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The challenge for Spain to use the EU's pandemic recovery fund wisely

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Theme

Spain is one of the main beneficiaries of the EU's pandemic recovery fund, aimed at making the economy more sustainable and innovative, but will it be able to take full advantage?

Summary

Spain's economy, with weak fundamentals before the outbreak of COVID-19, has been hit hard by the pandemic, particularly the tourism industry, the country's lifeblood. The €140 billion it will receive is not a panacea for the deep structural problems. Reforms are urgently needed. Such a large amount of money will sorely test the country's administrative capacity to adequately plan and execute the funds. In the 1990s and early 2000s Spain was very successful in using EU funds for large infrastructure projects, such as the high-speed rail network (AVE), but since then it has slipped. Now is the time to invest in human capital and not physical infrastructure (much of which is already world class) and emerge with an economy that is more knowledge-based, digital, greener and inclusive. The EU has responded to the pandemic with an unprecedented fund. Spain's leaders must rise to the historic occasion.

Analysis

Background

The magnitude of the €140 billion, roughly split between grants and loans, that Spain will receive from the Next Generation EU programme can be seen from the fact that it is more than the total funds of the US$12 billion Marshall Plan (equivalent to €112 billion today), launched in 1948 by the US after World War II to help re-build 16 non-communist countries in Europe, and from which Spain was excluded because of the pariah status of the Franco dictatorship.

Including the €30 billion of structural funds for 2021-27, the €170 billion at Spain's disposal (12% of GDP) is three times more than the €56 billion of cohesion and rural development funds received under the EU's 2014-20 budget.

Spain's economy was the worst hit by COVID-19 among the euro zone countries. GDP was 18.5% lower in the second quarter than in the first, compared with a drop of 10.1% in Germany, 12.4% in Italy and 13.8% in France and 9.8% in the OECD area. This shrinkage in just one quarter, the largest since the country's 1936-39 Civil War and double that during the 2008-14 Great Recession, reflects the very severe lockdown imposed on the country (lifted on 21 June after 98 days at the end of the Great Reclusion)

and the structure of the economic model, disproportionately based on tourism and construction.

Of the four big euro zone economies, Spain's tourism industry is the most important in terms of employment and balance of payments, according to the OECD's latest comparative figures (see Figure 1). In a normal year Spain receives more than 80 million tourists. The number in the first half of 2020 was 27.3 million fewer than in the same period of last year and receipts were down €28.4 billion. The economy of the Balearic Islands, one of the main tourism beneficiaries, slumped 26.4% in the second quarter and that of the region of Valencia fell by 22.1%.

Figure 1. Tourism indicators – the most visited four EU countries (2018)

	France	Spain	Italy	Germany
International arrivals (mn)	89.3	**82.8**	63.2	38.7
Domestic tourism, overnight visitors (mn)	189.7	**139.9**	62.8	159.3
Inbound tourism, total receipts (€ bn)	62.0	**60.0**	43.8	50.6
Outbound tourism receipts (€ bn)	49.1	**22.7**	32.0	88.1
Tourism balance of payments (€ bn)	12.9	**46.3**	11.8	-37.5
Persons employed in tourism (million)	1.4	**2.6**	1.9(1)	2.1(2)
Tourism jobs (direct) as % of total employment	7.5	**12.7**	8.3(1)	4.8(2)

(1) 2015.

(2) 2017.

Source: OECD.

The economy went into the pandemic with a fiscal deficit at 2.8% of GDP (it took an unprecedented decade to get it below 3%, the EU's threshold now suspended), public debt at 95.5% of GDP and unemployment at 14%, a far worse starting position than other EU countries. The sectors most affected by the pandemic account for around 25% of GDP. Furthermore, the corporate structure has a high weight of SMEs (90% of companies have fewer than 10 employees), making them more vulnerable as they have less access to external financing and higher costs relative to revenue. The crisis has also once again sharply highlighted that, as in previous recessions, job destruction is falling disproportionately on temporary employees (more than one-quarter of jobholders).

The economy is forecast to shrink by up to 13% this year, assuming there is not another confinement. The jobless rate would reach 20%, the fiscal deficit 15% of GDP and public debt 120% of GDP. More than one million workers lost their jobs in the second quarter, the worst fall for that period on record. Some 1.2 million workers are still on furlough (ERTE) down from a high of 3.4 million, guaranteeing most of their income, but a significant number of them might not return to work when the scheme is terminated possibly as late as the end of the year and not the end of September as originally planned. The government spent €8.1 billion on ERTEs between April and June, adding to the already high public debt, and last month requested more than €20 billion from the European Commission's SURE funds to help finance the scheme.

The pandemic is having a disproportionate impact on the poorest and most vulnerable. The relative poverty rate (those living with less than 60% of the median disposable income), which finally began to decline in 2017 after rising for a decade because of the

Great Recession, is increasing again and more sharply. The NGO Oxfam Intermón estimates the rate will rise to 23.1% from 21.5% before the pandemic. That might not seem very much, but it would lift the number in poverty by 700,000 to 10.8 million. In 2019 Spain was the EU country with the lowest average of family benefits per child.

The Gini income distribution index for Spain, where 0 represents perfect equality and 100 perfect inequality, is estimated to increase from 32.5 before the pandemic to 34.2. There again, that might seem insignificant but at the height of the recession between 2012 and 2013 the index rose by less than one point.

The weak public finances explain why Spain's immediate fiscal response (extra spending on healthcare, keeping people employed under its ERTE scheme, etc) and foregone revenue (such as the cancellation of social security contributions) to the pandemic was one of the least generous at 3.7% of GDP compared with 13.3% in financially sound Germany (see Figure 2).

Figure 2. Discretionary fiscal measures in response to coronavirus (% of 2019 GDP) (1)

	Immediate fiscal impulse	Deferrals	Other liquidity provisions & guarantees (2)
Belgium	1.4	4.8	21.9
Denmark	5.5	7.2	4.1
France	4.4	8.7	14.2
Germany	13.3	7.3	27.2
Greece	3.1	1.2	2.1
Hungary	0.4	8.3	0.0
Italy	3.4	13.2	32.1
Netherlands	3.7	7.9	3.4
Portugal	2.5	11.1	5.5
Spain	**3.7**	**0.8**	**9.2**
UK	8.0	2.3	15.4
US	9.1	2.6	2.6

(1) Measures adopted by 15 June 2020. The cut-off date was earlier for some countries.

(2) Includes only government-initiated measures (excludes central bank measures) and shows the total volume of private sector loans/activities covered, not the amount the government put aside for the liquidity support or guarantee (the amount of which is multiplied to cover a much larger amount of private sector activity).

Source: Bruegel.

The EU's recovery fund may seem like manna from heaven, but it comes with strings attached and is not a panacea for Spain's deep structural problems. Reforms are urgently needed. How the money is spent will be closely scrutinised. The leftist minority coalition government, led by the Socialists, has to send to Brussels in October its programme of reforms and how it plans to invest the money (70% of it in 2021 and 2022), and next March its definitive programme.

If one EU member state questions another's commitment to reforms, it can delay disbursements for up to three months and take the issue to EU leaders for debate. This was one of the concessions won by the so-called 'frugal five' economies (Austria, Denmark, the Netherlands, Sweden and Finland), who also scaled back the grant

element of the recovery fund. These countries were also promised larger rebates on their budget contributions, a mechanism that dates back to the UK's Prime Minister Margaret Thatcher. Backpedalling on reforms is likely to be an area of political disputes. The EU Commission has the final say. Spain (and Italy) is widely viewed among the northern EU countries as a reformist laggard.

Not only has the pace of reforms slowed down in recent years, but successive Spanish governments have been particularly prone to overturning the reforms of their predecessors, particularly in the areas of labour market, education, pensions, taxes and town planning. For example, governments in the last 40 years have passed more than 50 labour market reforms of one sort or another, apparently a world record, and yet unemployment has never been lower than 7% (considered a disastrous level in the US and UK). The dysfunctional labour market is exhausted with so many reforms. Part of the unemployment problem lies with the nature of Spain's economic model. Tourism is a seasonal industry.

Such a large amount of money will sorely test Spain's administrative capacity to adequately plan and execute the funds. In the 1990s and early 2000s Spain was very successful in using EU funds for large infrastructure projects, such as the 3,086km high-speed rail network (AVE), the world's second largest after China, but since then it has slipped. Spain only executed 30% of the funds from the EU's 2014-20 budget as of the end of 2019, well below the EU average of 40%. In the coming years, Spain has to complete the execution of the 2014-20 budget (under the N+3 rule if funds have been committed the period for executing them can be extended until 2023), plan and execute the investments linked to the Next Generation EU programme and begin to execute the funds from the EU's 2021-27 budget. There is a serious risk of public administrations suffering indigestion from the avalanche of funds and becoming bogged down in bureaucracy. The lack of cooperation between them is a structural problem.

Spain has a poor record of not managing to spend the money that it has budgeted in some cases. For example, in 2018 the public sector failed to execute almost half the funds allocated for R&D&i. At 1.2% of GDP, the country's investment in R&D is well below the EU average of 2% and miles from the top countries such as Sweden (3.3%).

Spain has also been painfully slow to put into force the EU's single market directives, taking almost 50% longer than the bloc's average, and only 12% of the European Commission's country-specific recommendations issued every year under the Semester Framework between 2011 and 2019 were implemented, slightly better than the Netherlands' 11%.

The initiatives that stem from the recovery fund and require the approval of the national parliament (where 16 parties are represented) would stand a much better chance of being effectively implemented if the political class finally learned the art of compromise, which means all sides making concessions. Parliamentary debates are little more than a litany of insults by most of the parties. With a weak minority government and little prospect of one with an absolute majority, the lack of compromise among the main political parties is a major obstacle to lasting reforms.The coordination mechanisms between the central government and the 17 regional administrations are also poor.

The first test will come in the autumn when the government puts its 2021 budget to the vote in parliament. The 2018 budget is still in force, because of the politicians' failure to agree new budgets since then. Another failure would mean yet another general election, the fifth in as many years and the last thing Spain needs or Spaniards want. The far-right VOX is not even waiting until the vote on the budget: it plans to put forward a vote of no confidence in the government during September. Thankfully, it has no chance of succeeding. Its move looks more like an attempt to put the mainstream conservative Popular Party on the spot.

A golden opportunity to make the economy more sustainable

Spain has an historic chance to make its economy more sustainable. Its shaky foundations were dramatically exposed when the massive real-estate bubble burst in 2008 (the number of housing starts in 2006 was higher than in Germany, France and Italy combined), which together with the global financial crisis triggered the Great Recession. Unemployment hit 27%. Just over a decade later, the pandemic has brought the problem home again: witness the devastating impact of the collapse of tourism and the hospitality industry in general, which have borne the brunt of the lockdown and confinement measures.

Now is the time to invest in human capital and not physical infrastructure (much of it is already world class) and emerge from the pandemic with an economy that is more knowledge-based, digital, greener and inclusive. Spain needs to attract back the legions of scientists, engineers, doctors, nurses and other skilled workers who left the country during the 2008-13 slump.

The Independent Authority of Fiscal Responsibility (AIReF) says the government should re-think its plan to invest a further €75 billion in expanding the AVE network, as it is not profitable and other forms of transport, such as commuter train services, need to be improved. Per kilometre of track, there are less than a third as many AVE passengers as in France.

How should Spain use the funds at its disposal? The European Commission's reports on Spain published in February,[1] before the pandemic, and May,[2] when COVID-19 was in full swing, give an idea of the direction in which Spain should move. The reports make clear the limited progress made in the Commission's recommendations (see Figure 3).

Figure 3. Progress with the recommendations for Spain

	Progress
Fiscal governance, little progress.	The new governance structure for public procurement is still not fully functioning, almost two years after the entry into force of the law on public sector contracts. Drawing up the National Public Procurement Strategy scheduled for 2018 is delayed. There have

[1] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52020SC0508&from=EN.

[2] https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52020DC0509&from=EN.

	been no other steps to strengthen the fiscal framework. If the departures from the 2013 pension reform are made permanent without adequate compensatory measures, pension expenditure will increase significantly and worsen inter-generational equity in the medium to long term.
Labour market policies, some improvement but limited effectiveness.	The share of temporary contracts in total employment remains high at above 26% in 3Q19. In the public sector, the use of temporary contracts increased further in 2019, despite the pledge to reduce it. Measures to reduce temporary contracts have focused on fighting abuse. Efforts to strengthen the public employment services continue in some regions. The implementation of the new Action Plan for Youth Unemployment and the Reincorporate Plan for the long-term unemployed is on track, but hiring subsidies still absorb about 40% of the budget for active labour-market policies and do not seem to be very effective.
Skills mismatches and early school-leaving, on-going initiatives.	Medium to high-level technical skills, and especially ICT specialists, are in short supply. The new Strategic Plan for Vocational Education and training (VET) may play a role in reducing skills mismatches and early school-leaving, once fully implemented. The business sector's role in the design of qualifications is being reinforced, and work is underway on a Digital Skills National Strategy.
Support for families and effectiveness of social assistance, limited progress.	The 2019 increase in the amount of the means-tested child allowance can only have a very limited impact on poverty reduction. National unemployment assistance schemes remain fragmented and the coverage of regional income guarantee schemes remains very limited in many regions, with the number of beneficiaries not even reaching 20% of the potential beneficiaries on average in the country.
Investment to foster innovation, resource and energy efficiency and to complete rail freight infrastructure and electricity interconnections. Limited progress.	The draft National Climate and Energy Plan is ambitious in scope, but it relies to a large extent on mobilising private investments, which have not materialised yet. There has been some progress in the ongoing development of electricity interconnections with France and with Portugal. Some steps were taken to support sustainable mobility but, overall, there was limited progress in fostering resource efficiency. Investments in rail infrastructure for freight did not increase in 2019. Spending on R&D remains low. Coordination of research and innovation policies across government levels remains a

challenge and the evaluation of research programmes and policies is not systematic.

Source: European Commission.

Long before the pandemic crisis Spain was far from reaching the Europe 2020 targets, the EU's agenda for growth and jobs, based on five goals for employment, R&D, climate change, education and poverty and social exclusion (see Figure 4).

Figure 4. Europe 2020: national targets and Spain's progress

Europe 2020 targets	**Spain's position**
Employment rate target: 74%	The rate for the 20-64 age group was 68% in September 2019.
R&D target: 2% of GDP	With R&D spending at 1.24%, reaching the 2% target in 2020 remains practically unattainable.
National greenhouse gas emissions target: -10% in 2020 compared with 2005 (in sectors not included in the EU emissions trading scheme)	Emissions from sectors not covered by the EU Emission trading scheme were reduced by 14% between 2005 and 2018, above Spain's 2020 target of -10% compared to 2005. Based on the latest national projections taking into account existing measures, the 2020 target is expected to be exceeded by a margin of 4 pp. However, Spain is expected to miss the 2030 target of -26% by 10 pp.
2020 renewable energy target: 20%	With a renewable energy share of 17.4% (2018), Spain is above its indicative trajectory to reach the 2020 target, despite a slight decrease compared with 2017, which will make the increase to meet its 2020 target, steeper.
Early school/training leaving target: 15%	The rate of early school leaving (18-24 years old) decreased by 0.4 pp in 2018 to 17.9%, but is still the highest in the EU and almost 3 pp above the target. The indicator varies greatly across regions and it is especially high for students with disabilities and non-EU born background.
Target for reducing the number of people at risk of poverty or social exclusion, expressed as an absolute number: -1.4 million compared with 2008	Although the number of people at risk of poverty or social exclusion has been declining since 2014, in 2018 it was still 1,261,000 more than in 2008. The 2020 target is far from reach.

Source: European Commission.

The buzzwords emerging from the Next Generation EU programme are innovation, digitalisation, connectivity, green energy transition, sustainable development, inclusion and resilience. In essence, the recovery fund's purpose is to spur economic transformation and modernisation.[3]

[3] The Elcano Royal Institute's report in Spanish published in July 2020 sets out the case for transformation, http://www.realinstitutoelcano.org/wps/wcm/connect/410d3de1-9de8-44fe-9f5e- (cont.)

But, as Josep Borrell, the EU's foreign policy chief, said: 'Our only message to an unemployed waiter on the Costa del Sol cannot be that their future will be green and digital. He will say "fine, but what about now?". In the short term there will be a problem of maintaining people's income and companies' capitalisation, which is more of a microeconomic problem. This will require considerable administrative efficiency in all countries.'[4]

In the sphere of digitalisation, Spain seemingly starts with an advantage as fibre optic coverage is high and nine out of 10 Spaniards are Internet users. The country has Europe's highest fibre to the home (FTTH) penetration rate (44%). But there is deep digital divide. During the pandemic confinement only half of schools had adequate digital learning platforms in place, and four out of every 10 households with a monthly income of no more than €900 did not have a computer at home. As a result of these deficiencies in material resources, the sudden shift to digital learning, particularly in rural areas, because of the closure of schools left behind students with no access to digital solutions. They will be hard pressed to catch up, raising the prospect of greater inequality and social exclusion. Other challenges are greater digitalisation of industry and businesses, particularly SMEs, as this would enhance the competitiveness of companies in global value chains and increase their capacity to export, and to better equip schools with digital learning platforms.

Building a knowledge economy is also generally held back by the low educational attainment of 25 to 34-year-olds, one-third of whom in 2018 did not have higher education qualifications after completing their compulsory secondary education. Some regions, notably the Basque Country, are in a better position, however. The early school-leaving rate of 17.3% in 2019 (down from 30% in 2006) was still almost double the EU average and the grade repetition rate (of a school year) high at 30.5% of 15-year-olds.

According to the Programme for the International Assessment of Adult Competencies (PIAAC), there is a big gap between Spain and other EU countries in knowledge skills. This is due more to the inefficient use of resources and training than spending as expenditure is roughly the same or more than in countries such as South Korea and Portugal, which have better results. Vocational training is a particularly weak area (see Figure 5). More time needs to be allocated to on-the-job training in companies and less to studying in the classroom, along the lines of the German and Swiss systems.

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[4] See interview with Borrell in *Cinco Días*, 23/VIII/2020, https://cincodias.elpais.com/cincodias/2020/08/23/economia/1598185282_012846.html.

Figure 5. Vocational training by countries (% of matriculated students aged between 15 and 19), 2018

	%
Austria	43
Italy	42
EU average	29
France	23
Portugal	23
UK	22
Spain	**12**

Source: Ministry of Education, Spain.

The transformation to a climate-neutral economy will require considerable investments, as Spain's very ambitious €241 billion 2021-30 National Energy and Climate Plan recognises. Eighty per cent, however, would apparently come from the private sector. Spain is in the forefront of renewable energy –wind turbines, for example, generate 20% of electricity and earn more export revenue than wine-. New investments should be concentrated in those sectors with the greatest job creation potential in the short term and greatest multiplier impact in the long term. If Spain meets its goals, renewables would account for 42% of the country's energy mix and generate 74% of its electricity by the start of the next decade. This would enable Spain to be a significant exporter of energy to the EU, particularly to France, provided the country's interconnection capacity is increased.

The tax system, state pensions and labour market regulations need overhauling. These areas do not strictly lie within the scope of benefiting directly from the EU's recovery fund, although reforms would make the country more resilient.

Spain's tax burden at 35.4% of GDP is much lower than the EU average, although marginal personal tax rates are similar to the bloc's average (see Figure 6). The problem lies with the effective rates for individuals and companies because of tax benefits, exemptions, deductions, rebates and loopholes, as well as fraud and evasion. The Popular Party's tax reductions approved in 2015, at a time when the structural fiscal deficit had not (and still has not) been corrected and the country was coming out of the Great Recession, were demagogic.

Figure 6. Tax-to-GDP ratio, 2002, 2007 and 2018 (1)

	2002	2007	2018
France	44.1	44.5	48.4
Italy	39.7	41.5	42.0
Germany	39.6	39.3	41.5
EU	38.6	39.2	40.3
Portugal	33.9	35.0	37.2
Spain	**34.1**	**37.3**	**35.4**
UK	33.2	35.0	35.1
Ireland	29.1	32.1	23.0

(1) The sum of taxes and net social security contributions as a percentage of GDP.

Source: Eurostat.

In a recent report, the AIReF put the cost of tax benefits in housing, pensions, employment, health and education at €60 billion (5% of GDP), two-thirds of which correspond to VAT and which mostly benefit high- and not low-income households, as they consume more. One of the anomalies is the 10% VAT on alcoholic and non-alcoholic drinks in bars and restaurants and 21% in supermarkets.

The tax benefit from annual contributions to private pension funds (up to a maximum of €8,000) has also not been effective. The incentive is attractive for low incomes, but these have little capacity to save, and not attractive for high incomes. The amount accumulated in these funds is small: close to one-third of total contributions are below €500 and less than 1% between €7,500 and €8,000. Furthermore, these funds when drawn have a maximum tax rate of 45% compared with 23% for mutual funds.

Spain's population is ageing fast and will have one of the highest old-age to working-age ratios among OECD countries, exerting strong pressure on financial sustainability (see Figure 7). The United Nations forecasts there will be 78 people over the age of 65 per 100 people in 2050 against 33 currently, and 53 and 31, respectively, in OECD nations on average.

Figure 7. Demographic indicators

	2008	2012	2014	2015	2016	2017	2018	2019	2020
Average age	40.8	41.6	42.1	42.4	42.7	42.9	43.1	43.3	44.5
65 and older (%)	16.5	17.4	18.1	18.4	18.6	18.8	19.1	19.3	19.4
Dependency rate (1)	24.5	26.1	27.4	28.0	28.4	28.8	29.3	29.6	29.8

(1) Population of 15 years or less+65 or more years/ working population of 16-64 years.

Source: FUNCAS.

Some of the measures implemented as of 2014 to make the ailing system more sustainable have been suspended. According to BBVA, the accumulated pensions deficit (the difference between payments and revenue) was €101 billion between 2011 and 2018. Pensions were increased in line with inflation at 1.6% in 2018 and 2019 instead of by 0.25% had the Revalorisation Pensions Index been still applied. The sustainability factor, which was supposed to start being applied in January 2019 to adjust initial pensions –when retiring– based on life expectancy changes has been suspended until 2023.

Now might not be the right time to lower public pensions, even though the situation is more critical because of rising unemployment and with it reduced funding via social security contributions for the pay-as-you-go system. The same can be said for increasing tax rates or making the system more efficient, but at some point, once GDP recovers its pre-COVID 19 level, the government is going to have to bite the bullet and find ways to raise more revenue and reduce spending.

The government is, however, expected to fulfil its commitment to change the labour market laws. Elements of the last (2012) reform by the Popular Party administration, such as allowing companies to opt out of collective pay-setting agreements within industries and to make their own deals with workers and giving firms greater

discretionary powers to adopt internal measures to limit job destruction, have proved to have saved if not created jobs. A wholesale scrapping of the 2012 reforms makes no sense.

The labour market duality between insiders (those on permanent contracts) and outsiders (those temporarily employed) could finally be addressed through the introduction of a single open-ended contract (the so-called equal opportunities contract, or EOC) at the same time that temporary contracts were abolished –with the exception of replacement contracts for maternity or sickness/disability leave-. Another problem is long-term unemployment: more than 700,000 generally poorly qualified people over the age of 45 have been jobless for more than a year.

Conclusion

The EU's recovery fund gives Spain a chance to make its economy more sustainable, innovative, productive and resilient. Whether it does so remains to be seen.