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The main economic challenges confronting Spain's next government

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Theme

Spain's next government faces major economic challenges and to overcome them it needs to regain the reformist momentum that used to characterise the country before political uncertainty set in.

Summary

The economy has rebounded from a long recession, and the focus now needs to be on a series of challenges on the fiscal front, a pensions system that is unsustainable, unemployment that is still very high, productivity that is low and an education system not providing what Spain needs. Resolving these issues will determine the shape of the economy in the future.

Analysis

Background

The fragmentation of the political system, with three general elections in the last three and a half years (the same number as between 2004 and 2015), has weakened Spain's capacity to carry out economic reforms. The country is still living with the 2018 budget as the previous minority Socialist government of Pedro Sánchez was unable in February to garner enough support in parliament for its 2019 budget, as a result of which a snap election was held in April.

The Socialists were the most voted party in that election, but without an absolute majority. Two months on Spain does not have a new government, although Sánchez is expected to be able to form one in July by the skin of his teeth. Whether that government will last the full term of four years is an open question. What is not in doubt is that Spain needs a stable and lasting government, able to implement structural reforms.

The continued political uncertainty comes at a time the economy is slowing down, as it is past the peak in the cycle of growth that began in 2014, following the extended double-dip recession in 2008-13 (see Figure 1). The pre-crisis GDP level was not restored until 2017.

Figure 1. Main indicators of the Spanish economy, 2014-18

	2014	2015	2016	2017	2018
Gross domestic product (a)	1.4	3.6	3.2	3.0	2.6
Private consumption (a)	1.5	3.0	2.9	2.5	2.3
Government consumption (a)	-0.3	2.0	1.0	1.9	2.1
Exports of goods and services (a)	4.3	4.2	5.2	5.2	2.3
Imports of goods and services (a)	6.6	5.4	2.9	5.6	3.5
Contribution of domestic demand to GDP growth (pp) (a)	1.9	3.9	2.4	2.9	2.9
Contribution of net external demand to GDP growth (pp) (a)	-0.5	-0.3	0.8	0.1	-0.3
Unemployment rate (b)	24.4	22.1	19.6	17.2	15.3
Unit labour costs (c)	-0.2	0.5	-0.6	0.2	0.8
Consumer price index (end of period) (c)	-1.0	0.0	1.6	1.1	1.2
General government fiscal balance (d)	-6.0	-5.3	-4.5	-3.1	-2.5
Net international investment position (d)	-98.0	-89.5	-85.3	-83.5	-77.1
General government gross debt (d)	100.4	99.3	99.0	98.1	97.1

(a) Annual rate of change.

(b) % of labour force.

(c) Rate of change.

(d) % of GDP.

Source: Bank of Spain.

On the surface, Spain looks to be doing quite well. GDP growth will still be more than 2% this year, higher than the Eurozone average (1.2%) for the fifth year in a row, the unemployment rate is down to below 15% from 26.9% in the first quarter of 2013, the current account has been in surplus since that year, partly due to record exports, inflation has remained at below 2% and the country received US$44 billion of direct foreign investment last year, double that in 2017 and the third-highest amount in the EU. Last year Spain, to the surprise of many, was the largest single contributor to Eurozone growth, ahead of Germany, the bloc’s traditional locomotive.

But there are imbalances that threaten the sustainability of growth, and ones that make Spain vulnerable in the event of another global economic crisis. The next government faces challenges on the fiscal front, in the ailing pensions system, an unemployment rate that is still very high, particularly for young adults, productivity that is low and an economic model that is still disproportionately based on tourism and construction, a sector that is regaining dynamism, a decade after the bursting of a spectacular property bubble, but far from the previous boom due to much reduced public works.

The fiscal challenge

The most immediate issue for the next government is to approve a budget for 2019. Spain was finally released in June from the European Commission's tutelage (the excessive deficit procedure), as last year's fiscal deficit came in, for the first time in a decade, at below the EU threshold of 3% of GDP (see Figure 2). The deficit peaked at a whopping 11% in 2009 (surplus of 1.9% in 2007, at the height of the boom). Brussels is keeping a watchful eye on the situation.

Figure 2. Spain's budget balance, 2013-18 (% of GDP)

2013	2014	2015	2016	2017	2018
-7.0	-6.0	-5.3	-4.5	-3.1	-2.5

Source: Bank of Spain.

Initially, Spain was going to cut the deficit to 1.3% of GDP this year and 0.5% in 2020. The Commission forecasts deficits of 2.3% and 2%, respectively. After years of austerity, the pressure to spend more is growing. The previous Socialist government extended the 2018 budget and adopted new spending and revenue measures by royal decree. On the expenditure side, the measures include some additional pension increases and a number of social policy measures. Some measures adopted in the 2018 budget law approved by the previous Popular Party government, such as a pay hike for public sector workers, restoring annual inflation-linked rises in pensions and the tax cut for low-income earners, will have a budgetary impact this year. The capacity for spending more is very limited unless there is a substantial rise in government revenue, due to growth effects and tax increases. Tax cuts are out of the question.

Spain's government revenue last year accounted for 38.9% of GDP, according to Eurostat, compared with a Eurozone average of 45%, while government spending was 41.3% (45.6% average). Effective tax rates are much lower than nominal ones due to a number of loopholes, but judging by the amounts of unpaid taxes recovered every year, Spain also has a substantial tax fraud and evasion problem. The Tax Agency netted €15 billion last year (see Figure 3). Spain's tax revenue as a percentage of GDP (33.7%) is well below the EU average of close to 40%, but among the 36 OECD countries it is almost in line with the average (see Figure 4).

Figure 3. Revenue recovered from tax fraud and evasion, 2009-18 (€ billion)

2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
8.1	10.0	10.5	11.5	10.9	12.3	15.7	14.9	14.8	15.0

Source: Tax Agency.

Figure 4. Tax revenues as % of GDP, 2017 and 2000

	2017	2000
France	46.2	43.4
Germany	37.5	36.2
Italy	42.4	40.6
Spain	**33.7**	**33.2**
UK	33.3	32.9
US	27.1	28.2
OECD average	34.2	33.8

Source: OECD Revenue Statistics.

As well as grappling with a fiscal deficit over the past decade, public debt has also soared –from 36.3% of GDP in 2007 to 97% in 2018–. The debt has hardly declined since 2014 when it stood at 100%. Servicing the debt accounts for a significant chunk of spending and its size makes Spain vulnerable to international interest-rate hikes. Excluding the interest paid on the debt, the State ran a small primary surplus last year equivalent to 0.72% of GDP.

An unsustainable pensions system

There is no shortage of warnings from within Spain (Bank of Spain) and outside (IMF and OECD) that the country's pensions system is headed toward a crisis unless measures are taken in time to restore its sustainability. In essence, a toxic mix of the retirement of the 1960s baby boomers, high and rising life expectancy (one of the highest in the world at 83 years) and one of the world's lowest fertility rates (1.25) is making pension reform a pressing issue. The number of deaths has outstripped births since 2015, a major demographic change. Last year there were 56,262 more deaths than births, the highest figure on record. Political parties under the so-called Toledo Pact failed earlier this year to agree any measures on pensions after three years of negotiations.

The reforms approved in 2011 and 2013 made some adjustments that countered the impact of ageing on public spending on pensions, but measures included in last year's budget delayed the application of a sustainability factor and reintroduced the annual inflation-based revaluation of pensions (eliminated as of 2014 when the annual rise was set at 0.25%, well below inflation, unless the system could afford more). The reform to allow for rising life expectancy in calculating pensions was put back from 2019 to 2023.

In the current context of an ailing social security system, restoring the inflation indexation is largely viewed as an irresponsible and populist measure. The decision was taken by the minority Popular Party government in order to secure support from the Basque Nationalist Party (EAJ/PNV) for its 2018 budget. Increasing pensions every year in line with inflation might seem just, but in the context of Spain's ailing system it adds a significant amount to the pensions bill.

The proportion of the over-66s compared with those aged 16-66 is forecast to double between 2018 and 2050 (see Figure 5). In other words, there will be fewer people of working age to support those who have retired in the pay-as-you-go system. For each person over 66, there will only be two persons aged 16-66. By 2050, Spain will have 15 million pensioners, up from 8.7 million today.

Figure 5. Historical and projected old-age dependency ratios, 1950-2050 (1)

	1950	1975	2000	2015	2025	2050
France	19.5	24.5	27.3	33.3	40.9	52.3
Germany	16.2	26.5	26.5	34.8	41.4	59.2
Italy	14.3	21.6	29.2	37.8	45.6	72.4
Japan	9.9	12.7	27.3	46.2	54.4	77.8
Poland	9.4	17.1	20.1	24.3	36.4	60.8
Spain	**12.8**	**19.0**	**26.9**	**30.6**	**38.6**	**77.5**
UK	17.9	25.5	27.0	31.0	35.9	48.0
OECD	13.9	19.5	22.5	27.9	35.2	53.2

(1) The old-age dependency ratio is defined as the number of individuals aged 65 and over per 100 people of working age defined as those aged between 20 and 64.

Source: United Nations Population Division.

The social security system has been in deficit for a decade and is the main reason for the general government deficit (in 2018 it was 1.41% of GDP, more than half the total deficit). Social security contributions collapsed as a result of the crisis after 2008, when unemployment soared and wages declined in real terms, while pension expenditure, which is much less linked to economic fluctuations, maintained its growth in real terms.

The gap between revenue from contributions and spending on pensions was largely covered until 2016 by running down a special reserve set up in 2000 during Spain's economic boom. That fund peaked at €66.8 billion in 2011. In 2017 and 2018 the gap was covered by recourse to state loans (€10.2 billion and €13.8 billion, respectively).

The Court of Accounts criticised this method in May 2019 for 'negatively affecting' the solvency of the social security system and called for the pensions deficit to be covered by taxes.

Action needs to be taken on the revenue and spending side. The Bank of Spain points out that even if the employment rate grows significantly, in order to maintain the present benefit ratio there would have to be a huge increase in revenue from social security contributions. The number of contributors has been growing but is still around one million below the peak of 20.7 million in 2007.

The first steps to increase the retirement age, a significant aspect of the sustainability of the pension system, were taken in 2011, and will be completed in 2027 when it will be 67 (for workers with less than 38.5 years' contributions). The age at which people are currently retiring is 63, below the statutory retirement age of 65.5, and there is no clearly upward pattern.

The government needs to implement other measures to reinforce the pensions system, such as making plans taken out by individuals more attractive (the amount that is tax deductible was reduced from €12,000 to €8,000 in 2015). Saving for a rainy day, however, is beyond the means of a large swathe of the working population who barely get by as it is. The household saving rate was at a historically low rate of 4.9% of gross disposable income in 2018, well below the peak of 13.4% in 2009.

There are also severe disincentives to combine work and a full pension. Spain is one of only seven OECD countries that applies limits to the earnings above which combined pension benefits are reduced. The pensions of those who continue working are reduced by 50%, apart from self-employed workers earning less than the minimum wage or hiring at least one worker. Furthermore, workers still in employment and receiving a pension do not earn additional pension entitlements although they pay a special 'solidarity' contribution of 8%, which does not apply to those continuing to work and deferring the pension.

Making the pensions system sustainable is a complex and highly important challenge that requires all levels of society to be made fully aware of the problem (not the yet the case) and for sacrifices to be made so that the system does not crack.

The persistently high unemployment rate

Spain's job creation in the last five years has been one of the most robust in the EU. Close to 3 million jobs were created, but that still left 3.3 million without work in the first quarter of this year. The unemployment rate dropped from a staggering 26.1% in 2013 to 14.7% in the first quarter of this year, double the EU average and the second highest after Greece (see Figure 6).

Figure 6. Seasonally adjusted unemployment rates, April 2019 (%)

	%
Greece	18.5
Spain	**13.8**
Italy	10.2
EU average	6.4
France	8.7
UK	3.7
Germany	3.2

Source: Eurostat.

Unemployment for those aged between 15 and 24 is particularly acute at more than 30%, and most of these people who do have jobs are on temporary contracts. Overall, around 25% of jobholders are on temporary and thus precarious contracts. The dual system of 'outsiders' (those on temporary contracts) and 'insiders' (those on permanent contracts) is one of the hallmarks of Spain's dysfunctional labour market.

Temporary workers were the first to lose their jobs when the financial crisis hit as of 2008, particularly in the construction sector, which shed 1.3 million jobs between 2008 and 2018. The number of housing starts plummeted from a peak of 865,561 in 2006 to around 100,000 last year, underscoring the depth of the shaky foundations upon which the economy was roaring along.

High levels of unemployment by the standards of other developed countries, even when the economy is growing at a brisk pace over a sustained period, have characterised Spain in the last 40 years. Comparisons with the last decade of the Franco regime (1939-75) are not fair because the virtually full employment during the last decade of the dictatorship was made possible by considerable *pluriempleo* (holding two or more jobs) in order to make ends meet, very low female participation in the labour market and massive emigration for economic reasons (2.75 million between the 1950s and 1973). Apart from the real-estate bubble period (2002-08), Spain's jobless rate has been at least five percentage points above that in Germany, France, Italy, the UK and the US, 10 points higher in the early 1990s and 15 points in 2013 and 2014. Even in 2007, at the height of the economic boom, Spain's unemployment rate was a 'historically low' 8% (the average rate in the Eurozone), a high level for countries such as Germany and the UK.

Companies complained they could not find qualified workers to fill posts, which led some economists to put Spain's structural unemployment rate at 8%, regardless of the economic cycle and particularly among women and young people.

Workers emerged from the Franco regime with ironclad job security, and those protections remained. Democracy brought class-based political trade unions but the paternalistic labour legislation was seen as a 'worker conquest' and political freedom gave the unions the muscle to exploit Franco's labour regulations (*ordenanzas*).

All governments in the past 40 years have adopted labour-market reforms of one sort or another (52 between 1980 and 2015), but the problem of high unemployment has not gone away. The first Socialist government introduced temporary contracts in 1984 as an exceptional measure in order to make the labour market less rigid and more flexible and bring the market's functioning more into line with the European norm (Spain joined the then EEC in 1986). As this system was maintained, employers were quick to use and abuse these contracts, creating the two-tier system that persists today. In 2012, the Popular Party's reforms, the deepest so far, allowed companies to opt out of collective pay-setting agreements within industries and to make their own deals with workers. They also gave companies greater discretionary powers to adopt internal measures to limit job losses. Dismissal regulations were also modified, redefining the conditions for fair dismissal. Severance payments in the case of unfair dismissal for those on permanent contracts were reduced from 45 days per year-worked with a maximum of 42 months to 33 days per year with a maximum of 24 months and the requirement of administrative authorisation in the case of collective redundancies eliminated. Compensation for permanent contract termination in the case of redundancies for objective reasons was set at 20 days per year-worked with a maximum of 12 months.

These reforms softened employment protection legislation, though severance pay for permanent workers in relative terms remains among the highest in OECD countries. The reforms, however, have lowered the GDP growth rate needed to create employment, spurring the job creation over the last five years.

Spain's economic model, heavily based on labour-intensive construction and tourism and not very productive, is also part of the unemployment problem as it does not provide jobs on a sustained basis. Spain has a very high number of small companies: fewer than 1% have more than 50 workers (compared with 3% in Germany). Firms need to be bigger so they have economies of scale, which would enable them to export more successfully, among other things. Tourism, which generates 12% of GDP, is a particularly seasonal industry. The Canary Islands, for example, received 15.6 million tourists in 2018 (seven times the islands' population) and its unemployment rate was 21% in the first quarter of this year.

The country is also at a greater risk from automation, which would compound the unemployment problem. One quarter of middle-income jobs are at risk compared with an OECD average of one sixth (see Figure 7).

Figure 7. Percentage of workers in occupations at high risk of automation, by income class

	Lower income	Middle income	Upper income
Spain	**29**	**24**	**15**
OECD average	22	18	11

Source: OECD (2019), 'Under pressure, the squeezed middle class'.

More focus on human capital and less on infrastructure

Spain's motorways, train services (the high-speed train network is the longest in Europe and the second in the world) and other infrastructure such as the fibre-optic network for high-speed data transmission (it covers three-quarters of the population) are world class. But the same cannot be said for its education system. Too much emphasis has been placed on physical infrastructure and not enough on human capital.

It is an axiom that educational attainment tends to increase employment prospects, and yet almost one in every five people in Spain last year had completed at most a lower secondary education and were not in further education and training, the largest rate in the EU, but down from close to one in three in 2006 when students dropped out of school in droves for a job that was easy to find, particularly in construction. When the massive property bubble burst and unemployment soared many more students had no option but to stay on at school. But Spain's progress has been nowhere near as stunning as Portugal's –from 44% in 2000 to 11.8% (see Figure 8)–.

Figure 8. Early leavers from education and training, 2018 and 2006 (% of population aged 18-24)

	2018	2006
Spain	**17.9**	**30.3**
Portugal	11.8	38.5
Italy	14.5	20.4
UK	10.7	11.3
EU-28	10.6	15.3
Germany	10.3	13.7
France	8.9	12.4

Source: Eurostat.

Spain has made considerable progress in attainment in the last 40 years and has done better than many other European countries as regards educational mobility: around 40% of adults have a higher level of education than their parents. It also leads in the area of early childhood enrolment rates: 96% of three-year-olds are in education compared with the OECD average of 76%. But, generally speaking, the country is not producing the skills it needs or will need.

Skill demands are more polarised in Spain than in many other OECD countries, with a big share of jobs requiring either very low levels of education or very high levels. The share of all jobs requiring only a primary education is higher in Spain (25%) than in any other OECD country; however, the supply of low-educated workers exceeds demand. At the other end of the labour force, Spain faces high over-qualification and field-of-study mismatch. 'Rising educational attainment has created a large supply of highly-qualified adults, but many of them are working in jobs for which they are over-qualified', the OECD noted in a recent report on Spain.

Among the problems of Spain's education system are endless reforms, which in practice have changed little, learning based excessively on memorisation as opposed to critical thinking, students having to repeat a year if they fail a certain number of subjects (which then demotivates them and leads them to drop out of school at 16), the university entrance requirement to take the teaching course is too low, which means that not always the best quality people become teachers, and a shortage of support personnel and a lack of autonomy for teachers, including the capacity to involve and interact with parents, compared with that, for example, in countries such as Finland and Singapore, among the top countries in the OECD's PISA tests, which evaluate education systems worldwide by testing the skills and knowledge of 15-year-old students who are nearing the end of their compulsory education.

Teachers in Spain are paid relatively well (above the OECD average) and the average number of students per class is among the lowest (13 compared with 21 in the UK and 22 in France), but the number of support staff per teacher is one of the lowest (one per 11 teachers compared with one for every two teachers in the UK).

Conclusion

The next government has a lot on its plate. Many of the reforms require cross-party support, which in the current climate of minority governments and a parliament fragmented among five main parties (two until 2015) is no easy task. Parties need to put aside their differences for the good of the country.

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