Change in employment share between 1995 and 2003 (%)	(D)	–2.2	–0.3	–0.9	2.0	2.3	–0.9	0	. .
Within effect[2]	(A x B x C)	0.057	0.061	0.201	0.074	0.511	0.159	1.063	**0.76**
Sectoral shift effect[3]	(A x C x D)	–0.016	–0.020	–0.010	0.016	0.028	–0.007	–0.008	**–0.09**

1. Labour productivity growth can be split in two effects. The first one measures the contribution of individual sectors' labour productivity growth to total labour productivity (within effect), while the second assesses the impact of shifts in employment shares among sectors with differing productivity levels (sectoral shift effect). This decomposition can be formally derived from the following equation:
$PDTY_{2003}/PDTY_{1995} = \Sigma_i(PDTY^i_{2003}/PDTY^i_{1995}) \times (ESh^i_{1995}) \times (PDTY^i_{1995}/PDTY_{1995}) + \Sigma_i(PDTY^i_{2003}/PDTY^i_{1995}) \times (ESh^i_{2003} - ESh^i_{1995}) \times (PDTY^i_{1995}/PDTY_{1995})$
with PDTY being the labour productivity, ESh the employment share, i the sectors, 1995 and 2003 the period considered. The first term of this sum represents the "within effect" and the second the "sectoral shift effect".
2. The contribution of individual sectors' labour productivity growth to total labour productivity.
3. The contribution of shifts in employment shares among sectors with differing productivity levels.

Source: OECD calculations based on INE national accounts data, January 2005.

the 1990s. In that survey, which includes mostly large firms but covers more than 60% of total value added, the deceleration of productivity during the second half of the decade was apparent in both manufacturing and service sectors, and was induced by a decline in the capital/output ratio, which was only partly compensated by an acceleration in total factor productivity to aggregate productivity growth. The survey also confirms that those sectors with lower value added are those which grew most between 1995 and 2000 (Núñez and Hurtado, 2003).

... but is also linked to problems of low human and physical capital investment...

In sum, these explanations probably account for only a small share of the productivity slowdown, which seems to be caused by deeper structural factors. These are linked to labour market rigidities, that have resulted in a segmented market between permanent and temporary workers, and their interaction with other factors, such as the quantity and quality of human capital, the pace of business investment and the quality of infrastructure, the intensity of ICT use and the production and use of R&D. All these elements have also reduced the profitability of productive investment, resulting in a lower capital-output ratio. Although the infrastructure has improved considerably, thanks in part to EU structural funds, equipment investment has been relatively weak. The average growth rate of equipment investment has been lower since 1996 than during the previous cycle, and has also been below that of construction investment.[7] This may have affected productivity, as equipment investment contributes more to productivity gains. Indeed, compared to the European Union and the United States, the weaker labour productivity growth observed since 1995 appears related to smaller contributions of capital per employee and total factor productivity to labour productivity performance (Hernansanz *et al.*, 2001).

Human capital investment is important in this context. Spanish firms invest little in training (Table 1.4). The dual structure of the labour market is also an obstacle to training, because temporary workers have no career prospects, while workers with permanent contracts have few incentives to improve qualifications as they know that their jobs are highly secure due to stringent employment protection.

The education level is still below the OECD average, though the young have attainment ratios which are broadly in line with international experience. Participation in upper secondary

Table 1.4. **Working time spent on training in enterprises**

Course hours per 1 000 working hours by size of company, 1999

	10-49 employees	50-249 employees	250 or more employees	Total
Spain	**3**	**5**	**10**	**6**
Austria	4	4	6	5
Belgium	5	8	11	8
Denmark	12	14	14	14
Finland	8	8	13	11
Germany	3	5	6	5
Ireland	8	8	12	9
Luxembourg	4	5	13	8
Netherlands	7	10	13	11
Norway	8	8	13	10
Portugal	1	3	8	4
Sweden	9	8	14	12

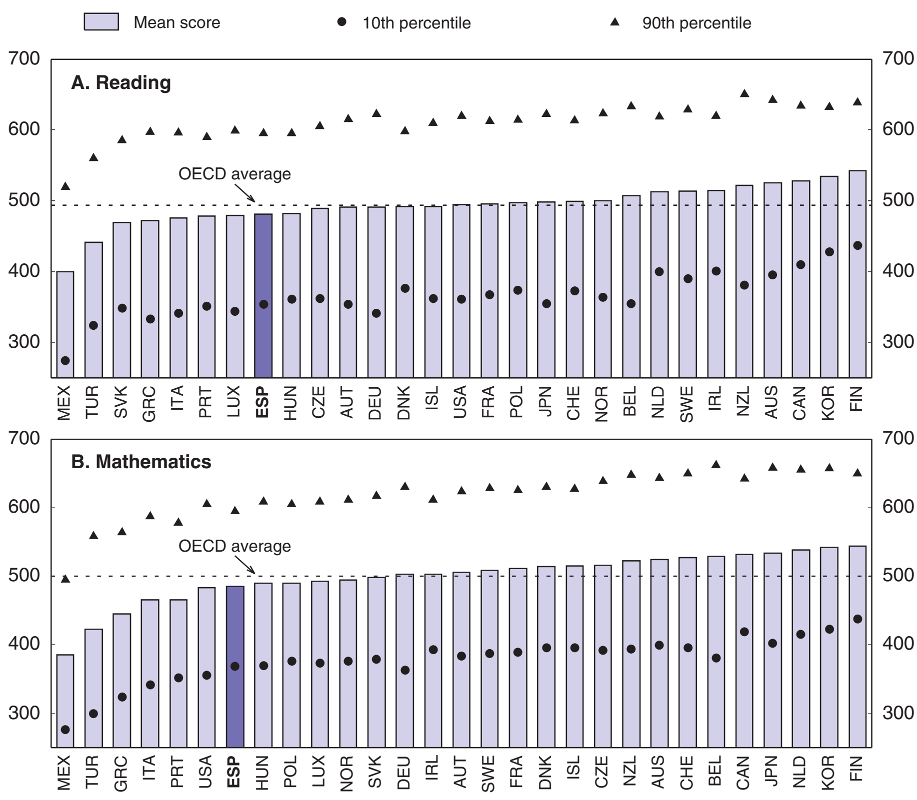
Source: Eurostat (2003), "Working time spent on vocational training in enterprises in Europe", *Statistics in Focus*, Theme 3, 1/2003.

education is, however, still fairly low, with a graduation rate of 68% against an OECD average of 81%. These comparisons refer to human capital levels, not rates of change. Indeed, comparisons of quality-adjusted employment inputs have found that changes have been higher than in other countries (Moral, 2003), which may suggest that human capital growth does not explain the productivity growth gap. However, the level of education attainment may affect productivity growth, as a better trained population may adapt more quickly to technological changes. Moreover, concerns about education relate mostly to quality, which has a direct impact on total factor productivity growth (de la Fuente *et al.*, 2003). Indeed, improving quality is a *leitmotiv*, when education issues are discussed. In this respect, the OECD PISA study, that tests 15 year-olds, shows that Spanish students perform worse than several countries with lower per capita GDP (Figure 1.7). Professional training has been considered for a long time as an option for "failed" students rather than an option for improving employability and has suffered from a lack of prestige. In university education, high participation rates are accompanied by low ratios of teachers per student and low spending per student. There is also a large mismatch between education and job assignments, with many young graduates filling jobs well below their notional skills. This suggests an under-utilisation of human capital due to labour market rigidities and signals a weak link between the skills provided by universities and those required by firms.

The low level of R&D and innovation is another factor contributing to low productivity: OECD studies demonstrate that there is a clear link between R&D and productivity (OECD, 2003). Spending on R&D is close to 1% of GDP, which is well below the EU average (2%) or US outlays (3%) (Figure 1.8). Moreover, private sector R&D is low, even though Spain has the

Figure 1.7. **Student performance in reading and mathematics**

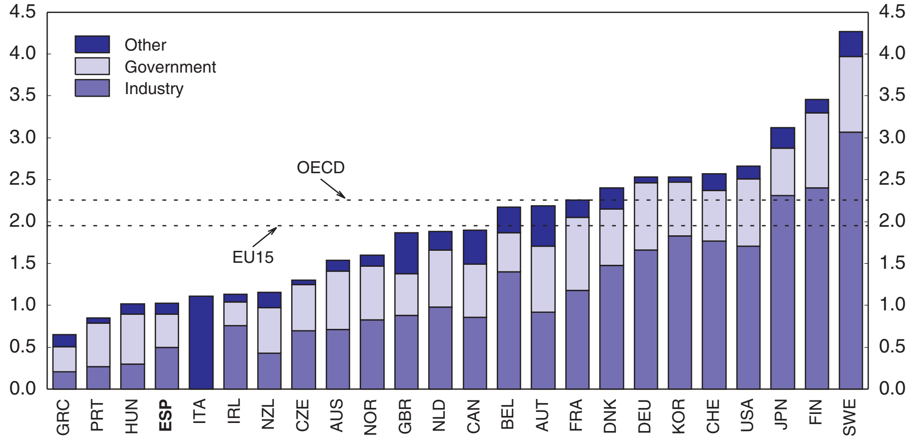
At age 15, 2003



Source: OECD (2004), *Learning for Tomorrow's World: First Results from PISA 2003.*

Figure 1.8. **Gross domestic expenditure on R&D**

By source of financing, in per cent of GDP, 2002[1]

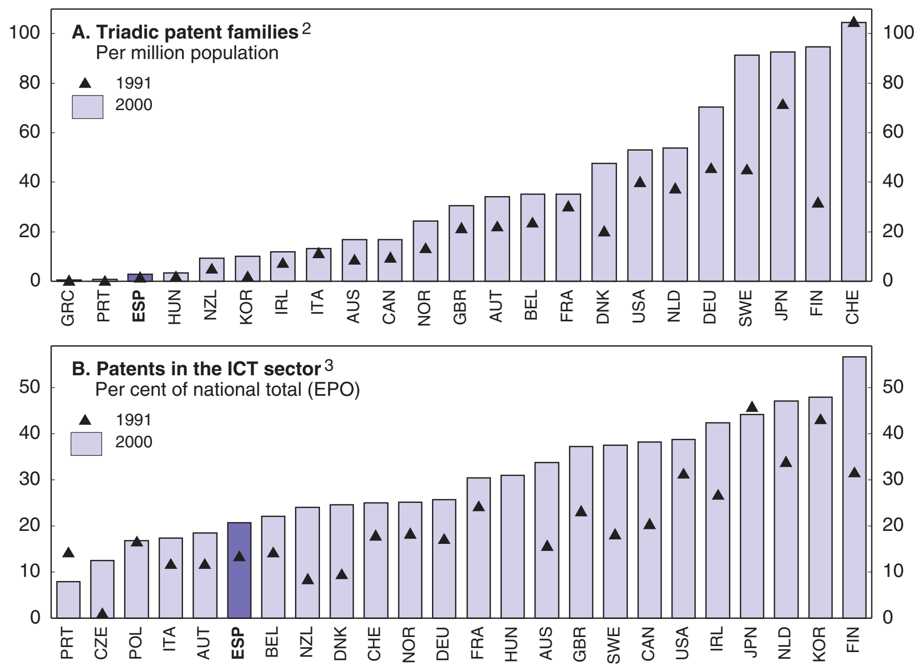


1. Or latest year. For Italy the breakdown of data by source of finance is not available.

Source: OECD (2004), *Main Science and Technology Indicators*, Vol. 2.

Figure 1.9. **Patent indicators for selected OECD countries**

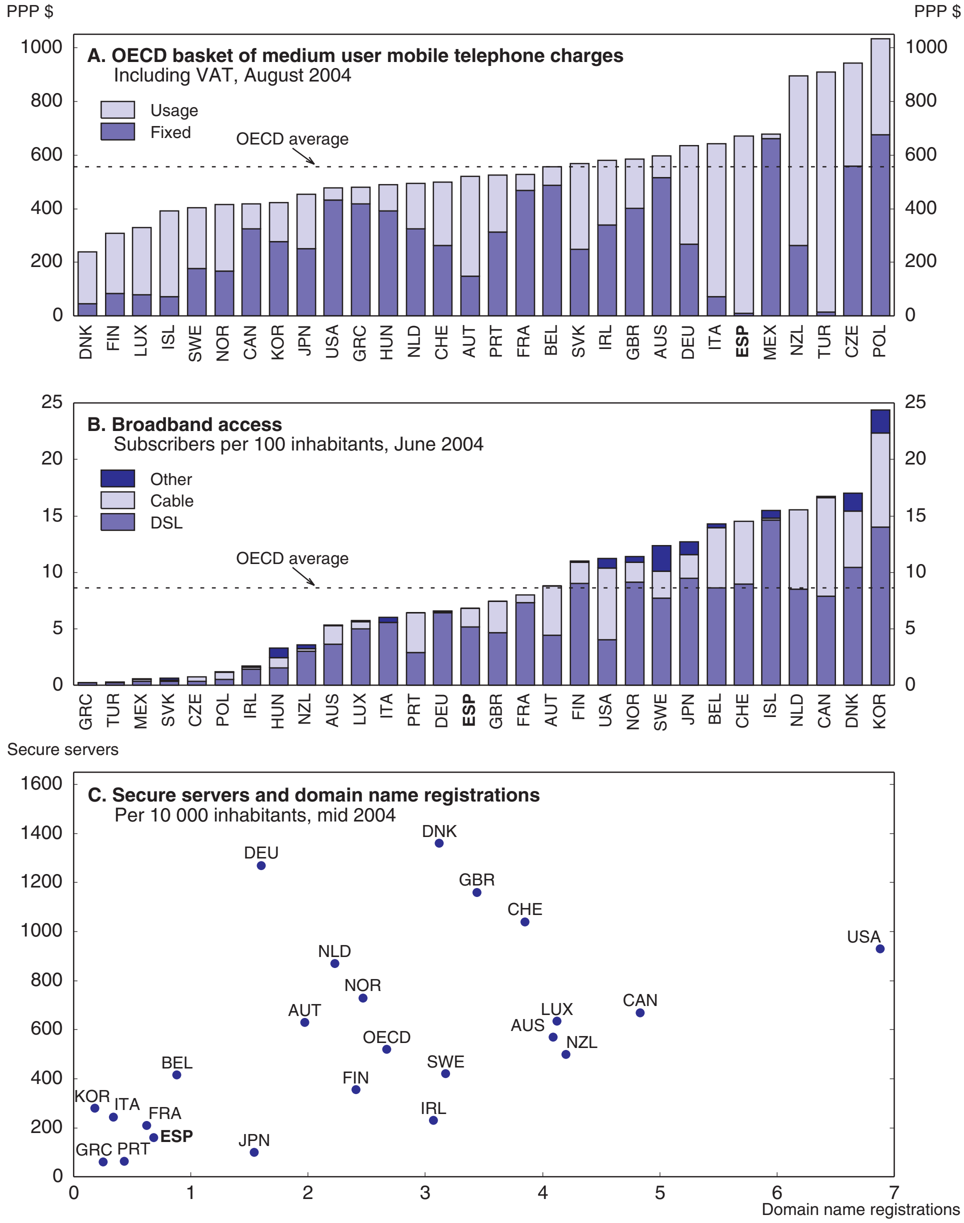
According to the residence of the inventors, by priority year[1]



1. The priority year is the year of the first international filing of a patent. 2000 figures are estimates.
2. Defined as patents filed at the European Patent Office (EPO), the US Patent and Trademark Office (USPTO) and the Japanese Patent Office (JPO).
3. Telecommunications, consumer electronics, computers, office machinery and other ICT.

Source: OECD (2004), *Compendium of Patent Statistics*.

Figure 1.10. **Telecommunications and ICT indicators**



Source: OECD, Key ICT Indicators and Telecommunications database, January 2005.

most generous R&D tax break in the OECD, and venture capital is mostly used for expanding activities and not for start-ups. The outcome of R&D activities, measured by the number of per capita patents, is also well below the OECD average (Figure 1.9). Concerning ICT capital, Spain lags behind (Figure 1.10). As elsewhere, investment in ICT capital has increased, but not at a higher rate than in other countries and Spain is at the bottom of OECD rankings for secured Internet servers or high speed Internet connections.

... which may hinder the ability of the economy to adapt to changes in international demand

Structural weaknesses relating to human capital could also undermine the adaptability of production structures to changes in the product composition of international demand. These difficulties can be highlighted in industry, where high-tech exports, which are small, have grown more slowly than in many other countries (Table 1.5). The correlation between the pattern of Spanish exports by product and OECD demand has also declined and is at present lower than for the ten new EU countries (Figure 1.11).[8] Spain's exports still consist essentially of low to medium-high technology goods (such as cars) for which price competitiveness plays an important role[9] and for which demand tends to be less buoyant than for high-technology products (Bravo and García, 2004). It is in these areas, moreover, that Spain is likely to face growing competition from the emerging countries which enjoy lower labour costs (Gordo, 2004).[10] Moreover foreign investment, which was a decisive factor in the restructuring of the economy (Crespo Galán and Velázquez Angona, 2003 and 2004),[11] is likely to play a more limited role in the future. Although the risks due to lower direct foreign investment and a relocation of companies to emerging countries seem no greater than in other countries, given that foreign firms find the large size of the Spanish market attractive (Buch *et al.*, 2001), new competitors could affect the sectoral pattern of investment flows. Indeed, capital inflows have continued in services sectors, but have been sluggish in industry since the mid-1990s. They have not declined in the low or medium-technology sectors such as automobiles, but there has been disinvestment by foreign firms in the high-technology sectors (Fernández-Otheo and Myro, 2003).

Table 1.5. **Share of high-technology products in total manufacturing exports**

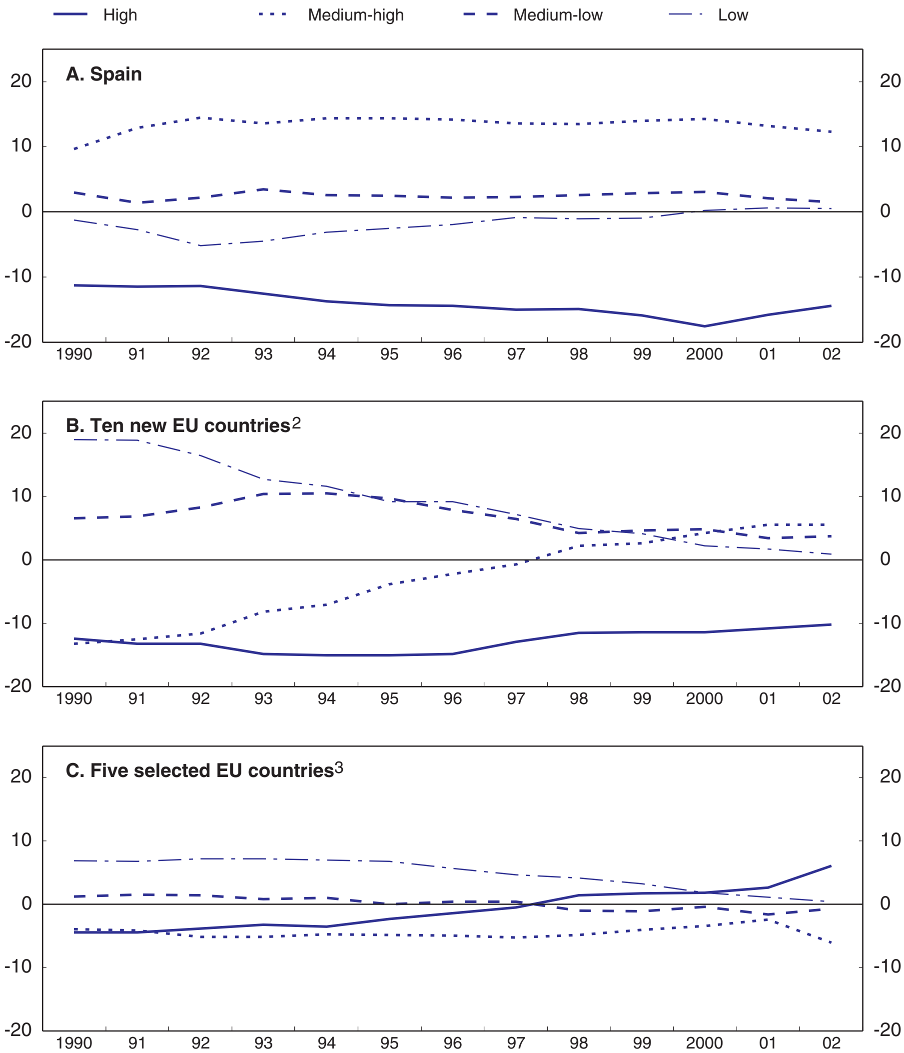
Average over period

	1980-82	1988-90	1991-93	1994-96	1997-99	2000-02
Spain	**4.9**	**8.4**	**9.4**	**9.3**	**9.4**	**10.4**
Belgium	6.8	7.6	8.7	9.9	12.0	16.2
Canada	7.9	9.6	11.3	10.9	13.0	14.2
Czech Republic	. .	. .	4.8	5.2	8.3	12.1
Denmark	8.7	13.0	13.3	15.2	18.0	21.1
France	11.1	15.9	18.5	19.5	22.9	25.1
Germany	11.9	13.9	15.0	15.3	17.5	20.0
Greece	1.5	2.1	2.6	3.8	6.2	9.7
Hungary	. .	. .	9.2	10.5	23.6	29.6
Ireland	18.2	34.3	34.5	40.0	48.5	55.4
Italy	7.8	10.0	10.3	9.8	10.1	11.8
Japan	20.6	30.5	30.4	31.4	31.0	30.9
Korea	. .	. .	. .	27.2	30.3	34.9
Netherlands	9.7	14.8	17.3	21.3	27.6	30.3
Poland	. .	. .	3.9	4.4	6.3	6.7
Portugal	8.2	6.0	6.0	7.3	8.0	10.5
Switzerland	24.9	25.8	27.8	28.9	32.1	36.2
United Kingdom	18.1	27.1	26.6	28.6	31.9	38.7
United States	25.6	33.8	33.5	33.1	36.7	37.5
European Union	10.9	14.7	15.9	17.1	20.2	23.4

Source: OECD, STAN Indicators 2004.

Figure 1.11. **Product specialisation developments**[1]

By technology level, per cent



1. Product specialisation is defined as the gap between the share of the product's exports relative to total exports in a given country or group of countries and the share of this product's imports relative to total imports of the OECD.
2. Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovak Republic and Slovenia.
3. Denmark, Finland, Ireland, Netherlands and Sweden.

Source: OECD, *Foreign Trade Statistics*.

Employment has risen sharply…

The excellent employment performance since the mid-1990s has raised the employment rate from 52% to 61%. Female employment has risen most rapidly, while the increase in the employment of older workers has also been substantial. Long-term unemployment has fallen from 54% to 40% of total unemployment, but is still above the OECD average (30%). These results are due both to the strong macroeconomic performance and positive labour market features. In particular, real wages have grown in line with productivity over the past decade as trade unions have moderated their attitude in wage negotiations. Immigration has also added to wage moderation, as most immigrants have a low reservation wage. Another key element has been the prevalence of temporary contracts, which now account for more than 30% of employees and have facilitated the incorporation of immigrants, the young and many women in the labour market. This high share of temporary jobs, which is partly due to the sectoral composition of output and to a larger extent to the sizeable gap in employment protection between permanent and temporary contracts, has, however, damaged productivity growth, as argued above.

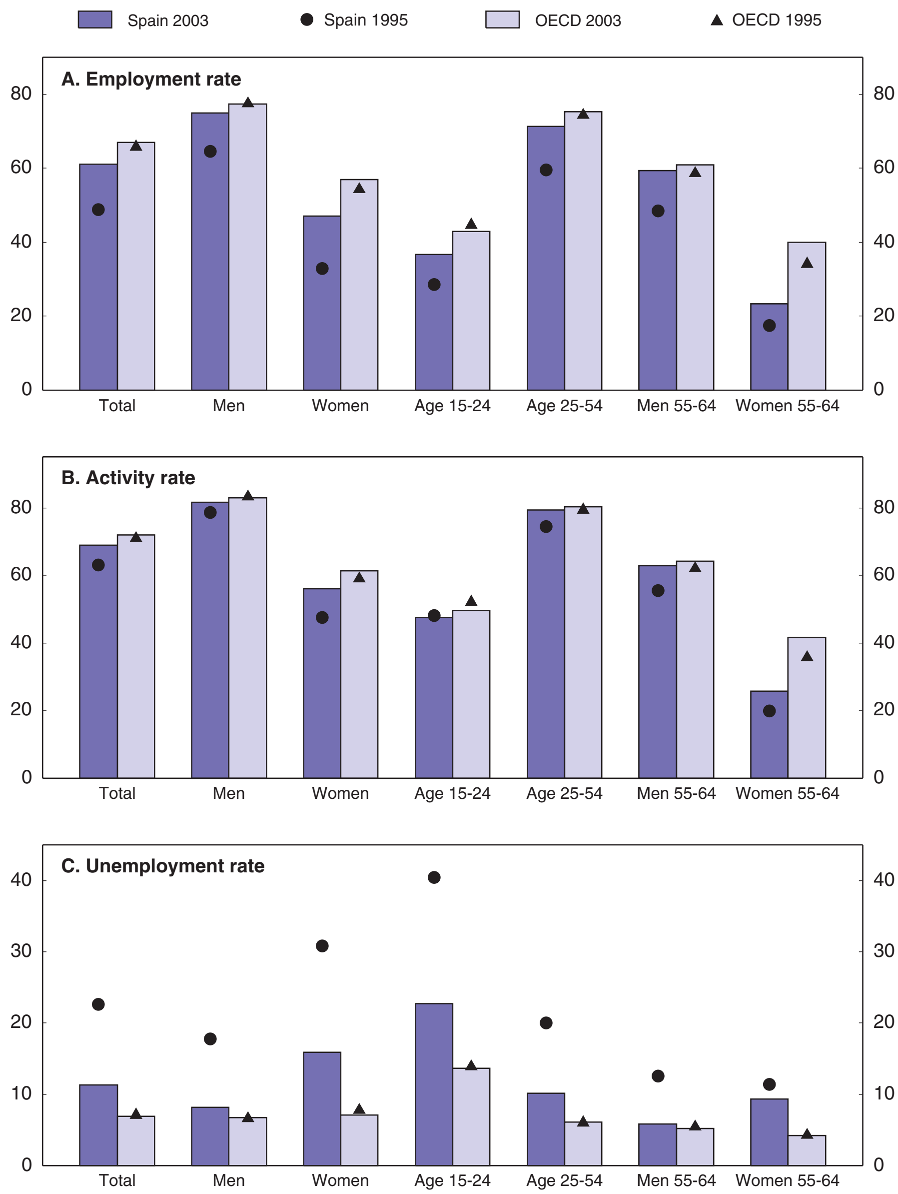
... but further progress is needed in this domain

There is still plenty of room left to improve labour market performance:

- The employment rate is 9 percentage points below the Lisbon target of 70% (Figure 1.12).
- Unemployment is above the EU average.

Figure 1.12. **Labour market indicators**

Per cent



Source: OECD database on Labour Force Statistics, November 2004.

- Participation is below the EU average, the latter being even less favourable for females and young workers.

This indicates that labour market problems affect female and young workers more than in other countries. This unequal incidence of employment and unemployment rates across age and gender groups is a feature of rigid labour markets, and points to the need for further reforms in this domain. Apart from relaxing the stringent employment protection for permanent workers, other reforms are needed. The wage bargaining framework, which is outdated, tends to keep inflation high. While minimum wages are relatively low, the government has announced a progressive increase of 30.3% over four years that has already started in July 2004. Unemployment benefit replacement rates are on par with those of other European countries, but they are not received by a sizeable proportion of the unemployed due to short employment histories. However, despite the 2002 reform that increased conditionality, the effective requirement of active job search for those receiving unemployment benefits has been very limited. A reform of passive labour market policy should go hand in hand with that of active policies, which are poorly financed and are not properly assessed and implemented (Table 1.6). These policies, which require changes in

Table 1.6. **Public expenditure on labour market policies**

As a percentage of GDP, 2002[1]

	Total	Passive measures	Active measures				
			Total	*of which:*			
				Administration PES[2]	Training	Subsidies	Other[3]
Spain	**2.42**	**1.55**	**0.87**	**0.09**	**0.22**	**0.45**	**0.11**
Australia	1.46	1.00	0.45	0.20	0.03	0.10	0.12
Austria	1.78	1.24	0.53	0.14	0.21	0.10	0.08
Belgium	3.65	2.40	1.25	0.21	0.30	0.60	0.14
Canada	1.23	0.80	0.42	0.20	0.15	0.03	0.04
Czech Republic	0.45	0.27	0.17	0.07	0.02	0.06	0.02
Denmark	4.63	3.04	1.58	0.12	0.86	0.17	0.43
Finland	3.07	2.06	1.01	0.12	0.30	0.33	0.26
France	3.06	1.25	1.81	0.18	0.23	0.35	1.05
Germany	3.31	2.13	1.18	0.23	0.34	0.22	0.39
Greece	0.93	0.47	0.46	0.06	0.21	0.08	0.11
Hungary	0.90	0.37	0.52	0.12	0.06	0.34	0.00
Ireland	1.83	0.70	1.14	0.24	0.15	0.53	0.22
Italy	. .	0.63	. .	. .	0.05	0.32	. .
Japan	0.76	0.48	0.28	0.18	0.04	0.06	0.00
Korea	0.41	0.14	0.27	0.05	0.07	0.11	0.04
Netherlands	3.56	1.85	1.72	0.28	0.60	0.33	0.51
New Zealand	1.66	1.14	0.51	0.12	0.12	0.08	0.19
Norway	1.41	0.54	0.87	0.13	0.05	0.01	0.68
Portugal	1.51	0.90	0.61	0.11	0.15	0.09	0.26
Slovak Republic	0.94	0.48	0.46	0.15	0.04	0.21	0.06
Sweden	2.45	1.05	1.40	0.37	0.29	0.21	0.53
Switzerland	1.30	0.77	0.53	0.11	0.13	0.13	0.16
United Kingdom	0.75	0.37	0.37	0.17	0.02	0.03	0.15
United States	0.71	0.55	0.15	0.04	0.03	0.01	0.07
Country mean	1.84	1.05	0.77	0.15	0.19	0.20	0.23

1. Or latest available data.
2. PES: Public employment service.
3. Includes measures targeted at young and disabled workers.

Source: OECD (2004), *OECD Employment Outlook*.

different complementary areas, are analysed in Chapter 3, which also considers the need for a comprehensive approach to reform to benefit from political economy aspects. The chapter also discusses reforms that would underpin a stronger productivity performance.

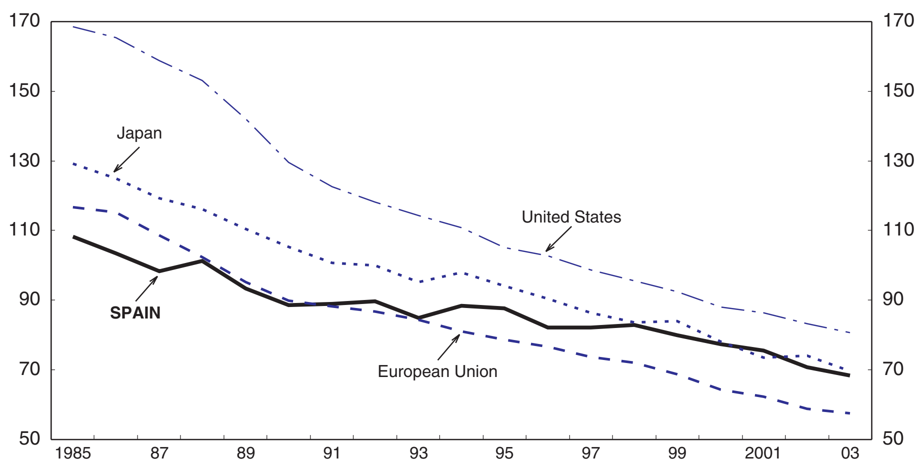
Implementing a strategy in response to global warming

Complying with the commitments related to environmental policy is another important policy challenge. This concerns in particular greenhouse gas emissions. To comply with the Kyoto protocol commitment, Spain's greenhouse gas emissions should not exceed their 1990 level by more than 15% in 2012. Emissions have risen sharply, exceeding the 1990 level by over 40% in 2002. This is not only the result of rapid growth, but also due to a delay in putting in place an emission abatement strategy. If the present trend were to continue, the 1990 level would be exceeded by 58% in 2012. A major shift in climate change related policies has however taken place over the last months:

- *First*, a system for allocating emission rights has been put in place for the electricity and five main industrial sectors, which account for some 40% of total emissions. The system is in line with EU directives that have established a European market for emission rights in 2005. For 2005-07, emissions of these sectors should be stabilised. The government has created emission rights factory by factory and has introduced penalties including fines of up to € 2 million and the closure of industrial installations which exceed their emission rights beyond those they have acquired. For the period 2008-12, the goal is to reduce emissions to 24% above the 1990 level. The difference with the Kyoto commitment will be covered by flexible mechanisms of the Kyoto protocol such as investing in projects in Latin America and by the estimated absorption by sinks. The cost of purchasing additional emissions rights through the Kyoto protocol mechanisms on the basis of € 5 per ton of carbon would be equivalent to € ½ billion per year.
- *Second,* an energy saving strategy mainly targeting the sectors not covered by the European initiative is currently being drawn up. In the present context of high oil prices, the need for an energy saving strategy is much greater in Spain because it is more dependent on oil than are the other European countries (Figure 1.13). For 2005 the

Figure 1.13. **Oil consumption intensity per GDP unit**

Tons per million PPP $



Source: OECD, *National Accounts* and IEA (2004), *Oil Information.*

government is preparing a law that aims at improving the thermal insulation norms applying to buildings dating from 1979. The cost of adapting to these norms could soon be recuperated thanks to energy savings. Other measures being considered include reducing the maximum speed of road transport and introducing urban tolls.

- *Third*, the renewable energy development plan will be revised, which at present aims to double the contribution made by such energy sources, bringing it up to 12% of total supply by 2010. The government plans to triple wind power production, which is already fairly well developed. It also plans to promote the use of solar panels, which are not yet very common.

These reforms move in the right direction, but seem too limited. Efforts to reduce emissions in earnest will not take effect until 2008. According to official estimates, the cost of the plan to industry ought to be very limited over the period 2005-07: some € 85 million per year. As of 2008, however, the Economic and Social Council predicts that the cost could be higher, especially if efforts are not soon made to lower diffuse emissions (CES, 2004). The introduction of a carbon tax would provide a cost effective way of reducing emissions in the sectors not covered by the Community's emission trading scheme. A green certificate market could also be used to ensure a cost-efficient increase in renewable energy production. But it is important to ensure that the promotion of such energy sources does not result in a high net cost to society. The restructuring of the coal industry and gradual abolition of the subsidies it receives should also be continued. Above all, the authorities need to pursue their current initiative and urgently review all options, carry out careful evaluations of their cost and benefits and then set out a more comprehensive programme for meeting the Kyoto objectives at least cost.

Ensuring sound public finances, while keeping a lid on spending in a decentralised framework

Pursuing a sound fiscal policy constitutes a major challenge

Considerable progress with fiscal consolidation has been made since the mid-1990s. The general government account has moved into balance while tax pressure is relatively low. The need to preserve the benefits of fiscal consolidation is recognised by the government and enjoys a consensus in Spain. There are, however, questions as to the best way of achieving this objective, bearing in mind the very decentralised way government is organised, the probable upward pressure on expenditure in the future and the need to ensure that fiscal policy takes into account cyclical developments.

Maintaining sound public finances is not going to be easy in the medium term: there is likely to be less room than in the past for reducing interest payments; spending will increase as a result of financing the new government's priorities as regards investment in infrastructure, research and development and education; and, lastly, the already noticeable pressure on welfare spending – and particularly on education, which shows a strong upward drift – can be expected to persist. With the increased decentralisation of recent years the regional and local authorities, which have more staff to manage than does central government and now have responsibility for spending on education, the social services and health, will be especially exposed to these pressures which are going to be exacerbated by population ageing.

The transfer of responsibilities between central government and the regions, which has been ongoing since the late 1970s, also poses problems relating to co-ordination between the different levels of government and creates pressures on public spending. The present financing system is not closely aligned with demographic pressures due to immigration, with a fiscal impact that differs across the regions. Also, the prospect of European regional funds diminishing as of 2007 as a result of EU enlargement will entail additional efforts to make spending effective so as to ensure the development of quality infrastructure throughout the country. Against this background and following the recent transfers of responsibility, reforms must ensure that the conditions are in place for regions to manage their resources and tax powers in a manner which is both efficient and in line with the preferences of the inhabitants. Chapter 4 evaluates the economic policy options to improve relations between the different levels of government so as to contain the upward drift in public spending, make it more effective and develop quality public services.

A further objective of the fiscal policy reforms is to ensure that fiscal discipline and co-ordination are compatible across the different levels of government. The present system, which requires that accounts be kept permanently in balance or in surplus at each individual level of government, seems too rigid. It tends to encourage the development of off-budget operations by the territorial authorities, which is detrimental to fiscal transparency. In addition, it is liable to result in fiscal policy being pro-cyclical, which can lead to difficulties in economic management as Spain no longer has an independent monetary policy.

The pension system's long-term financial viability has to be ensured

In the longer term, the main challenge is to guarantee the financial viability of the public pension schemes which are not actuarially fair because of the very generous parameters underlying pension calculations. Little progress has been made in reforming these schemes in recent years. Chapter 5 will highlight reform options to cope with the challenge of ageing, which comes later, but is likely to be more marked than in other countries. Also discussed will be the role that could be played by measures to increase the employment rate, including higher immigration, and by raising contributions so as to ensure pension funding over the long term. In view of the scale of the challenge, which does not yet seem to have been grasped by the public, Chapter 5 discusses also the necessity to accumulate assets in the next years to cope with the fiscal consequences of ageing.

The government's strategy in perspective

Against this background, the new government has embarked on an ambitious strategy that aims at modifying the growth pattern of the economy, favouring the development of higher value added sectors. It will introduce productivity enhancing measures by raising R&D spending and education outlays. At the same time, it will aim at balancing the budget over the business cycle rather than every year, while maintaining taxation stable at a relatively low level. Annex A provides more detail on the government's priorities, and compares them with the main policy recommendations discussed in this survey.

Notes

1. According to the Bureau of Labour Statistics, hourly labour costs in Spanish manufacturing, measured in dollars, was equal to 56% of the cost in the United States in 2002, whereas it was equal to 63% for the EU15 average. On the basis of purchasing power parity indicators, the average price differential between Spain and EU15 was 17% in 2002.
2. According to the Bank of Spain, a 1% gap between the level of indebtedness and its equilibrium value will reduce consumption by 0.11% and loan demand by 0.15% (Bank of Spain, 2004c).

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3. Molina and Restoy (2004) suggest that, while in 1990 a permanent 2 percentage point rise in short and long-term interest rates meant a 1.2% fall in GDP after three years, the fall reached 1.8% of GDP in 2002. They argue that this increased sensitivity is mainly due to stronger wealth effects.

4. At business cycle frequencies, and contrary to most other countries, labour productivity and GDP are also negatively correlated in Spain (*i.e.* productivity growth may increase as output growth falls) because recessions are associated with significant job destruction due to large sectoral shifts (1980s) or to flexibility of employment at the margin linked to the high share of temporary jobs. In most other countries recessions are periods of labour hoarding and recorded productivity growth falls as output growth declines.

5. While the average employment rate is still below the European Union and OECD average, the number of hours worked on average per employee is higher than in most other countries. Consequently, the utilisation of labour resources, measured by the total number of hours worked divided by the working age population, is above the EU average.

6. This national accounts revision might modify the level of GDP since the base year.

7. Between 1984 and 1996 the average growth rates of equipment and construction investment were, respectively, 5.2% and 4.7%, whereas between 1996 and 2004 they were 4.8% and 5.6%. Considering the much higher employment growth over the recent cycle, the evolution of the capital-employment ratio has contributed less to labour productivity growth.

8. The correlation between the pattern of Spain's industrial exports by product (measured on the basis of a breakdown into 20 sectors) and OECD demand fell from 0.83 in 1990 to 0.72 in 2000. Taking the average for the ten new EU countries, the correlation was 0.86 in 2000.

9. Spain's specialisation in traditional industries seems to partly reflect the fact that Spanish exports are more price-elastic than those of most other OECD countries (Buisán and Caballero, 2003 and Pain *et al.*, 2005).

10. The correlation between the pattern of Spanish exports by product and that of the ten new countries that have acceded to the European Union increased from 0.38 in 1990 to 0.80 in 2000.

11. This investment fostered transfers of technology and partly made up for the low level of domestic expenditure devoted to R&D (Barrios *et al.*, 2002). According to Fernández-Otheo and Myro (2003), over 40% of output and 30% of employment in manufacturing was in the hands of non-residents and foreign capital penetration reached 70% of value added in the automobile industry in the late 1990s.

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Chapter 2

Preserving macroeconomic stability and competitiveness

The persistence of a sizeable inflation differential with the euro area and a boom in the housing market represent the two most important risks threatening the dynamism of the economy over the medium term. This chapter discusses the structural and fiscal policy options which could ease these tensions. It will focus in particular on improvements to the wage bargaining system, ways to strengthen competition in sheltered sectors and reforms of housing policy.

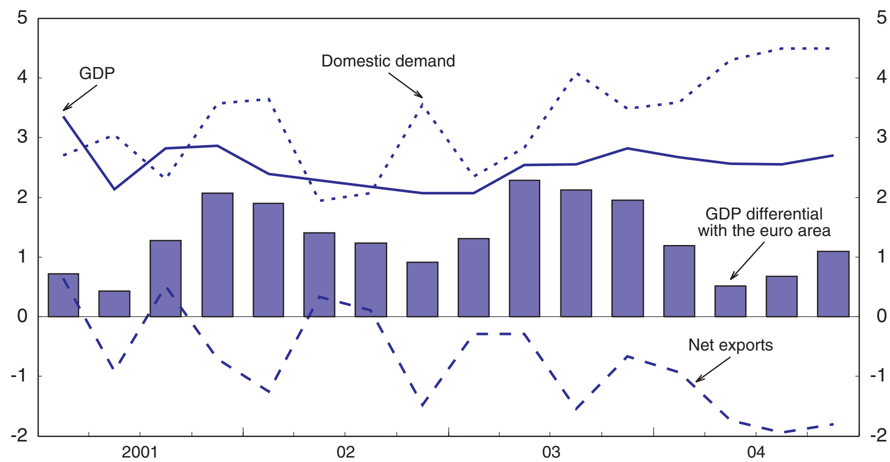
Recent trends and short-term prospects

Despite slowing, activity continued to grow faster than in the euro area

Spain has maintained a positive growth differential *vis-à-vis* the euro area average, but it narrowed in 2004 as a result of a less favourable foreign trade performance (Figure 2.1). Real GDP growth, which gathered steam throughout 2003, has stabilised since early 2004, fluctuating around 2¾ per cent. Output growth was boosted by strong domestic demand (Table 2.1). The gradual improvement in the international environment, a sound financial situation and good profitability propelled business investment, while spending by both households and general government remained buoyant. Continuing substantial job creation and sharply rising property prices have had a favourable impact on household incomes and wealth. Also low real interest rates underpinned household spending and business investment, and was accompanied by a further increase in household borrowing while lending capacity remained very low (Table 2.2).

Figure 2.1. **Domestic and foreign demand developments**

Year-on-year percentage changes



Source: OECD (2004), *OECD Economic Outlook*, No. 76, and INE.

The increasingly negative contribution of foreign trade to activity in 2004 reflected the surge in imports due to the steep rise in domestic demand which more than offset the upturn in exports. The ability of Spanish enterprises to face foreign competition on their domestic market and to take full advantage of the pick-up in foreign demand has been hampered by the appreciation of the euro and the positive inflation differential with the main competitors in the euro area. Tourism's modest improvement in 2004 meant that sluggish activity in this sector since 2001 continued, following the strong growth posted in the second part of the 1990s. Spain's "beach and sun" tourism, which accounts for some

Table 2.1. **Recent trends**

Year-on-year percentage changes (1995 prices)

	Average 1991-2000	2001	2002	2003	2004	2004			
						Q1	Q2	Q3	Q4
Private consumption	2.4	2.8	2.9	2.9	3.5	3.4	3.6	3.5	3.5
Government consumption	3.3	3.5	4.1	3.9	4.9	4.6	4.7	4.8	5.4
Gross fixed investment	3.0	3.0	1.7	3.2	4.6	2.7	4.0	5.8	6.0
Construction	2.5	5.3	5.2	4.3	4.4	4.2	4.1	4.6	4.9
Machinery and equipment	3.6	0.4	–2.6	1.7	4.9	0.7	3.8	7.5	7.4
Final domestic demand	2.7	3.0	2.8	3.1	4.0	3.4	3.9	4.3	4.5
Total domestic demand	2.7	2.9	2.8	3.2	4.2	3.6	4.3	4.5	4.5
Exports of goods and services	10.1	3.6	1.2	2.6	4.5	5.5	3.3	4.1	5.2
Imports of goods and services	9.2	3.9	3.1	4.8	9.0	8.0	8.2	9.5	10.2
Foreign balance[1]	0.0	–0.2	–0.6	–0.8	–1.7	–1.0	–1.7	–2.0	–1.9
Gross domestic product	**2.7**	**2.8**	**2.2**	**2.5**	**2.7**	**2.7**	**2.6**	**2.6**	**2.7**
Output gap (level)	–1.3	0.8	0.0	–0.5	–0.7	. .	. .	. .	. .
GDP price deflator	4.1	4.2	4.5	4.0	4.4	4.1	4.5	4.5	4.7
Private consumption deflator	4.2	3.3	3.4	3.1	3.0	2.5	2.9	3.3	3.3
Total employment	1.4	2.5	1.4	1.7	2.1	2.1	2.0	2.1	2.2
Productivity	1.3	0.3	0.9	0.7	0.6	0.6	0.6	0.6	0.5
Household saving ratio (%)	12.8	10.3	10.6	10.6	10.7	. .	. .	. .	. .

1. Contributions to GDP growth, at annual rate.

Source: INE.

Table 2.2. **Financial position of the economic sectors**

Per cent of GDP

	1998	1999	2000	2001	2002	2003
Gross saving						
Total economy	22.4	22.5	22.3	22.5	22.8	22.6
Financial corporations	1.6	1.0	1.5	2.2	2.0	2.0
General government	1.2	2.9	3.1	3.7	4.1	4.4
Non-financial firms	11.4	11.2	10.7	9.9	9.8	9.4
Households[1]	8.2	7.4	7.0	6.7	6.9	6.8
Capital transfers and investment						
Total economy	–22.2	–23.5	–24.8	–24.7	–24.3	–24.7
Financial corporations	–0.5	–0.5	–0.7	–0.6	–0.5	–0.6
General government	–4.2	–4.0	–4.0	–4.1	–4.3	–4.0
Non-financial firms	–12.5	–13.5	–14.4	–14.0	–13.5	–13.6
Households[1]	–5.0	–5.4	–5.7	–5.9	–6.0	–6.6
Net lending						
Total economy	0.2	–1.0	–2.5	–2.2	–1.6	–2.1
Financial corporations	1.1	0.5	0.8	1.5	1.5	1.5
General government	–3.0	–1.2	–0.9	–0.4	–0.1	0.4
Non-financial firms	–1.1	–2.3	–3.7	–4.2	–3.7	–4.2
Households[1]	3.2	2.0	1.3	0.8	0.8	0.3
	2003			2004		
	Q2	Q3	Q4	Q1	Q2	Q3
Net lending						
Total economy	–1.6	–2.6	–0.9	–4.4	–4.7	–5.5
Financial corporations	1.0	1.3	1.8	2.2	0.9	0.8
General government	–2.2	2.2	–1.3	2.0	–1.4	3.3
Non-financial firms and households[1]	–0.4	–6.2	–1.4	–8.6	–4.2	–9.6

1. Including non-profit institutions serving households.

Source: Bank of Spain (2005), *Financial Accounts of the Spanish Economy*, January.

12% of GDP, is facing increasing competition from less costly destinations in the Mediterranean and Caribbean which offer much the same services (Bravo Cabria, 2004).[1] The hotel trade, too, has suffered from the increasing number of homes being bought by non-residents who make them available to family and friends.

Productivity gains remained low, at approximately ½ per cent, while employment continued to increase rapidly. According to national accounts data, job creation measured in full-time equivalents accelerated slightly in conjunction with the strengthening of activity. The increase in the labour force, which reached 2% on average in 2004, mainly benefited the sheltered sectors of the economy (services, construction) which enjoyed a sharp rise in female and immigrant labour supply.[2] The downturn in industrial employment in 2003, caused by the squeeze in profit margins resulting, in part, from higher wage costs, has come to an end in the last quarter of 2004. Unemployment currently stands below 10½ per cent of the labour force, down by almost 1 percentage point on 2003. After easing in 2003 and early 2004, inflationary pressures were rekindled by the increase in oil and commodity prices. In February 2005, consumer price inflation ran at 3.3% (year-on-year), which was about 1¼ percentage point more than in February 2004. Having narrowed to ½ of a percentage point in early 2004, the inflation differential with the euro area average has widened again to approximately 1 percentage point.

Short-term prospects

Growth was 2¾ per cent in 2004 and should settle at around 2¾-3 per cent on average in 2005 and 2006, *i.e.* close to potential (Table 2.3).[3] The main driving force will again be domestic demand. Business investment should be stimulated by continuing low real interest rates and the increase in foreign demand. Private consumption could maintain its dynamism, with employment growth remaining strong and unemployment falling slightly. Households should continue to enjoy a positive wealth effect due to the rise in property prices, although this could ease somewhat with the slight slowdown expected in this sector. Foreign trade, on the other hand, will continue to curb the dynamism of production, thereby perpetuating the growth pattern observed in recent years. In view of the rise in oil prices, inflation could be around 3% in 2005, before receding to 2¾ per cent in 2006, given the persistence of a slightly negative output gap. The inflation differential with the euro area average will however remain at about 1 percentage point. This will keep real interest rates low and will continue to stimulate domestic demand, but it will also undermine the economy's international competitiveness. All in all, activity is set to outpace the euro area average, but the differential is likely to be smaller than in previous years.

In the short term, the main risks relate to the international environment and to developments in oil and commodity prices. OECD estimates suggest that a 5% effective appreciation of the euro would lead to a weakening of output in the euro area by nearly ½ per cent in 2005, while it would lower inflation by ¼ of a percentage point. On the other hand, a decrease of $10 per barrel of oil would raise growth by approximately ¼-½ of a percentage point in the euro area countries on average in 2005 and cause inflation to fall by about ¼-½ of a percentage point. The impact of such a shock could be somewhat stronger in Spain because of a higher oil dependency. Over the longer term, Spain's continued good performance could be jeopardized by the imbalances underlying its growth pattern in recent years. In the absence of policy changes, the inflation differential will erode the competitive advantage that Spanish enterprises enjoy in terms of cost and price levels, and this will gradually weaken the country's economic performance. The imbalance between

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Table 2.3. **Short-term prospects**

Percentage changes from previous period[1]

	Current prices, billion €, 2001	2002	2003	2004	2005	2006
Private consumption	381.9	2.9	2.9	3.5	3.2	3.3
Government consumption	115.1	4.1	3.9	4.9	3.4	3.0
Gross fixed investment	165.4	1.7	3.2	4.6	4.2	4.1
Construction	92.9	5.2	4.3	4.4	3.6	3.0
Machinery and equipment	72.5	–2.6	1.7	4.9	5.0	5.5
Stockbuilding[2]	1.9	0.0	0.1	0.2	0.0	0.0
Total domestic demand	664.3	2.8	3.2	4.2	3.4	3.5
Exports of goods and services	195.6	1.2	2.6	4.5	6.8	7.4
Imports of goods and services	206.0	3.1	4.8	9.0	8.3	8.1
Foreign balance[2]	–10.4	–0.6	–0.8	–1.7	–0.9	–0.6
Gross domestic product	**653.9**	**2.2**	**2.5**	**2.7**	**2.7**	**3.0**
Household saving ratio[3] (%)	. .	10.6	10.6	10.7	11.0	11.0
Private consumption deflator	. .	3.4	3.1	3.0	3.0	2.7
GDP price deflator	. .	4.5	4.0	4.4	3.5	3.6
Wage rate, total economy	. .	4.3	4.3	4.0	4.1	3.8
Unit labour cost, total economy	. .	3.9	4.1	3.4	3.8	3.2
Output gap[4] (%)	. .	0.0	–0.5	–0.7	–0.8	–0.6
As a % of GDP:						
Current account balance	. .	–2.4	–2.8	–4.5	–5.7	–4.8
Net government lending	. .	–0.1	0.4	–0.3	–0.1	–0.1
Primary government balance	. .	2.4	2.6	1.2	2.0	1.9

1. At constant 1995 prices for GDP and its components.
2. Contribution to GDP growth.
3. Household saving as a percentage of household disposable income.
4. Deviations of actual GDP from potential GDP as a percentage of potential GDP.

Source: INE and OECD estimates based on *OECD Economic Outlook*, No. 76.

developments in foreign and domestic demand, which favours the sheltered sectors, will be accentuated by the persistence of monetary conditions that are too easy, which encourages household borrowing and investment. These imbalances are also affected by housing policy, which partly underpins the strong momentum of residential construction and could keep house prices rising steeply in the short term. But this would increase the risk of a sharp fall in the medium term.

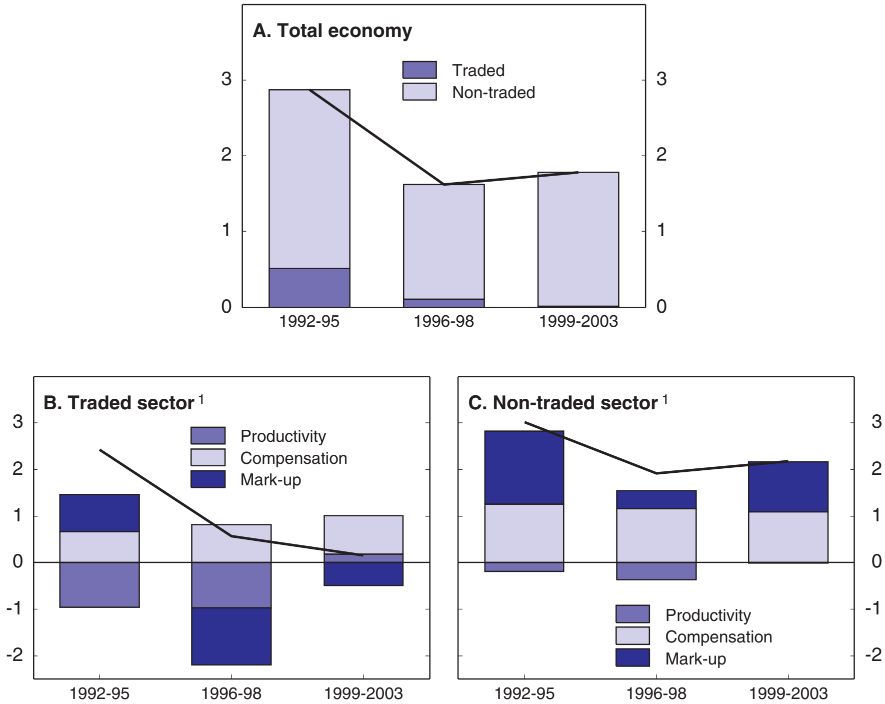
Reducing the inflation differential with the euro area

Structural reforms of labour, goods and services markets are needed

Reforms should focus on reducing the sizeable inflation differential with the euro area. It can be partly related to demand pressures, which have increased more rapidly than in the euro area over the last years, even though the more pronounced dynamism of Spanish demand was partly matched by higher potential output growth. Indeed, given the improved labour market performance and the sharp rise in immigration, most available trend growth estimates are close to 3% (Estrada *et al.*, 2004) whereas they are around 2% for the euro area. Demand pressure as gauged by output gaps, which was significantly lower than in the euro area until the middle of the 1990s, became similar or even slightly stronger since the early 2000s (Figure 2.2). However, significant uncertainties surround such estimates, in particular in the case of Spain because of the structural changes that have affected the labour market.[4] Nevertheless, various indirect indicators, such as real wage

Figure 2.2. **Decomposition of inflation differential between Spain and the euro area**

Per cent



1. Due to limited data availability, the traded sector includes only the manufacturing sector and the non-traded all others. A negative differential means that Spanish growth is below the euro area average.

Source: Eurostat, New Cronos database, December 2004.

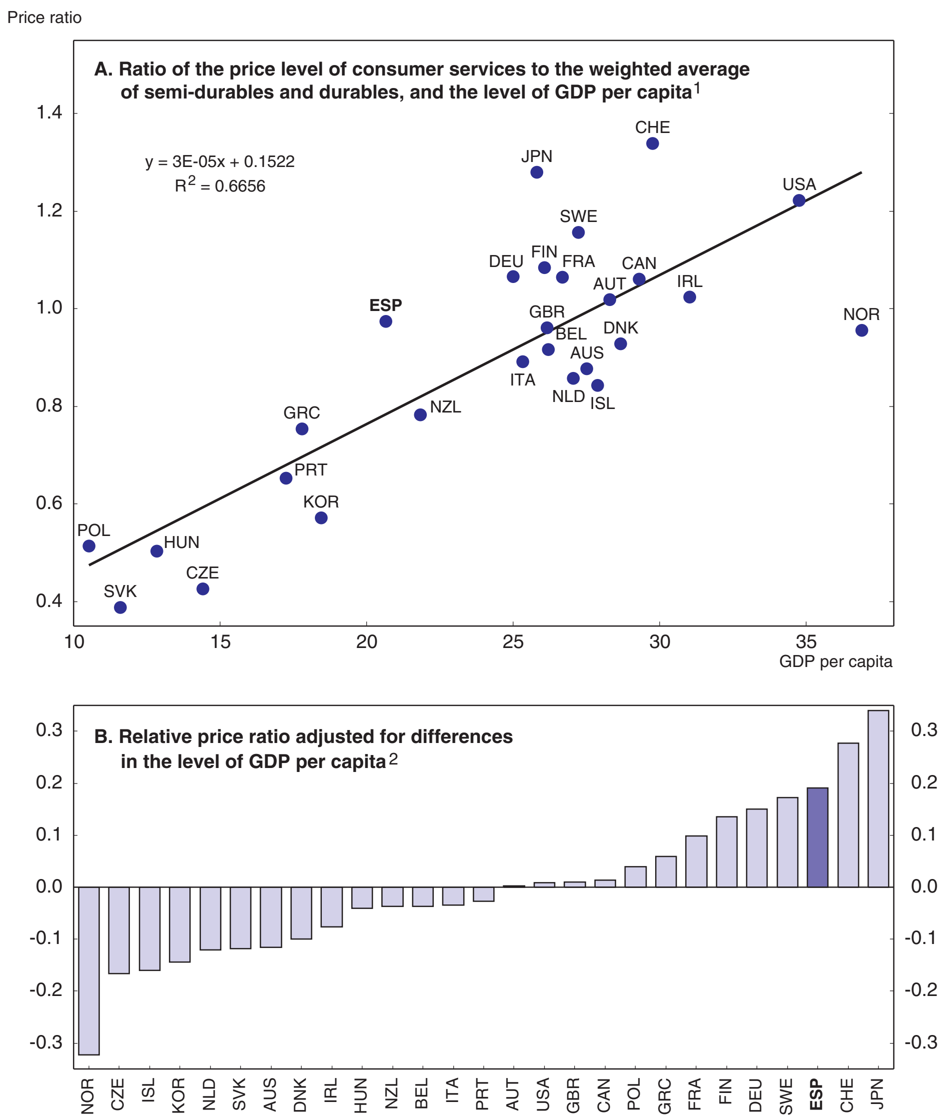
moderation, suggest that the strength of these tensions is probably quite limited, in particular on the labour market.[5]

Although the overall level of demand pressures appears to be similar in Spain and in the euro area, the incidence of these pressures has differed a lot between the exposed and sheltered sectors. The growth gap of domestic demand with the euro area has been much more marked than that of production.[6] This has accentuated the dual inflation problem, even though its main roots stem from deficiencies in labour, goods and services markets. The inflation differential is largely due to higher trend growth in labour costs and profit margins than in the euro area since the mid-1990s. The increase in margins is concentrated in the sheltered sectors (Figure 2.2) and is particularly marked in the construction and energy sectors. While strong demand in some of these industries has no doubt contributed, inadequate competitive pressure in some of these sectors has also tended to push prices up (Estrada and López-Salido, 2002 and Siotis, 2003). Production and distribution are, for example, very concentrated in the energy sector, with very little foreign competition, while in the retail sector there are also major obstacles to fierce competition (see below).[7] Abstracting from differences in per capita GDP across countries, relative prices of services appear high in international comparison (Figure 2.3).

Overly rigid wage bargaining is also at the origin of inflation inertia. The relatively high inflation expectations and the frequent existence of safeguard clauses that guarantee that

Figure 2.3. **Relative price of services and GDP per capita**

2002



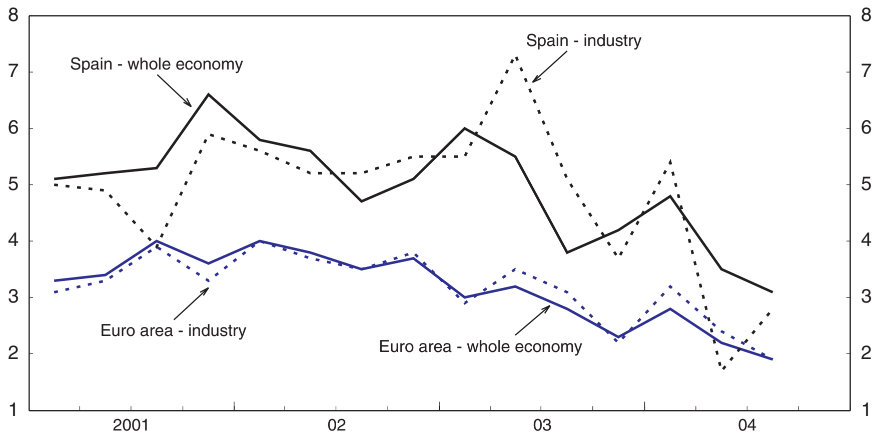
1. Consumer services is a proxy for non-tradable goods and semi-durables and durables are a proxy for tradable goods. The level of GDP per capita (in thousand $) is for 2002 on the basis of 2000 purchasing power parities.
2. Measured as the difference in the actual minus the fitted value of the price ratio appearing in panel A.

Source: OECD (2005), *Economic Policy Reform: Going for Growth*.

wage-earners' purchasing power will be maintained in the event of inflation surprises reinforce wage and price inertia, even though real wage growth has remained moderate in recent years.[8] The increase in energy prices in 1999, whose initial impact on inflation appeared somewhat more marked than in the other countries because of the higher oil dependency in Spain, triggered these safeguard clauses, which gave a lasting stimulus to inflation in the following years. Something similar is likely to happen again if oil prices remain high. Likewise, according to López-Salido *et al.* (2004), the high degree of wage rigidity combined with an expansion biased towards the demand of non-tradable goods has contributed significantly to the persistence of the inflation differential with the euro area. A rise in profit margins in the sheltered sectors, passed on by the wage indexation mechanisms, increases pressure on the exposed sector and reduces competitiveness. In the industrial sector, for example, where there is fierce international competition and where productivity gains have been modest, the rise in hourly labour costs has in the last few years remained stronger than in other sectors – in contrast with the situation in the euro area (Figure 2.4). Hourly labour costs in industry have come down in recent quarters, but these data do not yet include the wage increases that will be triggered by the catch-up clauses.[9]

Figure 2.4. **Hourly labour costs**

Year-on-year percentage changes[1]



1. The data shown are in nominal terms and not seasonally adjusted.

Source: Eurostat, New Cronos database, February 2005.

Reforming the wage bargaining system is key for taming inflation and lifting productivity performance

The collective bargaining system is complex. Negotiations at the company level are rare (affecting between 10% and 15% of workers), and cover mostly large firms and specific sectors, such as energy and mining companies. Industry level negotiations at the provincial and inter-provincial level are widespread, and affect mainly medium-sized and small firms that often operate in low productivity sectors (hotels and restaurants, construction and agriculture). National sectoral bargaining takes place in some other sectors, like financial services. Different levels of bargaining can co-exist, complicating the framework, with minimum conditions often set in higher level agreements that are then topped-up in lower level agreements. This prevalence of intermediate level negotiations is often considered inferior to either centralisation or decentralisation, as it impedes the matching of wage increases with productivity performance at the company level, while not taking advantage of benefits that may stem from coordination at the national level, especially on wage restraint in periods of high inflation (Calmfors and Driffill, 1988; and Layard *et al.*, 1991). In addition, by an extension clause, agreements cover all firms in an area and sector, including those enterprises that have not participated in the negotiations. Indeed, trade unions and business organisations receive their power to negotiate from elections rather than affiliation, and negotiate in the name of all firms in their respective sector and area. This general framework dates from the early 1980s, when the Worker Statute (1980) aimed

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at extending workers' rights through collective agreements. It was modified by subsequent reforms that attempted to decentralize the system (in 1994) or strengthen elements of coordination (in 1997). They had little effect and, being only partial, have not affected much the backbone of the system, the complex network of negotiations at the intermediate level.

In recent years real wage growth has been relatively moderate, with increases of 0.5% per annum between 1995 and 2003. Wage restraint is due to several factors. The attitude of unions has become more cautious, as they witnessed the sharp rise in unemployment in the early 1990s, while many workers with lower reservation wages, mostly temporary workers and immigrants, have entered the labour market. Moreover, several wage agreements were struck at the national level since the end of the 1990s that provided general guidelines for wage increases and helped moderate wage outcomes in lower level negotiations. Whatever the causes, real wage moderation has contributed, together with strong demand, to the exceptional employment growth since 1997. However, real wage restraint does not imply that bargaining guided by national wage guidelines has been a success. In particular, two important problems remain:

- Real wage moderation has not been accompanied by nominal wage restraint, as both wages and inflation have risen faster than the euro area average, thus raising relative unit labour costs. This positive differential has become more damaging as the single currency rules out devaluations, and is probably behind the waning of export market gains (Chapter 1). Nominal wage rigidity largely stems from indexation clauses for inflation, which are particularly damaging at times of positive price shocks, such as oil price shocks (Box 2.1).

Box 2.1. **Catch-up clauses in wage agreements**

Indexation clauses for inflation have been traditionally applied in wage settlements, although their incidence has increased since 2000 as national agreements have been signed to favour wage moderation. In principle, the social partners have accepted to negotiate on the basis of the inflation reference value, which is 2% (the upper end of the European Central Bank's [ECB] price stability range), but in exchange for these catch-up clauses. In 2003 they affected 73% of workers covered by wage bargaining (against only about 50% in 1998). Some clauses take as the reference variable the difference between actual and targeted inflation (usually 2%), thus guaranteeing the agreed gains in purchasing power, while others cover only against losses in purchasing power as they are activated only if actual inflation surpasses agreed wage increases (usually higher than 2%). The latter type is less inflationary. There are no data on the distribution of clauses by type of clause, but research by the Bank of Spain (Izquierdo *et al.*, 2003) shows that, in 2002, 29% of clauses implied a full recovery of purchasing power while 43% implied no revision at all. The rest of the revisions were somewhere in between. In some cases, the revision of wages is not retroactive (no payment of arrears) and only counts as a base for the following year starting point for negotiations. According to data from the Ministry of Labour, the overall impact of wage revisions was 0.7 percentage point in 2002 for an inflation rate of 4% (raising wage inflation from the agreed 3.1% to 3.9%) and 0.2 percentage point in 2003 for an inflation rate of 2.6% (raising wage inflation from 3.5% to 3.7%). The research by the Bank of Spain also shows that in recent years, when inflation has systematically surpassed the 2% reference value, those agreements that include a catch-up clause result *ex post* in higher wage increases than those without a clause, even if their *ex ante* increases are lower.

- The prevalence of intermediate level negotiations not only results in higher wage increases than company or national agreements (Izquierdo *et al.*, 2003), but also leads to a more compressed wage structure, which may distort resource allocation and reduce productivity growth (Abellán *et al.*, 1997). For instance, the ratio of agreed wages for workers with a university degree to that of manual workers is consistently much lower in provincial level agreements than in company or national agreements.[10]

These two features have contributed to the poor inflation and productivity performance, as wage compression reduces incentives for human capital formation. Partial reforms in the past have barely changed the *status quo* and a broad ranging reform should include the following elements:

- Enterprise bargaining should be at the centre of a new system especially for large firms, while the extension clause for higher level agreements should be eliminated and participation of firms in the agreement made voluntary. The current system allows for *opt-out* clauses, but they have not been used because their conditions are determined in higher level agreements and impose very restrictive conditions (like several years of losses by a firm). If participation of firms in a higher level agreement cannot be made voluntary, at least opt-out clauses should be made more flexible and not be limited to wages, but extended to other matters. Provincial agreements may still have a role, as collective negotiations at the firm level may imply high transaction costs for small firms, but should be on a voluntary basis for individual firms.
- National agreements may be useful for determining some work conditions, but they are not optimal for setting wage increases, since they reduce wage dispersion across firms and sectors. They may have made sense in periods of exceptionally high inflation, as they did at the beginning of the 1980s.
- Indexation clauses should be abolished. If they can not be eliminated, the inflation reference for wage negotiations should not be based on the headline consumer price index (CPI), but an underlying index to eliminate the impact of oil and food price hikes. Moreover, wage negotiations should take into account wage developments in the euro area.

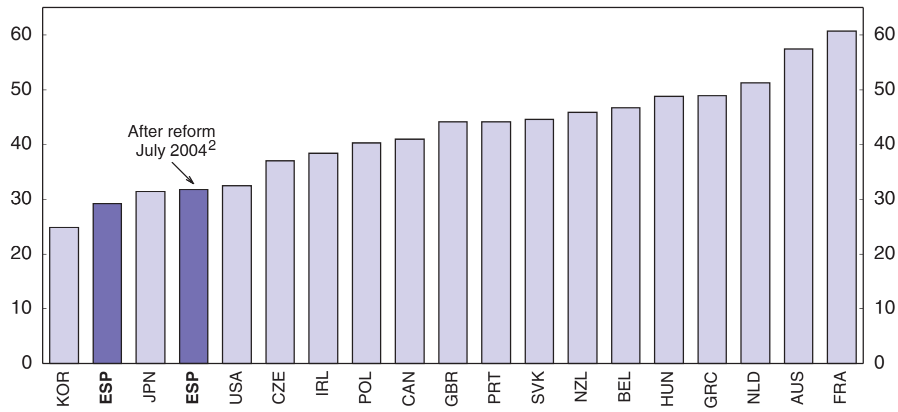
Minimum wages are being raised

The Spanish national minimum wage is low by international standards. It amounts to about 35% of the average wage, close to the US ratio but below that of most European countries (Figure 2.5). It was indexed to projected inflation over the last decade, while not adjusting for productivity gains. The new government has promised to raise it progressively by 30.3% during the next four years to € 600 per month in 2008, which would raise the ratio to about 43%. Since July 2004 the minimum wage has been raised from € 450 to the present level of € 513. Currently, an indexation mechanism to prevent that the minimum wage rises by less than inflation is under discussion. To avoid a strong budgetary impact, a large number of benefits and budgetary items that traditionally had been linked to the minimum wage will be de-linked, and up-rated by a new special index.

Raising minimum wages can reduce employment of low wage workers, as the new minimum could price them out of the market, but models that include market imperfections put that prediction into doubt (Freeman, 1996). The empirical literature is not clear-cut either.[11] For Spain, there is only evidence based on data prior to 1996, which suggests that there is no effect of minimum wage hikes on employment, although the

Figure 2.5. **Minimum wages in selected OECD countries**

In per cent of median wage, 2003[1]



1. 2002 for France, Greece, Hungary and Portugal.
2. Estimate.

Source: OECD database on Minimum Wages, November 2004.

increase of the minimum wage for 16 and 17 year-olds to that of adults in 1993 seems to have had a negative impact on their job opportunities (González Güemes and Pérez Domínguez, 2000).

However, the increase that will take place in Spain will be large and is likely to have a negative impact on some workers, those whose productivity is below the new minimum. And it poses three additional risks. *First*, although only about 5% of workers receive the minimum wage (Dolado *et al.*, 2000),[12] the presence of a large number of unskilled workers in the black economy, notably immigrant workers, implies that the incentives to become legal will be reduced. The new measure could even increase undeclared work. This may be especially the case in the home care sector, a large source of jobs for immigrants and a partial substitute for elderly care, which is to a large extent undeclared as social security payments seem to raise wages above what is affordable by many households. *Second*, the increase could raise wages higher up in the salary scale, pushing up wage inflation. If that does not happen, the salary scale will be compressed, which could reduce incentives for human capital formation and therefore reduce productivity growth. *Third,* while the new indexation system will not lead to wage compression by itself, it could well reinforce the indexation mechanism for higher wages and entrench nominal wage rigidity.

In-work benefits or negative income taxes are an alternative to raising minimum wages as an anti-poverty measure. Such measures can be means-tested and have the advantage of being targeted at low-income households as not all workers who earn a minimum wage live in a poor household. They transfer the burden of the extra payments from firms to the State. However, they may have a sizeable budgetary cost that entails raising the tax burden, and the phasing out of such benefits imply high marginal tax rates over the associated income range, leading to poverty traps. Nonetheless, a system combining minimum wages and negative income taxes, if carefully designed, can be effective in alleviating poverty while minimizing work disincentives and promoting the demand for low-skilled workers (OECD, 1998).

Competition policy needs to be strengthened in several areas

A stronger general competition body is desirable

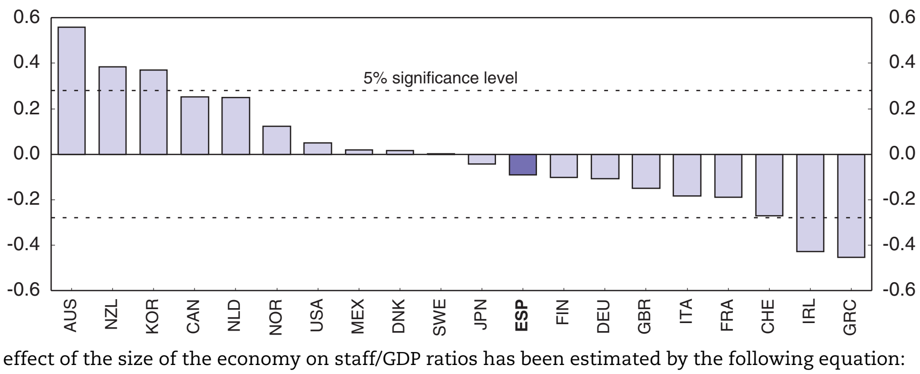
Raising competition is crucial for reducing the inflation differential and also key for raising productivity growth (Nicoletti and Scarpetta, 2003). There are two general competition bodies in Spain, the Competition Tribunal and the Competition Service. The first is independent and in charge of resolving cases, while the second depends on the government and is responsible for launching cases. Sectoral regulators are also crucial for the efficiency of recently liberalised markets. They include the National Energy Commission (CNE), the Telecommunication Commission (CMT) and the National Stock Market Commission (CNMV).

Competition policy has evolved in recent years, although its main structure has been maintained. Resources for the Competition Service have increased, and now, jointly with the Tribunal, the staffing is comparable to those of other EU countries (Figure 2.6). The Tribunal has intervened in several important cases with a clear pro-competition position; examples include the report on the possible merger of the two major electricity companies (Endesa and Iberdrola) that finally did not go ahead, and the imposition of fines on several dominant firms in network industries. Competition policy, however, could be strengthened by granting independence to the Competition Service and by increasing deterrence against anti-competitive behaviour. The new government has announced a reform of competition policy, with a white paper issued at the end of 2004 and legislation planned during 2005. Several potential improvements are being discussed:

- Increasing the independence of the competition bodies should be a priority. Members of the Tribunal should continue to be appointed for a fixed mandate without the possibility of a dismissal, while the Competition Service, if left separated, should be made more independent, particularly with respect to merger investigations. To raise the profile of the Tribunal, its president could report once a year to the Parliament. This policy could also be applied to sectoral competition bodies.

Figure 2.6. **Staff resources of competition authorities**[1]

2001[2]



1. The effect of the size of the economy on staff/GDP ratios has been estimated by the following equation:
   log(staff/GDP) = 0.594886 – 0.39352 × log(GDP)
   (2.0) (–3.7)
   (t-statistics in parentheses); S.E.: 0.27; R^2: 0.43. The chart shows the residuals after controlling for effects of country size.
2. 2002 for the Netherlands and 2003 for Switzerland and Spain.

Source: OECD (2003), *Economic Surveys: Italy*, Vol. 2003/13, and Ministerio de Economía y Hacienda.

- The two general competition bodies should be merged. The merger would lead to synergies in investigations and decision-making and shorten delays in deciding cases.
- The advocacy role of the Tribunal should be reinforced. Such a role existed until the mid-1990s, when it elaborated several high-profile reports that developed guidelines for liberalisation, but has disappeared since 1999 when a reform withdrew its capacity to issue such reports on its own initiative.[13]
- Sanctions should be strengthened. In principle, financial sanctions can be up to 10% of total annual firm turnover, but the sanctions actually applied never reach that level and are often paid with a delay of several years due to lengthy appeals. Deterrence is ineffective as the benefits from anti-competitive behaviour are larger than the fines imposed. It is often argued that the mere intervention of the Tribunal stops anti-competitive behaviour, but this argument ignores the fact that sanctions must also have a clear *ex ante* deterrent function. Leniency programmes, which are becoming common in other countries, should also be introduced to help uncover cartels, while penal sanctions on managers should be considered.
- Mergers are currently approved by the government, after a recommendation by the Tribunal. As in other countries, the final decision about compliance with the competition law should be left to the independent body, the Tribunal.

Regional competition tribunals have been created (Cataluña and Galicia) or are being set up elsewhere (Madrid), with the aim of intervening in regional cases. This has the advantage of increasing the resources for general competition policy, but may create problems of coordination with central bodies or result in the application of different rules in different regions. Most importantly, central oversight must ensure that regional tribunals do not favour local companies by erecting entry barriers. The new law should take these risks into account, by providing the necessary tools for co-ordination and, if necessary, for control.

Retail distribution is subject to regulatory barriers

Retail distribution is one of the sectors where more vigorous competition could raise productivity and reduce inflation pressures. Price increases of some consumer goods have been consistently above average inflation over the recent past, and price levels have converged with and even surpassed prices in other countries. Retail distribution was liberalised in 1985 when opening hours were freed. Since then, legislation has restricted opening hours again. Spain is still less restrictive than most other euro area countries, but is far more restrictive than other OECD countries such as the United Kingdom, Ireland or the United States. Shops are allowed to open a maximum of 90 hours a week, and to distribute those hours over the week as they want. However, the number of Sunday openings per year is limited for most types of shops[14] to a maximum of 12, although regional governments can raise this number. Most governments stick to this minimum, with the aim of protecting small shops. The new government has reduced the national maximum from 12 to 8 and hours from 90 to 72 as from January 2005, and most regional governments are likely to adapt to the new maxima, reducing effective opening time.

Entry barriers also affect competition. They have been imposed by many regional governments. The 1995 Commerce Law allowed the regions to issue a second permit (on top of the municipal one) for hypermarkets, with the aim of preserving competition in local markets. However, as shown by a Tribunal report, many regions have abused this law by restricting the issuing of a license, including a wide definition of hypermarkets to prevent the setup of smaller outlets, or making approvals conditional on viability studies for the eventual survival of the new business. As a result, investment in new hypermarkets has stopped in several regions.

Stronger competition through liberal opening hours would not only raise productivity and lower prices, but also improve consumer welfare through a wider choice of shopping hours and establishments. Extending shopping hours is also important to facilitate the reconciliation of family life with work, and would help to promote higher participation in the labour market. The recent change in the framework law that regulates retail opening hours, although it has allowed the settlement of an ongoing legal dispute that hampered the application of the former regulation, has been a step in the wrong direction as it allows regional governments to reduce maximum opening time for large outlets. Concerning entry restrictions, there are trade-offs between social objectives, such as preserving city centres and the productivity gains that come from larger retail outlets. These restrictions tend to insulate incumbent firms and limit innovations and competition in retail format strategies. Productivity gains could be large in Spain, as the outlet density is still among the highest in the European Union, and nearly double the EU average. The current planning restrictions may have become overly concerned with social objectives.

Effective competition in energy sectors has advanced slowly

Electricity. Despite the measures adopted to extend in advance the choice of provider to all consumers that have completed the liberalisation process initiated in the mid-1990s (Box 2.2), and the increase in the number of new firms, several factors hinder effective competition in the electricity market:

- Entry barriers: The market is still dominated by two large generation companies, Endesa and Iberdrola. Three companies own 80% of generation capacity and a large share of the distribution network. New entrants face hurdles in penetrating the market because of

Box 2.2. **The electricity market**

The liberalisation process ended in January 2003, when small customers were allowed to choose their provider. An independent sector regulator, the Comisión Nacional de la Energía (CNE) regulates the whole energy sector. The liberalisation framework is based on a spot market for wholesale electricity, legal unbundling of distribution and transport from generation and commercialisation and control of transmission by an independent company (Red Eléctrica Española), although there is not ownership separation yet as the largest firms participate in all segments except electricity transmission. Prices are regulated by the government for non-competitive activities (transmission and distribution) and for those customers that buy electricity at a tariff that is determined every year by the government and sets a maximum price. This tariff was progressively reduced until 2002, when the government became less aggressive in reducing prices but established that they would increase by around 1.4% per year, with an upper limit of 2%, until 2010. The methodology for determining price increases is too complex and does not help to achieve market transparency. Imports of electricity are limited for physical reasons (the barrier of the Pyrenees), although those from France will rise by 2010 to 4.6 GW (about 15% of current generation capacity), and the integration of the Spanish and Portuguese markets has been agreed.

their low generation capacity. They are squeezed between a distribution network controlled by their competitors, the relatively low prices they can charge (which are defined by a regulated tariff that effectively acts as a maximum price), and by spot market prices that are highly volatile and can be manipulated by the two largest players (López Milla, 2003). The sector regulator has published a report that contains a long list of effective entry barriers to new competitors mostly due to the market power of incumbent operators (CNE, 2004). In addition, entry through the acquisition of Spanish companies has been discouraged in the past by the existence of the golden share in one of the companies, although legislation on the golden share has been softened in 2003.

- Distorted prices: Electricity prices are not reflecting marginal costs. In the wholesale market, prices can be controlled by dominant players due to the high concentration of generation capacity, the working of the spot market and the influence of stranded costs. The spot market works with daily auctions where the price for all electricity purchased is determined by the marginal supplier. Some generators always offer at a price close to zero and always enter the market, as they cannot stop production or have a small stocking capacity (nuclear plants and hydropower). Usually, the marginal price is determined by coal and gas powered stations that can easily change production, while more expensive oil plants are only used when capacity is constrained by very high demand. This set-up should be effective for determining competitive prices in a well functioning market, but it is influenced by the stranded costs paid to incumbents only when prices are below € 36 per MWh, which provides an incentive to keep prices under that level even when marginal costs are higher, thus distorting prices and investment plans. A white paper on the electricity market is now under preparation by independent experts which will analyse, among other subjects, market developments and prices. On the basis of their conclusions, decisions will be taken regarding electricity prices and the market set-up.

All this points to the need to control the market power of large companies. The competition authorities and the regulator must ensure that entry barriers are scrapped, and that the wholesale market works properly. Ownership separation of different market segments or the splitting up of large producers through auctions of their generation capacity are options that have been exercised in other countries. There have been merger initiatives in the past that have been rightly subject to divestiture conditions (and have not taken place in the end). Takeovers or mergers with dominant operators in other energy sectors (natural gas), which have been pursued in the recent past, would reduce competition further if they are not linked to substantial transfers of production capacity and customers to new entrants, even if they may make sense because of the synergies of the gas and electricity markets, which are increasingly integrated as almost all new generation is through gas powered stations. Finally, all those elements of the electricity tariff that go to subsidies and stranded costs should be phased out and be paid only when they are justified by external effects. These issues will be also addressed in the forthcoming white paper.

Natural gas and oil distribution. The liberalisation of the gas market also followed the general principles of unbundling gas supply from transportation. Transport is controlled by Enagás, a company owned by market operators. Gas Natural, the former monopoly, still has a major stake in Enagás and controls 52% of the liberalised market and 80% of the regulated market sales of gas and the distribution network, although new competitors (including some electricity companies) have recently gained some market share due to several regulatory measures, the most important being the allocation through a tender in 2001 of a 25% share of the long-term gas pipe contract with Sonatrach, the Algerian exporter. Since liberalisation started in 1998, new entrants have also developed new import channels, with investment plans for liquefied gas stations and new pipelines planned to increase links with northern Africa. But, as in the case of electricity, vertical integration of the market provides the incumbent with advantages that constitute a barrier for new entrants to expand (CNE, 2004), while the control of Enagás by firms in the market may have hampered market access of foreign companies.

In oil distribution, the two largest operators (Repsol and Cepsa) were subject to temporary expansion limits between 2000 and 2003, although this has not led to a lower market share in revenue terms. Price agreements have been investigated, but the Competition Service has not found evidence of price fixing. The number of petrol stations, which is considered by the government to be too small, has increased only slowly, while distribution by hypermarkets is subject to administrative barriers by local authorities. However, such stations induce important price falls where they exist, and experience in other countries has shown that they can be an effective driver for greater competition.

Competition in telecommunications should be achieved through convergence of technologies

Liberalisation of telecommunications has followed the EU's model of liberalisation. In fixed telephony, Telefónica, the incumbent operator, is subject to price caps set by the government, which has favoured a rapid reduction in the price of calls. Increases in the price of line rentals have also taken place as part of the process of rebalancing prices to reflect costs. The rise in fixed prices has improved incentives for investment by new network operators, raising the scope for facilities-based competition in the long term. Telefónica is the incumbent operator in Europe that has maintained the highest market share since liberalisation (81.3%) despite several interventions by the sector regulator (CMT) and the Competition Service. Indeed, Telefónica was sanctioned by the Competition Tribunal in April 2004 for abusing its dominant position by impeding the transfer of customers to new operators through pre-selection. The unbundling of the local loop has not worked well in improving the access of new operators and few lines have been unbundled, in part because it requires investment by new operators, although they claim that Telefónica is making unbundling unduly difficult through all kinds of barriers and conditions.

In mobile telephony, the market structure is better balanced among the three operators[15] and a fourth license could be granted with the arrival of universal mobile telecommunication (UMTS) technology.[16] Although prices dropped during the first years of liberalisation, they have barely decreased further and are now higher than in all other EU15 countries. The CMT considers that mobile phone companies exercise market power and has forced the three operators to reduce their termination fees. The CMT also considers that the business strategy of mobile companies has evolved from an effort to gain customers early in the liberalisation process to maintaining market share, and that they have stopped competing on prices, which have decreased by only 10% between 1999 and 2003 (against a fall of 38% in fixed telephony) (Figure 1.10).

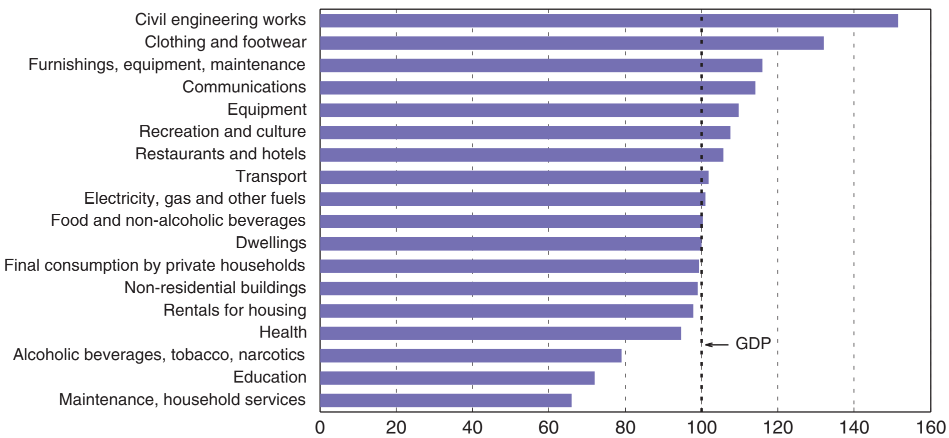
Looking ahead, regulators need not only ensure that dominant operators do not abuse their market position, but also need to adapt to the new EU liberalisation strategy that focuses less on specific technologies and more on services. The European Union has issued several directives requiring national regulators to, among other things, define those operators with significant market power in different service segments. The underlying idea is to liberalise prices in those segments where there is effective competition and to promote network investment by new entrants. After public consultation, the CMT will define such operators and markets during 2005. Accordingly, the government has postponed the liberalisation of prices by the incumbent operator, which was planned for January 2005.

Potential competition gains in other sectors

Other sectors are in the middle of a liberalisation process, often following EU directives. This is the case of railways, where separation of the infrastructure and operation of the monopoly, Renfe, has already been carried out, and will be followed by the entry of new companies in different market segments. In postal services, competition already exists except for letters up to 50 grams. In other sectors, like many professional services or pharmacies, there is still much scope for deregulation without damaging basic security concerns. Figure 2.7 presents a price comparison of specific prices in Spain relative to those in the European Union. It shows that prices are relatively high in some areas, which suggests high profits and little competition. In the case of civil engineering works, for instance, prices are relatively high, which suggests that the competition authorities should have an eye on the construction sector and public procurement procedures. Relatively high prices of clothing and footwear and furnishing, equipment and maintenance point to the need to liberalise the distribution sector, as highlighted above.

Figure 2.7. **Relative prices in Spain compared to the European Union**

Final consumption expenditure, 2002, GDP = 100[1]



1. Price differences are normalised to 100 for the GDP deflator. An index higher (lower) than 100 indicates that this product is relatively more (less) expensive in Spain than in the European Union, taking into account the average price level differential between Spain and the European Union.

Source: Eurostat New Cronos database, November 2004.

Stabilising the housing market

Stabilising the residential construction market is another crucial challenge. A continuation of the steep rise in house prices is increasing the risk of a marked fall in the medium term, while at the same time accentuating social problems, because housing services become increasingly unaffordable. The continuing rapid increase in households' residential investment and borrowing is making the economy more vulnerable to a rise in interest rates (Chapter 1).

The stabilisation of the housing market should involve structural reforms

The policy response should depend on the relative importance of the supply and demand factors responsible for the surge in house prices (Annex 2.A1). The sharp rise has been accompanied by a substantial increase in the supply of housing, in contrast with some other OECD countries. Recent research has stressed the importance of demand pressures which have been underpinned by low real interest rates (García-Montalvo, 2003; Martínez Pagés and Llanos Matea Rosa, 2003). Demand is also boosted by distortions caused by housing policy. They limit both the supply and the utilisation of the housing stock. Housing policy is designed to guarantee all Spaniards access to adequate housing. It has had mixed results despite a budgetary cost of 1% of GDP in 2004, which seems high in international comparison.[17]

There are still some problems with access to housing, but they do not seem to be widespread

The main aim of housing policy has been to facilitate home ownership through several measures: *i*) income tax relief on the purchase of a main residence, without any means test, granted both by the central and many regional governments; *ii*) assistance to help the least well-off households purchase a home via housing plans; *iii*) the application of a reduced value added tax (VAT) rate on residential construction; and *iv*) no taxation of the imputed rents of owner-occupiers.[18] Justified in part by the very high level of interest rates until the late 1990s, these measures have contributed to increase the proportion of owner-occupiers in recent decades (Table 2.4). The proportion reached 85% in 2001, the highest in the OECD. In recent years, it was also stimulated by the sharp fall in interest rates, longer-term mortgage loans and the growing proportion of households with two incomes. The latter has reduced the cost of home ownership as a proportion of the average household's income to a moderate level, despite the rise in property prices (Figure 2.8). While accessibility seems to be less of a problem than in the other European countries for a large part of the population,[19] difficulties persist for less well-off population groups (Pareja and San Martin, 2003) and the problem varies a great deal from region to region (CES, 2003) (Box 2.3).

Measures to encourage home ownership push prices up,...

Tax incentives in favour of home ownership have contributed to stimulate housing demand and to push prices up. As shown by van den Noord (2005), tax incentives for house purchases can also reinforce house price volatility (Figure 2.9). According to Domínguez Martínez (2004), income tax deductions reduce the effective interest rate by 2 percentage points on average and real after-tax interest rates have been negative since 1999. The scale of the subsidy, which varies with the size of the loan, the depreciation rate and the level of interest rates, allows buyers to increase their borrowing and the price of the home purchased by 15% to 20%. In view, however, of the strong pressure of demand and the rigidity of housing supply, it is likely that these tax deductions are largely capitalised into prices. López-García (2003) estimates that, without these concessions, property prices would fall by between 15% and 30%.

Table 2.4. **Tenure and availability of housing**

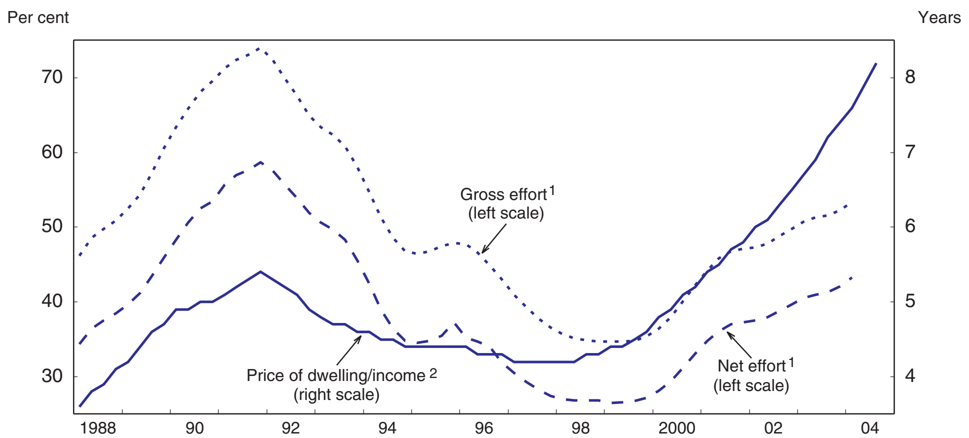
2001

	% of the stock of main residence			Dwellings per 1 000 inhabitants	1991 Vacant dwellings (% of total stock)
	Owner-occupied	Rented	Other		
Spain[1]	84.8	10.1	5.1	. .	. .
Census 2001	82.0	11.5	6.5	510	15.5
Census 1991	78.3	15.2	6.5	436	14.8
Census 1981	73.1	20.8	6.1	390	16.3
Austria	55.3	37.3	7.4	465	4.6
Belgium	73.9	23.4	2.7	456	. .
Denmark	66.6	32.9	0.5	469	4.8
Finland	68.1	30.7	1.2	483	6.9
France	63.4	31.3	5.2	477	7.2
Germany	43.8	52.6	3.6	473	1.8
Ireland	81.9	16.5	1.6	358	. .
Italy	76.2	17.5	6.3	459	7.2
Netherlands	55.3	44.0	0.7	416	2.2
Portugal	66.7	23.5	9.8	489	10.5
Sweden	59.8	40.1	0.1	483	0.4
United Kingdom	71.8	26.8	1.4	433	4.5
EU average	64.2	31.9	3.9	468	5.0[2]

1. Eurostat source.
2. Unweighted average of the above European countries for which data are available.

Source: Banco Bilbao Vizcaya Argentaria (BBVA), *Situación Inmobiliaria* (various issues) and Eurostat, New Cronos database, September 2004.

Figure 2.8. **Indicators of housing accessibility**



1. These indicators show the efforts (relative to the annual income, gross and net of tax) required for the reimbursement of a 15-year mortgage, to finance 80% of the acquisition cost of a 93.5 m^2 dwelling.
2. Number of annual incomes to afford a house.

Source: Ministerio de Fomento and Bank of Spain.

… their redistributive effect is debatable and they tend to distort resource allocation

This assistance can hardly be justified by positive externalities and their redistributive effect is debatable. As these tax deductions probably increase house prices, they result in a redistribution in favour of owners and hence between young and older people. Taking a longer-term perspective, they also create distortions by channelling a large share of savings into construction instead of other, more productive activities. According to Domínguez

Box 2.3. **Low-cost housing policy seems ineffective**

Low-cost housing policy consists mainly in building subsidised houses which are then sold to poorer households, contrary to most other OECD countries which have developed a sector of subsidised rented dwellings. The problems that households with modest incomes face in gaining access to the housing market have worsened in recent years in Spain partly as a result of the reduction in the construction of subsidised housing. After falling by half between the 1980s and the first half of the 1990s, the supply of this sort of accommodation has remained low, accounting for only some 10% of total annual housing construction. Because the bulk of this type of property is built by the private sector, the increase in real estate prices makes such projects less attractive to promoters, which results in a crowding out effect when the market overheats. In addition, the high budgetary cost of subsidised housing also tends to impede its expansion, with the result that strong demand has given rise to frequent irregularities in the way such homes are allocated to the targeted population: for example, sales sometimes take place at above the recommended price or such homes are purchased as secondary residences (Rodríguez López, 2004). The effectiveness of these measures is also called in question by the lack of control over subsequent transactions of low-cost housing (López-García, 2003). The construction and sale of low-cost homes are not a very effective way of solving the issue. Government assistance takes account of households' current income rather than their permanent income, and its irreversibility makes it impossible to adapt to changes in situation or to household's often transitory needs (Ruiz and San Martín, 2004).

Furthermore, the stock of subsidised rented dwellings is too small to meet demand. In the early 2000s, it accounted for just 6.3% of all main residences, compared with 13.7% for the European average, while the number of low-cost dwellings being rented covered only 35.4% of poor households, as against 72.8% on average in Europe (Pareja and San Martin, 2003). The low supply of low-rent housing,* is liable to cause growing problems in the future, because of the probable rise in captive demand for this type of accommodation due to the increase in immigration. Seventy per cent of immigrants rent their homes and most of them live in large towns where real estate prices are the highest (CES, 2003).

* According to the 2002-05 housing plan, only a little over 10% of subsidised housing construction was intended for rental in 2003.

Martínez (2004), the taxation of real estate purchases and financing, measured on a net basis, amounts to only some 5% of the purchase price and is even negative if only central government taxes are included. The low level of taxation compared with other investments undermines the neutrality of the tax treatment of saving, a phenomenon accentuated by the tax relief on capital gains from selling main residences. Those older than 65 years benefit from this in particular (Antón Perez, 2003). All told, the tax system makes investing in property especially attractive to build up and transfer wealth, but it distorts resource allocation, as illustrated by the large share of this sector in the economy.

The effect of demand pressures on prices is exacerbated by the rigidity of housing supply

Demand pressures on prices are accentuated by supply rigidities. The rise in the cost of building plots has accounted for a rising share of house prices, mainly because of restrictions by the municipalities regarding the classification of areas that can be built on.[20] Since the mid-1990s there have been various reforms[21] and, according to the Ministry

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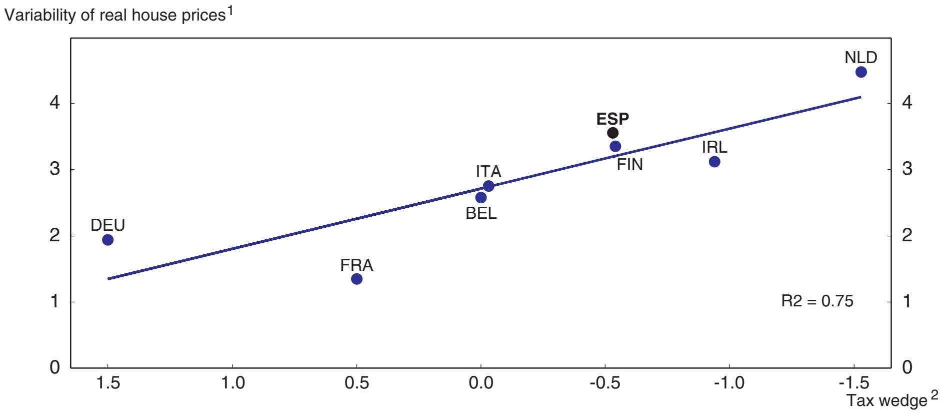
Figure 2.9. **Correlation between the tax wedge and variability of house prices**

Per cent



1. Root mean square deviation of real house price from trend, 1970-2001.
2. Difference between after-tax and pre-tax real interest rate on mortgage loans; 1999 tax rules, interest rates and inflation.

Source: P. van den Noord (2005), "Tax Incentives and House Price Volatility in the Euro Area: Theory and Evidence", *Économie Internationale*, CEPII (Centre d'études prospectives et d'informations internationales), Paris, forthcoming.

of Housing, the availability of building and developable land is no longer a problem. However, this assessment, which is difficult to confirm because of a lack of statistical information,[22] is not shared by many observers. The latter underline the persistent restrictive role of local governments, which control the supply of building land and are interested in keeping prices high by using arbitrary criteria to issue building permits since they benefit from the compulsory transfer of 10% of land when it is reclassified as developable. The importance of this phenomenon is however difficult to quantify. In any case, the likely restrictive effect on the supply of building land is reinforced by the length and complexity of the town planning procedures needed to build the necessary infrastructure, such as water and electricity. These procedures, which in the majority of regions are the landowners' responsibility, can last between 7 and 10 years.

The private rental market has declined because of weak demand...

Housing policy is also harming the development of the private rental market. The rental market accounted for only 11½ per cent of the stock of main residences in 2001, which is one-third of the EU average. The trend decline of this market, which was much more marked than in the rest of the OECD because of rental regulations that for a long time were tilted in favour of tenants (García-Montalvo, 2003), was not halted by the 1985 reforms.[23] The private rental market is still suffering from a chronic shortage of demand due, in part, to the tax deductions for house purchases. Because of them, non-captive demand from households with sufficient resources to choose the type of housing they want is turning into a decision to purchase. The discounted present value of the assets accumulated by a household buying a home very soon outstrips the capital built up by a tenant who systematically invests on the financial market the saving resulting from the difference between his rent and what he would have spent on a house purchase (OECD, 2003). This strengthens the public's traditionally negative attitude towards renting, which is seen as "a waste", and thus pushes private sector rentals down.

… and the supply of rental accommodation restricted by regulatory impediments

Private rental supply is also small, despite the large share of real estate in households' wealth (Chapter 1), due among other factors to the high underlying returns on investment if one allows for capital gains.[24] The result is a very large number of unoccupied homes. They account for some 14% of the total housing stock in 2001, which is about double the total stock of rental accommodation. This proportion is well above the average for other countries (Table 2.4), even though it is probably overestimated. It is partly the result of demographic factors[25] but is due above all to regulatory obstacles which encourage owners to keep their property unoccupied. With rent levels low, the return that owners can obtain from letting their accommodation would seem insufficient to offset the associated costs resulting, in particular, from damage to the premises and the risk of unpaid rents. The relationship between owners and tenants is complicated by the existence of a variety of different legal situations in a small market.[26] Moreover, the actions of the courts are often very slow to resolve flagrant abuses benefiting tenants (Martínez Pagés and Llanos Matea Rosa, 2003). Furthermore, the minimum five-year period for rental contracts, which was introduced in 1994, could well act as a major constraint for investors to sell, particularly when demand is high, which is no doubt why they leave their property unoccupied.

Measures have been adopted to resolve the difficulties of the housing market

To resolve these problems, the government has created a new Housing Ministry, whose resources have surged in 2005 (by 32%). They will be used to increase the subsidies in favour of home purchases by young people with low incomes. These measures come on top of an emergency plan costing € 1 billion. It has three main objectives:

- *First*, the plan increases the supply of low-cost housing by 65% (from 110 000 to 180 000 homes in 2004), with the maximum price of low-cost dwellings being raised by 4% to make the sector more attractive to private promoters. The bulk of the increase (40 000 houses) is for the rental market.
- The *second* objective is to expand the rental sector by boosting demand and supply. Assistance will be made available to tenants aged under 35 and with limited means for a maximum of two years.[27] In addition, subsidies are also being granted to firms and public bodies purchasing property for the purpose of letting it,[28] and also to private individuals letting accommodation for a minimum period of five years so as to cover their insurance costs against unpaid rents and the cost of repairing their property. In 2005, a public rental agency will be set up to ensure the transparency and development of the rental market, while a committee of experts will investigate improvements in the legal relations between tenants and owners.
- *Third*, to limit the rise in real estate prices the auctioning of public land will be abolished and replaced by "beauty" contests,[29] while an inter-ministerial commission will look into the possibilities of increasing the supply of public land for the construction of subsidised housing.

Assessment

Although moving in the right direction, these reforms further increase public spending on housing, the opportunity cost of which is high in terms of higher taxation or foregone revenues. They only partially correct the factors distorting the real estate market. The measures adopted under the emergency plan to expand rental demand are inadequate, for example; they only concern captive rental demand and appear to be narrowly targeted on demand by young people to solve the problems of access to housing. An increase in total rental demand is required[30] and this means gradually doing away with home ownership assistance, with its high budgetary cost and tendency to push property prices up. Abolishing this assistance would also improve the allocation of savings, a high share of which is channelled into the construction sector.

While measures to stimulate rental supply are needed, they should focus on eliminating the regulatory obstacles rather than granting further tax expenditure. In this respect, the plan to improve the legal safety of relations between tenants and owners is a sensible initiative which could be supplemented by a reduction in the minimum five-year duration of rental contracts. Once the regulatory framework of rental supply has been improved, the usefulness of the recent tax incentives in attracting private rental supply will need to be reconsidered. On the other hand, the cost-effectiveness of the current system of subsidies to social housing, which still relies largely on selling subsidised housing, should be reassessed. A less costly and more effective way of solving the problems of access to housing for disadvantaged population groups could be for example to let rather than sell subsidised housing. It is important, though, that such measures should be properly targeted, including periodic reassessment of the situation of the beneficiaries (OECD, 2004a). Alternatively, it might be preferable to ease the access of disadvantaged population groups through the introduction of a tenant-based voucher system. This approach would broaden the choice of the beneficiaries and would reduce the risks of creating "ghettos" that develop because of the lack of maintenance of rented houses (Olsen, 2003). In general, a policy that focuses on measures to encourage renting will have beneficial effects not just on the housing market, but also on workers' geographic mobility, which is currently very limited. Taken as a whole, these measures should reduce public expenditure on housing and ought to be accompanied by the relaxation of town-planning regulations. Removing the compulsory transfer of 10% of building land to the municipalities should also be considered in the context of a local tax reform (Chapter 4) to eliminate the incentive of the municipalities to keep prices high.

Continuing with a prudent fiscal policy is vital

Fiscal consolidation in recent years has played a stabilising role…

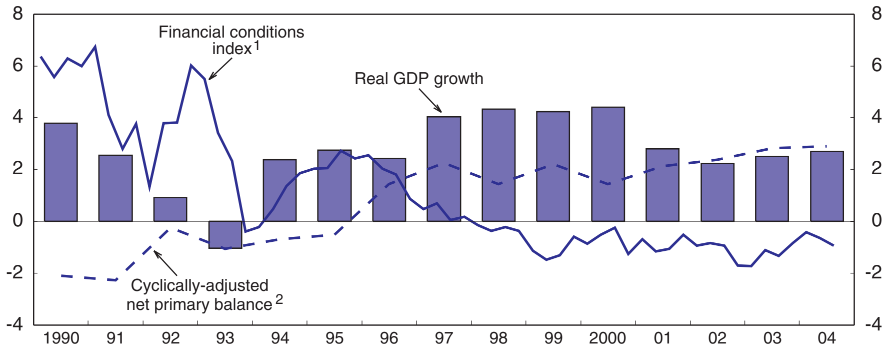
Although structural reforms have a key role to play in changing the growth pattern and reducing the inflation differential with the euro area, persisting with a prudent fiscal policy is also vital for coping with the fiscal consequences of ageing and to take out insurance against a renewed surge in domestic demand. In recent years, monetary conditions have remained fairly loose, despite some tightening due to the rise in the real effective exchange rate (Figure 2.10). As a result, growth of domestic lending, which averaged 15% between 2001 and 2004, has remained very strong. The expansionary monetary stance[31] has however been partially offset by fiscal consolidation in recent years. Public finances have been in balance in 2002 and 2003 and public debt was reduced to 52% of GDP in 2003, *i.e.* 16 percentage points less than in 1996.

… which tends to diminish, however

In contrast with the euro area average, the Spanish authorities continued with fiscal consolidation between 1999 and 2003, with the general government structural balance improving by 1½ per cent of GDP (Figure 2.11). This met or even surpassed the targets set

Figure 2.10. **The macroeconomic policy stance**

Per cent

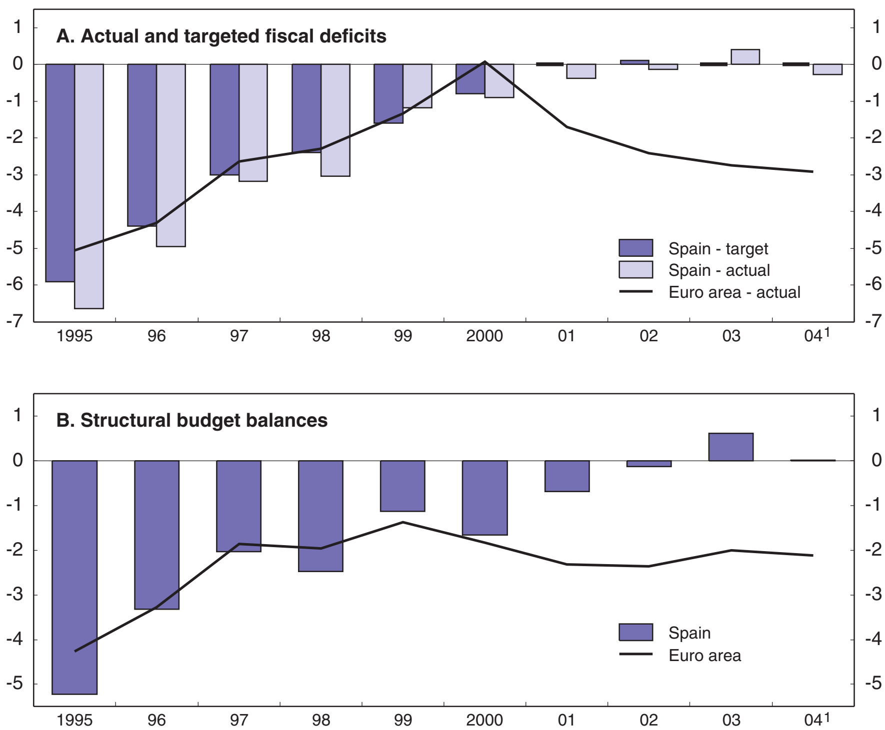


1. The financial conditions indicator is computed as the weighted average of the real short-term and long-term interest rate and the real effective exchange rate (based on unit labour costs in manufacturing). The interest rate variable has a unitary coefficient while the exchange rate coefficient is the ratio of exports to GDP.
2. As a per cent of potential output. The estimate for 2004 is corrected for exceptional spending.

Source: OECD (2004), *OECD Economic Outlook*, No. 76.

Figure 2.11. **Budget balances**

As a percentage of GDP



1. Preliminary estimates, including exceptional spending.

Source: OECD (2004), *OECD Economic Outlook*, No. 76.

by the government. It has been required to keep the public accounts balanced or in surplus since the Fiscal Stability Law (FSL) entered into force in 2003. In 2003, general government showed a surplus of 0.3% of GDP rather than being in balance as planned. However, public spending was less well controlled, despite budget outturns being better than forecast (Table 2.5).[32] This reflected, on the one hand, the concern to increase government investment and, on the other, the difficulty of further reducing primary current expenditure, despite the stated intention of doing so.[33]

Table 2.5. **The fiscal consolidation process**

	1995	1999	2003	Change over period	
				1996-99	2000-03
Per cent of GDP					
Financial balance	–6.6	–1.2	0.4	5.5	1.6
Cyclical effects	–1.4	0.0	–0.2	1.4	–0.2
Per cent of potential GDP					
Structural balance	–5.2	–1.1	0.6	4.1	1.7
Structural revenues	38.2	39.0	40.0	0.8	1.0
Structural expenditure	43.4	40.2	39.4	–3.3	–0.8
Current non-financial expenditure	32.4	31.8	32.1	–0.6	0.3
Interest payments	5.1	3.5	2.5	–1.5	–1.0
Investment and capital expenditure	6.0	4.8	4.8	–1.2	0.0

Source: OECD (2004), *OECD Economic Outlook*, No. 76.

The upward pressure on spending is also apparent in 2004. Initial estimates suggest that the budget showed a deficit instead of being in balance, mainly because of higher outlays. As in previous years, government revenues benefited from a solid rise in nominal GDP which was actually stronger than expected because of higher inflation. However, an audit of the public accounts by the new government revealed a number of outlays that had not been included in the initial central government budget which had a deficit target of 0.4% of GDP. The extra spending, put at 1.4% of GDP, is due to the repayment of debt to the Community of Andalucía (0.3% of GDP), accounting adjustments (0.4% of GDP)[34] and the reincorporation of capital transfers to public enterprises (0.6% of GDP).[35] Some of these adjustments improved the regional government accounts which showed an overall deficit of ¼ per cent of GDP in 2003. Furthermore, the overrun in the central government account was partially offset by a larger-than-expected surplus in the social security account so that the overall government balance showed a slight deficit of ¼ per cent of GDP (Table 2.6). However, this implies a deterioration in the cyclically-adjusted balance by ½ per cent of GDP, which is entirely due to past spending being underestimated. Excluding the impact of exceptional adjustments, the fiscal stance was marginally restrictive in 2004.

The objective of balancing the public finances in the future…

This small budget overrun should only be temporary, however. The authorities' objective is to show a surplus of 0.1% of GDP in the general government account as of 2005, which should rise to 0.4% of GDP by 2008. These projections are based on a realistic assumption of 3% growth between 2005 and 2008. This implies a neutral fiscal stance as from 2005 (excluding the exceptional adjustments on 2004 spending). As from 2006, this scenario would also be consistent with the general thrust of the scheduled changes in the

Table 2.6. **General government accounts**

As a percentage of GDP

	2000	2001	2002	2003	2004[1]
Current receipts	38.8	38.8	39.3	39.4	39.8
Direct taxes	10.5	10.4	10.9	10.6	10.7
Household	7.2	7.3	7.4	7.2	7.1
Business	3.3	3.1	3.5	3.4	3.6
Indirect taxes	11.7	11.3	11.6	12.0	12.4
Social security contributions	13.3	13.5	13.5	13.7	13.6
Other	4.0	3.6	3.3	3.2	3.1
Current expenditure	35.7	35.2	35.2	35.1	35.2
Government consumption	17.7	17.6	17.7	17.9	18.3
of which:					
Wages and salaries	10.6	10.5	10.4	10.4	10.4
Subsidies	1.2	1.1	1.1	1.1	1.0
Social security outlays	12.3	12.2	12.3	12.2	12.2
Property income paid	3.3	3.2	2.9	2.5	2.2
Other	1.2	1.2	1.3	1.4	1.5
Gross saving	3.1	3.7	4.1	4.3	4.5
Capital outlays	4.0	4.3	4.4	4.1	4.8
Net lending	–0.9	–0.5	–0.3	0.3	–0.3
Memorandum items					
Net primary balance[2]	2.4	2.6	2.6	2.8	1.9
Net borrowing of:					
Central government	–1.0	–0.7	–0.5	–0.3	–1.3
Social security	0.4	0.8	0.9	1.0	1.0
Local and regional government	–0.4	–0.7	–0.6	–0.4	0.0

1. Preliminary data.
2. Difference between the actual balance and net interest payments.

Source: Ministerio de Hacienda and other national authorities.

FSL, which are designed to take better account of economic conditions on the public accounts (Chapter 4).

... could be jeopardised by upward pressure on public spending

Achieving these objectives in 2005 and beyond will depend crucially on the authorities' ability to control spending. The government will partially index the income tax schedule for the first time since 2000 and has decided to maintain fiscal revenues stable as a proportion of GDP. For central government, slippage should be limited by the cap on outlays introduced by the FSL. Having worked well in 2003, this mechanism has set the maximum spending increase at 6.2% in 2005, close to projected nominal GDP growth. Expenditure overruns could occur at the regional and municipal level, however, which now manage more staff than does central government and which are responsible for spending on both education and health, where the underlying spending trend is sharply upwards. Moreover, the audit carried out by the government has identified further risks in coming years stemming from capital transfers to public enterprises, like those in 2004. Although difficult to quantify, they could amount to some 1¾ per cent of GDP.[36] Also the margins for lowering interest payments are smaller than in the past as interest rates are more likely to go up rather than down, even if indebtedness should continue to decline. Lastly, future spending could also be affected by a number of measures reflecting government priorities, which have been incorporated in the 2005 budget. These measures include: an increase of minimum pensions and other social spending items; higher expenditure on housing (32% in 2005 budget); more grants for students (10%); infrastructure development (9%); and a boost to innovation and research (25%). The latter appropriations are scheduled to double in four years.

A strategy of balancing the budget for the central and sub-national governments while accumulating social security surpluses should be considered

With the fiscal stance set to be neutral in coming years, the monetary and fiscal policy stance taken together is likely to be more expansionary than in the past. In the short term, this appears appropriate as activity should remain moderate and the output gap should remain slightly negative in the short run. However, domestic demand is likely to gather steam again and fiscal policy should take out some insurance, especially as there are upside risks stemming from the housing market. However, it is also clear that fiscal policy is not an effective tool for combating inflation of a structural origin and structural reforms should have priority.[37] The fiscal consequences of ageing provide a more important argument for keeping the fiscal stance tight over the medium term (Chapter 5). Building up assets prior to the demographic bulge would cut the need to reduce the generosity of the pension system fairly drastically. The authorities should, as part of the reform of the FSL, consider maintaining a balanced budget for central government and the territorial authorities over the cycle while allowing the social security system to build up surpluses as long as it benefits from favourable demographic developments.

The budgetary priorities for this legislature, which are designed to encourage technical progress and human capital, are consistent with the requirements of the economy. Both would stimulate productivity growth and damp inflation. At the same time, public spending needs to be firmly controlled so as not to jeopardise the macroeconomic public finance objectives. Appreciable progress could be made in increasing the effectiveness of spending in the decentralised framework of the Spanish institutions (Chapter 4) and certain tax incentives, such as those encouraging house purchases could be scaled back, as argued above. In addition, the generosity of tax incentives for private pensions (Chapter 5) should be reconsidered in conjunction with the tax reform scheduled for the second part of the current legislature.

Notes

1. The tourism sector's modest profitability compared with other destinations in the Mediterranean and Caribbean is prompting Spain's big tourism companies to invest abroad (El País, 2004).
2. According to the labour force survey, approximately one quarter of the jobs created since 2000 were filled by immigrants.
3. These forecasts were drawn up on the basis of a euro exchange rate of $1.30 and an oil price declining linearly from $47 per barrel in late 2004 to $44 at the end of 2006. They are broadly consistent with the projections presented in November 2004 in the *OECD Economic Outlook*, No. 76, but incorporate the carryover effects derived from the updating of national accounts data for the fourth quarter of 2004.
4. For example, according to the OECD data, the output gap in 2000, at the peak of the last cycle, is estimated at 1%, whereas it is around 2% according to the Bank of Spain and 1½ per cent according to the Ministry of Economy. The estimate of the structural unemployment rate, which is required for the potential output calculation of the OECD, is particularly uncertain. Statistical difficulties also relate to the employment data.

5. Since 1995, real wages rose by ½ per cent per year whereas productivity gains reached around ¾ per cent per year.
6. The growth gap for domestic demand with the euro area was 1.7 percentage points per year between 1995 and 2004, while it was 1.2 percentage points for production.
7. There may be price convergence across European countries that is unrelated to a Balassa-Samuelson effect. Should such a phenomenon exist, it would imply a rise in profit margins. This might have happened in the food industry.
8. Even though wage negotiations start on the basis of the 2% reference value, collectively agreed wages have increased by between 3% and 3.5% (before the activation of the safeguard clauses) since 2000, which implies either an *ex ante* rise in real wages above productivity gains, or inflation expectations being higher than 2%.
9. The deceleration in labour cost in industry does not seem confirmed by national accounts data. The rise in compensation per employee (expressed in full time equivalent) in the industry sector has remained close to 4% in 2004, a similar rate as in 2003.
10. This confirms for Spain the theoretical conjectures of Calmfors and Driffill (1988), which have been difficult to show with cross section data (OECD, 2004b).
11. There is evidence that points to negligible negative effects of minimum wages on employment in a number of countries. See Card and Krueger (1995) for the United States, and Dolado *et al.* (1996) for various European countries.
12. The government argues that only 90 000 individuals will be affected, although that number, equivalent to 0.5% of workers, seems implausibly low.
13. The Law 52/1999 reforming the competition law transferred the capacity of issuing competition reports from the Tribunal to the Service (Berenguer, 2004).
14. Shops in tourist areas and convenience shops, among others, are excluded.
15. The market shares of the three main companies in mobile telephony are 54%, 27% and 19%, respectively.
16. However, the business plans of the fourth holder of an UMTS license, which were planned for mid-2004, have not been developed yet.
17. In the late 1990s Spain was devoting more resources to housing policy (1.4% of GDP) than were other European countries (0.8% of GDP). Such international comparisons are, however, difficult to make and need to be interpreted with some caution (ECB, 2003).
18. Applying the reduced VAT rate of 7% to residential construction, instead of the normal rate of 16%, amounts to a revenue shortfall of € 2.7 billion in 2005. Income tax relief on the purchase of a home amounts to € 4.4 billion (including tax relief granted by regions). Housing plan assistance, which takes the form of direct grants or subsidised loans subject to a means test for the purchase of homes having specific characteristics in terms of size and price, represents about € 1 billion.
19. Expenditure on housing as a proportion of household incomes is lower on average than in Europe. Although more Spanish households are owners and their financing costs are similar to those in other European countries, a larger proportion of them has finished paying for their homes (65.9% of households in Spain compared to 38.6% in Europe). Also, there are fewer people renting and average rents are lower as a percentage of income than in Europe (Pareja and San Martín, 2003).
20. The linkage between trends in the price of land and house prices has been emphasised, since the former cannot be mechanically identified as the cause of the rise in real estate prices. The price of land depends in fact on house price expectations, bearing in mind the amount of building that town-planning regulations allow on the plots in question. This interaction does not, however, call in question the central role played by the market for land (the supply of which is neither reproducible nor homogeneous, which gives landowners a certain monopoly power) in ensuring a flexible supply of housing.
21. In 1996, for example, the authorities simplified the method used to classify urban land and reduced from 15% to 10% the amount of the land that private promoters had to transfer to the municipalities for the construction of low-cost housing and amenities.
22. Some statistics suggest a recent easing of building land prices, the increase of which slowed substantially in 2002-03 after it had exceeded 30% per year on average in 2000-01 (Bank of Spain, 2004). There are however some doubts about the quality of these data.

23. The Boyer Act liberalised post-1985 rental contracts. In 1994, the minimum length of rental leases was set at 5 years. Nowadays, rents are initially negotiated freely and then indexed on the CPI for the life of the contract.

24. Bank of Spain estimates suggest that, between 1988 and 2003, the average return on property investment was 13½ per cent, which was higher than on stock market investments (9%) measured on the basis of the IBEX-35 index.

25. The proportion of empty dwellings is higher in provinces where the population has declined (Martínez Pagés and Llanos Matea Rosa, 2003). However, the high proportion of empty dwellings is probably somewhat overestimated in Spain because of the difficulty of distinguishing secondary from empty houses with the data collection techniques used for the census.

26. A far from negligible share of the housing stock let before 1985 is still subject to constraints requiring the extension of contracts and to rules limiting rent levels by comparison with market prices, even though the latter are progressively updated. According to Trilla and Carreras (2001), 50% of rental housing in Barcelona is subject to these rules.

27. This assistance is available to persons signing a new rental contract who are aged under 35 and earn less than € 15 792 per year; it cannot exceed 40% of the person's annual income or € 240 per month. The aim is to reduce the housing expenses of the target population by some 20%.

28. Individuals receive assistance worth € 6 000, while firms and public bodies enjoy subsidies which take the form of preferential loans amounting to between 12% and 16% of the purchase price of the rented housing. These measures are additional to those adopted in 2002 to stimulate the supply of rental accommodation, which included a reduction in tax on the net rental income declared by households and a substantial decrease in tax on corporate profits granted under certain conditions to firms providing property to let.

29. Contrary to the auction system, "beauty" contests do not rely only on the price criteria for determining the successful bidder but take also into account parameters such as the architectural quality, the conception, the construction lag or environmental aspects.

30. A 50% reduction in the proportion of unoccupied homes, which would leave Spain with a vacant housing rate above the European average, would represent additional housing service supply of 1.5 million dwellings, or the equivalent of three years' production.

31. This expansionary monetary stance can be illustrated by the gap of some 330 basis points between the level of short rates and that suggested by a Taylor rule. That differential, which is an estimated average value for 2002-03 (Hoeller *et al.*, 2004), could even reach 400 basis points according to the Spanish authorities. The calculation of the differential depends on the parameters used in the Taylor rule which links short-term interest rates to the output gap and the difference between inflation and the inflation target.

32. This good performance was the result of a bigger-than-forecast increase in tax revenues due to the buoyancy of employment, and also to larger-than-expected nominal growth in output, despite an overestimation of real growth (BBVA, 2004).

33. In fact, the target for the reduction of primary current expenditure, which was written into the stability programmes, has been systematically over-run since the one drawn up at end-1999 (BBVA, 2004).

34. This extra spending corresponds to accounting adjustments for operations that were predictable when the budget for 2004 was prepared but had a greater impact on the deficit in national accounts than in budgetary terms These operations include: the adjustment due to the inclusion of spending on military investment (0.14% of GDP), the adjustment for the capital gains of the Bank of Spain (0.10% of GDP) and other minor adjustments due to infrastructure financed according to the "German method" (0.04% of GDP) or the cancellation of credits of the Fund for Development Assistance (0.02% of GDP).

35. According to the national accounts, capital transfers to public enterprises are not included in the government deficit if the enterprise in question has private revenue accounting for at least 50% of their resources and is profitable. If not, such transfers are considered to be subsidies and are therefore included in the deficit. In the first instance, this applies to transfers to the national railway company, Renfe. It is also the case of Spanish Radio and Television (RTVE) which has for a number of years been largely financed by borrowing and whose deficit has had to be reinstated in the general government account at Eurostat's request.

36. That estimate concerns transfers to national public enterprises, in particular rail and airport companies and water distribution companies. However, regional and local firms, such as the enterprise in charge of building the subway of Madrid, could also be affected.

37. According to standard simulations performed with the OECD's Interlink model, reducing public spending by 1% of GDP would reduce inflation by about a ¼ of a percentage point after two years.

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ANNEX 2.A1

The role of supply and demand effects on the rise in property prices

This annex provides empirical evidence on the relative importance of supply and demand effects on the steep rise in property prices. A number of recent quantitative studies (Ayuso *et al.*, 2003 and García-Montalvo, 2003 for example) have clearly shown the role played by the strength of demand, yet few have sought to assess the impact of supply-side rigidities. To gauge the importance of these two factors, the analysis presented here compares estimates of Spanish house price equations, which explicitly incorporate supply and demand variables, with those obtained by a similar approach for the United Kingdom, the United States and the Netherlands. The United Kingdom and the Netherlands having, in contrast with the United States, recorded house price rises similar to those in Spain, this comparison provides a useful perspective on the sources of this trend.

The approach to estimate these price equations draws on that proposed by Meen (2002). The specification makes the real price of housing depend positively on households' disposable income and negatively on housing supply and real interest rates. Housing supply is measured on the basis of a real housing stock variable obtained from the Bank of Spain. Incorporating this effect in the estimated error-correction equation avoids the risk of distorting negatively the demand elasticity of prices, which is correlated with the housing stock variable.

The results for Spain are shown in Table 2.A1.1. The relationships, which also contain a demographic effect (measured by the change in the population), show significant effects with the expected signs for the supply and demand variables. As in Ayuso *et al.* (2003), on the other hand, it was not possible to make a significant distinction between the impact of real interest rates on property prices as opposed to the impact of demand.[1] The two equations, which differ mainly in terms of the method of calculation, give fairly similar results.[2]

A comparison between these results and similar work carried out in the United States, the United Kingdom (Meen, 2002) and the Netherlands (OECD, 2004a) tend to confirm how important demand effects are in explaining house price rises, by comparison with supply effects. Thus, the long-term elasticity of real property prices in relation to demand (ranging between 3.3 and 4.1, depending on the model estimated) is higher than in the United States (2.7), the United Kingdom (2.5) and the Netherlands (2.0). The elasticity of prices in relation to the long-term housing stock variable (between –6.9 and –8.1) is similar to that found by Meen for the United States (–7.6) and much higher than for the United Kingdom (–1.9) or

Table 2.A1.1. **An error correction model of real house prices**

Sample 1989-2003

	Equation 1 Direct estimation		**Equation 2** Estimation based on the Engle-Granger method	
	Dependant variable: Dln (real house price)		**Short-term equation** Dependant variable: Dln (real house price)	
	Coefficient	t-student	Coefficient	t-student
Dln (real disposable income)	2.01	(4.3)	1.91	(3.6)
Dln (population)	21.76	(4.1)	6.24	(3.4)
Dln (real house prices)$_{-1}$	. .	. .	0.33	(2.4)
Residuals of the long-term equation	. .	. .	–0.69	(–2.8)
			Long-term equation Dependant variable: Ln (real house price)[1]	
			Coefficient	t-student
Ln (real house price)$_{-1}$	–0.87	(–4.7)	. .	. .
Ln (real disposable income)$_{-1}$	2.85	(2.9)	4.1	(7.8)
Ln (population)$_{-1}$	10.44	(2.2)	16.9	(8.5)
Ln (housing stock)$_{-2}$	–5.97	(–3.0)	–8.1	(–7.7)
Long-term elasticity:				
Income	3.3	. .	4.1	. .
Housing stock	–6.9	. .	–8.1	. .
R^2 adjusted	0.88	. .	0.83	. .
Standard error of regression	0.0256	. .	0.0297	. .
DW	2.13	. .	1.88	. .

1. The explanatory variables of this equation are : Ln (real disposable income), Ln (population) and Ln (housing stock)$_{-1}$.

the Netherlands (–0.5). Coupled with the sharp increase in the supply of housing in the last few years, these estimates suggest that supply-side rigidities were not the main factor driving the boom in property prices in Spain, in contrast with the situation in the Netherlands and the United Kingdom, even though the increase in supply was not sufficient to satisfy demand and prevent a steep hike in prices.

Notes

1. To show a significant real interest rate effect, Ayuso *et al.* (2003) impose an unit elasticity on the disposable income variable.
2. In the case of equation 1 in Table 2.A1.1, a direct estimate was carried out, while for equation 2 a two-stage Engle-Granger approach was used to determine the long-term relationship of real housing prices before identifying their short-term dynamic.

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Chapter 3

Raising productivity growth, while maintaining strong job creation

Since the mid-1990s, employment has expanded at a remarkable pace, while the unemployment rate declined from its peak in the early 1990s to about 10.5% at the end of 2004, although this is still one of the highest rates in the OECD. Several interrelated factors have underpinned strong job creation, including very favourable monetary conditions and the arrival of a large number of immigrants, who have mostly taken jobs in a few low productivity sectors. Labour market reforms have also played a role, especially those implemented in 1997 that lowered severance payments and social security contributions for some workers. But labour market institutions, including employment protection legislation, active labour market policies and unemployment benefits, still require comprehensive reforms to push unemployment down further, while fostering a better productivity performance. Reforms of the education system and firm training, and the promotion of business R&D activities through better framework conditions are also essential to improve the productivity record.

The need for further labour market reforms

The duality of the labour market is very pronounced

In many respects the Spanish labour market was an extreme case within the OECD. Spain not only suffered from one of the highest unemployment rates for many years, but also had one of the highest effective levels of severance payments for permanent workers. Not surprisingly, reducing firing costs has been one of the recurrent recommendations of national and international organisations, although in practice reforms had only limited scope. Indeed, employment protection of permanent workers continues to be one of the highest in the OECD. Temporary contracts, liberalised in 1984, have been increasingly used since the early 1990s and account currently for about a third of all employees, as compared to an OECD average of 13%. Severance payments introduce a high and uncertain cost and deter the creation of permanent jobs, while temporary contracts are not subject to such costs. Although these should only be used for a limited duration (they can be renewed at most three times to a maximum of two years), they are widely used beyond the legal limit. They have thus lowered labour costs significantly at the margin, reducing labour hoarding and increasing the volatility of employment over the business cycle. In fact, job destruction was very high during the early 1990s recession, while job creation has been rapid since the mid-1990s and has allowed entry of many new workers, the long-term unemployed, low-skilled and young workers, and women without work experience. Temporary contracts are so favourable in terms of labour cost that they continue to be widespread even after the 1997 reform that introduced financial incentives and lower firing costs for permanent contracts for certain groups of workers (Box 3.1). As a result, their share in total

Box 3.1. **The 1997 reform of permanent contracts**

In 1997 the government approved a reform of permanent contracts that was previously agreed with social partners. Its main goal was to reduce the share of temporary work and to promote the use of permanent contracts for some types of workers. A new type of permanent contract was created that carried lower severance payments in case of "unjustified" individual dismissal (which in practice corresponds to most dismissals, as it is difficult to justify them under current legislation). Specifically, firms have to pay 33 days of salary per year of work in the firm, instead of the prevalent 45 days for normal contracts. These contracts only apply to some types of workers: those under age 29 or over 49, workers with a temporary contract, women in sectors where they are underrepresented and disabled workers. The reform did not touch severance payments of existing contracts. In addition, the government decided to reduce social security payments for these workers during the first two years of work. The reduction varies according to the target group, and has evolved over time, but it can reach up to 60% of contributions. The budgetary cost of this measure is about 0.4% of GDP. These measures, which in principle were set to be only temporary, were made permanent in 2001, although they continue to apply only to target groups.

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employment has barely changed, although the private sector share has decreased, while the public sector share has risen, mostly due to a greater use of temporary work by sub-national governments.

While boosting employment, the duality of the labour market generates significant costs. It has created an unequal treatment of different groups of workers and has contributed to the poor labour productivity performance. Indeed, workers with a permanent contract enjoy job stability beyond the protection given by firing costs, since temporary workers are the subject of employment adjustments at the margin and act as a "buffer" when jobs are being scaled back. This has reinforced the traditional insider-outsider mechanism associated with strict employment protection legislation (EPL) by adding a third group of workers (temporary workers) to the groups of unemployed and permanent workers, which raises the effective protection of permanent workers: wage inflation can thus be high, despite high unemployment (Bentolila and Dolado, 1994). Apart from unstable jobs and frequent transitions between unemployment and short term jobs, temporary workers also seem to be paid less, although it is not clear whether this is due to lower skills (Davia and Hernanz, 2000) or to wage discrimination (Dolado *et al.,* 2003). However, temporary workers suffer from worse working conditions and have a higher risk of suffering from work accidents (Hernanz and Toharia, 2004).

The effects of the dual labour market on labour productivity growth are difficult to disentangle, but likely to be negative overall (Dolado *et al.,* 2003). Workers with fixed-term contracts may increase their work effort if they know they have a chance to stay in the firm, but they may have the opposite incentive if it is clear that their contract will not be renewed. Many contracts are for one month or even shorter, suggesting that attachment to a firm is quite low. A stronger influence on productivity works through training and human capital formation: temporary workers and companies will not invest in job-specific training if attachment is low. Even from the perspective of permanent workers, too much job protection may hinder human capital formation, as they do not risk losing their job if skills do not improve. Indeed, human capital formation within firms is very low in Spain (Table 1.4). A third channel works through sectoral shifts: those sectors where temporary work is traditionally prevalent are low productivity sectors, so encouraging temporary work may bias investment towards them, reducing aggregate productivity. This third effect, however, can not be avoided completely if there is a large number of unskilled unemployed workers that seek employment.

In sum, the lack of job creation that was prevalent during the early 1980s was addressed through the liberalisation of temporary contracts, but this was a second-best solution. The capacity of firms to create employment has been enhanced, and indeed the elasticity of employment to GDP has increased substantially as many new workers have entered the labour market when demand conditions were favourable, but the excessive reliance on temporary work has damaged productivity growth. The core problem of high EPL for permanent workers remains, despite the 1997 reform, and the EPL indicator is still among the highest in the OECD (Table 3.1). The comparison with other countries is most striking when looking only at the key indicator, *i.e.* the level of severance payments for permanent workers, which is very high as most firings are considered as non-justified by the tribunals.

Table 3.1. **Overall EPL indicator and severance payments for workers with permanent contracts**

Compensation in months of salary, 2003

	Unfair dismissal, compensation at 20 years of tenure	No-fault individual dismissal, compensation at 20 years of tenure	Overall strictness of protection[1] (index)
Spain[2]	**22**	**12**	**2.9**
Australia	6	1	1.5
Austria	6	0	2.4
Belgium	14	0	1.7
Canada	. .	2.1	1.3
Czech Republic	8	1	3.3
Denmark	9	1.5	1.5
Finland	14	0	2.2
France	16	4	2.5
Germany	18	0	2.7
Greece	12	5.9	2.4
Hungary	10	5	1.9
Ireland	24	1.89	1.6
Italy	15	0	1.8
Japan	9	2.9	2.4
Korea	6	0	2.4
Mexico	16	3	2.3
Netherlands	18	9	3.1
New Zealand	. .	0	1.7
Norway	12	0	2.3
Poland	3	0	2.2
Portugal	20	20	4.2
Slovak Republic	10	1	3.5
Sweden	32	0	2.9
Switzerland	6	2.5	1.2
Turkey	26	20	2.6
United Kingdom	8	2.4	1.1
United States	. .	0	0.2

1. The overall indicator takes into account other variables, like procedural barriers, notice period for dismissals and difficulty of dismissals. Scores can range from 0 to 6 with higher values representing stricter legislation.
2. In Spain close to 90% of dismissals are considered as unfair dismissals by tribunals.

Source: OECD (2004), *Employment Outlook* and OECD (2005), "Assessing the OECD Jobs Strategy: Past Developments and Reforms", *Economics Department Working Paper*, forthcoming.

Other labour market features have an important impact on productivity growth

Although employment protection legislation has been at the centre of the reform debate, other labour market institutions also influence productivity performance. The current wage bargaining system (Chapter 2), for instance, also has a negative impact on productivity growth since it tends to reduce wage differentiation across firms with different performance.

Active labour market policies (ALMPs) may have a direct impact on productivity by improving workers' skills, as well as influencing the employability of the jobless. Spending on ALMPs is low in international comparison, especially considering that half of it (0.45% of GDP, the second highest ratio in the OECD) subsidises employment, mostly permanent contracts with lower severance payments. But these subsidies have a very large deadweight loss, and are typically considered as the least cost-effective active measure.

Apart from phasing out these subsidies and devoting resources to better targeted measures, there is wide scope for improving ALMPs in other respects:

- ALMPs covering the unemployed are not evaluated on a regular basis. The evaluations that have been carried out point to a negligible increase in the long-term employability of the unemployed who follow training programmes (European Commission, 2002a). These evaluations do not provide clear guidance on what measures work better for different groups of workers. Such evaluations have been carried out in other OECD countries, such as Australia, France, Switzerland and the United Kingdom, and are used to improve ALMP measures. The distribution of spending across different active measures does not seem optimal. International experience suggests that the most effective measures for helping the unemployed are counselling and job search assistance (Martin and Grubb, 2001), ahead of training measures and far ahead of employment subsidies or public work programmes. However, counselling and job search assistance seem to be underdeveloped in Spain despite the recent increase in resources for these purposes,[1] as many officials of the public employment service (INEM) spend their time registering the enormous amount of temporary, short-duration contracts. Indeed, the INEM is involved in less than 20% of job placements. Well-targeted training courses would also be effective, but in Spain the spending per unemployed is low and the number of participants high, which suggests that training is provided in small quantities to many unemployed workers, resulting in a negligible effect on employability.
- There is no close co-ordination between ALMPs and passive measures, as those who receive unemployment benefits are not effectively required to participate in active measures. The 2002 reform of the unemployment benefit system aimed at reinforcing conditionality, and also hardened the requirements for rejecting a job offer, while receiving benefits. However, conditionality criteria are very loosely applied, or not at all.

Training of employed workers also has a direct impact on productivity growth. Although workers' training is low, public support for training programmes is equivalent to 0.1% of GDP in Spain, which is relatively high as compared to other countries. It is financed to a large extent by the European Social Fund and social contributions and channeled through a public foundation (*Fundación Tripartita*, former FORCEM) managed by the social partners and since 2004 also by the government. The FORCEM was reformed in 2003 after several cases of fraud and malfunctioning. Under the new system, which is transitional and will be re-evaluated by the new government, subsidies are provided in the form of lower social security contributions rather than grants, while the *Fundación Tripartita* will encourage training in small firms, which have so far been underrepresented. However, the new system still does not require co-financing of training projects, which would ensure that public aid for training goes to projects that firms consider worth pursuing.

Labour market reforms should be comprehensive

Reducing unemployment and the duality of the labour market are declared goals of the Spanish authorities, but they require the reform of several labour market institutions. Decentralising wage bargaining and lowering EPL for permanent workers should be the priority, but other areas should also be addressed. These reforms should be undertaken at the same time, and the white paper currently being elaborated by an expert group provides an opportunity to do so. There are two reasons for a comprehensive strategy. *First*, there are complementarities among different reforms. Such complementarities are obvious, for instance, between ALMPs and the management of unemployment benefits. Enforcing conditionality for receiving unemployment benefits would help to shorten unemployment spells, but it requires better ALMPs, especially better employment services, to improve employability. Reducing the current abuse of temporary contracts through job inspections would help to lower their share in total employment, but the attractiveness to the employer of permanent workers also needs to be improved through lower EPL because otherwise employment may suffer. Lowering EPL would free resources currently used as subsidies for permanent contracts that could be used for alternative policies like increasing funds for better targeted ALMPs. *Second,* political economy reasons would also argue for complementary reforms. Many of these reforms are opposed by trade unions or employers' associations, and hence are very difficult to pursue in isolation.

Perhaps the best example of complementarities can be found between EPL and unemployment benefits. Both partly fulfill the same roles. In the current framework, severance payments have two objectives: *i*) they provide revenue to laid-off workers, and *ii*) they raise the cost of dismissals, which lowers employment volatility. Both goals are justified to some extent by social preferences and efficiency considerations. The latter recognise that excessive employment volatility may undermine economic performance (Blanchard and Tirole, 2004) and that job search requires some time to match a worker's skills with job requirements. However, high and uncertain costs of dismissals also create a strong disincentive to grant permanent jobs, as has been the case in Spain for many years. The first objective of severance payments is also addressed by unemployment benefits, whereas the second objective can be targeted by alternative instruments, such as a bonus-malus system (experience-rating) for firms that increases with the number of dismissals, penalising those companies that lay-off often. Therefore, a system that provides adequate benefits for the unemployed and a bonus-malus system would fulfill both objectives without undermining employment creation. Alternatively, the EPL system could be overhauled in a similar way as in Austria: there, employers pay a contribution to individual accounts of workers that are given to the worker in the case of dismissal or at retirement if the worker is never laid off. This would eliminate the uncertainty element in the current Spanish system. All these proposals are perhaps too radical to gather wide support immediately, but show that it is worth looking at alternative solutions that fulfill the role of providing revenue for the unemployed and reducing excessive employment volatility, but with a less negative impact on employment creation.

Improving human capital investment

Enhancing education quality is a priority for the authorities

A good education system fulfills a number of social goals. It also affects economic performance by raising human capital. More education not only raises the stock of knowledge, raising labour productivity levels, but also provides the means to acquire new skills, raising future productivity growth. Education is a reform priority for the Spanish authorities, and initiatives to improve education quality have mushroomed, touching all levels of education from pre-primary school to university. The previous government initiated reforms in early childhood education (extending free education to ages 3-6), in compulsory education (introducing, among other things, more intermediate tests and separating students into groups by ability at earlier ages than was previously the case) and in tertiary education. Many of the changes introduced by these reforms have not been implemented yet and are not supported by the new government, which has opened a public debate on education reforms and may reverse some of the approved measures.

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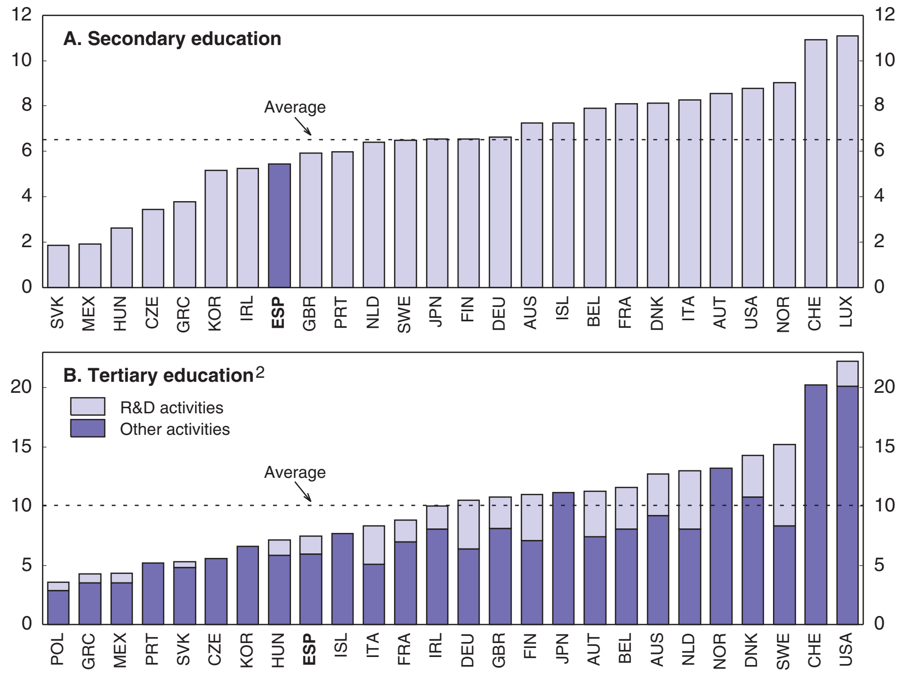
Spending is below the OECD average at all levels of education. The gap is small for primary and secondary education but much wider for university education (Figure 3.1) and the new government has promised to raise spending. There is a long-standing debate on whether "money matters" for education outcomes, which has not arrived at clear-cut conclusions. Although few empirical studies have found a significant relationship between more spending and improved results (Hanushek, 1997), a recent reassessment seems to find some evidence that additional resources may have a positive impact on performance (Krueger, 2002). Across OECD countries, results of the PISA report on education outcomes of 15 year-old students do not show a significant correlation with spending per student. What seems uncontroversial, however, is that socio-economic variables that fall outside policy control, like the income level or the education background of parents, have by far the largest impact on children's performance (Mancebón Torrubia and Muñiz Pérez, 2003). More resources may be necessary in some areas to improve quality, or in favour of some disadvantaged groups to increase participation, but it is more important to carefully design reforms, so that the right incentives help maximise results from available resources.

Figure 3.1. **Education expenditure per student**

By level of education, in thousand $, 2001[1]



1. Converted using purchasing power parities and based on full-time equivalents. Public institutions only for Hungary, Italy, Poland, Switzerland and Turkey. Public and private independent institutions for the United States.
2. Includes post-secondary non-tertiary education for Denmark, Japan and the United States. Public institutions only for Norway.

Source: OECD (2004), *Education at a Glance.*

Child care facilities should be expanded

Participation in formal education of children aged 3-6 is almost universal, but that of children aged 0-3 is well below the OECD average. This poses problems for female labour market participation and probably reduces the fertility rate, both of which are well below the OECD average (Jaumotte, 2003). To the extent that female work is constrained by the lack of child care facilities, improving child care provision would probably imply large productivity gains, as the ratio of adults per children is much lower in the education system than at home. In principle, this is internalised in the participation decision of women, who may find it convenient to work and use part of their salary to pay for formal child care. However, there is also a rationale of public provision of early child care, as education at early stages has a positive externality linked to the socialisation of young children, health screening and readiness for school. A second positive externality stems from the role of early childhood education in integrating immigrants' children, which is a pressing need because of the rapid inflow of immigrants. A third externality is linked to the taxes paid by the additional workers. In Spain, public provision is almost non-existent, although some autonomous communities have recently approved some tax breaks for spending on child care institutions and formal childcare is VAT-exempt and enjoys tax advantages on the corporate income tax. More public funding, for example through more generous tax breaks, seems to be justified. These should be designed at the national level, as it is the level at which tax externalities accrue.

The Education Quality Law (LOCE), passed in 2003 but not yet implemented, provided for lower skill requirements for workers in child care institutions to underpin the rapid expansion of such facilities. In particular, it stated that a degree at vocational training level, rather than a three year university degree, would suffice. This measure has been contested with the argument that child care has also an important education content and therefore requires highly qualified personnel. Best practice in other countries would seem to validate this argument. To limit costs, however, and to allow the expansion of supply, which is currently limited, the relevant authorities may wish to consider a mix of personnel in services. For example, a certain percentage of tertiary trained staff could be aided by child assistants trained to upper-secondary vocational level. As the system matures, the percentage of the more highly trained staff should then be increased.

Quality in education would benefit from greater school autonomy

In compulsory schooling, one of the main problems is education quality, which was addressed by the LOCE. The law attempts to improve quality by encouraging responsibility of students and especially helping the best of them to perform better. Indeed, results from the PISA study demonstrate that the average Spanish student performs below the OECD average in core subjects, but also that the dispersion of results is relatively low, implying that there are not many outstanding students. However, experience in other OECD countries shows that those countries that score better in PISA tests are also those with low dispersion, since they are those which pay more attention to not leaving under-performing students behind. This suggests that high average performance is compatible with maintaining good results for most students.

Education quality would benefit from developing more effective evaluation mechanisms, and from greater autonomy of schools, since this would give them flexibility to adapt to local conditions and to students' backgrounds. This is relevant in the current context of strong immigration, which is creating serious integration problems in some areas and poses one of the main challenges for education policy. More decentralisation of decision-making may also increase efficiency by reducing bureaucracy, and allow more initiative at the school level (OECD, 2004a). Spanish schools have little autonomy, especially on allocating resources and on personnel management, although there is greater

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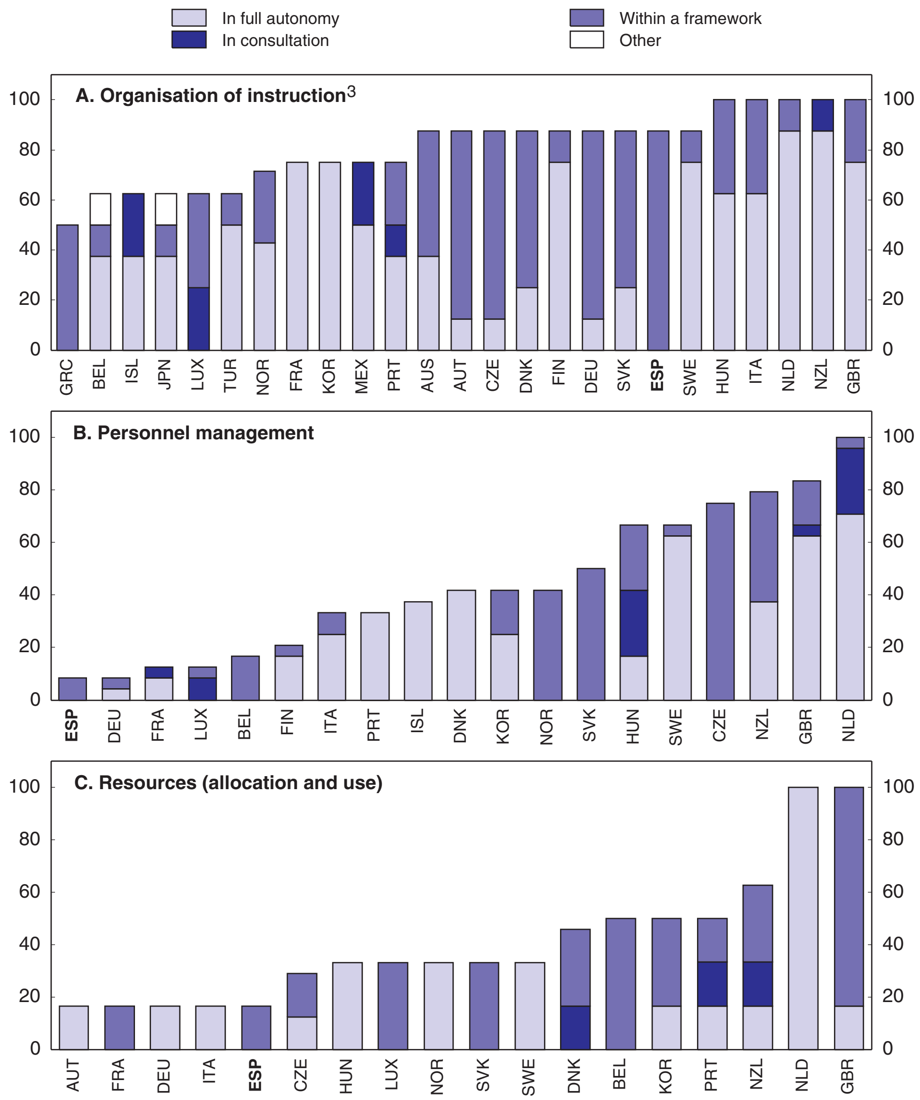
autonomy in the organisation of schooling (which includes admission policy and instruction time) (Figure 3.2). The LOCE provides for more autonomy by reinforcing the role of the school head, although this does not extend to personnel management, such as hiring policies and wage determination. Wages per hour are higher than the OECD average in secondary education despite a decrease in real terms between 1995 and 2003, although in primary education they are much lower. Wage scales are rigid and narrow, as they only evolve slowly with seniority. The gap between the starting salary and that after 15 years of experience, for example, is one of the smallest in the OECD. Moreover, there is no effective linkage of wages to performance, which suggests that incentives to raise teaching quality

Figure 3.2. **Measures of autonomy in school management**[1]

Public sector lower secondary education, per cent, 2003[2]



1. The modes of decision making are the following: full autonomy, after consultation with bodies located at another level within the education system, independently but within a framework set by a higher authority, other bodies within the education system.
2. Limited data coverage for the United Kingdom (England only) and for Belgium (French speaking part only).
3. For Turkey, data refer to primary education only.

Source: OECD (2004), *Education at a Glance*.

and to attend training are very low. Reforms introducing greater pay flexibility could follow the example of a number of OECD countries where teacher excellence is evaluated through performance results and rewarded (OECD, 2004a).

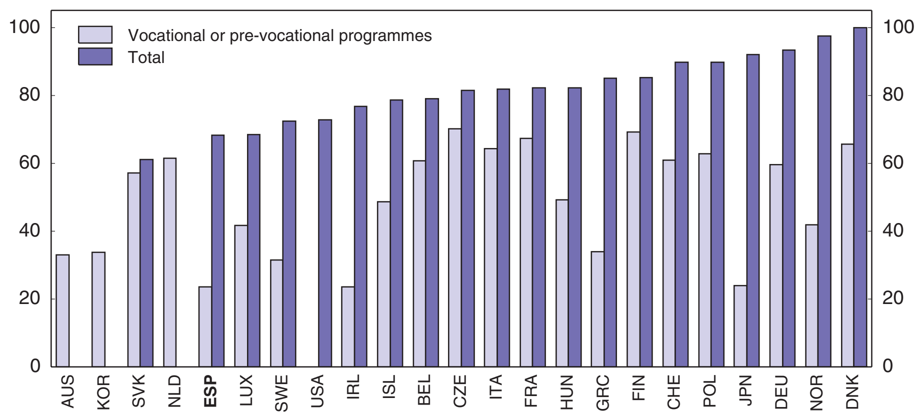
The LOCE also provides for separation of students earlier than before, at age 13, on the premise that grouping them together by previous performance will allow the best students to progress more rapidly and to provide special help to less able students. Although there is some logic to this argument, it can also be argued that the best students contribute to more dynamic classrooms and early separation may increase dispersion of performance. PISA tests suggest that those countries where separation is implemented at early ages (like Austria, Germany or Italy) do not perform above the OECD average. The new government will probably reverse this measure, although it may keep separation in some core subjects like mathematics or language courses.

Participation in upper secondary education and vocational training is low

Compulsory education is crucial in providing basic skills and forming citizens. Post-compulsory education (after age 16) has a more direct link with work skills, so it is important to properly match education with economic skill requirements. Post-compulsory education suffers from similar organisational constraints as compulsory schooling. In addition, participation in post-compulsory education is low. Compulsory education was extended to age 16 in 1990 when the previous schooling law (LOGSE) was implemented, which raised participation closer to OECD levels. However, the share of the population with upper secondary education is one of the lowest in the OECD. Only 41% of the adult population has attained upper secondary school or higher, while the OECD country mean is 67%, although the attainment ratio for the generation aged between 25 and 34 is much higher than for older generations. Even so, the current graduation rate is still far below the OECD average (Figure 3.3). At the same time, vocational training is under-developed. Most students of upper secondary school train for joining university (where enrolment is higher than the OECD average), whereas in many other OECD countries most go to professional training. This is despite the fact that wages and employment

Figure 3.3. **Participation in post-compulsory education and vocational training**

Graduation rate in per cent of population at the typical age of graduation, 2002[1]



1. In both public and private institutions. 2001 data for Denmark, Finland, France and Italy. For Spain, a significant proportion of the youth cohort is missing.

Source: OECD (2004), *Education at a Glance*.

perspectives for those with vocational training are better than for those with university training early in their working life.

All this points to a skill mismatch. Many young workers with university degrees have problems to find adequate vacancies for their qualifications and perform jobs which are below their educational attainment. According to Collard *et al.*, (2002), the proportion of low-skill jobs filled by highly-skilled workers was 15% in 1996, and others have found evidence that firms prefer to hire university graduates rather than training lower skilled workers (García-Serrano and Malo-Ocaña, 1996; Beneito *et al.*, 1996). As a result, those with only secondary education have high unemployment rates. It has been argued that this "ladder effect" is a sign of over-education of some tertiary level graduates (Dolado *et al.*, 2000; Lassibille *et al.*, 2001).

Increasing participation in upper secondary education is not easy, as participation may be driven by the opportunity cost *vis-à-vis* alternatives (work) and ultimately may be related to economic development, although the gap in participation with respect to most other EU countries seems to be larger than differences in per capita GDP. Part of it may also reflect credit constraints of poorer families, especially in less developed regions where low participation is much more prevalent (de la Fuente *et al.*, 2003). In this respect, it may be advisable to further develop grant or guaranteed loan programmes for less well-off students, especially in the poorest regions, as human capital investment is probably more productive than other types of investment for achieving regional convergence (Chapter 4). Another option is to improve the attractiveness of vocational training, or to expand the availability of university degrees of short duration, which are much less common than in other OECD countries.

Vocational training (*Formación Profesional*) has traditionally suffered from a lack of prestige as it was compulsory for some students when it was introduced in the 1970s. For a long time, it was considered as the option for those not attending university. After the 1990 reform enrolment has risen, especially for the second cycle of vocational training (which is classified as tertiary education), and the paths to access university from vocational training have been improved. Recently, the catalogue of activities or "professions" has been expanded and redefined to take service sector requirements better into account. Business organisations have participated in the process, and revisions of the catalogue will take place every five years. The catalogue has also been merged with that of professional training (workers) and occupational training (unemployed), to facilitate life-long adult learning, as recommended by the OECD. This is positive, but may not be enough. One area where there is wide scope for improvement is the availability of apprenticeships in firms, which are much less developed than in other EU countries (OECD, 2003a). For that, the institutional framework, with participation of business associations, needs to be developed further. Another option is to develop non-university tertiary institutions, as was done in Finland, Austria and Switzerland.

Ultimately, a powerful way to solve the possible mismatch between education and skill requirements is to design adequate financial incentives to different education options. In this respect, it could be necessary to improve incentives for participation in upper secondary education and vocational training, while raising fees for universities. Fees for university education are very low, covering only a small percentage of the cost (10%). This implies a large subsidy to university students, even though they earn much higher lifetime wages and will have low unemployment rates. Generous public funding for secondary education is prevalent throughout the OECD and is justified by large externalities to school education. Such externalities also exist for university education, but to a lesser extent as the high rates of return attached to university education accrue mostly to the individual, rather than to society in general (Blondal *et al.*, 2002). Raising fees would reduce incentives to enter university for those students that in the end do not profit much from it, which are many as demonstrated by the high dropout rates in the first university years, and improve incentives to enter alternative education paths. Higher fees would also help to improve university financing, and to expand a programme of subsidised loans or loans subject to income-contingent repayments for those students who are subject to liquidity constraints.

Improving quality in university education requires linking their financing to performance

Quality concerns have also been raised for the university system. Although there are no international comparisons in the form of test results, universities provide education to a large number of students in large classrooms, with a low rate of teachers per student in many disciplines, although this is less so now as the number of courses has expanded and the number of students has diminished thanks to demographic dynamics. Survey information shows that teaching of Spanish graduates does not correspond well to labour market needs, with a low weight on practical skills such as use of computers, oral communication and planning skills, ability to solve practical problems and ability to work under pressure (COTEC, 2004). In research, Spain has a relatively high number of publications in scientific journals per researcher, but the share of highly cited publications is only 0.47% of the total number of publications, compared to 1.64% in the United States, 1.10% in the United Kingdom, 0.88% in France and 0.73% in Italy (European Commission, 2002b). Student mobility across universities in Spain is very low, in part because many universities exist but also because specialisation across them is limited. Almost every town with more than 50 000 inhabitants has a university, offering often a broad range of subjects. In addition, the external control of the selection system for professors should be improved in order to reduce the excessive number of jobs that go to internal candidates (endogamy). This selection system has been recently modified by implementing a national pre-selection exam before vacancies are filled by university departments. However, this system has resulted in some cases in a drop in the number of vacancies, as university departments are afraid that their own candidates do not pass the pre-selection process. A more open selection process is needed, based on objective criteria and probably with participation of renowned international experts to ensure independence.

Raising university fees would provide resources for higher education spending

More importantly, the financing system of university departments should be linked to performance. This, more than anything, would reduce endogamy and would push universities to devote all their efforts to improve teaching and research quality, which would in turn increase student mobility. Currently, universities are financed by the regions and funding does not follow transparent or uniform criteria. Among the tools to develop a performance-based financing system is the national agency for evaluating universities created by the university reform, which will base evaluation on a wide range of quantitative indicators. These indicators should be used not only to inform the public on which are the best universities, but also to redirect resources. In addition, the financing system of research activities in universities and public centres should also be based on the evaluation of their results, as it is the case for instance in the United Kingdom or New Zealand. Combining this performance-based financing with higher fees for students would not only be more progressive, but also increase competition among universities and would provide incentives for students to get the maximum out of their years in education.

Boosting research and development and the adoption of new technologies

Business R&D spending is well below the OECD average

Despite improvements in recent years, Spain is still close to the bottom of R&D rankings with a spending-to-GDP ratio of 1.1%, against an EU average of 2% and 2.8% in the United States. New EU member states, which have much lower per capita GDP than Spain, are close to Spain at 0.84%. Almost half of spending (48%) is carried out by the public sector (universities and government institutions), while about 65% is private in many EU countries and 70% in the United States. The authorities' goal is to reach the 3% Lisbon target by 2010, and to raise the share of private spending to two-thirds. This objective is a policy priority of the current government. It has promised to double public support for R&D in the next four years and has already started with a 25% increase in the 2005 budget.[2] Public policy for R&D is carried out by both the central government and autonomous communities. These not only control universities, but also have their own R&D policies, which vary widely across regions.

Providing public funds for R&D purposes has a clear rationale, as most studies show that positive externalities of R&D are large, especially in basic science, which is almost a pure public good that usually generates very low private but high social returns. Spillovers from R&D also include spin-off applications for other firms, while human capital externalities (network effects) also exist. Public incentives for R&D are also justified by the fact that protection of intellectual property rights is limited in time and scope. As a result, they cannot fully appropriate the consumer surplus generated by new products, reducing incentives for innovation below the optimal level (Jones, 1998; OECD, 2004b). Moreover, the OECD Growth Study has found that R&D is an important driver of productivity growth, especially when it comes from private sources (OECD, 2003a). This makes policies that promote R&D and innovation all the more important. However, to raise private R&D spending, the strategy should focus on improving framework conditions.

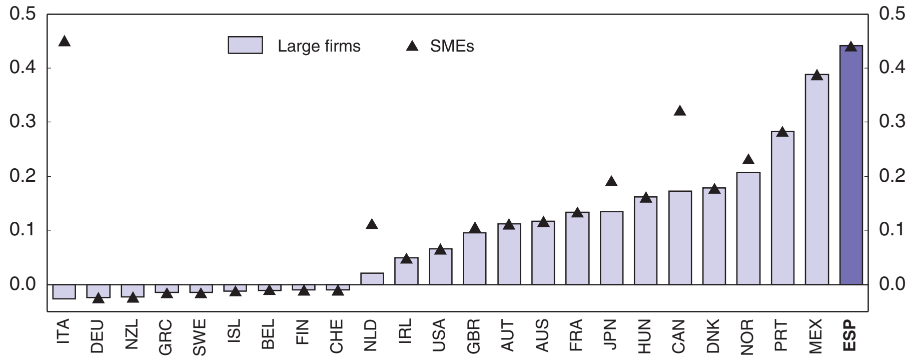
Public support for business R&D activities has to be carefully designed and evaluated

Choosing the right tool to channel support to the private sector is important, although there are no clear-cut advantages of either tax credits or subsidies. On the one hand, tax credits do not interfere with the choice over different R&D projects and are more market-neutral than subsidies, which are of a more discretionary nature; they are also easier to manage for firms. On the other hand, tax credits are less transparent and carry a higher deadweight loss than subsidies, as they also finance projects that would have been undertaken anyway (van den Noord, 2005). The discretionary nature of subsidies can also be an advantage when R&D policies are able to discriminate in favour of those projects that generate larger externalities (Atkinson and Stiglitz, 1980).

Spain has the most generous R&D tax break in the OECD (Figure 3.4), including a full write off for R&D-related investment in fixed assets, deductions for R&D-related spending (30%), deductions on incremental spending (50% of spending above the average of the previous two years), and an additional 20% on researchers' wages. However, these

Figure 3.4. **Tax breaks for R&D activities**

Percentage ratio of tax subsidies for $1 of R&D, 2004



Source: OECD (2004), *OECD Science, Technology and Industry Outlook*.

incentives are not much used. Only 15% of companies which innovate benefit from the tax breaks (COTEC, 2004). The authorities attribute the lack of use to bureaucratic problems, as the Ministry of Economy and Finance, responsible for implementing the deduction, has not the required technical expertise to evaluate the projects and select those qualifying for the deduction. The system has been improved by the introduction of an optional certificate to be issued by the Ministry of Industry, Tourism and Trade, whose content is binding for the tax administration. In the authorities' view this should increase their use.

Subsidies are provided in the form of grants and loans with no interest payments, the latter being more prevalent. Conditional soft loans have the advantage of being cheaper and eliminate risks, as they are not reimbursable if the project does not succeed. They also imply a large private contribution to the project in case of success. In other cases, however, the incentive provided by subsidisation of interest payments may not be high enough to attract firms to projects that generate large external effects. In Spain, loan subsidies are provided conditional on strong guarantees by firms, which add a considerable cost for firms. Direct funding for R&D projects is provided, among other institutions, by a public agency (CDTI), but this agency has only provided funding on very low risk projects. In general, R&D and innovation policy has focused on deciding which are the priority areas for investment, without paying enough attention to the adequacy of economic instruments (tax incentives, grants and soft loans) to channel public aid to different types of projects and without evaluating the costs and benefits of different projects. From an institutional point of view, the defunct Ministry for Science and Technology, created in 2000, concentrated all R&D related policies in a single department, which should have made it easier to carry out such evaluations in a comprehensive way. However, since 2004 R&D responsibilities have been split among different ministries, making coordination more difficult. As in other areas related to public spending, it would be useful if systematic evaluation of the efficiency of all R&D policies were carried out with objective criteria. In this sense, the National Plan for Research, Development and Innovation includes a follow-up mechanism which has not been implemented yet, but any rigorous evaluation will need detailed quantitative objectives in the current programmes. An independent evaluation of the main subsidy programme (PROFIT) revealed a loose link between projects and R&D activities. In addition, it is important to address other problems that are holding back R&D

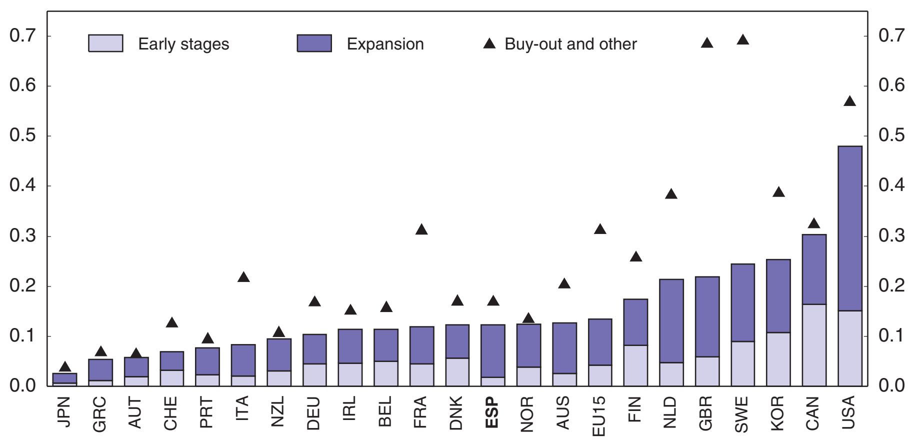
spending in businesses, such as information and human capital barriers, lack of entrepreneurship or a risk-averse financial and management culture.

Framework conditions for business R&D spending and entrepreneurship are important

As in many EU countries, business R&D is mostly carried out by large firms, but this has not raised innovation activities to the level of other OECD countries. The largest Spanish firms are relatively small in international comparison, so that R&D activities that require scale are limited. Moreover, the number of small but rapidly expanding technology firms, which have played an important role in some OECD countries for "new economy" sectors, is negligible. Liquidity constraints are in many countries behind the lack of start-ups, as credit market failures impede the flow of capital to risky technology projects. To cope with these failures, venture capital markets can provide favourable conditions for such investments. In Spain, venture capital regulations were merged in a single law in 1999, defining venture capital activities and providing an adequate framework for venture capital institutions. Fiscal incentives were also provided in the form of full tax deduction of capital gains and dividends of start-up companies (if the investment is maintained for between 2 and 15 years). Even if the start-up company is floated in the stock-market, which normally would eliminate the possibility of any tax advantage on capital gains, these special tax breaks can be maintained for one year. Despite some expansion, venture capital investments have not yet taken off, as they account for only 0.12% of GDP. In addition, venture capital for start-up companies is particularly low, since most institutions prefer to invest in the expansion phase of already existing companies and in traditional sectors rather than high-tech firms (Figure 3.5). The reasons for this bias are difficult to identify, but they are probably related to the prevalence of a highly risk-averse financial culture. Lack of experience of venture capital managers is also a problem, but could be overcome by co-operation with international venture capital funds which have already entered the Spanish market, or more directly through the implementation of small public equity programmes that invest public funds in start-up firms through

Figure 3.5. **Venture capital by type of investment**

In per cent of GDP, 2000-03[1]



1. 1999-2002 for the United States;1998-2001 for Australia, Japan, Korea and New Zealand.

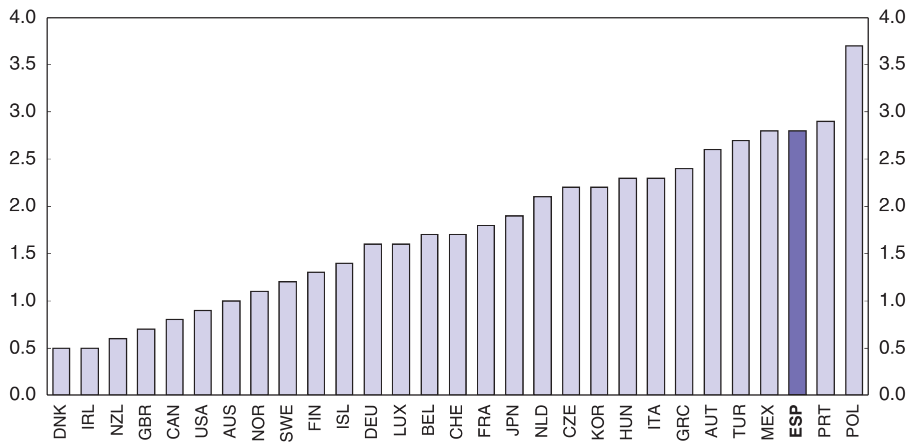
Source: OECD Venture Capital database, January 2005.

professional management companies (OECD, 2003b).[3] Tax breaks for venture capital investment should also be extended to individuals and firms (which at present pay the normal rates of 15% and 35%, respectively, for capital gains) to allow the emergence of "business angels".

Developing a dynamic venture capital sector is not the only road to promote R&D activities through the creation of new small high-tech firms. Other factors, such as developing entrepreneurship and reducing administrative barriers to create new firms would also help. Bankruptcy regulations have not traditionally promoted an entrepreneurial spirit as they seemed to put a stigma on economic failure, rather than considering it one of the possible outcomes of risky economic activity (European Commission, 2003). The new bankruptcy law (*Ley Concursal*), approved in 2003, has modernised insolvency procedures and has made easier the resumption of business activities by the debtor after the insolvency procedure (unless the procedure is classified as fraudulent). This should help to remove barriers to entrepreneurship. Administrative burdens to create new businesses also seem high as compared to the OECD average. According to the OECD summary indicator, Spain has the highest burden for business start-ups, despite some progress in recent years (Figure 3.6). Addressing these issues would have a sizeable effect on start-ups for business R&D and high-tech sectors; indeed, the Spanish authorities recognize these problems and are ready to implement a plan to promote entrepreneurship in 2005.

Figure 3.6. **Administrative burdens for startups**

Indicators of strictness of legislation, 2003[1]



1. Scores can range from 0 to 6 with higher values representing stricter legislation.

Source: OECD, *Product Market Regulation Indicators*, October 2004.

Framework conditions are also affected by human capital resource issues. As highlighted above, the number of university graduates has grown substantially. The share of science and technology graduates is now slightly below the EU average, but the graduation rate at PhD level, which is a key factor for R&D activities, is one of the lowest in the OECD. Spain ranks fifth in the European Union in the relative number of researchers per thousand employed, but most are in the public higher education sector. The number of researchers per thousand employed in industry is only 1.6, as compared with 5.4 in France, 5.7 in Germany or 2.2 in the United States. This is partly due to the low level of business

R&D, but may also reflect labour market rigidities that result in low wages for researchers. Although no data exist on wage levels with respect to similarly skilled workers, researchers in universities and public institutions are mostly civil servants and wage compression is higher than in the private sector. Work conditions for young researchers during and after their post-graduate studies are far from optimal, as salaries are low and sometimes they have no access to some social security benefits. Researchers trained abroad often have difficulties in finding a job in Spain as the selection process of personnel in some universities suffers from endogamy, although there exist special programmes that facilitate their return. The civil service nature of the jobs undermines job mobility towards the private sector. In this respect, linkages between public research institutions and private business, which are another sign of a dynamic business R&D environment, are still low, in part because of a managerial culture in Spanish firms that is reluctant to embark on R&D projects. In this respect, programmes that foster the participation of public researchers in private firms are useful to increase the absorption of R&D and new technologies by firms, but their budget allocation is small. Business-funded research in universities and public R&D centres is rare, and only 36% of Spanish companies consider cooperation as part of their innovative strategy, against 48% in the European Union. Lack of co-operation with universities is considered by experts as one of the major bottlenecks (OECD, 2004c). Addressing these issues should be a priority for innovation policy.

Promoting clusters would encourage innovation by small firms

One of the sources of returns to scale within a firm is the amount of knowledge and experience that can be shared among its employees. Small firms do not enjoy this advantage, but they may be able to co-operate in some areas and share knowledge if they are close to their clients and to each other by exploiting spatial externalities in clusters. In Spain there are clusters of technology firms in some technology centres, which group together firms that carry out innovation services, usually formed by small firms that cannot carry out innovation activities on their own. Technology centres are usually privately managed by client companies. The Spanish authorities want to expand their role, creating new ones after consultation with employers' associations and connecting them in networks to increase their potential external effects. The promotion of such centres seems an efficient way of fostering R&D activities of small firms and of introducing new processes and products, even in sectors which are not high-tech or less innovative. International experience shows, however, that the government should not be the main architect of such centres but should leave the initiative to the private sector. Some public role may be useful, however, to reduce information barriers by providing viability studies and identifying innovation bottlenecks, and to provide administrative and management support (OECD, 2002).

Notes

1. Public employment services (PES) appear to be understaffed compared other OECD countries. In 1999, the annual flows of job seekers per PES staff member exceeded 1 000 in Spain whereas it reached 246 for the United States, 439 for Japan, 97 for Germany, 137 for France and 351 for Italy. The budget for the INEM, the public employment service, has increased by 13% in 2004.
2. The previous National R&D Plan had a target of 1.29% for 2003 which was not achieved. The current Plan (2004-07) includes an intermediate target of 1.22% for 2005.
3. Some regions, like Cataluña, and universities, have programmes for the promotion of start-ups through venture capital.

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Chapter 4

Getting the most out of public sector decentralisation

In about two decades, Spain was transformed from one of the most centralised countries to one of the most decentralised. Spending functions were devolved rapidly. The regions have exercised their discretionary powers quite extensively and innovative policies have been implemented. But devolution was also accompanied by a hike in public employment and pressures on public spending, reflecting duplication in resources and poor co-ordination across and between government levels. The recent devolution of taxing powers could raise the accountability of the regions and, thus, cost-consciousness, although their effective use has been limited. Securing fiscal discipline would require better information on sub-national governments' policies and outcomes so as to allow citizens to press for improved performance. The financing system of the regions also needs to be reformed to ensure sustainability in the face of changing demographics, while the fiscal rules need to be upgraded to avoid recourse to off-budget operations.

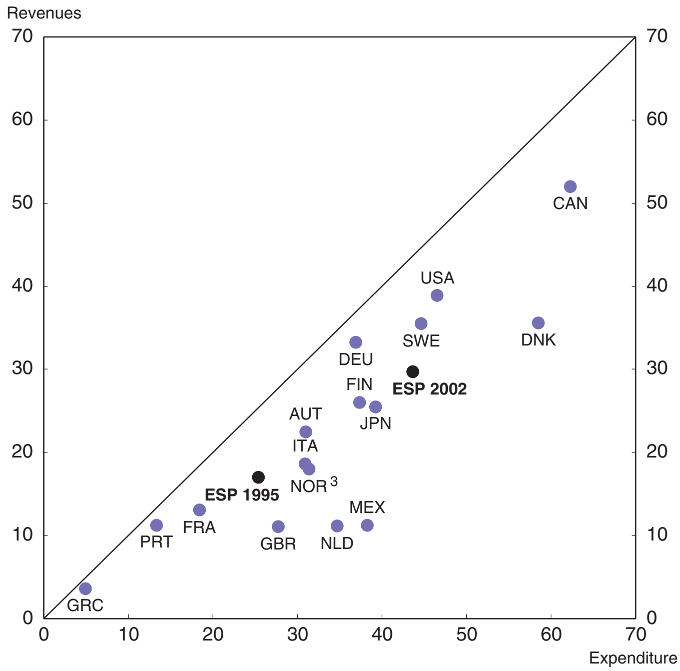
Forces shaping fiscal relations across levels of government

Responding to regional demands for more autonomy

Demands for greater regional autonomy, which have led to a rapid decentralisation over the recent years (Figure 4.1), have been spurred by a long history of asymmetric federalism. The so-called *Foral* system, which dates back to the 18th century, gives País Vasco and Navarra significant autonomy. They have wide-ranging discretionary powers to set tax bases and rates (value added tax [VAT] being the notable exception), collect most of them and remit a payment to the central government for the services it provides. And in País Vasco, the regional government is now pressing for even greater autonomy.[1] The other 15 regions, known as "common regime regions", have less autonomy, in particular in setting and collecting taxes. Spending responsibilities across common regime regions also

Figure 4.1. **Sub-national government share in general government revenues and expenditure**[1]

Per cent, 2002[2]



1. Revenues include direct and indirect taxes as well as non-tax revenues received by regional and local governments and are expressed as a share of revenues received by the general government. Expenditure corresponds to total expenditure by regional and local governments expressed as a share of general government expenditure. Transfers between governments are netted out. The country ranking in this figure does not necessarily correspond to the comparative fiscal autonomy of sub-national governments.
2. Or latest year available: 2000 for Japan and Mexico, 2001 for Portugal.
3. Mainland only. Data exclude revenues from oil production.

Source: OECD, *National Accounts*; Statistics Norway; Statistics Canada; US Bureau of Economic Analysis.

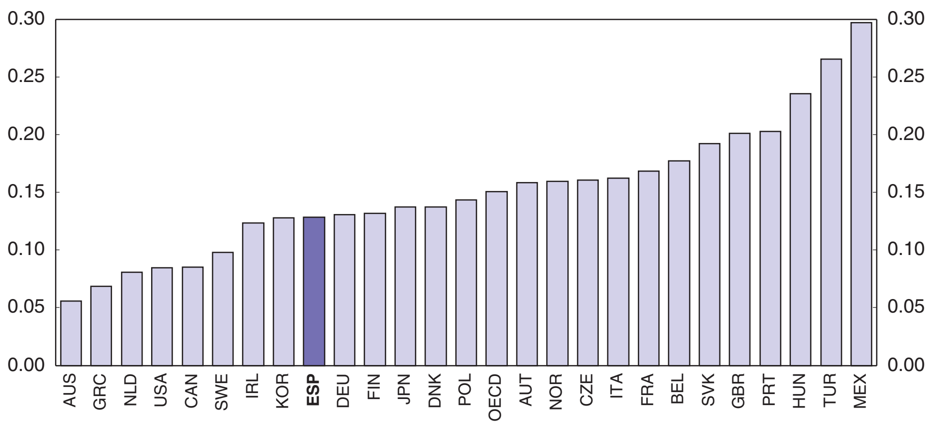
varied significantly from the late 1970s to 2002, when the devolution of the health and education systems was completed. The Foral regions contribute less to fiscal equalisation schemes than the common regime regions. This asymmetric federalism has nurtured demands for more autonomy in regions with a strong regional identity (in particular Cataluña) and has challenged intergovernmental transfer schemes. At the same time, the role of the regional representatives has grown significantly over the past decade, although not directly through the upper chamber (the senate). Since 1993, political parties elected to govern have had an absolute majority in Parliament for only four years and have had to win the support of regional nationalist parties, in particular from Cataluña, País Vasco and, to a lesser extent, from Canarias.[2]

Addressing regional income disparities

Reducing income disparities and promoting a balanced development throughout the country are important policy objectives. Income disparities across regions have declined, albeit slowly (de la Fuente *et al.*, 2003a), and were narrower than in many other OECD countries in 2001 (Figure 4.2). Central government efforts to develop infrastructure in low-income regions and EU structural funds have played a role in fostering convergence. Total structural fund expenditure accounted for 3.8% of the aggregate output of the Objective 1 regions in Spain over the period 1994-99, for almost 50% of the total spending on infrastructure and 13.8% of other investment in physical capital (de la Fuente, 2003). EU enlargement will likely entail that some regions will no longer qualify for Objective 1 funding since their GDP per capita has moved above the EU-wide 75% income threshold. At the same time, existing fiscal rules imposed on sub-national governments, by limiting recourse to indebtedness, may impinge on sub-national investment. This situation will likely require exploiting opportunities to raise public spending efficiency at the sub-national level, so as to provide some room to finance investment needs from existing resources.[3]

Figure 4.2. **Regional dispersion in GDP per capita in OECD countries**

Gini index, 2001[1]



1. Gini coefficient with GDP per capita in NUTS3 territorial units weighted by population. 2000 data for Mexico, Norway and Turkey.

Source: OECD (2004), *OECD Regions at a Glance*, forthcoming.

Coping with demographic developments

Migration and ageing will have significant fiscal consequences on sub-national governments and create funding tensions. Immigration has increased dramatically since the late 1990s. The number of foreigners on municipal registers (*padrón*) reached 3.1 million in 2004, more than four times the 1999 level. Some regions have attracted most of this inflow – in 2003 the proportion of foreigners reached 9% or more of the population in Baleares, Canarias, Comunidad Valenciana, Madrid and Murcia, compared with 6.2% for Spain as a whole.[4] Internal migration flows, although very low by international comparison, are adding some momentum, with some regions experiencing a constant decline in population. These demographic developments have had a significant impact on the demand for public services funded by the regions (in particular health care and education, to which foreigners are given free access as soon as they are registered in a municipality). Ageing populations will also create significant spending pressures. Health and long-term care services are funded by the regions and spending is projected to increase steadily as the population ages. Raising the female participation rate – one of the objectives of the central government – will require developing elderly and child care services, two areas in which Spain is clearly lagging behind most other EU countries. All these considerations call for a reassessment of the existing funding principles for the regions, in particular to ensure that sub-national governments' revenues adjust adequately to demographic developments, and to avoid too distortive adjustments in sub-national taxes.

Securing sound public finances

In a highly decentralised setting, strengthening fiscal co-ordination across levels of government is of paramount importance to ensure that the overall fiscal framework does not unduly restrain the growth potential of the economy. While the progress made with fiscal consolidation since the mid-1990s is impressive and the tax-to-GDP ratio relatively low, demands for increasing social spending are accumulating and the fiscal impact of population ageing is projected to be large. Balanced budget rules have been imposed on sub-national governments. But allowing a role for automatic stabilisers, avoiding recourse to fiscal gimmickry and ensuring that public investment does not bear most of the brunt during downturns remain important concerns. In addition, by targeting fiscal balances, existing fiscal rules do not directly restrain public spending, leading to the risk of a rise in sub-national taxes with potential adverse effects for the economy as a whole. Creating the appropriate incentives for sub-national governments to improve the cost-effectiveness of spending should be a priority. The strengthening of peer and competitive pressures across sub-national governments, as well as the design of intergovernmental grants are, in this regard, important instruments.

Spending assignment issues

The devolution of spending responsibilities to the regions has been rapid and far-ranging since the early 1980s (Box 4.1). It comprised the two largest public spending items after pensions, namely education and health care. In addition, social assistance – which the 1978 Constitution already placed under regional control – has gained in importance. Overall, the share of the regions in total public spending rose from 14% in 1985 to 31% in 2002, a high share compared with most other federal OECD countries (Figure 4.3, panel A). Devolution has had positive features but some thorny issues have also arisen. To

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Box 4.1. **Spending assignment across levels of government**

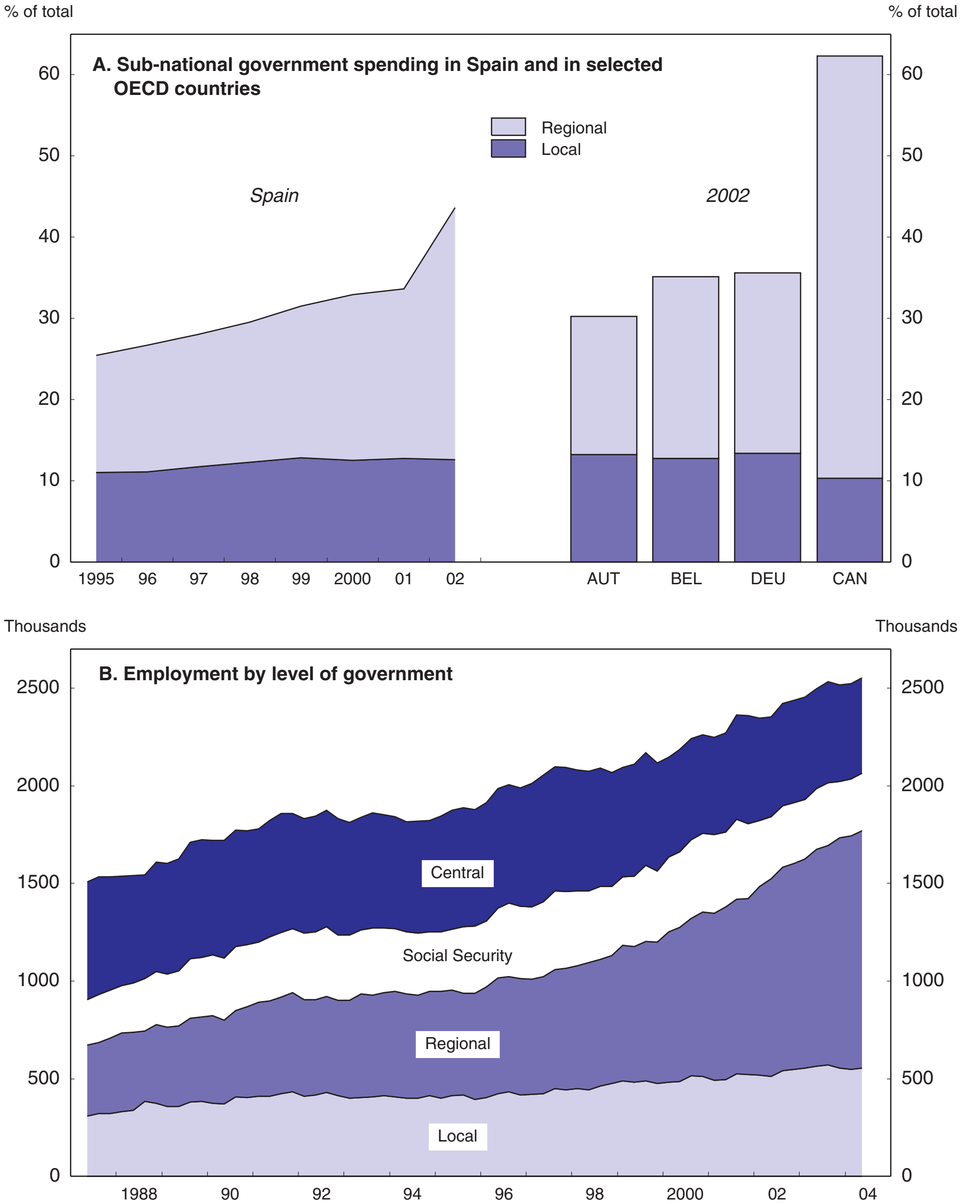
All ***regions*** now have broadly the same responsibilities as regards the delivery of public goods and services, after two decades of asymmetric federalism – some regions took over responsibilities much earlier than others, *e.g.* for health care, ALMPs or education. The Constitution enumerates the powers that may be adopted by the regions (Article 148) and those which are an exclusive competence of the central government (Article 149):

- Article 148 lists the 22 functions over which regions may assume regulatory and executive responsibilities. These include: urban regulation, housing, regional infrastructure (railways and highways which are confined to the territory of the region, recreational ports, airports and water infrastructure in its territory), health care and social assistance. The devolution of health care responsibilities began in 1981. By 1995, seven regions, out of 17, had taken over this responsibility. The devolution of health care to all regions was completed in 2002. In addition, each region may take over the responsibility for delivering specific services as long as it does not conflict with central government's prerogatives.
- Article 149 of the Constitution concerns the central government's exclusive responsibilities to legislate and execute.* It also recognizes that some of them may be implemented in tandem with the regions. These include: labour market policies, civil service status and compensation conditions, social security, education, environment and public security. Article 150 of the Constitution further acknowledges that some of the central government's responsibilities may be transferred or delegated to the regions. In particular, responsibilities for managing training programmes for both the unemployed and the working population have gradually been transferred to the regions, starting in 1992, although the central government still issues the National Vocational Training and Insertion Plan and sets criteria for those workers who will undergo training. Similarly, the overall organisation of the education system, the regulation of academic and professional titles and school inspection is under the central government. Some operational responsibilities (*e.g.* decision on the number of teachers, some recruitment criteria and specific compensation elements) were transferred to seven regions in the 1980s and for the other regions the transfer was completed in 1997. Part of the curriculum content is also under the responsibility of the regions.

Local government responsibilities are not enumerated in the Constitution; they are defined in the Local Government Act of 1985. They vary with the size of municipalities. All municipalities are responsible for: public lights, cemeteries, water supply, sewerage, waste management, paved roads, urban planning and building control, food and beverage control. Municipalities with a population over 5 000 must provide public parks, a library, a market place and solid waste treatment. Municipalities with a population over 20 000 have to provide social services, fire fighting, sport facilities and slaughterhouses. Municipalities with a population over 50 000 must provide urban public transportation and environmental protection services. Services which are not provided by smaller municipalities can be made available to citizens through specific co-operative arrangements managed at the regional level.

* These include: justice, defence, foreign affairs, constitutional rights, national infrastructure (transport and water infrastructure that runs through more than one region; ports and airports of general interest), academic degrees and health service standards. The Constitution also puts basic regulation and co-ordination of health care, as well as legislation on pharmaceutical products, fully under central government's responsibility.

Figure 4.3. **Spending and employment by level of government**



Source: INE and OECD *National Accounts*.

illustrate them, this section covers two sectors in more detail: health care – which amounts to 35% of regional government spending – and active labour market policies (ALMPs) – which have an important role to play in a country with a still high unemployment rate.

The functions of the municipalities have changed little over the past 25 years. However, a debate on decentralisation to the municipal level (*Pacto local*) is under way, even though there is not yet an agreement on the functions which could be best performed at this level. With rather small municipalities, the existence of economies of scale should be an important factor in shaping reform.

An upward drift in public spending

The rapid decentralisation has created pressures on public spending, with some duplication of tasks and a loss of cost-effectiveness in a number of domains. Experience to date, similar to that in other OECD countries (in particular Italy), has shown that territorial transfer of personnel is difficult. General government employment has risen by almost 70% since 1987, much faster than in virtually all other OECD countries, with employment creation at the regional level, and to a lesser extent at the municipal level, far outpacing the decline at the central level (Figure 4.3, panel B).[5] Although the rise in the coverage of key services (*e.g.* the increase in school enrolment) has played a role, there are also indications that regional employment needs have not been entirely covered by transfers of employees from the central government (Marqués Sevillano and Roselló Villalonga, 2002).

The central government imposes a limit on the increase in the number of permanent employees at the sub-national level and sets basic salaries for civil servants as well as their annual adjustment, be they employed by the central or sub-national governments.[6] Sub-national governments, however, do have some flexibility to set performance-based elements for permanent employees and have increasingly relied on temporary job contracts which offer more flexibility in terms of both employment and compensation levels. Between 1997 and 2004, 56% of total public employment contracts were temporary job contracts. In mid-2004, 23% and 30% of regional and local government employees, respectively, had a temporary work contract, compared with 13% at the central level (CES, 2004). The proportion of temporary contracts varies also quite widely across regions (*i.e.* from less than 13% in La Rioja to 33% in Extremadura) and is higher in smaller municipalities (less than 20 000 inhabitants) than larger ones. Significant variations in compensation levels have also arisen. A recent study for the health care sector revealed that, for a similar position, compensation can vary by up to 43% across regions, creating labour shortages and wage pressures in the less "generous" regions.[7]

The regions have wide discretionary powers,...

Sub-national governments have significant discretionary powers in a number of domains allowing them to implement innovative policy options. The health care sector provides many examples of regional pilot programmes. Regional governments' efforts to contain pharmaceutical costs – *e.g.* by regulating doctors' prescription practices and/or reimbursement conditions – and to reduce public hospital waiting lists have been numerous and some have proved to be successful.[8] Other initiatives have tended to increase health care spending, such as the decision by Andalucía and Navarra to reimburse drugs included on the negative list established by the central government. Regional governments have also taken the lead in designing and implementing anti-poverty programmes (de Ayala Cañón *et al.*, 2001). In particular, regional governments have complete autonomy to set the level and eligibility criteria for the minimum income assistance schemes, which do differ significantly across regions. In the education sector, the Ministry of Education establishes the minimum curriculum content but still leaves 35% to 45% of the curriculum under the responsibility of sub-national governments (depending on regional language requirements). In sharp contrast, conditions for managing active labour market policies seem rather strict. Obtaining funding (the share of social security contributions earmarked for training is 0.7% of the wage bill) requires regional governments to pay providers at a price set by a 1993 royal decree. Some regional governments consider these amounts too low to find suitable providers, in particular since they are not allowed to top up this amount.

... but co-ordination failures can be costly

The rise in sub-national government spending reflects not only citizens' preferences and structural trends (in particular for health care) but also a lack of co-ordination across and between government levels.

Too little sharing of experience and lack of benchmarking

The lack of consistent and reliable information on sub-national government policies and outcomes has weakened the benefits of decentralisation. While regional governments have carried out many policy experiments, obtaining information on them and their outcomes is arduous. Although there are some *ad hoc*, bilateral, discussions across regions and between the regions and respective ministries, most observers recognise that the sharing of good and bad experiences at the sub-national level is too limited and informal.

Citizens do not have access to a consistent set of information to assess the policies of their government, benchmark them against others and thus press for a more efficient public sector. Examples include: the absence of a standardised measure for hospital care waiting lists or student learning achievements and the parsimonious information on eligibility conditions and user charges applied by the regions for elderly care.[9] This contrasts with the practice in several other decentralised countries. The Norwegian experience in this domain stands out: Statistics Norway, which is recognised for its independence and impartiality, collects information on the quantity and quality of services provided by each municipality (such as elderly care facilities and number of adults per dependent person), as well as prices, tax parameters and the fiscal position. All this information is available on the Internet. The Danish government has recently announced that it will set up an evaluation unit to benchmark local government performance in various areas with the objective of lifting average performance by naming and shaming the weakest performers.

Co-ordination failures: the case of decentralised ALMPs

In a fragmented government system, lack of co-ordination can weaken the effectiveness of public policies. Since the mid-1980s, the responsibility for managing ALMPs has been gradually transferred to the regions, including training programmes as well as job matching functions, while the central government remains in charge of regulating and managing unemployment benefits.[10] The lack of co-ordination in the information system for job vacancies and demands has, however, reduced the efficiency of labour market policies. Because the system used by some regions is not compatible with that of the central government, it has been difficult to fill job offers in some regions, hampering labour mobility (CES, 2000). Although this problem was already identified in 2000, the implementation of an integrated job database (SISPE) was only completed at the end of 2004.

The separation between active and passive policies may have weakened the regions' incentives to implement more effective policies to reduce unemployment. Under the current set-up, the regions do not receive the fiscal windfall of a reduction in unemployment – the decline in unemployment benefits the central government. They may, however, receive less grant income from the central government since the criterion to allocate funds across regions is the number of unemployed. A carousel effect could also develop as suggested by the experience in Canada and Switzerland which are among the few countries where spending and financing arrangements for labour market policies are broadly similar to Spain. Partial evidence in these two countries suggests that in some cases, ALMPs are not designed to promote employability but rather to place recipients into short-term jobs which re-qualify them for unemployment benefits paid by the central government, lightening the fiscal burden of social assistance programmes paid by the Canadian provinces or Swiss cantons.[11] In Spain, there is no evidence of such a carousel effect but similar concerns have arisen for disability benefits (OECD, 2003a). The regions may have an incentive to shift case-loads from social assistance (which they pay for) onto non-contributory disability, which they administer, but do not pay for.

There is too little co-operation among sub-national governments

Decentralisation has resulted in duplication as there is little incentive to engage in co-operative arrangements between regions. The health care sector provides an illustration. Disparities in resources across regions were significant when the devolution in health care was completed in 2002, with endowments in facilities and personnel well below the national average for instance in Castilla-La Mancha while others, such as Aragón and Madrid, were in an enviable position (Table 4.1). The 2001 reform of funding arrangements (Box 4.2) recognised these disparities and set the regions' entitlements to central government grants in an asymmetric way. It increased financial resources for those regions with low health costs and less developed facilities significantly but maintained higher transfers for those with high costs. It also required regional governments to spend on health care a minimum amount, based on the financing needs set for the 1999 base year (which are updated according to the criteria listed in Box 4.2). The whole resources of the financing system are conditional on the regions' spending the minimum amount. As a result, spending in regions with low costs has increased steadily. As an illustration, Castilla-La Mancha is building four new hospitals and raising the number of doctors significantly.

While an attractive option to avoid the duplication of specialised services in a context of a high variation in installed capacity across regions, co-operative arrangements in the health care sector have hardly been promoted. Co-operative arrangements could be designed so that, instead of building new facilities, regions with low capacity buy specialised services from a better equipped region. This form of co-operative arrangement has been implemented for hospital services in Italy and in Switzerland and it also applies to other services, in particular tertiary education in Switzerland (OECD, 2002). It has two attractive features: it allows the exploitation of scale economies and introduces some competition if one region can buy services from different suppliers (other regions or private providers). Another argument for co-operative arrangements is the "critical mass effect". For highly specialised health care facilities, safety conditions may deteriorate substantially below a certain threshold of use. Similarly for tertiary education, too low a number of students may reduce network effects, and thus educational outcomes.

The Cohesion Fund was created to compensate regions for providing health care services to non-residents (either foreign tourists or residents from other Spanish regions). However, it does not create strong incentives for providers to participate in such arrangements since the financial compensation received for non-residents does not cover all costs. On the other hand, regional governments may have an incentive to push their

Table 4.1. **Health care spending and resources by region**

Health care responsibilities assumed by the regions before or during 2002

	Health care facilities, 2000				Financial resources			Health care spending, € per capita, 2004[2]
	For 10 000 inhabitants			X-ray rooms, for 1 million inhabitants	Per capita, average[1] = 100		Cohesion fund, thousand €, 2002	
	Hospital beds	Personnel	Doctors		Previous system	Current system		
Before 2002								
Andalucía	32	96	16	75	98	96	0	727
Canarias	52	114	18	89	96	99	0	800
Cataluña	49	99	20	61	105	103	8 381	657
Comunidad Valenciana	31	92	18	76	100	98	2 117	672
Galicia	40	100	18	91	101	102	0	691
Navarra	45	135	21	76	. .	. .	. .	846
País Vasco	42	92	19	81	. .	. .	. .	767
In 2002								
Aragón	48	123	22	83	109	109	0	737
Asturias	42	104	18	106	112	110	3	737
Baleares	45	116	26	109	86	101	0	612
Cantabria	46	110	18	77	110	121	3 443	820
Castilla-La Mancha	31	84	15	68	97	102	0	743
Castilla y León	47	100	18	84	100	104	0	716
Extremadura	41	95	15	77	102	103	0	768
Madrid	43	120	22	97	95	93	31 176	681
Murcia	36	99	18	67	97	96	0	758
La Rioja	35	87	13	104	96	123	0	881
Spain	41	102	19	80	100	100	45 120	711
Memorandum item:								
Coefficient of variation	0.16	0.13	0.16	0.18	0.07	0.08	. .	0.10

1. Excluding País Vasco, Navarra, Ceuta y Melilla.
2. Adjusted for the population age structure, budget data.

Source: Ministerio de Economía y Hacienda; Ministerio de Sanidad y Consumo; INE; R.M. Urbanos (2004), "El impacto de la financiación de la asistencia sanitaria en las desigualdades", in *Gaceta Sanitaria*, SEPAS, Vol. 18, Supplement 1.

own citizens onto other regions' health care services since they do not pay for the associated costs, creating a risk of under-provision of health care services at the national level in the longer run. The reluctance of patients to be treated far away and the closer proximity between voters/patients and policy makers may, however, mitigate this effect.

The case for transferring responsibilities to the municipalities is mixed

Spanish municipalities have rather limited responsibilities. Local governments' share in total public spending is smaller than in several unitary OECD countries, largely reflecting their very low involvement in the education and health care sector. Their spending share is, however, very similar to that of federal OECD countries. The devolution of responsibilities to municipalities (*Pacto local*) is now on the political agenda, in particular because of the willingness to rebalance political forces between the central government and the regions. Economic functions under consideration for decentralisation include limited responsibilities concerning education, housing and employment policies which may have effects which extend beyond municipal boundaries (spillover effects). As discussed above, to be effective employment policies need to be co-ordinated throughout the country; there is a risk that existing problems at the regional level could be exacerbated if core responsibilities were transferred to the local level. It is also telling that in

Box 4.2. **Transfer of responsibilities for health care management and its financing**

Responsibility for health care management was transferred gradually to 7 out of the 17 regions over the period 1981-94. At the time of devolution, a financial agreement had to be reached between the central government, subject to specific contextual and political pressures (European Observatory on Health Care Systems, 2000). This resulted in somewhat heterogeneous criteria for defining the accompanying earmarked transfers, including notably historical costs and the population covered (Ministerio de Sanidad y Consumo, 2003). In 2002, a new financing arrangement was agreed between the central government and the five common regime regions with health care responsibilities before 2002 (País Vasco and Navarra are financed under a different arrangement, see below), comprising a General and a Cohesion Fund to cover the costs of health care services for residents and non-residents.

The *General Fund* was set by applying two principles:

- It first recognised the amount of health care spending in the five common regime regions in 1999 (the last year for which data were available at the time of the agreement) and allocated this amount across them according to three criteria: population (75%), population above 65 (24.5%) and island status (0.5%). Regions with historical spending below the national average thus received additional funds compared with their previous spending level.
- A "minimum guarantee" was then applied to ensure that no region would lose from the introduction of the new financing arrangement. This basically entailed that regions with high spending received higher per capita transfers compared with the national average.

The remaining ten common regime regions took responsibility of the health care sector in 2002 and bilateral negotiations between each of them and the central government were carried out at that time to set their health care financing needs, mostly on the basis of actual costs.

The agreement also foresaw that for all common regime regions: *i)* It creates a guarantee for a minimum growth in the financial resources for health care for the period 2002 to 2004; if financial resources in every year increase less than GDP, the central government will transfer the difference. However, changes in total population or in its demographic characteristics (in particular the share of elderly people) are not taken into account.* *ii)* Spending on health care should be at least equal to the financial resources recognised by the new financing arrangement for the five common regime regions which had taken over health care responsibility before 2002 and to the amount recognised through bilateral negotiations for the ten others (adjusted over time by the increase in central government tax revenue, the so-called ITE *nacional*). Any increase in spending above this level is to be financed by the regions from their own revenues, either by reallocating resources or by raising taxes (including by introducing the tax on retail sales on oil products), whose proceeds are earmarked for health care or environmental policy.

A so-called *Cohesion Fund* was created to cover (part of) the costs of hospital care for non-residents. The compensation received by providing regions is paid fully by the central government but at a level set below the unit cost for services – on the ground that providing regions, being often those with highly specialised care facilities and thus high health care costs, are already entitled to higher transfers since past actual costs have been accounted for when setting their level.

* Negotiations between the central government and a region could be opened if a region's total population grows by more than 3 percentage points faster than the national average in any given year. Cumulative deviations are, however, not accounted for.

Switzerland, a highly decentralised country, municipal labour offices have recently been replaced by regional placement offices. As far as housing is concerned, decentralisation could result in the under-provision of social housing because municipalities could be reluctant to attract low-income households since they often entail higher costs (*e.g.* for social welfare programmes). Concerns are less acute for primary education since the central government still controls part of the curricula, thus avoiding large differences across municipalities which could create a barrier to geographic mobility. But the lack of professional expertise to manage schools in very small municipalities still remains an important cause of concern.

One serious constraint to the transfer of responsibilities is the high degree of fragmentation. Several empirical studies suggest that there are significant risks of losing the benefits of scale economies below 5 000 inhabitants.[12] Among them, Solé-Ollé and Bosch (2003) estimated that spending needs per head in a municipality with 1 000 inhabitants is 23% higher than in a municipality with 5 000 inhabitants. Yet, Spanish municipalities are very small in international comparison with, on average, 5 269 inhabitants in 2003 and with 85% of municipalities having less than 5 000 inhabitants (Table 4.2). While many countries have encouraged the merging of municipalities to exploit scale economies, no mergers have taken place in Spain since the early 1980s.[13] Some municipalities have even split, raising the number by 86. Meanwhile, 74% of the municipalities have entered into co-operative agreements (*mancomunidades* and *consorcios*) to jointly provide some services, most frequently waste treatment, water provision and elderly care. Although joint provision may allow scale economies to be exploited, it is not without drawbacks. In France where this approach is common, concerns have been raised that reliance on such subsidiary bodies may lead to a failure of democratic control leaving citizens with little influence over local services because these intergovernmental bodies – with different legal background and territorial coverage – are not elected by the population and are often not very transparent (le Saout, 1998).

Table 4.2. **The size of municipalities in Spain and several EU countries**

A. Distribution of municipalities by size in Spain (2003)				B. Average size of a municipality: international comparison (2001)[1]	
Number of inhabitants[2]	Number of municipalities	% of total	% of total population	Country	Number of inhabitants
0-999	4 921	60.7	3.6	**Spain**[2]	**5 269**
1 000-4 999	1 983	24.5	10.5	Belgium	17 400
5 000-9 999	531	6.5	8.5	France	1 600
10 000-49 999	543	6.7	25.3	Germany	5 900
50 000-99 999	73	0.9	11.5	Italy	7 100
100 000-499 999	51	0.6	23.3	United Kingdom	135 700
> 500 000	6	0.1	17.2	Sweden	30 800

1. 2003 for Spain.
2. Population data are based on municipality registration numbers.

Source: INE and Dexia Crédit Local.

Financing arrangements for regional governments

Spain recently introduced a new financing arrangement for the common regime regions which is based on several commendable principles (Box 4.3). *First*, although País

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Box 4.3. **Main features of the 2002 financing arrangement for common regime regions**

A new financial arrangement for 15 (out of a total of 17) regions was agreed upon in 2001 and implemented in 2002. It embodies a set of criteria that set the financial resources for the regions and their distribution across them, as well as rules on how these resources, and in particular intergovernmental transfers, will be adjusted over time.

Computing the amount of resources to be made available for regional governments for the base year

- Regional spending needs in 1999 were set as the sum of revenues (tax proceeds and central government grants) regional governments received collectively in that year (set as the base year) as a result of the financing systems in force until 2001. These included the one corresponding to common responsibilities, the one corresponding to the health care system and the other to social services. Nevertheless, for those regional governments which took over health care responsibilities in 2002 the financing needs were set in bilateral negotiations with the central government (mainly on the basis of historical costs).
- The overall spending needs in the 1999 base year amounted to € 54.9 billion (9.7% of GDP). The spending needs deriving from the exercise of the common responsibilities amounted to € 30.7 billion, including a general fund to be allocated across regional governments, a fixed amount (€ 0.04 billion) given to each region, and a fund for sparsely populated regions (€ 0.05 billion) and a fund for poor regions (€ 0.2 billion). The general fund was split according to population (94%), area (4.2%), population density (1.2%) and island status (0.6%). Health care spending needs amounted to € 23.4 billion. The criteria used for allocating the heath care fund were population (75%), population above age 65 (24.5%) and island status (0.5%). Social service spending needs amounted to € 0.81 billion, and their allocation was based on population above age 65. Several adjustments were made afterwards. In particular, no region would lose from the new financing arrangement (*garantía de minimo*).
- For 2002, the financial resources provided by the arrangement amounted to € 67.4 billion, *i.e.* 9.7% of GDP. In fact, regions received more resources, because actual revenue from the taxes they collect was higher than notional tax revenue embodied in the arrangement.
- For each region, transfers from, or contributions to the central government were calculated as the difference between "adjusted" spending needs and its revenue-raising capacity. Two regions (Madrid and Baleares) have revenue-raising capacities exceeding their financing needs and, thus, contribute to the main fiscal equalisation scheme (the *Fondo de Suficiencia*). All others are net recipients. In 2002, net transfers from the central government via the *Fondo de Suficiencia* amounted to € 22.6 billion (3.3% of GDP). This system entails significant differences in the composition of revenues across net recipient regions. As an illustration, central government transfers through the *Fondo de Suficiencia* accounted for 63% of Extremadura's financial resources provided by the new arrangement in 2002, compared with 17% in Cataluña.

Adjusting regional government resources over time

Equalisation grants to the regions will be adjusted in line with central government's tax revenues, irrespective of each individual region's actual economic performance. To reduce the risk of too strong differences in revenues across regions from emerging, the system specifies maximum and minimum growth rates for overall regional government resources.

Central government equalisation transfers to net recipient regions will be adjusted every year in line with the rise in central government tax revenues. The net contribution of Baleares and Madrid to the equalisation pool will be adjusted to reflect changes in the region's tax revenues (excluding the effect of discretionary changes in regional taxes) or, if lower, national tax revenues.

Vasco and Navarra are still governed by a specific system for historical reasons (see below), the new financing arrangement now covers all the 15 common regime regions. The 1997-2001 arrangement had not covered three regions which thus remained under an earlier arrangement. *Second*, contrasting with previous quinquennial arrangements, the new arrangement is conceived to be permanent. This should reduce uncertainty as well as political and financial negotiation costs. *Third*, the regions' reliance on locally-raised taxes was increased significantly, reducing the gap between their spending responsibilities and revenue-raising powers. *Fourth*, equalisation principles underlying the new arrangement are sound and widely accepted. The regions' contribution to the common pool is progressive since the central government retains a share of income and consumption taxes, while financial resources made available to them reflect population needs as measured by objective criteria (*i.e.* demographic and topographic variables). *Fifth*, central government transfers have been made independent of the regions' actual economic performance, thus reducing moral hazard problems and the risk of poverty traps. As the implementation of the system has deviated from initially defined principles, several serious issues have emerged, however, which tend to undermine the acceptance of the current arrangement. This section will highlight the most important ones.

The regions are now less dependent on grants and have more revenue-raising powers

The new financing arrangement provides for a significant increase in the financial autonomy of the regions by substituting central government grants for tax resources. In the mid-1990s, regions' own taxes accounted for less than one-quarter of their financial resources and the discretion to set either the tax base or rate was virtually non-existent.[14] The 1997-2001 arrangement provided the regions with a 15% share of the personal income tax revenues collected within their boundaries with limited rights to set rates and tax credits. The 2002 arrangement vastly widened both the range of tax bases and the regions' discretionary powers (Table 4.3). In 2003, own taxes accounted for 53% of the regions' total revenues and regional governments had the power to set rates or bases for over half of these taxes. In this new set-up, regional governments are now expected to be in a better position to respond to local citizens' preferences in terms of the quality of public services and tax levels. Higher revenue-raising powers at the regional level should also reduce the need for central government assistance were some regions to face financial difficulties (implicit bailouts), thus limiting moral hazard problems. On the other hand, a higher reliance on locally-raised taxes has increased the regions' sensitivity to cyclical shocks. The diversification of regional tax bases, with consumption taxes now accounting for almost two-thirds of their tax revenues (Figure 4.4), however mitigate the risk of excessive volatility on the revenue side.

The greater regional tax autonomy has not been fully exploited, likely reflecting the lack of tax data at the regional level as well as expectations that the financing arrangement will be revised. Regional governments have introduced various tax reliefs on the taxes on wealth and wealth transfers and four of them have introduced a tax on retail sales of oil products. They have, however, only marginally used their discretionary powers for the personal income tax which accounts for the lion's share of the tax revenues over which they have discretion. So far, none has changed statutory rates and, though most of them have introduced or increased deductions associated with family or housing expenses, the revenue impact was tiny in most cases (Table 4.4). This may partly reflect the difficulties in estimating the potential revenue impact of any changes in marginal rates, since tax data

Table 4.3. **Regional governments' main tax resources before and after 2002**

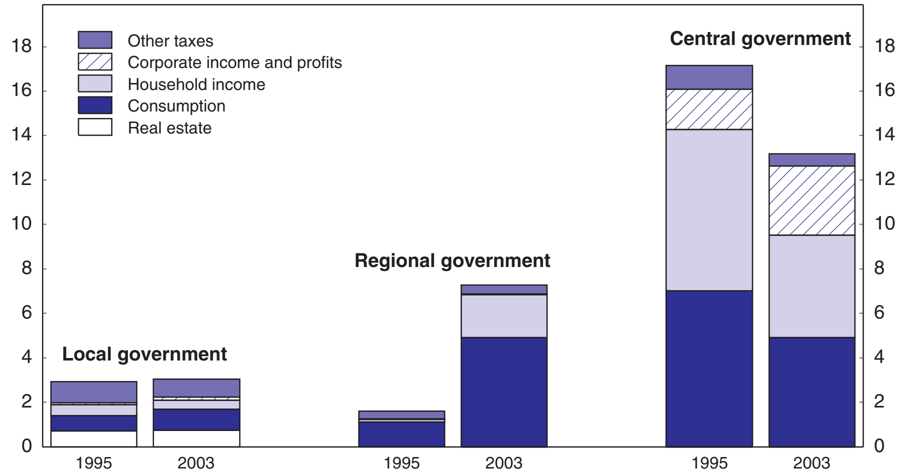
Before 2002	After 2002
Personal income tax	
Regional governments were allowed to set tax rates and introduce tax credits over 15% of the personal income tax base with some limitations. In particular, the rates had to be maintained within a +/–20% range of those set by the central government. They received a further 15% of personal income tax revenue collected within their jurisdiction but had no discretionary power over this share.	Regional governments are allowed to set tax rates (the +/–20% limit was removed but regional governments have to maintain a progressive schedule and the same number of brackets as the central government) over 33% of the personal income tax base. They can also set tax credits and modify central government tax credit for the acquisition of a residence though with some limitations.
Value added tax	
Regional governments had no share and no discretionary power over the VAT.	Regional governments receive 35% of the revenues collected within their jurisdiction but have no discretionary power to set either the base or the rate.
Wealth tax	
Regional governments received all the revenues and were allowed to set the exemption threshold, rates and to introduce specific tax reliefs, though with some limitations.	Same as before 2002 except that restrictions on the level and progressivity of tax rates were removed.
Inheritance and gift tax	
Regional governments could introduce tax allowances and credits. They could also set rates but with some limitations as regards their level and progressivity.	Same as before except that restrictions on the level and progressivity of rates were abolished.
Tax on wealth transfers and legal acts	
Regional governments received all the revenues and were allowed to set the rates and introduce tax credits, with some limitations.	Same as before 2002 except that limits on the setting of rates were softened.
Tax on gambling	
Regional governments received all the revenues and were allowed to set the taxable base and rates.	Same as before 2002.
Excise taxes on tobacco, alcohol and mineral oil	
Regional governments had no share in, and no discretionary power over, excise taxes.	Regional governments receive 40% of revenues collected within their jurisdiction but have no discretionary powers on the base or rates.
Tax on retail sales of oil products	
This tax did not exist.	Regional governments are allowed to piggyback on the central government excise tax, within certain limits.
Tax on electricity	
Regional governments had no share in, and no discretionary power over this tax.	Regional governments receive 100% of the revenues collected within their jurisdiction but have no discretion over the base or rates.
Tax on certain means of transport	
Regional governments had no share in, and no discretionary power over this tax.	Regional governments receive 100% of the revenues and can set the tax rates, with some limitations.

Source: National authorities.

are not fully available to regional governments to perform policy simulations, while the costs of introducing tax credits are much easier to assess. Long delays in publishing data on regional tax collection further reinforce this uncertainty and hinder the use of discretionary powers by the regions. The agreement between the central government and the regions reached in October 2004 has the potential to improve the situation, however. Another reason for the reluctance of the regions to use their tax powers is that the existing

Figure 4.4. **Tax revenue by government level**

In per cent of GDP



Source: OECD, *National Accounts*.

Table 4.4. **The use of regional governments' discretionary powers for personal income tax**

	Change in rate level or structure since 2002	Revenue loss from regional changes in tax parameters in 2002[1] (%)	Special tax credits in 2004				
			Family	Housing	Employment	Environment/ culture	Education
Andalucía	No	0.0	Yes	Yes	Yes	. .	. .
Aragón	No	0.0	Yes	. .	. .	. .	. .
Asturias	No	0.0	Yes	Yes	Yes	. .	. .
Baleares	No	0.5	Yes	Yes	. .	Yes	. .
Canarias	No	0.0	. .	. .	. .	Yes	Yes
Cantabria	No	0.0	Yes	. .	. .	. .	. .
Castilla-La Mancha	No	0.7	. .	. .	. .	. .	. .
Castilla y León	No	0.5	Yes	. .	. .	Yes	. .
Cataluña	No	0.3	Yes	Yes	. .	. .	Yes
Comunidad Valenciana	No	0.6	Yes	Yes	. .	Yes	. .
Extremadura	No	3.3	Yes	. .	Yes	Yes	. .
Galicia	No	0.8	Yes	Yes	. .	. .	. .
Madrid	No	0.2	Yes	Yes	. .	Yes	. .
Murcia	No	0.3	Yes	Yes	. .	Yes	. .
La Rioja	No	0.8	Yes	Yes	. .	. .	. .

1. Measured as the differences between actual and potential revenues (*i.e.* without any change in the tax parameters at the regional level) over the receipts deriving from the regional part of the personal income tax (33% of the tax rates).

Source: Ministerio de Hacienda, *Medidas normativas aprobadas por la comunidades de regimen comun en materia de tributos cedidos*.

arrangement is under rising criticism. Regional governments may prefer to adopt a strategic wait-and-see attitude since any move could weaken their negotiating position should the arrangement be re-negotiated.

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There is not enough flexibility to account for demographic developments

Although the new arrangement was conceived to be permanent, it has been increasingly questioned. Demographic variables used to derive the financing needs were those of 1999. Since then, however, immigration has risen rapidly and is concentrated in a few regions. In 2003, 68% of the foreign residents registered by municipalities (*padrón*) were living in four regions (Madrid, Comunidad Valenciana, Cataluña and Andalucía). Although the overall fiscal impact of immigrants is likely to be positive, it may not be so for all levels of government. In particular, the rise in social security contributions, accruing to the central government, accounts for most of the revenue gains from migration while the effect of migrants on public spending is concentrated on health care and education services (in particular for non-EU migrants) which are funded by regional governments (OECD, 2003b).[15] As a result, some regions claim that their financial resources are insufficient to deliver proper education and health care services to which immigrants are entitled as soon as they are registered in the municipal *padrón*. The arrangement does allow for some adjustment – the so-called *asignaciones de nivelación* – but only if a region's population grows by more than 3 percentage points above the national average in one year. This condition is very restrictive, because it does not account for the accumulation of deviations over a longer period of time.[16] This adjustment mechanism is also asymmetric since it only leads to an upward adjustment for those regions with a growing population and no downward adjustment for those with a declining population. In addition, while the arrangement did take account of the age structure in 1999, no adjustment is envisaged afterwards while demographic developments may differ significantly from one region to another.

Financial arrangements are still subject to criticism

Despite efforts to give prominence to objective needs criteria in designing the new financing arrangement, all regions are not treated equally. To reach an agreement with all regional governments, the central government had to guarantee that no region would lose from its implementation compared to the previous model – the so-called *garantía de mínimos*.[17] Since similar guarantees were implemented in previous negotiations, initial misallocations were perpetuated. Likewise, when assessing the financial needs for those regions which had health care responsibilities transferred only in 2002, past actual costs have been accounted for, with some regions receiving significantly more, on a per capita basis, than others. Reaching final agreement with all regional governments also required special bilateral negotiations and adjustments (including *convenios* and *contratos-programas*) to the objective criteria, although information on the extra financial resources granted to the regions is not yet available.[18] Overall, while no region has lost from the implementation of the new arrangement – the amount of resources made available to them even increased – deviations from an objective criteria model are spurring demands for more central government financing and/or a higher share in national tax revenues.[19]

The specific financing arrangements for País Vasco and Navarra exacerbate demands for more regional tax autonomy in other regions and/or adjustment to the existing financing framework. Per capita incomes in both País Vasco and Navarra are among the highest in Spain. Yet, the *Foral* system (Box 4.4) entails that these two regions keep virtually all the taxes collected within their jurisdiction and do not contribute to the pooling of tax revenues at the central level. As a consequence, they do not participate in the regional equalisation system and their financial resources per inhabitant are above those of other

Box 4.4. **Main features of the *Foral* system for País Vasco and Navarra**

While País Vasco and Navarra's spending responsibilities are broadly similar to those of any other Spanish region, their financing principles differ significantly:

- Revenue-raising powers are much wider than in the 15 common regime regions. País Vasco and Navarra are responsible for setting the tax rates and base, managing and collecting all taxes, except for customs duties and some excise taxes (VAT rates and exemptions are set by the central government but collected by the País Vasco and Navarra administration). They basically retain all tax revenues collected within their jurisdiction, although some arrangements between the central government and País Vasco and Navarra are in force to share some revenues, *e.g.* for companies operating both in País Vasco or Navarra and in another region or for VAT.
- Intergovernmental transfers flow from País Vasco or Navarra to the central government, contrasting with the situation in other regions which retain only a part of tax revenues collected within their jurisdiction. The so-called *cupo*, paid by País Vasco and Navarra to the central government, corresponds to the region's payment for a few public services provided by the central government (mainly foreign affairs and defence, as well as debt amortisation). This level of contribution is defined by the ratio of País Vasco and Navarra's GDP to the national GDP.

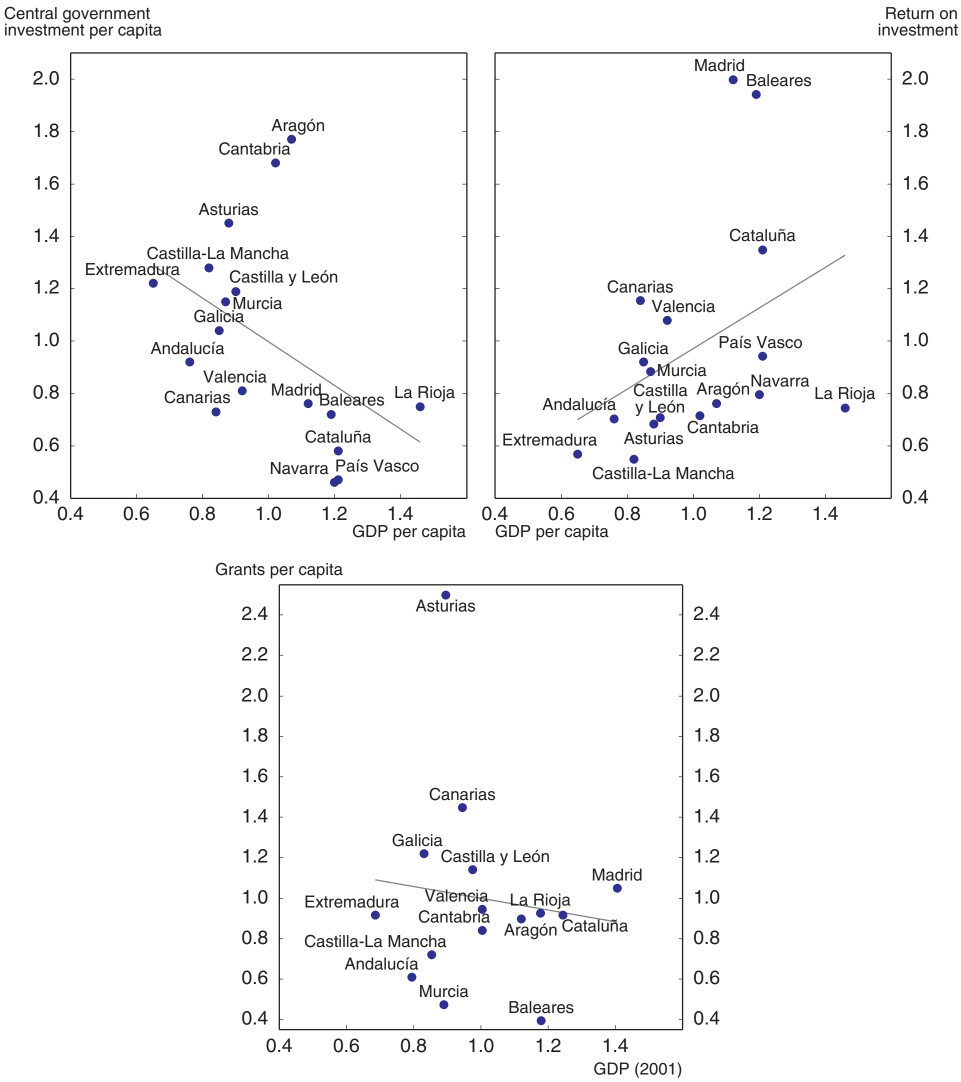
rich but common regime regions, leading to claims by the latter that they are unfairly treated.[20] Extending the Foral system to all regions would, however, reduce the resources flowing from rich to poor regions to a pittance and, thus, entail reconsidering two principles embodied in the Constitution: solidarity across regions and sufficiency in resources to finance the activities transferred to them. On the other hand, because País Vasco and Navarra are two relatively small regions (they accounted for 6.4% and 1.7% respectively of Spain's GDP in 2003), extending the new financing system for common regime regions to them would not change drastically the contribution of rich regions to the equalisation pool.

Rich common regime regions are increasingly claiming that they are penalised by financing arrangements. *First*, although there are no official price indices which would allow a comparison of price levels across regions, partial evidence suggests that the cost of providing services is higher in the richest regions. In particular, wages, construction and housing costs are higher (Carbó Valverde, 2004). Since the financial resources made available to these regions are based on the number of residents without adjusting for differences in delivery costs, rich regions may not be in a position to provide comparable services to their citizens for the same amount of funding per capita. Adjusting for provision costs may, however, create serious disincentives to control costs, especially since public wages account for a large share of spending on core public services (such as education and health care). *Second*, the demand for some public services (*e.g.* health care or tertiary education) tends to increase with the level of income. It would, however, be difficult to justify economically and politically higher transfers for rich regions, especially since they do have significant revenue-raising powers.

Aside from the equalisation schemes, the central government provides extra financial support to regional governments on a discretionary basis, though with a clear redistributive bias in a number of cases. The distribution of earmarked grants associated with bilateral agreements between the central government and individual regions as well as the distribution of central government investment across regions provides some evidence. A distributional bias in public investment in favour of low-income regions also exists in other OECD countries, in particular Japan. In Japan and Spain, however, rates of return on public infrastructure in the poorer regions tend to be low (Figure 4.5). It could thus be argued that it would be preferable to take decisions on the regional allocation of central government public investment purely on efficiency grounds while relying on more efficient instruments for the redistribution of income across regions (such as equalisation

Figure 4.5. **Regional distribution of central government investment and earmarked grants**[1]

National average = 1



1. Central government investment for 1991-2000 and GDP for 1991-95 are both at constant prices. The return on investment is measured by the marginal rate of return on public investment in 1995, using the calculations of de la Fuente. Data for earmarked grants correspond to central government transfers in the form of specific transfers (*subvenciones estatales, convenios* and *contratos programa*) for 2001.

Source: Ministerio de Fomento (2003), "Estudio de la regionalización y provincialización de la inversión pública. Año 2002"; A. de la Fuente (2001), "Infraestructuras y política regional", Centra de Recerca en Económia Internacional (CREI), Cataluña; INE; Ministerio de Economía y Hacienda and information provided by national authorities.

schemes) and/or across individuals (the tax and social security systems).[21] De la Fuente *et al.* (2003b) further suggest that increasing educational attainment in low-income regions would be more effective in reducing the productivity gap than infrastructure projects.

Existing financial arrangements may make it difficult to cope with future spending pressures

The sustainability of the current financing model may be undermined over the long run because of ageing-related spending pressures. The two main components of regional governments' resources – *i.e.* tax resources and central government transfers – are likely to grow broadly in line with GDP over the long term, although a slightly faster increase in revenues from consumption taxes in the coming years can be expected.[22] Pressures on regional governments' spending on health and elderly care are, however, likely to be considerable, partly reflecting population ageing. Available estimates for a number of OECD countries that will experience a milder demographic shock and already have better developed facilities for the care of the elderly suggest that total health expenditure (including long-term care) related to ageing might increase by about 3% of GDP by 2050.

The financing of this likely increase in regional spending is an important question. Requiring regions to use their revenue-raising powers to cover most of it would likely strengthen incentives to improve cost-efficiency. An increase in regional excise taxes could be envisaged, in particular because overall excise taxes on tobacco and oil products are low in Spain compared with most other EU countries. Still, the regional governments' room for manoeuvre is currently limited and such environmental/health taxes may not be the best sub-national taxes.[23] Since personal income tax is the main tax that can be changed, this would also imply a significant increase in taxes on labour. Negative consequences on the country's economic performance and on the central government budget – a potential decline in working hours and employment and, thus, reduced social security contributions combined with higher social benefits to be paid should be of concern.[24] An increase in consumption taxes, which are mostly controlled at the central government level, would likely have a less adverse impact on the economy, but there is the risk that this would undermine the drive for cost-consciousness by the regions.

Financing arrangements for local governments

Local governments' taxing powers are wide,…

Tax revenues accounted for more than half of local governments' non-financial resources in 2002, a high share by international standards (Figure 4.6). Local governments also have significant discretionary powers, in particular the right to set the rate (within a range defined by the central government) and to introduce specific tax relief for their own five taxes: real estate and local business taxes, the taxes on motor vehicles, construction and public works and on capital gains on land. The 2003 local government tax reform (Annex 4.A1) exempted individuals carrying out professional activities and companies with a total turnover lower than € 1 million (over 90% of taxpayers) and compensated municipalities through grants and tax-sharing arrangements. The overall impact on local government taxing powers is, however, mixed and in any case difficult to assess at this early stage since small municipalities have been given wider discretion to set rates and large municipalities now receive a share of VAT revenues, personal income tax and excise taxes collected within their jurisdiction, though with no right to set either the base or the rates.

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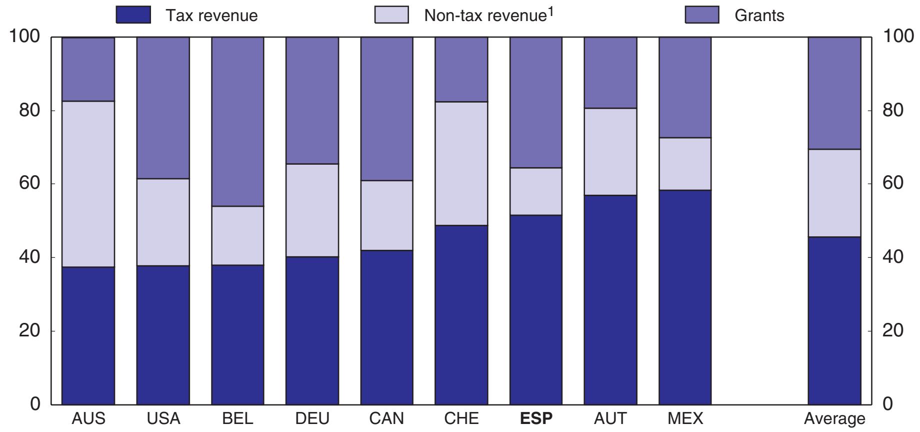
Figure 4.6. **Local government financial resources in selected OECD countries**

In per cent of total, 2000



1. Non-tax revenues include: operating surpluses of public entreprises controlled by sub-national governments; property income; fee, sales and fines; contributions to government employee pension funds and capital revenues.

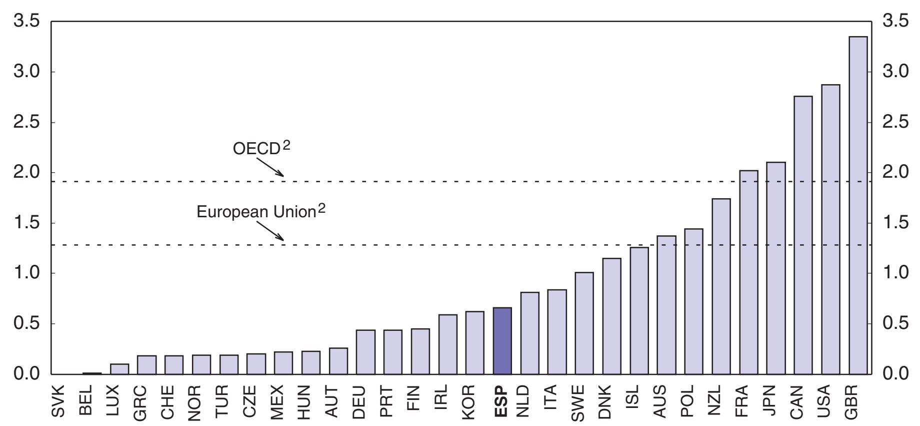
Source: IMF (2004), *Government Finance Statistics Yearbook, 2003*.

… but some local taxes raise equity and efficiency issues

The local business and real estate taxes still raise equity and efficiency concerns which should be addressed. To mitigate the potential perverse impact of a presumptive business tax on company creation, small and recently-created companies were given special treatment. This has not only introduced new distortions and could spur tax avoidance. The introduction of the threshold has raised the complexity, though some simplification has also been made. Firms have incentives to exploit the progressivity of the corporate tax system by breaking up activity into multiple firms to keep their marginal tax rates low, although new rules attempt to avoid this.[25] The real estate tax also raises important issues. Property values for tax purposes are well below market prices, because they are re-evaluated by the central government only about every decade. In addition, revisions are not carried out simultaneously across the territory and this can create

Figure 4.7. **Recurrent taxes on immovable property in OECD countries**

Revenues in per cent of GDP, 2002[1]



1. 2001 data for Portugal.
2. Weighted average using 2000 GDP and PPPs.

Source: OECD (2004), *Revenue Statistics, 1965-2003*.

significant horizontal inequities across municipalities, calling into question the legitimacy of this tax base.[26] Partly as a result, municipalities have tended to introduce tax relief. This is reflected in a much lower ratio between actual and potential revenues for the real estate tax than for any other municipal tax (Poveda Blanco and Sánchez Sánchez, 2002). Overall, proceeds from the real estate tax amounted to 0.7% of GDP in 2002, a low share in international comparison (Figure 4.7).

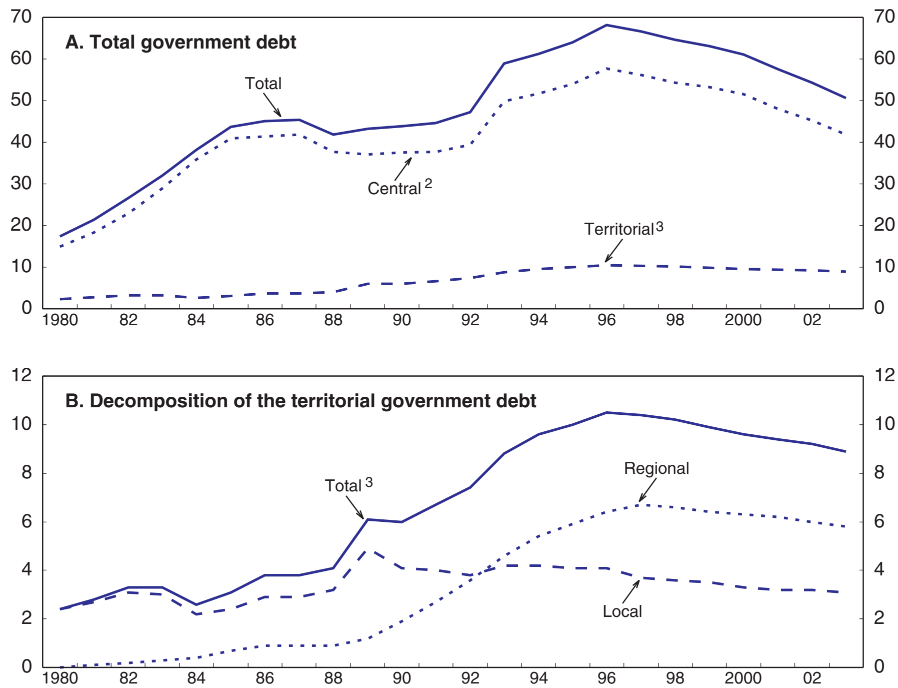
Managing fiscal policy in a decentralised framework

Decentralisation has been accompanied by fiscal consolidation

Spain's budgetary situation has been relatively good since the early 2000s, even though important pension reforms are necessary to maintain this situation in the long run (Chapter 5). The regional and local authorities' debt has been low and slightly decreasing as a proportion of GDP, while that of central government is falling rapidly (Figure 4.8). This performance is considerably better than the euro area average and has been achieved within the context of increasing decentralisation. It is the result of a strategy in place since 1992, the thrust of which is twofold: on the one hand, close co-ordination between the fiscal consolidation policies of all levels of government so as to comply with commitments under the Maastricht Treaty and the Stability and Growth Pact and, on the other, the application of central government administrative controls on territorial authorities' borrowing.

Figure 4.8. **Public debt by level of government**

In per cent of GDP[1]

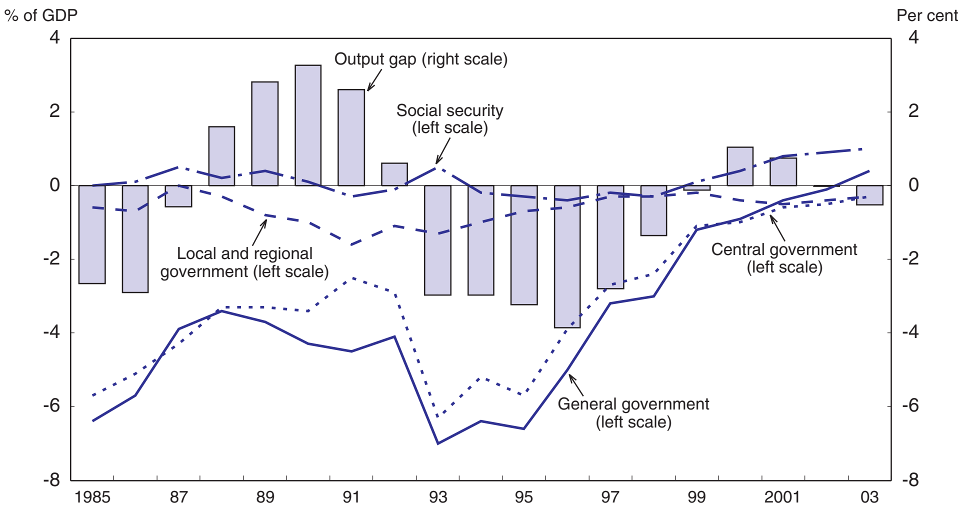


1. On the basis of ESA 79 (European system of accounts 1979) before 1995.
2. Including social security.
3. Territorial government is composed of the regions and municipalities.

Source: Bank of Spain.

The need to implement such a strategy became apparent with the worsening of the public accounts in the late 1980s and early 1990s, which mainly affected the budgets of the regions, whereas the economic situation was still favourable (Figure 4.9). This fiscal slippage seems to have been partly due to strategic behaviour, the regions underlining their growing resource needs in the context of the decentralisation process then under way (García-Milà *et al.*, 2001). It could not be prevented by the then existing mechanisms to guarantee the financial health of the territorial authorities. These mechanisms mainly involved limiting the authorities' borrowing.[27] To ensure Spain's participation in monetary union, the authorities established in 1992 a system for co-ordinating the fiscal policies of the different authorities. Medium-term consolidation scenarios were drawn up so as to be consistent with the convergence plans for the country as a whole. The central authorities and regions, meeting in the framework of the Council for Fiscal and Financial Policy (CPFF), thus decided on the breakdown by level of government of the maximum deficit and debt consistent with national objectives. They did this on an individual basis for the regions and central government and on a global basis for the local authorities. These limits supplemented the administrative borrowing restrictions over which the CPFF also established closer control.[28] Being based on a broad consensus, this fiscal policy co-ordination seems to have been essential in ensuring fiscal consolidation (Salinas Jiménez and Álvarez Garcia, 2002). In fact, the application of these plans brought a reduction in debt and deficit levels as of the mid-1990s, even if targets were overshot in some regions and, generally speaking, finances were less well controlled in the large towns than in the small municipalities (Monasterio-Escudero and Suárez-Pandiello, 2002).

Figure 4.9. **Government financial balances**



Source: Ministerio de Economía y Hacienda.

The new Fiscal Stability Law is designed to preserve fiscal discipline

Decentralisation advanced further in 2001-02, with health spending devolved to all regions, and the desire to perpetuate the benefits of fiscal consolidation prompted the authorities to amend the co-ordination system by adopting the Fiscal Stability Law (FSL). It was applied for the first time in 2003 and established a uniform rule requiring that accounts at all levels of government be kept permanently in balance or in surplus (Box 4.5).

Box 4.5. **The Fiscal Stability Law**

The objective of the FSL is to maintain fiscal discipline at all levels of government by keeping the public accounts permanently in balance or in surplus.*

This rule is incorporated in a multi-annual framework (the stability programme) to be consistent with the targets set at the beginning of each year and approved by Parliament. Its application is overseen by the Council for Fiscal and Financial Policy (CPFF), which consists of the central government Finance and Public administration ministries and the representatives of the communities. The law does not rule out deficits. However, that possibility is confined to temporary and exceptional situations and has to be properly justified. In the event of a deficit, a four-year action plan to improve the situation has to be submitted within 20 days and has also to be ratified by the CPFF, even if this deficit is of a cyclical nature.

The FSL does not provide for any disciplinary action if the regions do not comply, unless failure to do so causes the Maastricht Treaty's 3% deficit ceiling for government as a whole to be exceeded and thus results in Spain eventually having to pay a penalty. Compliance with fiscal discipline is nevertheless ensured by the supervision and mutual surveillance exercised by the central government and the regions within the CPFF. Also, if the fiscal stability targets are not met, borrowing by the Communities to ensure their financing has to have central government approval. The same authorisation is required for bond issues or loans in foreign currency.

* This rule also applies to public companies. During a transition period which is scheduled to end in 2012, the balance constraint imposed by the FSL applies to the consolidated sector of the State and social security.

The FSL tightened the restrictions on indebtedness requiring that indebtedness stabilises or falls, except for the purchase of financial assets since such operations do not affect the deficit, or when there are temporary occurrences of a deficit as stipulated by the law. In such cases, the territorial authorities are obliged to obtain central government authorisation for credit transactions, which first of all requires the approval of a consolidation plan.

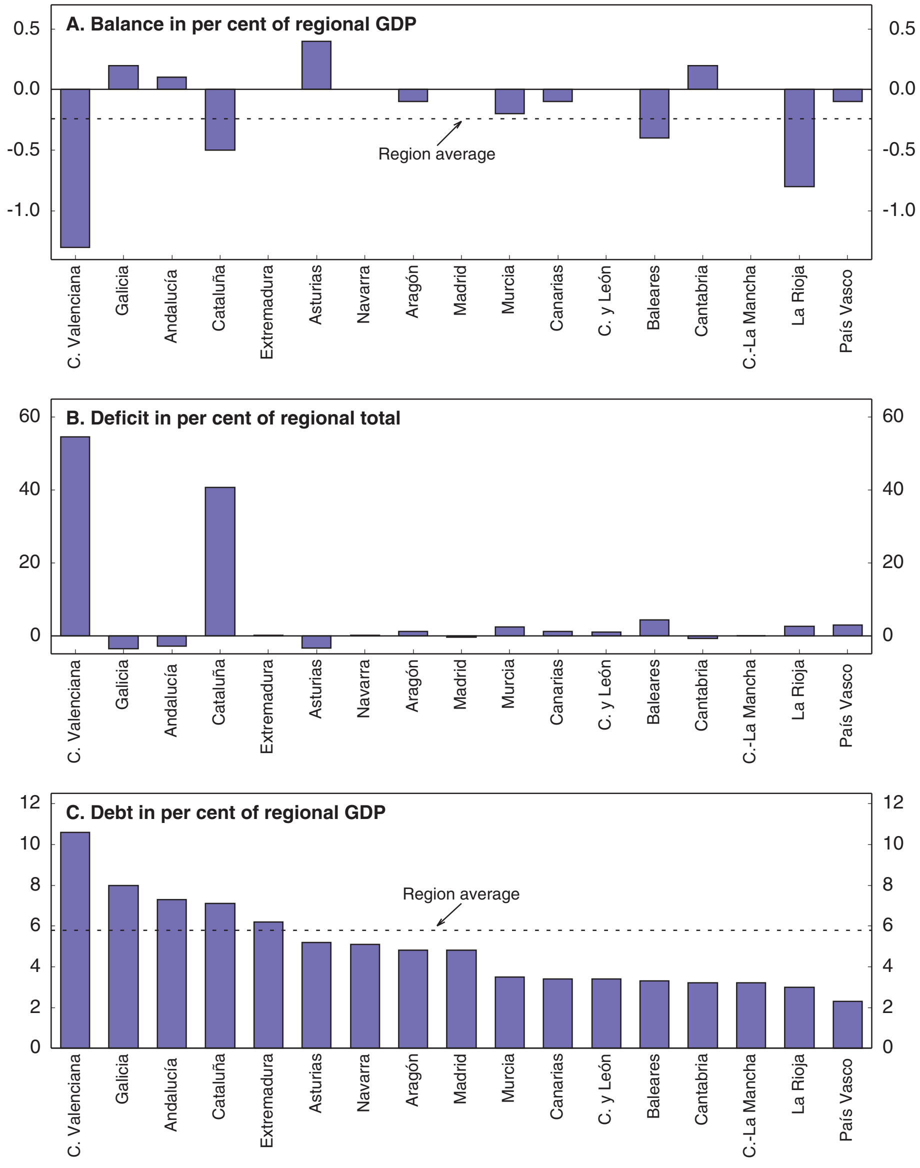
During its first year in operation, the FSL fulfilled its role of keeping the public accounts in balance, even if the local and regional authorities did record small deficits – respectively of 0.1% and 0.2% of GDP in 2003. Although the balance or surplus target was not met in 11 out of 17 regions, most of the deficits were reduced. Only two Communities, Comunidad Valenciana and Cataluña, which account for over 95% of the total regional deficit (Figure 4.10), were required to submit a plan to restore financial equilibrium by 2008.

Recourse to a fiscal rule is appropriate...

Recourse to a fiscal rule, such as the FSL, shows the authorities' concern that all levels of government play an active role in maintaining sound public finances. In contrast with the situation in a number of federal OECD countries, the autonomous communities have not formulated their own fiscal rules for guaranteeing the financial viability of their public finances. The fact that central government has introduced a fiscal rule aimed at filling the vacuum seems preferable to a strategy relying solely on the financial markets to ensure fiscal discipline. Although the markets do make some distinction between the risk premiums on borrowing by the different regions, the differentials remain limited.[29] This is no doubt due in part to the low level of regional debt, but it may also reflect that

Figure 4.10. **Regional debt and deficits**

2003



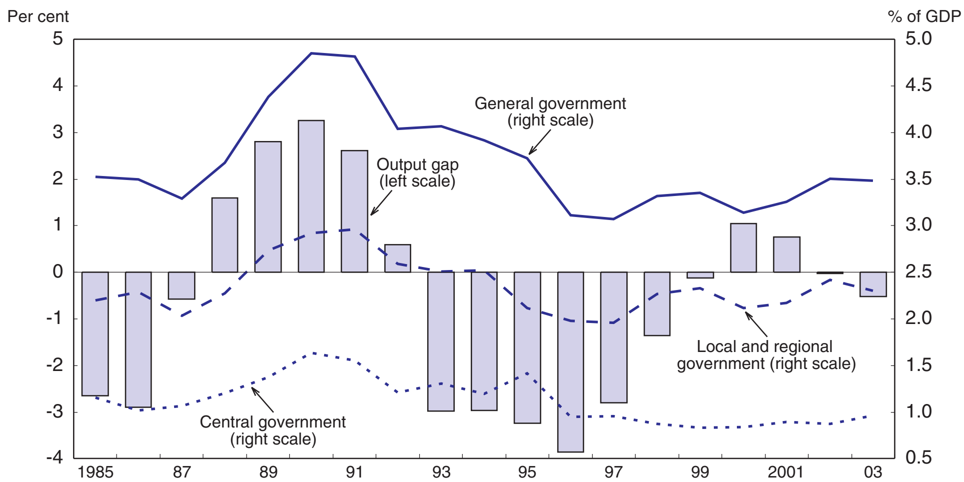
Source: Intervención General de la Administración del Estado (IGAE) and Bank of Spain.

administrative authorisation is required in order to borrow – a system which could well be seen as a tacit central government guarantee with respect to regional borrowing. It would probably be difficult to resist political pressure for a rescue plan in favour of an authority in serious financial difficulty. In the early 1980s, for example, there were financial rescue plans for municipalities (Monasterio-Escudero and Suárez-Pandiello, 2002).[30] Failure by central government to intervene in such circumstances could result in disruption in the provision of public services, equal access to which is guaranteed by the Constitution.

… but the FSL's excessive rigidity could have a destabilising macroeconomic effect…

Another advantage of a fiscal rule is to reconcile fiscal discipline and co-ordination between the different levels of government. From that point of view, however, the FSL poses problems which the authorities have recognised. While it has the advantage of being both simple and easy to convey, the rule is nevertheless formulated in a rigid way. It does not allow for the effects of the economic situation on the public accounts, which could result in fiscal policy playing a destabilising pro-cyclical role. This is a problem that affects central government and the social security most, their revenue being closely linked to the economic situation.[31] However, it also affects the regions and large towns following the recent reform of the way they are financed, which has made their resources more sensitive to cyclical fluctuations, while the inertia of regional spending has been accentuated by the transfer of responsibility for health care. Having too rigid a framework makes it more difficult for the territorial authorities to manage investment programmes. Empirical work shows that capital expenditure was one of the main adjustment variables during periods of sluggish activity (Esteller-Moré *et al.*, 2004) (Figure 4.11).[32] The application of the FSL could accentuate this feature, which is not desirable either for reasons of macroeconomic stabilisation or for reasons of effective project management.

Figure 4.11. **Government investment and the economic cycle**[1]



1. Break in series in 1995 for investment.

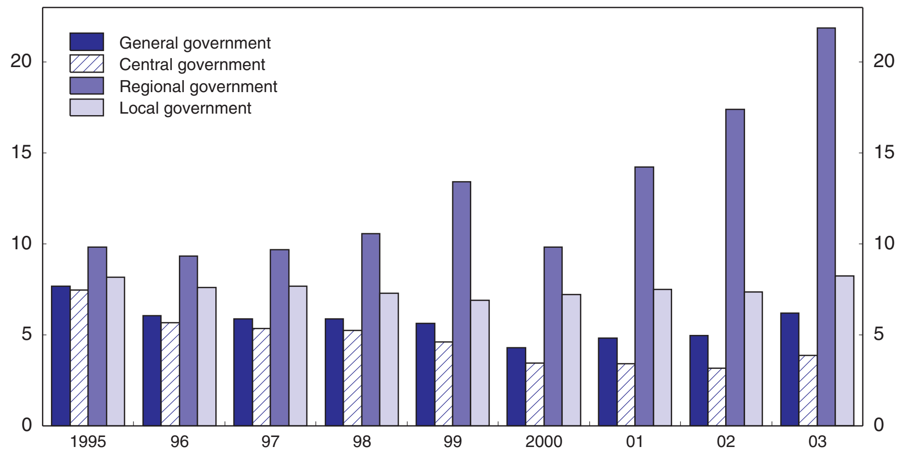
Source: INE and Bank of Spain.

… and to foster the growth of off-budget operations detrimental to transparency

If the rule is seen as being too coercive, there is a risk that it will encourage the development of off-budget operations, which raises transparency problems and could call the rule's credibility into question. The authorities' only way of increasing their borrowing to finance investment currently involves the acquisition of financial assets via capital transfers to public companies which are not covered in the general government accounts (Amor and Pou, 2004). However, such operations, which use the experience of the business sector in managing certain types of infrastructure and introduce greater competition in the provision of certain services, also appear to be driven by the desire to escape the borrowing constraints. This is suggested by the recent sharp increase in the debt of public companies controlled by the regions, a phenomenon which is also apparent – though to a lesser degree – in the case of the local authorities (Figure 4.12). What is more, the risks surrounding future trends in the deficit and the debt attaching to these transfers or to the various forms of partnerships with the private sector are not always systematically identified and quantified and this information is not contained in the budget documentation.[33] Such problems were identified for central government and led to an upward revision of spending in the 2004 budget (Chapter 2), but they also apply in much the same way to the sub-national governments, which nowadays account for two-thirds of total public investment.[34]

Figure 4.12. **Debt share of public entreprises**

In per cent of their respective government debt



Source: Bank of Spain.

Greater transparency of the public accounts is needed

The new government has announced its intention of remedying the FSL's shortcomings and dealing, first of all, with the problems concerning the transparency of public sector activity as a whole. This will be done by improving the documentation of the central government budget so as to ensure for instance a better assessment of the future risks involved by investment programmes.[35] Changes to the FSL have also been proposed to raise transparency, which are especially pertinent in the case of the regions whose accounts are available late and only in fragmented form.[36]

The fiscal rule should be made more flexible…

The government also plans to increase the flexibility of the FSL by keeping the general government accounts in balance over the cycle rather than in each year. However, applying this principle, which seems a legitimate way of preventing fiscal policy from destabilising the economy, raises various practical questions. The first of these concerns the level of government to which the new principle should apply. At present, the FSL requires that the accounts of all levels of government taken individually be kept in balance. Using a fiscal balance norm throughout the entire cycle is, however, not a feasible option authority by authority, including at local level, nor is it even necessarily desirable. In the case of the social security, for example, maintaining structural surpluses seems preferable to applying a fiscal balance rule, both for reasons of macroeconomic stabilisation and to strengthen the public finances to cope with ageing.

… but this will require a pragmatic and transparent approach…

While balancing budgets over the cycle would seem applicable in the case of central government and the regions taken as a whole,[37] for example by calculating structural balance indicators, it looks less relevant for local authorities. Indeed, local authorities' revenues are not very responsive to cyclical fluctuations so it would be better to exclude them from any structural balance rule.[38] While applying a structural fiscal balance rule in the case of the regions might seem to be easier, applying it to individual regions would raise practical problems. This is because the regions, especially the smallest ones, can be affected by specific shocks which may make their cyclical position asymmetric to that of the rest of the economy, and this is liable to affect their revenues (Figure 4.13). Small regions' budgets can also quickly move into deficit because of large investment projects, as was the case in La Rioja in 2003 following the construction of a hospital. To overcome this difficulty, the authorities could consider applying a mechanism for sharing deficit and debt targets which would be set globally for all the regions, in much the same way as the co-ordination system worked between 1992 and 2002. This arrangement, which was based on a consensus as to the general objectives and a system of implicit sanctions linked to the borrowing constraint imposed by central government, appears to have been effective. To solve a similar problem, Austria experimented with a mechanism for trading deficit rights between territorial authorities, but the effectiveness of this system is not yet established.[39]

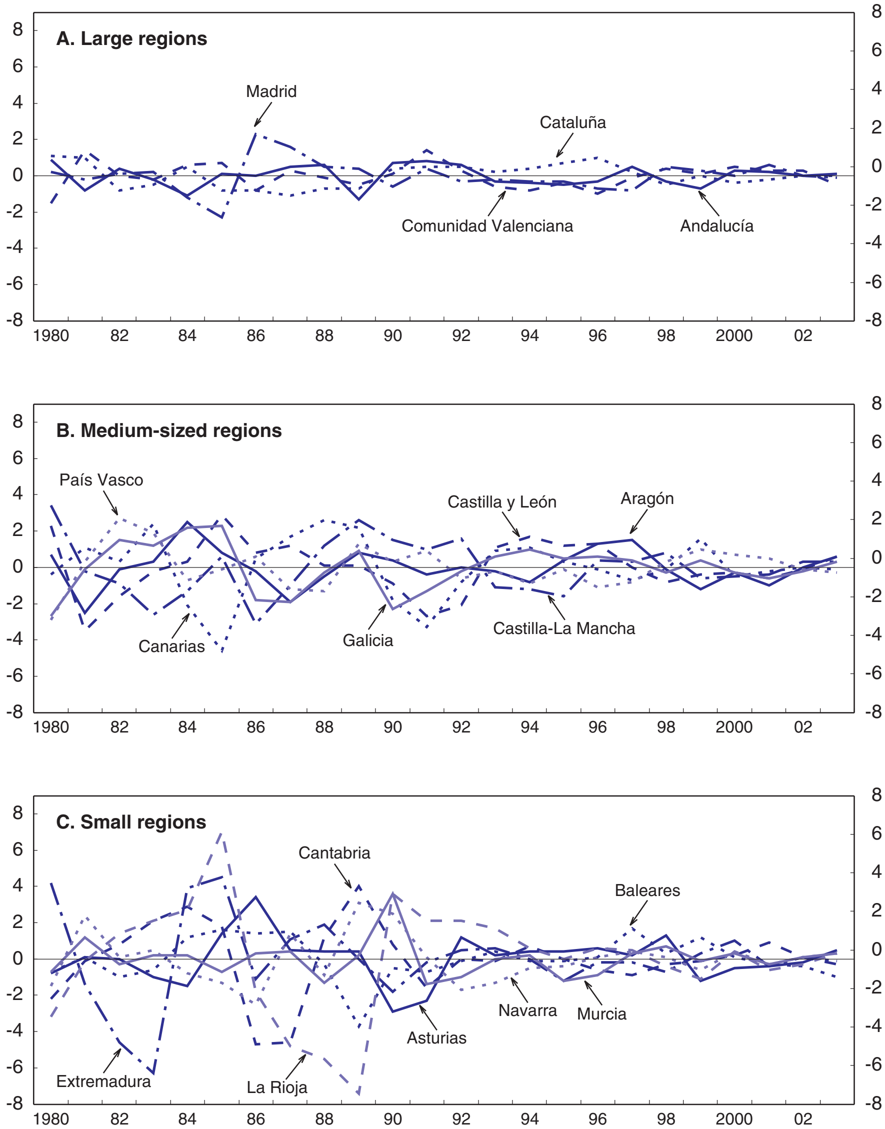
A second challenge is to avoid a weakening of the norm as a result of its increased complexity. If the new rule were insufficiently transparent, there could be opportunities for manipulation which would undermine its credibility; however, that risk could be limited by establishing clear mechanisms for assessing the cyclical position of the economy. A mechanical method of producing statistical estimates of the output gap could be used to guarantee the transparency of the calculation,[40] but a probably better solution would be to ask a group of experts, or an independent institution such as the central bank, to provide an estimate of the output gap by means of a detailed analysis. The effect of the business cycle on government accounts has also to be taken into account in a transparent manner by providing information on the tax revenue elasticities with respect to economic activity. In any case, it should be recognized that structural balances are difficult to estimate and need to be cross-checked using alternative approaches.[41]

… which needs balance between the specific regional requirements and those of the whole country

The debate about the flexibility of the fiscal rule at the regional level prompts questions as to the limits that should be set in this connection. In some respects, even if the effect of the business cycle were taken into account, a uniform fiscal balance rule could seem unnecessarily restrictive, bearing in mind the regions' differing requirements stemming from their sizeable disparities in development. It might in that case seem preferable to resort to a golden rule and leave the regional governments more room to invest and borrow so as to build the infrastructure essential to their development. However, such an approach would to some extent call into question the co-ordination of fiscal policies. Also, making a distinction which attaches more importance to physical capital than to current spending looks debatable considering, for example, how effective a

Figure 4.13. **Regional gap differences from the country average**[1]

Per cent



1. Trend output is calculated via a Hodrick-Prescott filter.

Source: Eurostat.

well-managed education system is as a way of bolstering human capital and economic growth. In addition, the catch-up problems facing some regions could be solved by a greater use of the equalisation mechanism.

Another point of view, however, holds that it is important not to underestimate the risks attaching to a fiscal rule which relates solely to budget balances and can therefore result in a steep and simultaneous rise in expenditure and taxation, even though up to now the sub-national authorities have apparently been reluctant to increase their taxes. This phenomenon was observed in Denmark, Finland and Sweden, where the territorial authorities have considerable independence with respect to direct taxation – as in Spain –

but do not take account of the negative externalities that an increase in their tax pressure generates.[42] Risks of this sort would justify introducing an expenditure-capping mechanism, whereas at present the regions are free to decide whether to raise taxes or lower outlays to balance their accounts. Such constraints might be thought excessive in the case of Spain however; tax pressure is still relatively low and education and infrastructure are still lagging behind a little, while upward pressure on health spending will persist.

An agenda for further reform

The rapid devolution of spending and revenue-raising responsibilities to the regions has not compromised fiscal consolidation. The current assignment of spending and tax responsibilities across levels of government and the intergovernmental transfer system provide opportunities to better meet local preferences and promote innovative policy approaches while maintaining policy consistency at the national level. However, reaping the full benefits of this decentralised framework would require the implementation of a number of reforms (Box 4.6 provides a synopsis). These reforms would contribute, in particular, to: avoiding the duplication of resources and containing the upward drift in public spending; promoting high quality public services; ensuring that the overall tax system does not create large distortions; and securing fiscal discipline while avoiding a pro-cyclical fiscal stance or an increase in off-budget operations.

Develop information systems on sub-national government policies and performance

Consistent and timely information on policies implemented at the sub-national level and on their outcomes should be made widely available so as to promote the diffusion of best practice, facilitate co-ordination and promote competitive pressure and fiscal discipline. To play such a role, the collection and publication of the relevant information should be independent from the government to raise acceptance and credibility.

A more systematic sharing of bad and successful experiments is desirable. In the past, conferences organised by the central government ministries have had a limited success in this regard, partly because regional governments' decision to attend has often reflected political affiliation. The October 2004 meeting of regional and central governments, mostly devoted to the discussion of health care financing, is a notable exception in this regard. Efforts to improve co-ordination across and between levels of government should be further promoted and should be complemented by a greater use of benchmarking so as to better identify best practice. Benchmarking would also have the advantage of enhancing competitive pressures on sub-national governments – pressures which are less well developed in Spain than in several other OECD countries (in particular Switzerland and the United States) where citizens "vote with their feet" (geographic mobility is higher than in Spain) and/or voice their preferences through an extensive use of local referenda on policy matters.

Benchmarking would require defining and publicising indicators, consistent for the whole territory, on regional and local public services so as to enable citizens to press their government to improve cost-effectiveness. In Spain, the new government is committed to improve the quality of information on public services, in particular with the creation of the National Quality Agency. The previous government also passed a Law on University Reform which created a new national agency to evaluate teaching and research activities of university departments and the Health and Consumption Ministry set up an agency for health quality in August 2003. However, the lack of resources for these new agencies and

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Box 4.6. **Recommendations for improving fiscal relations across levels of government**

Develop information systems on sub-national government policies and performance

- Promote the sharing of experience across sub-national governments.
- Develop benchmarking for services provided by sub-national governments and make the results public (for instance, waiting lists for hospital care) so as to enable local citizens to exert pressure on regional governments to improve the cost-effectiveness of their actions.
- Facilitate sub-national governments' access to tax data on a timely basis so as to enable them to introduce better informed tax policies.
- Improve the transparency of sub-national government budgets and audit them by an independent body to avoid the expansion of off-budget operations through public enterprises.

Reform the rules governing public employment

- Increase the flexibility of permanent job contracts in the public sector and of wage setting to better reflect local circumstances.

Upgrade the financing framework for the regions

- Take demographic developments better into account by softening the conditions for implementing the *asignaciones de nivelación* when regions have experienced changes in total population since 1999. Population changes should be taken into account in a symmetric way. Announce well in advance how financing arrangements for the regions will respond to the likely increase in regional government spending stemming from population ageing.
- Gradually correct existing deviations from the objective needs criteria when adjusting the regions' financial resources for developments not fully accounted for in the framework (in particular demographic developments and the fiscal consequences of ageing).
- Relax the obligation for regional governments to spend a minimum amount on health care. Make the health cohesion fund more supportive of regional co-operative arrangements: the financial compensation received by providing regions should cover the full costs and be paid by the region of origin.
- Avoid using earmarked grants or at a minimum increase transparency on the overall amount and criteria used to allocate them across regions. Reconsider undue regulations imposed on regional governments using earmarked grants, in particular for ALMPs.
- Reduce the bias in favour of less developed regions in allotting central government investment. Consider using more effective instruments in supporting poor regions' growth potential (such as education policies) and/or in redistributing income.

Reform local government taxes and be prudent in transferring new spending responsibilities

- Consider carefully the potential risks (losses of the benefit of scale economies and adverse spillover effects) which would result from the transfer of new responsibilities to the local sector before taking a decision.
- Increase local governments' reliance on the real estate tax. To this end, the land register should be upgraded so as to provide more homogeneous and up-to-date property tax values.
- Abolish the local business tax.

Box 4.6. **Recommendations for improving fiscal relations across levels of government** *(cont.)*

Enhance the flexibility of the fiscal rules

- Amend the Budget Stability Law so as to account for the impact of cyclical developments on the central government and aggregate regional budgets.
- Rely on the Council for Fiscal and Financial Policies to set fiscal targets for individual regions on the basis of individual medium-term scenarios. Regions overshooting their targets because of a significant structural deficit should still be required to present a medium-term adjustment plan.

the new government's decision not to publish regional data for health care waiting lists seriously limit the potential benefits of these agencies' work. Proper evaluation of regional ALMPs should also be implemented so as to ensure that they fully support the government's objective of promoting employability. The Swiss system provides a valuable experiment, where benchmarking of regional labour offices has helped to identify best practice. Introducing financial incentives for the regions to improve the quality of ALMPs or transferring to them the financial responsibility for unemployment benefits could raise difficult political and equity concerns and should thus only be envisaged if the naming and shaming of the weakest performers did not suffice to lift average performance.

Better information systems would facilitate the achievement of national objectives, the formulation of regional policies and the co-ordination across sub-national governments. The recent implementation of an integrated system for job demands and offers (SISPE) in all regions should facilitate adjustment in regional labour markets. It would also be useful for the central government when designing the National Vocational Training and Insertion Plan and for regional governments to implement it. A regular assessment of this new information system should be performed so as to ensure that it responds adequately to the evolving needs of both the regional and central authorities. Likewise in other sectors (in particular health and elderly care), existing facilities could be used more effectively, needs could be better identified and duplication could be avoided if better information were available. Regional governments should also be given sufficient access to tax data in a timely fashion not only to carry out policy simulations and implement better informed tax policies but also to fight tax avoidance. To this end, improved co-operation between the national tax administration and regional governments should be given priority over decentralisation of the tax administration, since it would both reduce information segmentation and contain tax collection costs.

Greater transparency of sub-national government accounts is also vital in view of the substantial increase in off-budget operations in recent years. It would also give some impetus to the complementary role played by financial markets in keeping the public finances in a sound condition by differentiating more between the borrowing conditions on the basis of their financial performance. There should be greater transparency in book-keeping between government and public enterprises, particularly in the framework of public-private partnerships. The expansion of such operations would probably be slowed by the removal of the present constraint prohibiting borrowing other than for the purpose of purchasing financial assets. Transparency should be assessed by an independent body so as to avoid credibility problems stemming from partisan approaches and make it easier

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to check the accounts of the regions. Lastly, efforts need to be made to reduce the long delays in publishing the detailed final accounts of all levels of government and to ensure the publication of quarterly accounts reflecting general government budget outturns on a consolidated basis consistent with the national accounts.

Reform the rules governing public employment

Reforming the rules governing public employment would contribute to avoiding the duplication of resources and to better adapting to changing needs for public services. To put an end to the upward drift in public employment, less reliance on life-long job contracts should be considered and barriers to mobility within the public sector scrapped, in line with recent developments in a number of OECD countries. Sub-national governments should be given more leeway in designing the work contracts of their employees and in setting wage levels so as to reflect local conditions better.

Upgrade the financing framework for the regions

The main principles underlying the new financing arrangement for the regions are sound but some adjustments are needed to make them sustainable in the face of demographic developments, in particular recent migration inflows as well as population ageing. In the absence of such adjustments, three risks could materialise: *i)* some regions will no longer be in a position to deliver the minimum national standards for core public services; *ii)* regions will increase regional taxes, resulting in a tax mix which is sub-optimal for the country as a whole and thus impinging on its growth performance; and *iii)* the regions expect revisions to the model, do not raise taxes but rely on debt with the expectation to be bailed out by the central government. To avoid these risks, the central government should account for recent demographic developments, and in particular changes in population reflecting large migration flows into some regions, in adjusting central government transfers to, or from, the regions over time. This should be done by changing the *Asignaciones de nivelación* which are currently too strict and asymmetric – regions with a growth in population compared to 1999 should receive more central government transfers while those with a declining population should receive less.

Although ageing has had little budgetary effect so far, its future effect should be recognised and accompanying changes in the regional financing arrangement should be announced well in advance so as to avoid putting its credibility at risk. Efficiency gains in the public sector may serve to finance part of the likely increase in regional spending on health and long-term care over the medium term. However, some increase in taxes seems difficult to avoid if spending for these items were to grow as much as projected. In this context, an important objective of the central government should be to contain the potential negative impact of a tax hike for the economy as a whole, while creating the right incentives at the regional level to control spending. An increase in excise and value-added taxes, which are relatively low, would likely be better than an increase in personal income tax (mainly falling on labour), which is the main tax regional governments can change. In distributing the proceeds from higher consumption tax rates across regional governments, two approaches could be implemented to keep regional governments cost conscious. The first one would be to assess *ex ante* the amount of extra spending regional governments would have to finance and distribute this amount across them on the basis of a set of objective criteria, as opposed to actual spending, so as to avoid moral hazard problems. This approach could well be implemented within the new financing arrangement for the regions by recognising future spending needs, and thus increased central government transfers, and by giving more weight to the old-age population in the current objective criteria distribution system. In the second approach, extra financing needs could be assessed *ex post*, *e.g.* on the basis of the actual increase in the three "best-performing" regions. Under both scenarios, regional governments would have to finance any deviation from the benchmark or the *ex ante* agreement from their own budget. While adjusting financial resources so as to account for the fiscal consequences of ageing or for recent demographic developments, care should also be taken to reduce existing regional disparities in financial resources, in particular those resulting from past recognition of historical costs or from the implementation of the *garantía de mínimos*.

The design of several intergovernmental transfers and support programmes should be reviewed so as to promote cost-effectiveness before increasing the overall amount of financial resources for the regions. *First*, the obligation to spend a minimum amount on health care should be abolished since it reduces incentives to introduce cost-saving measures. *Second*, the health care Cohesion Fund should be reformed so as to encourage regional co-operation for hospital care services. To avoid duplication, or alternatively a too low supply of facilities, the financial compensation received by providing regions should reflect the full costs of treating non-residents and should be paid by the region of origin instead of the central government. Giving regional governments a choice between building their own facilities or buying services from other providers would, however, require redressing existing disparities in financial resources across regional governments. *Third*, the use of bilateral arrangements between the central government and individual regions associated with earmarked grants should be transparent and their distribution across regions based on objective criteria so as to avoid moral hazard and recurrent claims for more central government funds. *Fourth*, conditions imposed on regional governments using earmarked grants should be reconsidered, in particular for ALMPs (*e.g.* those regarding unit costs of training programmes and the prohibition of the regions from topping up central government money with their own resources). *Fifth*, the criteria for distributing central government investment across regions should be reviewed, giving more emphasis to those projects which support productivity gains most and leaving redistributive objectives to other more effective instruments (pure fiscal equalisation schemes or tax and welfare systems).

Reform local government taxes and be prudent in transferring new spending responsibilities

Based on economic considerations, the case for transferring new spending responsibilities to local governments is weak, but their financing could be improved. In the absence of a reform that will lead to the merger of small municipalities, the local supply of core public services will likely suffer from producing at a smaller scale and raise difficult spillover issues (*e.g.* how to ensure that local decisions on housing, education or employment policies are consistent with national objectives?). On the basis of current spending assignments, their revenue-raising capacity is sufficient. The local business tax (IAE), however, raises equity and efficiency issues. By abolishing the tax for the most affected companies, the 2003 reform has eliminated some problems while creating other distortions. From this perspective, it would be desirable to reconsider the IAE. Increasing the real estate tax which is low by international standards could offset the loss in revenues, while maintaining sufficient revenue-raising powers to respond to local citizens' preferences by adjusting rates over a wider tax base. Reform would probably need to be gradual since people are often particularly sensitive to changes in the real estate tax. It would also require more up-to-date, and thus fairer, property values for tax purposes. New Zealand's approach in this domain could be an attractive model. The national property database was devolved to local governments in 1999. Councils are now responsible for assessing property values for tax purposes at least every third year and can outsource this task to Valuation Service Providers. Rules setting out valuation requirements are under the responsibility of the central government, whose main objective is to ensure a nationally consistent, impartial, independent and equitable valuation system.

Enhance the flexibility of the fiscal rules

In recent years, fiscal discipline has been ensured at all levels of government. Recourse to a budgetary rule seems appropriate as it reconciles budgetary discipline and co-ordination between the different levels of government. However, the FSL has since 2003 required that the accounts of all levels of government taken individually be kept permanently in balance. This seems too rigid as it could lead to a pro-cyclical fiscal policy. The rule should be made more flexible to maintain a balanced budget over the cycle, as envisaged by the authorities, even though some caution is warranted given the uncertainties concerning the cyclical adjustment of budget balances. Some pragmatism will be needed, but this approach would appear possible for central government and the regions as a whole. The authorities would be able to record deficits during cyclical troughs, but these would have to be offset by surpluses during periods of buoyant activity. For local authorities, on the other hand, there does not appear to be a need for change. The specific breakdown of the overall target between the different regions could be managed within the CPFF, as was the case between 1992 and 2002. This collective surveillance system, based on medium-term scenarios for each region and monitoring of borrowing by the central government, seems to have been effective. This mechanism appears also more transparent than a system based on bilateral agreements between each region and the central government, which seems to be currently envisaged. It would strike the right balance between the specific requirements of the regions and those of the country as a whole. This would avoid having recourse to penalties, which are difficult to implement, as international experience shows. The regions should nevertheless continue to be obliged to present a medium-term fiscal adjustment plan if they appreciably overshoot their targets, which would clearly indicate a structural imbalance in their accounts. It would, however, be important to ensure that this new norm is imposed even-handedly on all the regions, whatever their size. It is also important to ensure that complying with a budget balance rule does not prompt a sharp rise in regional and local taxes, which has been an issue in some OECD countries.

Notes

1. In December 2004, the País Vasco Parliament approved a proposal calling for a quasi-independent status for País Vasco, based on the idea of a "free association" of separate nations, with the right to secede fully from Spain at a later stage. Discussions on this issue between the central and regional governments have started. The central government and the main political parties strongly oppose this project, which might lead to a serious institutional clash. The next elections in País Vasco are planned for April or May 2005.

2. The Catalan conservative party (CiU) played a pivotal role in Spanish politics between 1993 and 2000 when it held the balance of power in parliament. The Popular Party won an absolute majority in the 2000 general election. In the 2004 general elections, the Socialist Party did not win an absolute majority and depends on the support of regional parties. The Catalan Republican Left (ERC) has emerged as a significant force in regional politics and has become the fourth-biggest party. The upper chamber (the Senate), which has powers of amendment, has 208 directly elected members, with a further 51 designated by the regions. The government envisages a reform of the senate, which requires changing the Constitution, so as to give more power to the regions by transforming the Senate into a chamber representing the regions and/or by giving the regions the power to veto laws when they could affect their autonomy. The wisdom of going in this direction is open to question, at least on economic efficiency grounds. In Germany for instance the complicated mediation process between the Bundestag and the *Länder* chamber of Parliament (*Bundesrat*) has slowed and diluted the structural reform process. The OECD 2004 *Economic Survey* of Germany recommended to consider limiting the power of the *Bundesrat* to block federal legislation.
3. Reducing income dispersion across regions will also require improving framework conditions, and in particular labour mobility, which are shaped to some extent by the assignment of spending and revenue-raising responsibilities across government levels. In particular, a well-functioning job-matching system and education policies, consistent active and passive labour market policies are all important ingredients. For further discussion on the forces shaping convergence across regions, see the special chapter "Regions at work" in the 2004 OECD *Economic Survey* of the euro area.
4. The 2003 OECD *Economic Survey* of Spain contains an in-depth chapter on the economic impact of migration.
5. The labour force survey (EPA) likely overestimates general government employment. As a share of total employment, it rose from 10% in 1980 to 15% in 2003, *i.e.* a level close to the OECD average. Cross-checking with national accounts data for the wage bill of the general government, however, reveals an apparent inconsistency with the data from the *Registro* (with surprisingly large movements in wages per capita and a high growth in public wages compared to the private sector).
6. Under the 2004 norm, local and regional governments are not allowed to create permanent positions on a net basis. Up to 2004, all levels of government could replace only one in four retiring civil servants.
7. See the study *Estudio comparative del salario del médico en España* (SIMEG, 2004).
8. In Andalucía, Castilla-La Mancha and Extremadura, doctors are required to prescribe on the basis of active ingredients and patients are reimbursed on the basis of the least expensive pharmaceutical containing them. Cataluña has introduced an approach to hospital financing that provides incentives for efficiency and has been a leader in contracting out integrated management of services to private companies (Conference Board of Canada, 2004). Madrid and Comunidad Valenciana have defined maximum waiting times for specific specialised treatments and, once reached, patients are given free access to private health care centres. A system to control prescriptions of anti-inflammatory drugs developed in Andalucía has recently been extended to the whole of Spain. In the long-term care sector, there are also significant regional differences in approaches and services provided (Comas-Herrera *et al.*, 2003).
9. A consumer association (*Organización de Consumidores y Usarios,* OCU) has carried out valuable exercises to compare the price and quality of services across the country (including elderly and hospital care) but also recognises the difficulty of obtaining reliable information.
10. Responsibility for managing training programmes for the employed was transferred to Cataluña in 1992, Comunidad Valenciana, Galicia and Andalucía in 1993, and to all remaining regions by 1999. Responsibility for training programmes for the unemployed and for placement services was transferred later and completed in the early 2000s (Alujas Ruiz, 2004).
11. In Canada, the federal government maintains total control of the unemployment insurance benefits, but social assistance programmes fall nearly entirely under the control of provincial governments; the funding and the administrative responsibility for a portion of ALMPs were transferred from the federal government to most of the provinces in 1997 (Gray, 2003). On invalidity policies in Spain, see OECD (2003a).
12. These estimates should be considered with caution, since larger municipalities tend to offer more services, resulting in higher average spending per capita.
13. Recently, the Danish government announced a merger reform which is expected to reduce the number of municipalities from 271 to around 100 although the average size of a municipality is

already about 20 000 inhabitants. This reform is expected to deliver some efficiency gains but most certainly a higher quality of public services.

14. Taxes on wealth and property transactions were until 1997 the main tax resources of regional governments and their base and rates were set by the central government.

15. The net fiscal costs of immigration can also be high for a few medium-sized municipalities which receive a large number of illegal immigrants. They often have to provide food and urgent care to illegal immigrants arriving in poor health condition. The government has, however, announced the creation of a special fund for the most affected municipalities.

16. As an illustration, using the main population variable (*población protegida*) when assessing the need of adjustment (*asignaciones de nivelación*), the population of Madrid region grew by 8.1% over the period 1999-2002, compared with a 4.3% national average.

17. According to Montero *et al.* (2004), extra-costs associated with this guarantee would amount to € 844 million, *i.e.* about 2% of the total regional financing needs.

18. For 2001, earmarked grants associated with bilateral agreements between the central government and individual regions (*subvenciones*, *convenios* and *contratos programas*) amounted to € 3.7 billion, *i.e.* over 0.6% of GDP.

19. According to the Ministry of Finance, the implementation of the new model resulted in a € 1.8 billion increase in financial resources for regional governments for the base year (*i.e.* 0.3% of GDP), discounting the effect of the changes in spending assignments but excluding other specific transfers which may have been granted to reach an agreement (*e.g. convenios* and *contratos programas*). Montero *et al.* (2004) provide estimates of some of the negotiation costs (increase in transfers) incurred by the central government in reaching an agreement with the regions.

20. The exception is the contribution of Foral regions to the *Fondo de Compensacion Interterritorial*, which finances infrastructure development projects in poor regions (*i.e.* those meeting the Objective 1 criteria for European Structural Funds). The overall amount of this fund is, however, small (less than € 1 billion in 2003, *i.e.* 0.1% of GDP).

21. For an in-depth discussion of these issues, see de la Fuente (2002), de la Fuente *et al.* (2003a) as well as Garcia-Milà and McGuire (1996). Alvarez Pinilla *et al.* (2003) also estimated rates of return on public infrastructure across Spanish regions. While recognising that estimates vary significantly along with the model used to compute rates of return, this work also shows that the rate of return is higher in richer regions.

22. The elasticity of consumption taxes with respect to spending has been above unity since the early 1990s (Bouthevillain *et al.*, 2001). One reason is the changing composition of the consumption basket from goods which are taxed at a reduced VAT rate towards semi-durable and luxury goods which are taxed at the standard rate.

23. Regional governments can introduce a tax on retail sales of oil products up to 1 cent per litre. Granting more discretionary powers on environmental taxes to regional governments, however, raises two main issues. First, tax competition could be intense and benefit small and central jurisdictions (the case of Luxembourg with low VAT and excise taxes on oil products and a very high share of non-residents' consumption). Second, a conflict in objectives may arise since environmental taxes should primarily serve to reduce pollution.

24. Rough calculations provide some illustration. Personal income tax revenues of the regions amounted to € 14.5 billion in 2002, *i.e.* 2.1% of GDP. Were the regional governments responsible for financing only two thirds of the likely increase in health and long-term care spending over the next decades, a doubling of personal income tax revenues would be required. *Ceteris paribus*, this would entail at least a doubling of regional statutory rates. The top marginal tax rate (45% in 2003 when combining the central and regional government rates) would thus increase by over 16 percentage points.

25. Goolsbee (2004) provides such evidence for the United States.

26. To mitigate this bias, the tax law allows municipalities to adjust the tax base (*i.e.* property values as estimated by the register – *Catastro*) for the nine years following the revaluation.

27. Up until 2003, the regions' borrowing capacity was limited by capping the total debt service burden (interest plus capital) at 25% of current revenue. In addition, total local government debt could not exceed 110% of current revenue and the authorities had to show positive saving to be able to borrow. If these conditions were not met, the territorial authorities had to obtain Ministry of Finance approval. The increase in current revenue prompted by decentralisation and the fall in

interest rates resulted in the relaxation of the borrowing constraint on the part of the regions which had no debt when they came into being in the late 1970s.

28. Up until 1992 the mechanisms for overseeing the borrowing rules, which in particular meant that borrowing could only be used to finance investment, were found wanting (Salinas Jiménez and Álvarez García, 2002).
29. According to Alcade Fradejas and Vallés Giménez (2002), certain differences between risk premiums based on the regions' degree of indebtedness existed between 1990 and 1995. However, they were small. Recently, the rating differential between regions has been between AA- and AA+.
30. In addition, the periodic renegotation of the regions' financing models in the past also seems often to have provided an opportunity to help certain Communities faced with budgetary difficulties.
31. The higher weight taken by corporate tax revenues in total central government resources after the 2002 regional financing reform has no doubt reinforced the sensitivity of the central government revenues to the cyclical fluctuations of the economy.
32. Between 1985 and 2003, the correlation between the output gap and the investment ratio of the regional and local authorities was stronger (0.62) than for central government (0.32). Similar empirical results have been found in other European countries such as Denmark (Borge *et al.*, 2001). See also Monasterio-Escudero and Suárez-Pandiello (2002) for the case of Spain.
33. Since the mid-1990s, investment by public/private partnerships has amounted to 6% of GDP. Such partnerships have in many cases been set up at regional level (IMF, 2004).
34. Eurostat reported recently, for example, that consideration was being given to reinstating in the deficit of the Community of Madrid the transfers it had made to Mintra, the public company responsible for building the capital's underground railway system.
35. Clarification of the links between the public accounts presented on a budgetary basis and those drawn up using national accounts criteria is planned, bearing in mind the difficulties recently encountered in this area concerning both the central and also regional government, as in Cataluña.
36. The most recent detailed information available for all individual regions relates to 2001 and it is difficult to obtain long time series of individual regional accounts on a national accounts basis.
37. The slight fiscal overrun in 2003, which many regional governments attributed to a problem with the financing of health spending, was no doubt also partly due to the cyclical downturn. As a rough guide, a 1% rise of the output gap leads to a change in the cyclical fiscal balance by 0.1% to 0.2% of GDP for the regions as a whole.
38. In view of the share of their revenues in GDP, which is 6%, a 1% decline in the output gap results in a cyclical budget deficit by the local government of less than 0.1% of GDP.
39. The experience of Austria in this domain does not appear yet very conclusive. It is likely that finding a proper compensation for the acquisition of a deficit right by a region may require some sort of political agreement with another region, which may not be very transparent. Also, developing a system of trading deficit rights could be more difficult in Spain because of the wide differences in size between the regions.
40. In Switzerland, the output gap used in the budget procedure is calculated by the Hodrick-Prescott filter.
41. For instance, it would be useful to ensure that the increase in public expenditure does not differ much from the trend growth rate of the economy in case where, initially, the budget is in structural equilibrium and no tax change is scheduled.
42. An increase in direct taxation prompted by the territorial authorities reduces the incentives to work, to save and to grow. It also reduces the social insurance contributions and taxes received by central government and can result in higher spending on welfare.

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ANNEX 4.A1

Recent reforms of the local government financing system

The local government financing system was reformed in two steps, with some changes in local taxes in 2003 and a reformulation of central government grants in 2004.

The 2003 reform made the local tax system more friendly towards small companies, employment, the environment and families. It also removed the specific limits on small municipalities' taxing powers by allowing them to set the rates within the same range as large municipalities. The main changes in local taxes are as follows:

- The local business tax (IAE): *i)* small businesses (turnover less than € 1 million) – *i.e.* over 90% of taxpayers – are now exempt, while higher and progressive rates are imposed on larger ones;* *ii)* the number of employees no longer forms part of the tax base and municipalities are given the opportunity to grant special tax relief to job-creating companies; *iii)* newly-created companies are exempt for a 2-year period and pay only half of their tax liabilities for the next five years; *iv)* small municipalities can now vary the tax rates within a wider band, similar to that implemented for large municipalities.
- Tax on immovable assets (IBI): *i)* municipalities can now differentiate rates according to the use of the property (commercial, industrial or residential); *ii)* they have more discretion to introduce tax relief for families with more than three children or for households using renewable energy sources. All municipalities now can set the tax rate within a range of 0.4% to 1.1% (small municipalities previously had to set rates within a narrower band).
- Small municipalities have been given the same powers as large ones to set rates for the tax on motor vehicles, the tax on the increase in land prices and the tax on construction and public works.
- Central government transfers to municipalities were reformed in 2004 and an asymmetric system has been introduced: Large municipalities (over 75 000 inhabitants) receive a share of the personal income tax (1.7%), VAT (1.8%) and excise taxes (2.1%) collected within their jurisdiction. These revenues substitute part of the unconditional grant. Small municipalities still receive transfers from the central government based on

* The abolition of the local business tax for small companies reduced IAE revenues by € 900 million, *i.e.* by more than half (Sánchez Soliño, 2003). Taking into account the increase in rates on large companies, the net losses for municipalities would amount to € 630 million. Since the tax paid is deductible from the personal or corporate income tax bases, the overall loss for public administrations would be lower – about € 410 million. On the other hand, tax liabilities of large companies have increased and are deductible from central government taxes, so that the net effect is difficult to evaluate.

their needs (population and ability to pay) as well as their tax effort. The differentiation in weight given to the population index has, however, been adjusted to better reflect differences in obligations for service provision according to a municipality's size. A special regime was also introduced for municipalities classed as tourist centres. These will also be assigned a share of the fuel and tobacco excise tax collected within their boundaries (2.0%) to compensate for the specific costs associated with large inflows of tourists.

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Chapter 5

Reforming the pension system

Like the other OECD countries, Spain will be faced with population ageing. The consequences were analysed in detail in the 2001 Economic Survey. It concluded that a reform of the public pension system, including a lowering in the generosity of the parameters underlying pension calculations, was needed to guarantee the long-term financial viability of the system. Since then, demographic prospects have been affected by the surge in immigration. Also various studies have been published, including official ones, suggesting that the scale of the challenge to the public finances may be less critical than had been thought. This chapter takes stock of the situation and assesses the cogency of the OECD's past recommendations in this area. It also discusses the role that could be played by various measures that aim at increasing the employment rate for women and older workers and by a fiscal policy accumulating surpluses ahead of the demographic shock.

The need to reform the public pension system

As in many European countries, the pension system consists mainly of a compulsory contributory insurance scheme administered by the public sector and operating on a pay-as-you-go basis. Spending was a little over 8% of GDP in 2003 and the system will come under heavy pressure over the coming decades.[1] The impact of ageing is likely to be more marked than elsewhere because ageing will be more pronounced, even though occurring later than in the OECD on average, while the parameters underlying the calculation of pensions are more generous. Thus, projections carried out in 2000 for all the OECD countries pointed to the ratio of public pension spending to GDP rising by 8 percentage points by 2050, as against 3 to 4 percentage points in the rest of the OECD (OECD, 2001).

The increase in immigration will help only little

The statistical office's (INE) latest population projections do, however, suggest that the population ageing predicted previously will ease somewhat. The immigrant population, which has grown by nearly 420 000 per year since 1998, stood at approximately 7% of the total population in 2004. The new projections, which take this into account, assume a continuation of substantial inflows of immigrants (stabilising at 250 000 persons per year as of 2010) and forecast a rise of 33 percentage points in the dependency ratio of the elderly by 2050, *i.e.* nearly 6 percentage points down on the previous projections (which assumed immigration of 60 000 persons per year between 2010 and 2050).[2] However, there are a number of reasons why increased immigration will probably be of only limited and temporary help in solving the public finance problems that ageing will bring:

- Despite these revisions, the rise in the dependency ratio of the elderly will probably still be more marked than in the other OECD countries, where it could reach 26 percentage points on average by 2050 (Casey *et al.*, 2003). A sharp increase in the dependency ratio looks inevitable and uncertainties are limited because those who will be aged over 65 in 2050 are already over 19.
- To slow the rise in the dependency ratio further, the increase in immigration would have to be much greater than the already relatively sharp rise in the latest INE scenarios.[3] However much higher immigration could give rise to political and social tensions because, for example, the rental housing market is not expanding sufficiently (Chapter 2).
- The beneficial short-run effect of social insurance contributions and taxes paid by the immigrant workers is partly offset by the increase in certain outlays – on education and health in particular – as several regions are already realising (Chapter 4). Lastly, while immigration will raise the working age population and employment, it will also increase the number of pensioners in the long term.[4]

All in all, more immigration will not solve the financial problem posed by ageing. The answer has to involve measures aimed at raising employment, including extending people's working life, and also adjustments to pension benefits and contributions. The role

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of these different measures can be shown by a simple analytical framework, which breaks down the ratio between pension payments and GDP into sub-components: the rise in the dependency ratio of the elderly, the employment rate and the institutional factors determining the number and level of pensions paid, *i.e.* the generosity of the system.[5] The breakdown of pension outlays in 2003 can be extrapolated on the basis of recent demographic projections and simple assumptions regarding trends in the other variables.

Lowering the generosity of the parameters underlying the calculation of pensions seems inevitable...

This extrapolation, which assumes a gradual rise in the employment rate to 70% (the Lisbon summit commitment) and keeping constant both the level of pensions in relation to productivity and their number in relation to the over-65 population, gives an increase of 7¾ percentage points in the ratio between pension outlays and GDP by 2050 (Table 5.1). While not a projection, this mechanical exercise does provide a gauge of the magnitude of the coming shock. The increase is similar to the OECD's estimate in 2000 and, more recently, Jimeno (2002) and Alonso Meseguer and Herce (2003). The exercise also shows clearly that, on the basis of recent demographic projections and a normative but reasonable assumption about increased employment, a sharp rise in pension expenditure will be unavoidable if the number of pensions increases at the same pace as the over-65 population and if benefits increase in line with productivity.

There are, however, differences between recent studies concerning the future generosity of the system (Conde-Ruiz and Alonso, 2004). Assuming no change in policy, the latest projections published by the Ministry of Labour forecast a rise in the pension expenditure/GDP ratio of no more than 4½ percentage points by 2050. This relative optimism stems from a slide in the average level of pensions relative to productivity and a decline in the number of pensions in relation to the over-65 population. These two assumptions do, however, prompt a number of questions as pensions in real terms have risen in line with productivity in the past, while the number of pensions per retired were stable (Box 5.1). To remove the uncertainty surrounding changes in the number and size of pensions in the future, the determinants of the two variables need to be analysed in greater depth. This task will be made easier since researchers have recently been given a wider access to microeconomic information that the social security has on careers and pension entitlements.

Table 5.1. **Public expenditure on pension: current situation and prospects**[1]

	Current situation	Baseline scenario			Increase in employment rate			Increase in employment rate and reduction of pension benefits		
	2003	2020	2040	2050	2020	2040	2050	2020	2040	2050
Dependency ratio	26.8	32.2	50.4	60.0	32.2	50.4	60.0	32.2	50.4	60.0
Employment rate	61.1	65.0	70.0	70.0	65.0	70.0	75.0	65.0	70.0	75.0
Number of pensions/ population 65+	1.10	1.10	1.10	1.10	1.10	1.10	1.10	1.10	1.05	1.00
Average pension/productivity	16.7	16.7	16.7	16.7	16.7	16.7	16.7	16.7	16.0	15.1
Pension expenditure/GDP	**8.1**	**9.1**	**13.2**	**15.8**	**9.1**	**13.2**	**14.7**	**9.1**	**12.1**	**12.1**

1. The breakdown of the ratio pension expenditure/GDP was obtained with the following identity:
Pension expenditure/GDP = (pensioners/population of over 65) × (dependency ratio) × (1/employment rate) x (average pension benefit/ average productivity).
This calculation applies to the compulsory contributory insurance schemes (*i.e.* excluding civil servant schemes and welfare benefit system).

Source: OECD calculations based on INE data.

Box 5.1. **Towards an "endogenous" fall in pension generosity?**

The latest official projections suggest that the average level of pensions in relation to productivity will fall over the next few decades, but this is in contrast with past trends. Since 1980, pensions have risen faster than productivity and real wages by an average of ¼ to ¾ of a percentage point per year. This reflects the increased length of and improvement in the careers of workers, fewer people now receiving minimum pensions and the periodic increases in minimum pensions in recent years, including in the 2005 budget.

Even so, the link between productivity growth and pension increases is not direct, the latter, including maximum pensions, being indexed to inflation. In addition, the statutory contribution bases used to calculate pensions do not take increases in real wages and productivity fully into account.[1] According to Burdiel and Varela (2004), for example, the increase in the statutory contribution bases in the latest official projections passes on only half of the forecast gains in labour productivity, thus weakening the relationship between the average pension and productivity. Also, according to Conde-Ruiz and Jimeno (2004), keeping the maximum pension stable in real terms, as in the official projections, would erode generosity at a pace that will be all the more rapid the stronger productivity gains will be in the future.[2]

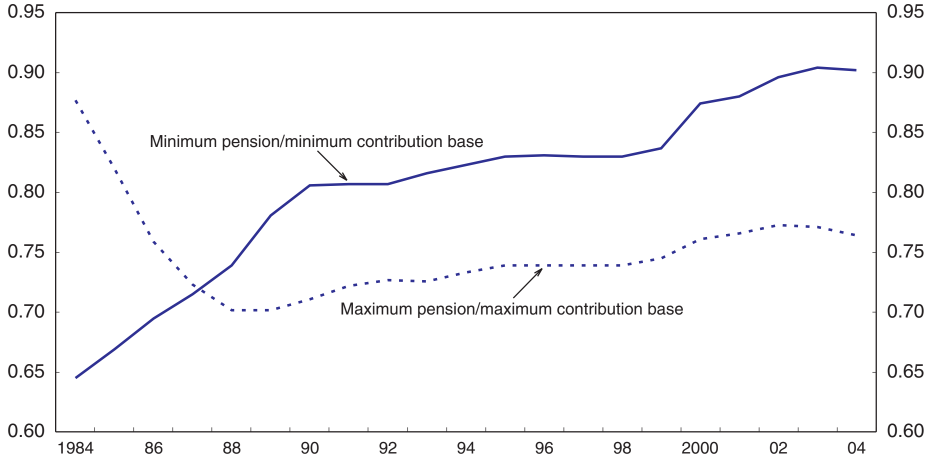
The second factor behind the relative optimism in the official projections is the reduction in the number of pensions in relation to the over-65 population. Yet this projection is difficult to equate with that variable's stability in the past.[3] What is more, the assumption made in the projections that the female employment rate will rise, together with the possibilities of combining old-age and widow's pensions without means testing, would rather point to the number of pensions increasing faster than the over-65 population in the future.

1. Pensions are computed on a statutory contribution base and a replacement rate the level of which depends on the number of years of contributions and the age of retirement. The statutory contribution base is calculated as the average of actual earnings subject to contribution (between an upper and a lower limit) over the last 15 years in work. These earnings are indexed to inflation, and not wage increases, for the period prior to the past two years, while the past two years are not indexed. The indexation of the minimum and maximum contribution bases is carried out every year in the budget on a discretionary basis.
2. According to Conde-Ruiz and Jimeno (2004), if the maximum pension continues to be indexed to inflation, it will be paid to nearly 40% of pensioners in 2050 if productivity rises by 3% per year. If, on the other hand, productivity were to increase by 1½ per cent per year, only 25% of pensioners would receive the maximum pension.
3. According to the official projections, the number of pensioners should rise by 64% between 2000 and 2040, while the over-65 population will increase by 83% (Ministerio de Trabajo y Asuntos Sociales, 2002). Historically, the ratio of the number of pensions disbursed to the over-65 population has remained fairly stable, although the figure has varied depending on the population census data used.

However, the reduction in generosity, as incorporated in the official projections, is likely to result in only a limited improvement in the financial balance of the pension schemes, unless contributions and benefits are de-linked. In the absence of a change in the pension calculation parameters, which are among the most generous in the OECD (OECD, 2005a), de-linking would involve, for example, coupling the capping of pensions with the uncapping of contribution bases. However, de-linking would run counter to the updated Toledo Pact agreement that was signed by the social partners and the Parliament in late 2003, which recognized that contributions and benefits needed to be closely linked and, generally, that there had to be a closer tie between contribution bases and wages. In recent years, moreover, there has not been any trend widening of the gap between contribution bases and benefits, maximum pensions included (Figure 5.1).[6]

All in all, a downward revision of the system's parameters looks inevitable if the long-term financial viability of the pension schemes is to be ensured. The discounted value of old-age pensions is higher than the sum of the corresponding contributions. This partly

Figure 5.1. **Ratio of pension benefits to contribution basis**



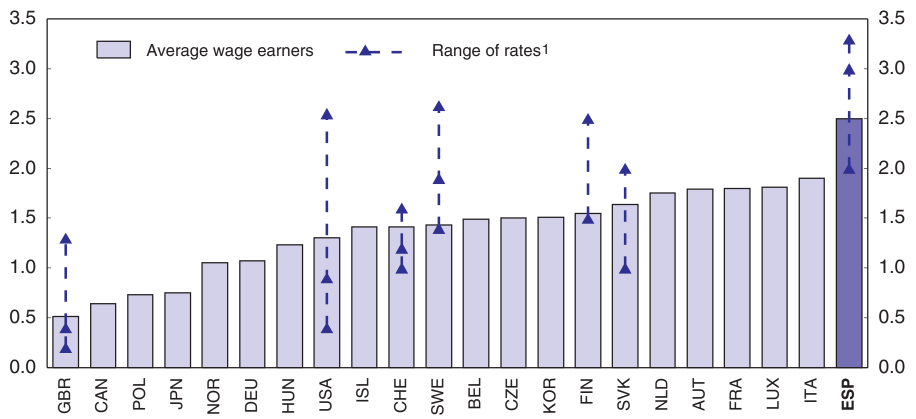
Source: OECD calculations based on data provided by the Secretaría de Estado de la Seguridad Social.

results from a rate of accumulation of pension rights which is much higher than in other countries (Figure 5.2). The internal rate of return that equalises the discounted value of contributions and the amount of pensions paid is approximately 4% for the general social security scheme, *i.e.* a rate higher than potential growth over the coming decades (OECD, 2001). The system's lack of actuarial fairness, which also affects maximum pensions, is especially pronounced in the case of workers contributing to special schemes such as the farm workers' and domestic employees' schemes to which many immigrants contribute.[7]

In view of the size of the challenge, the necessary reforms could, for reasons of intergenerational equity, be split between measures targeting both receipts and benefits. It would appear, for example, that an increase in the level or period of contributions to certain schemes is needed, such as those for the self-employed, farmers and domestic employees. In 2003, nearly 45% of pensioners in these schemes, who represent 25% of all

Figure 5.2. **Accrual rates for defined benefit pension schemes**

Annual rate in per cent, 2002



1. Accrual rates can vary with earnings (Sweden, United Kingdom, United States) or, for full-career workers, they can vary by age (Switzerland) or years of service (Finland, Spain, Slovak Republic).

Source: OECD (2005), *OECD Pensions at a Glance: Public Policies Across OECD Countries*, forthcoming.

pensioners, had contributed for less than 20 years and 44% of them were receiving a minimum pension.[8] This reflects a minimum pension "purchase" strategy by these workers. They are free to choose their contribution base between the minimum and maximum thresholds and have no interest in increasing their contribution periods since doing so reduces their pension wealth because of the existence of a minimum pension (OECD, 2001).

A prolongation of the period to calculate pension rights (at present the last 15 years of working life and not a person's entire career) is also needed to make the pension system more actuarially fair. This was acknowledged in the updated Toledo Pact agreement, but has not given rise to any specific action yet.[9] However, calculating pensions on the basis of earnings over the whole of a person's working life will probably not suffice to ensure the pension system's long-term financial viability.[10] The rate of accumulation of pension entitlements will no doubt also have to be reduced and the number of pensions drawn made subject to means-testing. A reduction in the high returns on contributions is vital if measures to encourage an increase in employment, such as immigration, are not to result in the problems being deferred but, ultimately, made worse.

... but could be limited by running budget surpluses over the next decade

A reduction in the generosity of the parameters underlying the calculation of pensions, resulting in a significant decline in their level as measured against productivity, could however prove socially hard to accept. The average level of pensions, which is lower than in the majority of other European countries (Table 5.2), is widely thought in Spain to

Table 5.2. **Pension expenditure relative to population aged 65+ and GDP per capita**

2001

	Pension expenditure		Population aged 65+[1]		GDP per capita €	Pension expenditure per person aged 65+	
	Million €	% of GDP	Thousand	% of total population		€	% of GDP per capita
Spain	**63 494**	**9.7**	**6 846**	**17.0**	**16 200**	**9 275**	**57.3**
Austria	30 119	14.0	1 242	15.5	26 800	24 258	90.5
Belgium	28 426	11.2	1 738	16.9	24 700	16 355	66.2
Denmark	19 045	10.7	578	10.8	33 200	32 939	99.2
Finland	14 804	10.0	782	15.1	26 100	18 924	72.5
France	195 046	13.2	9 577	16.2	24 200	20 367	84.2
Germany	272 607	13.1	13 880	16.9	25 200	19 640	77.9
Hungary	5 146	8.9	1 548	15.2	5 700	3 324	58.3
Iceland	541	6.3	33	11.6	29 900	16 355	54.7
Ireland	4 218	3.7	431	11.2	29 700	9 782	32.9
Italy	179 117	14.7	10 460	18.1	21 000	17 124	81.5
Luxembourg	2 223	10.1	61	13.9	49 900	36 148	72.4
Netherlands	55 374	12.9	2 187	13.6	26 800	25 324	94.5
Norway	14 744	7.8	677	15.0	42 000	21 769	51.8
Portugal	14 049	11.4	1 694	16.5	11 900	8 293	69.7
Slovak Republic	1 689	7.2	614	11.4	4 300	2 751	64.0
Sweden	27 907	11.4	1 531	17.2	27 600	18 222	66.0
Switzerland	35 625	13.0	1 117	15.4	38 500	31 903	82.9
United Kingdom	188 016	11.8	9 149	15.9	27 100	20 551	75.8
Simple average	..	10.6	..	14.9	..	..	71.2

1. 2000 data for Italy.

Source: Eurostat, New Cronos database and UK National Statistics, January 2005.

be too low at present.[11] Under these circumstances, advance financing of pensions could be envisaged as a way of preventing too marked a decline in the relative level of pensions or limiting the scale of future contribution increases which could have an adverse effect on the cost of labour, competitiveness and employment. Continuing to run a budget surplus so as to reduce the public debt more quickly and increase social security assets ahead of the demographic shock that will begin in 2015-20 could provide part of the answer to the ageing problem. In this connection, it would seem advisable to keep all of the social security surpluses in the reserve fund over the next years.[12]

Promoting an increase in the employment rate for women and older workers

In general, the reduction in the generosity of pension benefits will be the smaller the more effective are the policies to increase the employment rate. Thus, a 5 percentage point rise in the employment rate by 2050 (from 70% to 75%) would reduce the level of pension expenditure as a proportion of GDP by 1 percentage point at that time (Table 5.1). Reaching such a level of employment would imply continuing progress in improving labour market performance, particularly for women and older workers (Table 5.3). The female employment rate, for example, would need to increase by some 20 percentage points over the coming decades to arrive at an average employment rate of 70% (Table 5.4). And to arrive at an average rate of 75%, employment rates by age category and sex would have to be aligned on the level of the five best-performing OECD countries. Achieving that objective, which would mean employment progressing at much the same rate as it did between 1996 and 2003, would require improving incentives and the abolition of some of the obstacles to the participation of women and older workers in the labour market.

Table 5.3. **Employment rates in selected groups of OECD countries**

Per cent, 2003

	Total				Male				Female			
	15-24	25-54	55-64	Total	15-24	25-54	55-64	Total	15-24	25-54	55-64	Total
Spain (1995)	28.6	59.5	32.4	48.7	35.1	78.6	48.4	64.6	21.8	40.3	17.5	32.9
Spain	**36.8**	**71.3**	**40.8**	**61.1**	**42.8**	**86.0**	**59.3**	**75.0**	**30.5**	**56.5**	**23.4**	**47.1**
Five best OECD performers[1]	56.6	83.1	63.9	76.7	57.3	87.9	71.0	81.5	55.8	78.3	56.9	71.8
EU15	40.3	77.2	41.5	65.4	43.5	86.5	51.4	73.9	37.1	67.9	32.0	56.7
OECD	42.9	75.3	50.1	67.1	46.8	86.7	60.8	77.4	39.0	64.1	39.9	56.9

1. Unweighted average of Denmark, Norway, Sweden, Switzerland and United Kingdom.

Source: OECD database on Labour Force Statistics, December 2004.

Strengthening the incentives in favour of career extension

Reforms brought in at the start of the 2000s to encourage older workers to extend their careers included the lowering of social security contributions and the possibility of moving gradually and flexibly towards retirement by being allowed to combine the receipt of a partial pension and income from part-time work after the age of 65 (OECD, 2003a). A number of additional reforms affecting both labour supply and demand could be envisaged:

- *A revision of the accumulation rate of pension entitlements during the course of the career*. The latter are in fact lower at the end of a person's career than at the start, which lessens the incentive to remain in the labour market.

Table 5.4. **Employment rate projections**

Per cent

		2003		2020		2040		2050		2003-50
		Population weight	Employment rate	Population weight	Employment rate	Population weight	Employment rate	Population weight	Employment rate	Required employment rate change
Baseline										
Male	16-54	43.0	77.1	40.7	77.1	38.7	77.1	40.7	77.1	0.0
	55-64	7.4	62.6	10.1	62.6	12.5	62.6	10.6	62.6	0.0
Female	16-54	41.9	51.2	38.8	51.2	36.5	51.2	38.4	51.2	0.0
	55-64	7.8	25.1	10.5	25.1	12.3	25.1	10.4	25.1	0.0
Total	16-64	**100.0**	**61.1**	**100.0**	**60.2**	**100.0**	**59.4**	**100.0**	**60.3**	**–0.9**
70% by 2050[1]										
Male	16-54	43.0	77.1	40.7	77.1	38.7	77.1	40.7	77.1	0.0
	55-64	7.4	62.6	10.1	63.5	12.5	64.5	10.6	65.0	2.4
Female	16-54	41.9	51.2	38.8	61.0	36.5	68.0	38.4	70.0	18.8
	55-64	7.8	25.1	10.5	34.0	12.3	46.0	10.4	50.0	24.9
Total	16-64	**100.0**	**61.1**	**100.0**	**65.0**	**100.0**	**68.4**	**100.0**	**70.3**	**9.1**
Level of 5 best[2]										
Male	16-54	43.0	77.1	40.7	79.0	38.7	83.0	40.7	83.0	5.9
	55-64	7.4	62.6	10.1	64.0	12.5	68.0	10.6	70.0	7.4
Female	16-54	41.9	51.2	38.8	60.0	36.5	72.0	38.4	72.0	20.8
	55-64	7.8	25.1	10.5	35.0	12.3	49.0	10.4	57.0	31.9
Total	16-64	**100.0**	**61.1**	**100.0**	**65.5**	**100.0**	**72.9**	**100.0**	**74.7**	**13.6**

1. Increase in employment rate required to reach an average of 70% by 2050.
2. Increase in employment rate to the level of the five best OECD performers.

Source: OECD calculations based on INE data (December 2004).

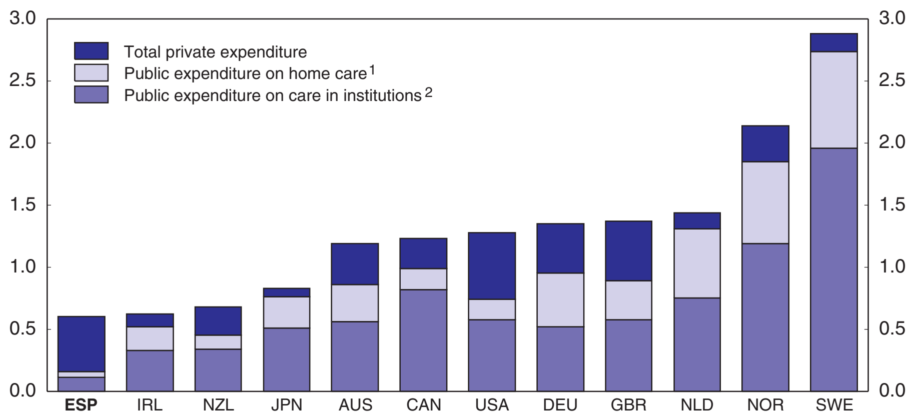
- *The introduction of flexible retirement arrangements making career extension a possibility.* The incentives adopted in recent years to encourage people to extend their careers, including after 65, have been sometimes in conflict with collective agreements, which impose a compulsory retirement age.[13] It would be desirable to prevent the collective agreements from imposing a compulsory retirement age and to draw up clear and flexible rules allowing firms to negotiate with wage-earners who wish to continue their careers beyond the age of 65.
- *A reform of the sickness and invalidity benefit system, which favours early retirement by older workers or slows their reintegration in the labour market.* Consideration could be given to extending the period of sick leave paid by employers, which is short at present. Care must also be taken to ensure that regional management of the non-contributory invalidity pensions financed by central government does not result in these benefits being awarded too easily. Lastly, persons in receipt of invalidity benefit would be more likely to return to work if accepting a job resulted in a distinct improvement in their financial situation, the chances of which would be enhanced by in-work benefits at low wages (OECD, 2003b).

Organising an efficient provision of care for dependent elderly persons

The female employment rate has increased rapidly, reducing the wide gap with other countries. However, the catch-up process could be slowed by the lack of child care facilities (Chapter 3) and facilities for elderly dependent persons. Demand for long-term health care services will increase over the coming years, even if the scale is uncertain.[14] Compared with other countries, organised long-term health care provision for dependent elderly persons is not well developed (Figure 5.3). Traditionally, it is largely (over 70%) organised by families, particularly women (Costa-Font and Paxtot, 2003). Although efforts have been made recently to develop long-term care in the framework of gerontology plans, provision still falls short of the authorities' plans and meets only a small proportion of demand. The social and long-term health care services are at present managed on a decentralised basis by the regions and municipalities and access to these services, which is means-tested according to scales that differ from region to region, is also dependent on provision which varies in terms of both intensity and quality. Furthermore, the structure of institutionalised long-term care supply does not match requirements, resulting in inappropriate use of acute care services such as prolonged hospitalisation, while at the same time failing to meet the demands of dependent persons who prefer to remain at home.

Figure 5.3. **Expenditure on long-term care**

In per cent of GDP, 2000



1. Including services in support of informal care.
2. Nursing homes for example.

Source: OECD (2005), *Long-term Care for Older Workers*, forthcoming.

Regional disparities in long-term care provision are liable to become more marked. There is also a danger of polarising the way the dependency problem is handled, with increased welfare for the most disadvantaged groups and the development of private provision for better-off households, while intermediate categories of households would find themselves the least well-off. To solve this problem, the 2005 budget includes a 45% cut in pension contributions for domestic employees hired to take care of a dependent person. This measure could, however, have an adverse effect on the financial balance of this special pension scheme. On the other hand, the Ministry of Labour has announced its intention of bringing in reforms and a committee of experts, meeting in 2004, proposed the introduction of a system of dependency insurance. This would be a compulsory system financed by contributions from employees, firms and government. The idea would be to gradually put in place, as of 2005, a national system co-ordinated by central government, together with the regions and municipalities, with the objective of slowly expanding the provision of services, notably home care.

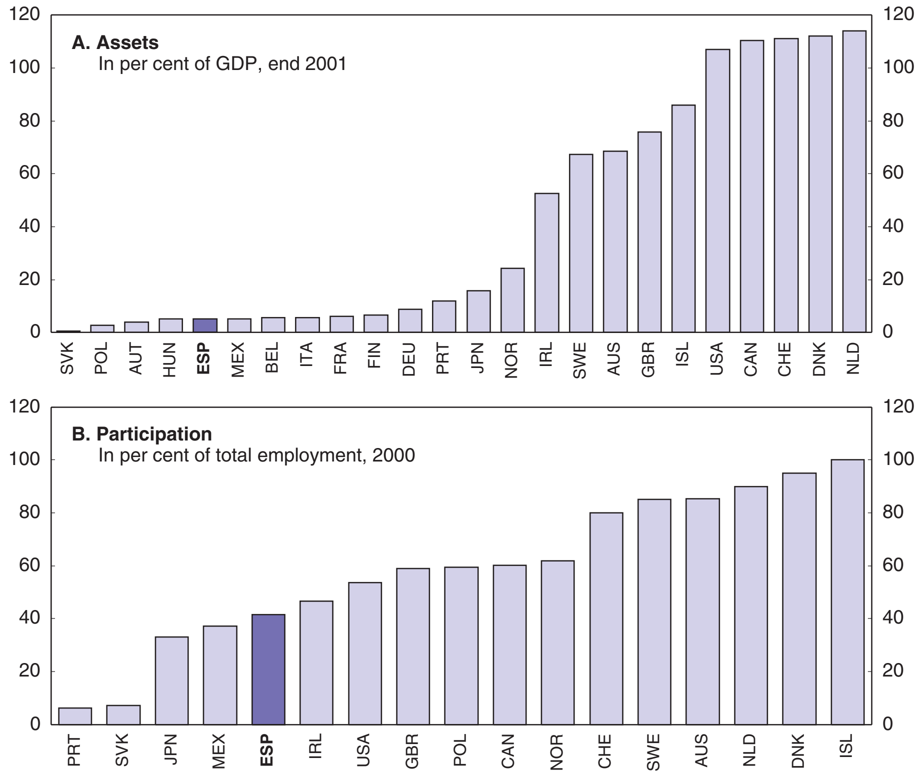
This project is heading in the right direction. In view of the foreseeable increase in demand for long-term care, not responding to it by additional investment is likely to be more costly for the overall economy and society than developing an efficient supply of quality care, which will increase the number of jobs in this field and reduce the obstacles to the integration of women in the labour market. The experience of other countries suggests that this objective can best be achieved by, first of all, ensuring that the provision of health care and social services for the elderly is properly organised, *i.e.* that it is carefully co-ordinated, in particular with acute medical care provision, and that it targets the most important needs (OECD, 2005b).[15] Emphasis has also to be placed on keeping dependent persons at home, which is usually what most want and is the least costly solution. This means, in particular, backing up informal care provision with home visits by specialists, flexible arrangements between working and family life and the introduction of a system of temporary stays in centres with medical care so that families can have some relief. Even in countries with well-developed systems of care, informal assistance remains very important. Informal care, for example, accounts for two-thirds of all care in Sweden (Johansson, 2000). What is more, programmes allowing dependent persons to choose freely what specific form of aid they would like – notably in order to be able to remain at home – by paying informal helpers for example (often relatives), seems to be giving encouraging results from the point of view of quality and costs.

Another important factor to be taken into account concerns the way such care is financed, the objective being to limit the negative effect of increases in contributions. To cope with demand for long-term care, which is in response to a dependency risk affecting the entire population and involving potentially very high but unpredictable costs, a growing number of OECD countries have developed a universal system of compulsory public insurance similar to sickness insurance. To limit adverse labour market effects, the contributions must have as broad a base as possible, including by pensioners themselves. Also, it would seem that direct participation by households in financing this care should be higher than for acute care. In such a financing system, supplementary private insurance could play an important role to cover cost-sharing by households, as shown by other countries' experience (OECD, 2005b).

Reappraising the incentives in favour of private pensions

In conjunction with a reform of the public pension system, the incentives to join private pension plans also need to be reconsidered. In Spain, the private system of pension provision is not very extensive (Figure 5.4). Since 1988, firms or individuals have been able to take out private pension plans with financial institutions on a voluntary basis. As in many other countries, contributions to such plans and the income on the assets invested are tax-exempt, whereas pensions are taxed in the same way as other household income. According to OECD estimates, the net tax cost of these programmes is high if the tax incentives do not generate additional savings, *i.e.* the initial losses of tax revenue during the contribution phase are not offset by subsequent increases in tax on pensions (Yoo and de Serres, 2004). The size of the subsidies is similar to that in other countries with a similar system and represents about 20 cents per euro of contribution (Figure 5.5). The potential additional saving generated by these plans is difficult to evaluate, but the value of the net subsidies measured on a discounted basis remains negative even assuming a reasonable increase in saving (Antolin *et al.*, 2004) (Figure 5.6). As in other countries, it would seem that these incentives affect mainly portfolio allocation,[16] even though the participation of

Figure 5.4. **Tax-favoured retirement saving plans**

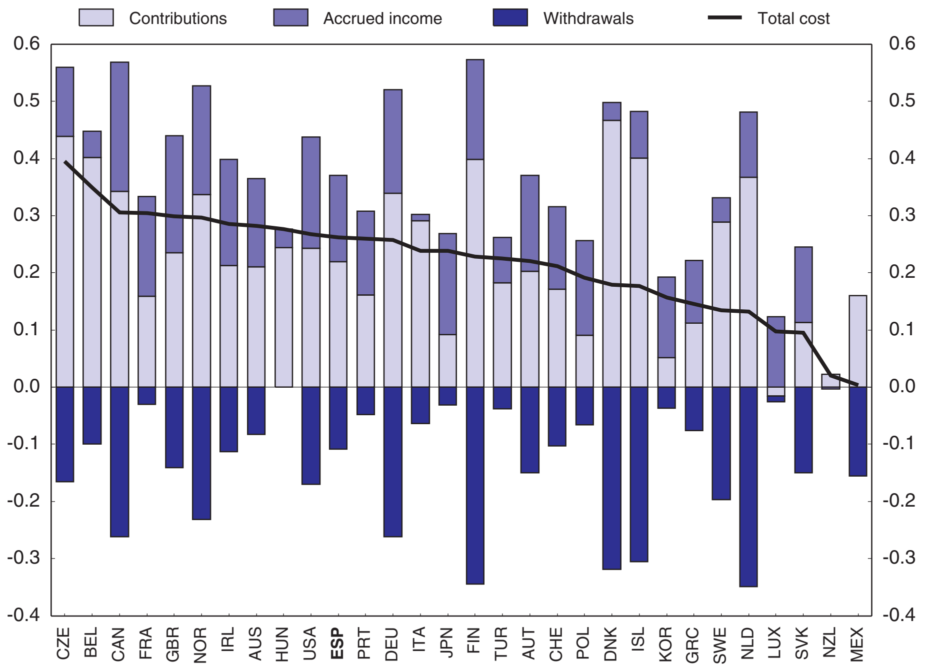


Source: International Pension Funds and their Advisors (2003), Aspire Publications, London; National sources; P. Antolin, *et al.* (2004), "Long-Term Budgetary Implications of Tax-Favoured Retirement Plans", *Economics Department Working Papers*, No. 393, OECD, Paris.

lower-income individuals in these plans appears relatively high, with a large proportion of people contributing small amounts. This suggests that the authorities should reassess the effectiveness of these tax incentives and limit their budgetary cost in the context of the tax reform planned for the second part of the legislature. Consideration could, for example, be given to taxing the investment income on invested assets even though this could be taxed less than alternative financial instruments. The overall ceiling for contributions (both for employee and employer), which are fairly high, could also be lowered while the existing tax deduction could be replaced by a non-wastable tax credit to tighten incentives for the better-off without affecting those on lower incomes. Despite a less favourable treatment of the private pensions system, its relative attractiveness could be enhanced by simultaneously reducing tax incentives in favour of house purchases.

Figure 5.5. **Net tax cost associated with one dollar of contribution**

Cohort average, 2002[1]

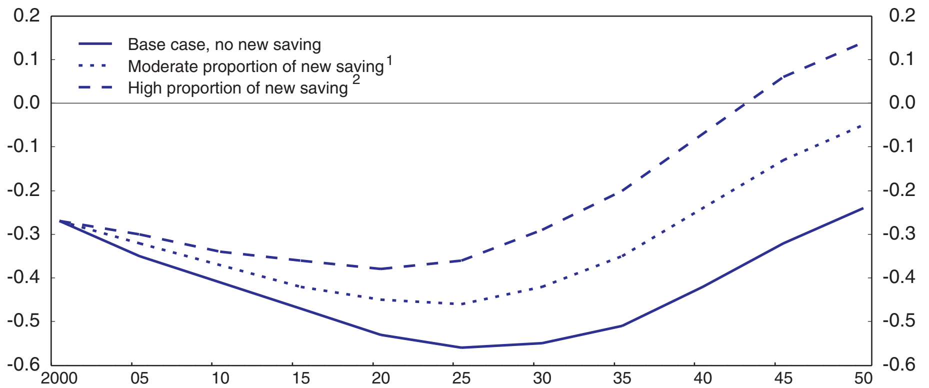


1. Reflecting the cost (in net present value terms) per unit of contribution invested in 2002. Based on the employer-sponsored schemes (except Italy and Korea) and lump-sum withdrawal at 65. However, for countries in which tax treatment between the employer's and employee's contributions is the same, the distinction between employer-sponsored and individual pension schemes is meaningless. The outcomes in New Zealand and Mexico are driven by the following factors: New Zealand – employers' contributions are taxed at 21%, the rate lower than the marginal tax rate; Mexico – exempt income accruing to regular investment from taxation.

Source: P. Antolin, *et al.* (2004), "Long-Term Budgetary Implications of Tax-Favoured Retirement Plans", *Economics Department Working Papers*, No. 393, OECD, Paris.

Figure 5.6. **Net fiscal revenues under alternative assumptions on new savings**

Per cent of GDP



1. Moderate case assumes that 25% of contributions to pension are new saving.
2. High case assumes that 50% of contributions to pension are new saving.

Source: P. Antolin, *et al.* (2004), "Long-Term Budgetary Implications of Tax-Favoured Retirement Plans", *Economics Department Working Papers*, No. 393, OECD, Paris.

Notes

1. The old-age insurance system also comprises a specific pension scheme for the central civil service, with expenditure of 0.9% of GDP, and a supplementary and voluntary private scheme operating on a funded basis. Lastly, welfare benefits are means-tested and paid to the elderly not eligible for the contributory scheme. Total public pension expenditure, including welfare benefits and the central government civil servant scheme, amounted to 9.7% of GDP in early 2000s.
2. These new projections were published by the National Statistical Office (INE) in August 2004.
3. According to this scenario, foreigners or people born abroad would account for some 28% of the total population by 2050, which is high compared to other countries.
4. The pension system rules, however, require contributions for at least 15 years before being eligible for a contributory pension.
5. The pension expenditure/GDP ratio is broken down by the following accounting identity: Pension/GDP = (number of pensions/population over 65) × (dependency ratio) × (1/employment rate) × (average pension/average productivity).
6. The ratio of benefits to contributions being lower for people with high incomes, an increase in the proportion of workers receiving maximum pensions would, however, ease the pension schemes' financial problems.
7. The internal rates of return for the farm workers', self-employed and domestic employees' schemes range between 5 and 6½ per cent per year. In the case of maximum pensions under the general scheme, the internal rate of return is approximately 4% per year.
8. Where the general scheme is concerned, the proportion of pensioners with less than 20 years of contributions did not exceed 5% and 23% of them received a minimum pension. A full pension requires 35 years of contributions and retirement at age 65.
9. The last reform, dating from March 2001, contained no measures aimed at improving the pension system's long-term financial viability. It raised minimum pensions, introduced the possibility of flexible retirement and extended the possibility of early retirement to unemployed workers who had contributed for more than 30 years.
10. According to Alonso Meseguer and Herce (2003), who predict that pension expenditure will increase by 7½ percentage points as a proportion of GDP between 2003 and 2050, a pension calculation based on 35 years instead of the last 15 years of working life would reduce this increase by 2 percentage points. This assessment tallies with the OECD's calculation in the 2001 *Economic Survey*.
11. The low level of pensions, despite the existence of generous calculation parameters, is attributable to four main factors: *i)* the low labour market participation of women, a large proportion of whom receive only a widow's pension; *ii)* the method used to finance the special schemes, which encourages workers to limit their contribution periods; *iii)* careers being interrupted because of unemployment; and *iv)* the system of inflation-indexing which lowers relative benefits for the oldest age groups (OECD, 2001).
12. Reserve fund assets stood at 2.6% of GDP at the end of 2004, whereas the combined social security surplus reached 4.2% of GDP between 1999 (when the fund was set up) and 2004.
13. The lack of clear rules in this respect, plus the fact that some collective agreements continue to impose a compulsory retirement age, has in recent years been the cause of disputes between employers and employees, and these have given rise to costly legal procedures.
14. According to Bains and Oxley (2004), public spending on care for the elderly could rise by an average of a little over 1% of GDP by 2050 in the OECD on average. Similar findings were arrived at by Comas-Herrera and Wittenberg (2003). The latter predict that long-term health care spending could reach 1.6% of GDP in Spain by 2050. The prospect of increased spending could be mitigated by a reduction in invalidity problems thanks to medical progress as life expectancy increases – something which is corroborated by the analysis carried out by Jacobzone *et al.* (2000).
15. Sometimes, as in Sweden, the supply of care has had to be targeted more specifically at the most serious needs to limit spending.
16. Since the mid-1990s, the number of individual contracts has grown much more rapidly than that of corporate contracts. Individual investors have been switching from investment to pension funds, which enjoy tax relief.

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GLOSSARY

$	United States dollar
€	Euro
ADSL	Asymmetric digital subscriber line
ALMPs	Active labour market policies
BBVA	Banco Bilbao Vizcaya Argentaria
CES	*Consejo Económico y Social* (Economic and Social Council)
CMT	*Comisión del Mercado de la Telecomunicaciones* (Telecommunication commission)
CNE	*Comisión Nacional de Energía* (National energy commission)
CNMV	*Comisión Nacional del Mercado de Valores* (National stock market commission)
CPFF	Council for Fiscal and Financial Policy
CPI	Consumer price index
ECB	European Central Bank
EPA	*Encuesta de población activa* (Labour force survey)
EPL	Employment protection legislation
EU	European Union
EU15	European Union, first 15 member states
FORCEM	*Fundación para la Formación Continua* (Foundation for professional training)
FSL	Fiscal stability law
GDP	Gross domestic product
GW	Gigawatt
IAE	*Impuesto sobre actividades económicas* (Local business tax)
ICT	Information and communication technology
IMF	International Monetary Fund
INE	*Instituto Nacional de Estadística* (National Institute of Statistics)
INEM	*Instituto Nacional de Empleo* (Public employment service)
LOCE	*Ley de calidad de la educación* (Education quality law)
MWh	Megawatt hour
PES	Public employment services
PISA	Programme for International Student Assessment
PPP	Purchasing power parity
R&D	Research and development
UMTS	Universal mobile telecommunications system
US	United States
VAT	Value added tax

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ANNEX A

Progress on structural reform

This annex provides a compendium of recommendations carried forward from the previous *Economic Survey*, finalized in March 2003, and records what actions have been taken since then together with an updated assessment and current recommendations as appropriate.

Labour market

Previous survey:

Reduce the gap in protection between permanent and temporary workers by lowering further severance payments for permanent contracts and improving controls on the abuse of temporary contracts. Consider taking into account severance payments when compensating the unemployed for the loss of a job.

Restrict eligibility conditions of the subsidy programme for unemployed rural workers to enhance regional labour mobility.

Unemployment benefits should be linked to training and/or workfare. Enhance monitoring of the effectiveness of active labour market programmes (ALMPs). Improve efficiency and resources of the INEM on active labour market policies.

Decentralise the wage bargaining system. Eliminate indexation clauses in wage negotiations.

Policy actions taken and current assessment:

The budget of the INEM has been increased by 13% for 2005.

A "Declaration in favour of Social Dialogue 2004: competitiveness, stable employment and social cohesion", signed in July by the government, employers and unions, defines the general guidelines for development of labour relations. The Declaration envisages a Commission of Experts that will elaborate a comprehensive report to evaluate the employment policies undertaken in the last ten years and will propose labour market reform measures to be taken during 2005.

Recommendations in this survey:

The reform priority should be the reduction of severance payments for permanent workers which, together with a better control of renewals of temporary jobs, should help to reduce labour market duality.

The Commission of Experts envisaged in the Declaration should provide an opportunity to address labour market reforms in a comprehensive way, taking into account synergies between different reforms and political economy aspects. Synergies are clear between active and passive policies for the unemployed, as stricter participation requirements on training programmes or job search should be matched by an improvement of active labour market policies.

Continuous evaluation of ALMPs should be independent and provide feedback for improving measures.

Eliminate *ex post* indexation clauses in the wage bargaining system. If the elimination of indexation clauses is not possible, it should be based on core rather than headline inflation.

Human capital and R&D investment

Previous survey:

Allow more independence for schools, including setting incentives through wage differentiation.

Reform university finances by raising tuition fees while providing more grants or subsidised loans to less well-off students.

Improve incentives for R&D and eliminate obstacles to the diffusion of new technologies.

Policy actions taken and current assessment:

Several aspects of the Education Quality Law have been suspended, until a new law is approved for compulsory schooling.

A national agency for the evaluation of universities (ANECA) has been created. Its goal is to coordinate and promote quality management policies in Spanish Universities.

The budget for R&D has increased by 25% for 2005 and raising R&D spending, especially in the private sector, has become one of the priorities of the government.

The system for determining what expenditures are R&D related and give therefore the right to a tax break has been improved by the introduction of a certificate to be issued by the Ministry of Industry, Tourism and Trade, whose content is binding for the tax administration. This is expected to raise the utilisation of such tax breaks by firms.

Recommendations in this survey:

Child care for children aged 0-3 should be promoted, possibly through tax credits.

In primary and secondary education more autonomy for schools, including incentives for teachers, should remain the priority and should match any spending increases.

The financing of universities should be linked to performance, using evaluations carried out by ANECA as guidance. Raise fees for students while implementing flexible payment mechanisms for low income students.

The increases in public aid to R&D need to be accompanied by improving framework conditions that foster entrepreneurship, including the promotion of venture capital with some limited government equity programmes, promotion of clusters and expansion of programmes for participation of researchers in businesses.

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Housing market

Previous survey:

Simplify the criteria and reduce the waiting period for obtaining building permits.

Implement tax neutrality between home ownership and rental housing by phasing out tax allowances for home ownership.

Policy actions taken and current assessment:

A Ministry of Housing has been created, and an emergency plan has been launched. The plan includes the following measures: an increase of 65% in the construction of social housing in 2004; a rise in the maximum price of social housing to attract private promoters; subsidies for under-35 year old tenants; subsidies for firms that buy property for letting; set-up of a public rental agency to ensure the transparency of the private rental market; abolition of the auctioning of public land and substitution by beauty contests.

Recommendations in this survey:

To implement tax neutrality between home ownership and rental housing, phase out the various forms of assistance to home ownership.

Improve the legal safety of relations between tenants and owners and reduce the minimum 5-year duration of rental contracts in the case the owner wants to sell it to promote supply of rental housing.

Revise the cost-effectiveness of the present system of social housing, relying less on house sales and introducing a system of housing vouchers for disadvantaged groups to facilitate access to the private rental market.

Make local-level planning regulations more flexible and abolish the compulsory transfer of 10% of developable land to the municipalities to raise land supply.

Goods and services markets

Previous survey:

Increase the resources of the competition authorities and consider consolidating decision processes by merging the Competition Tribunal and the Competition Service.

Ensure that regional competition tribunals do not add substantially to costs of competition policy. Ensure that they do not favour local firms.

Envisage splitting production and distribution companies in energy sectors if anti-competitive practices persist.

Withdraw price controls for long-distance national and international calls and ADSL connections from the price cap for Telefónica.

Autonomous communities should not restrain the establishment of new hypermarkets in their territories.

Further liberalise postal services.

Liberalise rail transport. Consider franchising in railways and urban transport.

Policy actions taken and current assessment:

The personnel resources for the Competition Service have been increased and a comprehensive White paper on Competition Policy has been prepared.

In retail distribution, regional governments are now allowed to reduce the maximum opening Sundays per year for large outlets from 12 to 8. This will restrict the number of opening hours, although it has made possible the settlement of an ongoing legal dispute that hindered the former regulation to be applied.

Retail prices for ADSL services were liberalized in November 2003. Price control on long distance and international calls will be revised by the national regulatory authority, following the EU directives.

In rail transport the separation of the company that will manage the railways from RENFE, the main public operator, has been made effective, together with the transfer to the State of a large part of RENFE's debt.

Recommendations in this survey:

The merger of the Competition Tribunal and Competition Service should be accompanied by reinforcing their advocacy role and providing more independence for the new institution by making it accountable to Parliament. Leniency programmes to help discover anti-competitive behaviour should be adopted.

In energy sectors, the market power of the large incumbent operators should be reduced, and separation of production and distribution activities envisaged. Barriers for the establishment of new firms, including foreign companies, should be eliminated.

Retail regulations should be liberalised. Especially, barriers set up by regional governments for the establishment of new hypermarkets and shopping centres should be dismantled.

Pensions

Previous survey:

Reform the pension system to make it actuarially fair.

Policy actions taken and current assessment:

The reserve fund for future pension payments has been increased. It now accounts for 2.9% of GDP.

Recommendations in this survey:

Make the public pension system at least actuarially fair. To go in that direction, pensions could be based on life-time earnings instead of earnings from the last fifteen years, or the rate of accrual of pension rights could be reduced.

The pace of accrual rates should be reconsidered so as to improve incentives for older workers to remain in the labour market.

Prevent collective agreements from imposing a compulsory retirement age on workers.

Reform the sickness and invalidity benefit system. In particular: *i)* consider the extension of the period of sick leave paid by employers; *ii)* ensure that non-contributory invalidity pensions financed by the State but managed by regional governments are not awarded too easily; *iii)* promote the return to work of persons receiving invalidity benefits through in-work benefits.

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To reduce the extent of reforms needed to make the public pension system sustainable, increase day-care facilities for young children and health and home care provisions for dependent elderly to raise female employment further.

Accumulate all social security surpluses to reduce government indebtedness and leave a larger margin of manoeuvre for future spending.

Reconsider the generosity of tax incentives favouring private pensions.

Public sector

Previous survey:

Speed up implementation of hospital management reforms and adopt global budgets instead of line budgeting.

Extend and speed up the authorisation of generics.

Introduce means-tested co-payments on pharmaceuticals for pensioners.

Enhance co-ordination among regions and increase incentives to raise efficiency of public finance management.

Policy actions taken and current assessment:

A special plan has been approved to reduce pharmaceutical spending. It includes, among other measures, a reduction of 6% over two years of prices of non-generics, a reduction in distribution margins from 9.6% to 7.6% over two years, a reduction of margins for pharmacies on the sale of generics and information campaigns for the promotion of generics. The authorisation of generics has also been accelerated, and is now automatic when it implies a price fall of 30% to 50% with respect to the corresponding non-generic product.

Recommendations in this survey:

Improve transparency of sub-national government budgets and audit them by an independent body to avoid the expansion of off-budget operations through public enterprise.

Develop benchmarking for services provided by sub-national governments and make results public to enable citizens to exert pressure on their regional governments.

Promote the sharing of experience across sub-national governments.

Provide sufficient resources and ensure independency of the National Agency for the Evaluation of Public Services Quality and Public Policies to be created.

The new financing model should make fully operational its mechanisms to make it sustainable in the face of demographic developments, especially immigration and the prospects of population ageing. The financial resources of the new financing arrangement should follow more closely the net fiscal effect of these changes.

Avoid using earmarked grants or at a minimum increase transparency on the overall amount and criteria used to allocate them across regions.

Relax the obligation for regional governments to spend a minimum amount on health care. Reduce the bias in favour of less developed regions in allocating central government investment. Consider using more effective instruments in supporting poor regions' growth potential, such as education policies.

Consider carefully the potential risks (high unit costs and adverse spillover effects) which would result from the transfer of more responsibilities to local governments.

Improve the financing of municipalities by reconsidering the local business tax, and increase local governments' reliance on real estate taxes.

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