

Executive summary

The economy is slowly emerging from a deep recession, which will have a lasting effect.

While the depth of the recession in terms of real GDP has been similar to other advanced OECD economies, it has led to a much larger increase in unemployment and a sharper deterioration in government finances, both to a large extent structural. In Spain, the global crisis has been compounded by an unsustainable domestic demand boom driven by residential and business investment, resulting in rising private sector debt. While fiscal and financial policies had been relatively prudent before the crisis, investor confidence declined during the crisis and this may weigh on the recovery as sovereign spreads remain high. Nonetheless, following the publication of bank stress tests and bold policy initiatives, funding conditions have improved.

Rebalancing the Spanish economy will require broadening and deepening the current policy efforts.

The government response includes substantial front-loading of fiscal consolidation, significant steps to address some of the long-standing shortcomings of labour market institutions, decisive measures to strengthen the savings banks and reforms to remove barriers to competition in product markets. These efforts need to be broadened and deepened. Labour market reform is the cornerstone to rebalance the economy. Combined with product market reforms, labour market reform will help to improve competitiveness. The public finances need to be put on a sustainable basis and the government is committed to doing so. Finally, sustainable growth will also require addressing environmental issues, notably the scarcity of water.

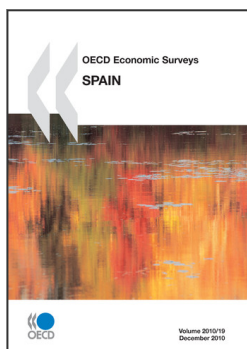
A large structural fiscal shortfall needs to be closed. More than half of the deterioration of the government balance is likely to be structural. The government's consolidation package makes substantial progress towards sustainability, although specific measures need to be spelled out. Once sufficient fiscal consolidation has been achieved, the tax system could be reformed to be more growth friendly by switching the tax burden from labour to consumption and property taxes. To contain significant ageing costs, a reform of old-age pensions, including an increase in the legal retirement age and restrictions to subsidised early withdrawal from the labour market, is urgent so as to allow for gradual implementation.

Bringing the unemployed back to work requires deep reform of a broad range of institutions.

The approved labour market reform legislation is a positive step to reduce excessive protection of workers in permanent contracts, although some uncertainty remains on how the courts will interpret part of the new legislation. It should be ensured that severance pay entitlements are reduced substantially at least for all new contracts as intended. Firms and workers can now more easily agree to opt out from sectoral collective agreements. Nonetheless, abolishing the legal extension of collective bargaining outcomes to all businesses may be desirable. To improve human capital, entry conditions for youth to upper secondary vocational education and training should be eased. The performance of the regional public employment services should be benchmarked. Job search incentives for unemployment benefit recipients need to improve.

The use of economic instruments in water management needs to be extended. Water prices should better reflect total costs, including the opportunity cost resulting from its scarcity and

environmental costs. The transparency and scope of cost recovery should be raised. Volumetric pricing should be further extended in irrigation. Further steps in this direction could include the easing of some limitations on concessions trade. Abstraction charges for overused aquifers would help stem overexploitation, which also requires ensuring adequate resources for control and enforcement. Governance of water policy should be strengthened by widening stakeholder representation in water management to more representatives outside the irrigation community, such as the scientific community.



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