ISSN 1725-3209 (online)
ISSN 1725-3195 (print)

EUROPEAN ECONOMY

Occasional Papers 216 | June 2015

Macroeconomic imbalances Country Report – Spain 2015

Economic and Financial Affairs

Occasional Papers are written by the staff of the Directorate-General for Economic and Financial Affairs, or by experts working in association with them. The Papers are intended to increase awareness of the technical work being done by staff and cover a wide spectrum of subjects. Views expressed in unofficial documents do not necessarily reflect the official views of the European Commission.

Comments and enquiries should be addressed to:

European Commission
Directorate-General for Economic and Financial Affairs
Unit Communication
B-1049 Brussels
Belgium
E-mail: ecfin-info@ec.europa.eu

LEGAL NOTICE

This paper exists in English only and can be downloaded from http://ec.europa.eu/economy_finance/publications/.

Luxembourg: Publications Office of the European Union, 2015

KC-AH-15-216-EN-N (online)
ISBN 978-92-79-44888-1 (online)
doi:10.2765/07579 (online)

KC-AH-15-216-EN-C (print)
ISBN 978-92-79-44887-4 (print)
doi:10.2765/208999 (print)

European Commission
Directorate-General for Economic and Financial Affairs

Macroeconomic imbalances

Country Report – Spain 2015

EUROPEAN ECONOMY Occasional Papers 216

Results of in-depth reviews under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances

Spain is experiencing *macroeconomic imbalances, which require decisive policy action and specific monitoring*. Spain exited the financial assistance programme for the recapitalisation of financial institutions in 2014 and is currently subject to post-programme surveillance and European Semester surveillance. Despite some improvement in the current account rebalancing, risks related to the high levels of private and public sector indebtedness and the highly negative net international investment position continue to deserve close attention in a context of very high unemployment. The need for action so as to reduce the risk of adverse effects on the Spanish economy and, given its size, of negative spillovers to the economic and monetary union, is particularly important.

Excerpt of country-specific findings on Spain, COM(2015)85 final_SWD(2015)28 final, 26.02.2015

CONTENTS

LIST OF TABLES

LIST OF GRAPHS

LIST OF BOXES

EXECUTIVE SUMMARY

The recent overall economic and financial developments confirm the stabilisation that has been unfolding over the last two years in Spain. In 2014 and early 2015, economic growth in Spain was supported by rapid employment creation, easier financing conditions, improved confidence, and lower energy and oil prices. These factors are expected to continue to support growth in the short to medium term, despite high private and public debt levels continuing to exert a drag on growth. Financial markets have stabilised, but the country remains vulnerable to sudden changes in global investor sentiment. Labour market conditions are improving, but unemployment remains very high. Social indicators are continuing to deteriorate, although the positive evolution of labour markets may bring some improvement over the next years. Moreover, negative inflation in 2014 provided some relief in real gross disposable income for households in a context of continued wage moderation. Housing prices seem to be close to bottoming out.

In March 2014, the Commission concluded that Spain was experiencing macroeconomic imbalances that require specific monitoring and decisive policy action. In several dimensions, adjustment of the identified imbalances has advanced, and the return to growth has reduced risks. Nevertheless, the nature, magnitude and interrelations between the imbalances, in particular private and public sector indebtedness, the negative net international investment position and the various policy challenges in the labour market still expose Spain to risks. This Country Report assesses Spain's economy against the background of the Commission's Annual Growth Survey which recommends three main pillars for the EU's economic and social policy in 2015: investment, structural reforms, and fiscal responsibility. In line with the Investment Plan for Europe, it also explores ways to maximise the impact of public resources and unlock private investment. Finally, it assesses Spain in the light of the findings of the 2015 Alert Mechanism Report, in which the Commission found it useful to further examine the persistence of imbalances or their unwinding. The main findings related to macroeconomic imbalances contained in this country report are:

- Despite a positive development in recent years, the current account surplus narrowed significantly in 2014. This is caused by the slowdown in the main Spanish export markets and the rebound of imports linked to robust domestic demand. Spain's external sector performance is also affected by the high import content of exports, Spain's energy dependence, the relatively smaller size of Spanish firms, and the high sensitivity of exports to changes in relative prices and costs.

- The large stock of external liabilities has kept increasing, making Spain vulnerable to adverse shocks or shifts in market's confidence. The overall high stock of private and public debt, both domestic and external, poses risks for growth and financial stability. The recovery of private sector balance sheets is advancing, backed by credit contraction.

- Job creation has gathered pace, but unemployment remains very high. Youth joblessness is very high, and long-term unemployment risks becoming structural, and leading to labour and social exclusion. Labour market segmentation remains a challenge.

- Negative macroeconomic developments in Spain would have a significant impact on other euro area countries. Structural reforms in Spain can contribute to supporting activity in the euro area.

- Boosting private and public investment would help Spain further increase productivity growth and improve competitiveness. Further investment to increase security of supply and stimulate competition in energy markets remains a priority. Spain's research and innovation performance still suffers from i.a., inadequate funding and governance.

- While the 2014 reform of the personal and corporate income tax simplifies the tax system, its impact on the achievement of budgetary targets is still unclear.

- Despite progress made, starting-up and operating a business in Spain remains relatively cumbersome, a fact that could slow the number of new firms. A competition-enhancing reform in professional services has been on the agenda for long to intensify business dynamics and contribute to lower consumer prices. A fragmented corporate structure of the Spanish economy exacerbates cyclical problems with bank financing.

- Early school leaving is decreasing, but remains very high. Combined with relatively low basic skills', this can limit Spain's growth potential.

- The ongoing reform of public administration can contribute to efficiency gains and fiscal savings. Enhancing the efficiency of the judicial system is also an important lever to improve Spain's business environment.

- The recent reforms of the electricity and gas sectors will possibly reduce the tariff deficits from 2014 onwards. But the effectiveness of measures to limit potential liabilities for public finances stemming from transport infrastructure is still uncertain.

This Country Report also assesses progress towards implementing the 2014 Country Specific Recommendations. It concludes that on average, Spain has made some progress in implementing them. Most significant progress has been recorded on the operationalization of the new independent fiscal authority on easing the establishment of large-scale retail premises and on the reform of the public administration. Spain made some progress in the implementation of the recommendation on tax reform, improving the cost-effectiveness of the healthcare sector, conducting a spending review, completing the reform of the savings banks, widening SMEs' access to finance, removing the remaining bottlenecks in the corporate insolvency framework, enhancing the effectiveness of active labour market policies and promoting labour mobility, applying the education reform, putting in place the national Youth Guarantee system, increase transparency of administrative decisions, implementing the law on market unity, facilitating business licensing and eliminating the deficit in the electricity system. Only limited progress is recorded on the recommendations on social issues, combatting labour market segmentation, strengthening public employment services, implementing the new national strategy for science, technology and innovation, enhancing cooperation between higher education and employers and adopting pending judicial reforms. Lastly, there has been no progress on the implementation of the recommendation on professional services, on creating a state research agency and on increasing control mechanisms at sub-central government level.

The Country Report discusses the policy challenges stemming from the analysis of macro-economic imbalances:

- Re-orientation of the economy towards exporting sectors and competitiveness' recovery is a necessary condition for reducing the large stock of external liabilities. Removing obstacles to firm growth, supporting SMEs to expand their markets and enhancing innovation appear key to boosting export capacity, job creation, compete more efficiently also in internal markets and enhancing overall productivity.

- Ongoing deleveraging pressures continue to impact economic growth. The adjustment of private sector balance-sheets is advancing, but the deleveraging of households is taking place at a slower pace.

- While the public deficit remains on a declining path, without further consolidation efforts in the medium term Spain would not bring down the general government debt.

- High long-term unemployment and high segmentation continue to hamper productivity growth and working conditions. Without adequate targeting and implementation of active labour market and activation policies, including re-skilling towards sectors with job-creation perspectives, addressing the unemployment problem remains a challenge.

- Other policy challenges that Spain faces include consistent implementation of reforms at regional level, creation of conditions for an innovation-friendly business environment, improvements in business licensing, reform of professional services, completion of measures on insolvency; reinforcement of links between education and the labour market and strengthening of public employment services, and improvements in water and waste management.

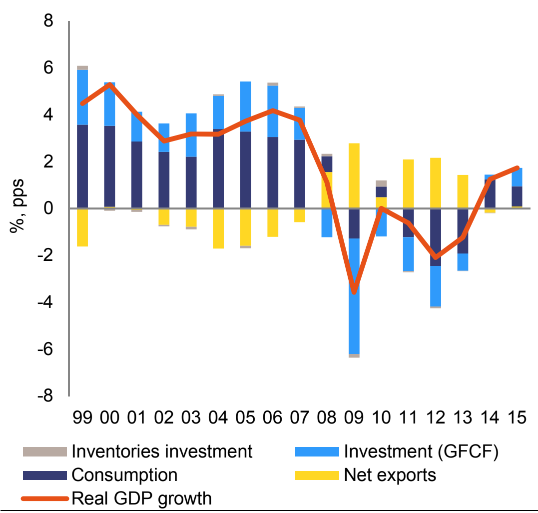
After three years of recession, growth resumed again in 2014 and prospects for 2015 and 2016 are on the rise. After having expanded by 0.5 % quarter-on-quarter in both the second and the third quarters of 2014, economic activity has gained further momentum in the last quarter and is expected to accelerate further in 2015 and 2016. The positive growth outlook is backed by better labour market prospects, loosening of financial conditions, improved confidence and reduced uncertainty about the strength of the recovery, and lower energy and oil prices. These factors are expected to continue to support growth in the short to medium term, although high private and public debt levels continue to exert a drag on growth through deleveraging pressures.

Domestic demand, led by private consumption, keeps driving growth while the contribution from net exports has turned negative again in 2014. Growth is set to continue to be mainly driven by domestic demand, led by robust private consumption and investment (Graph 1.1). Strong private consumption has been underpinned by higher than expected job creation, as well as negative inflation in 2014 that provided some relief to households for their real gross disposable income in a context of continued wage moderation. The sizeable drag from the external sector observed over the first half of 2014 has been due to the slowdown in Spain's export markets and an exceptionally robust pick-up in imports that partly reflected renewed confidence and temporary measures. As these effects phase out, the negative contribution of the external sector is expected to narrow in 2015 and to turn neutral in 2016.

Investment was one of the main factors behind the recovery. Some of the factors holding down investment in recent years (weakness of private demand, financial fragmentation, fiscal consolidation, uncertainty) are starting to recede, although others (deleveraging, sectorial rebalancing) are likely to have a more lingering effect. Key macroeconomic indicators covering from 2007 to 2016 are summarised in Table 3.2.1.

Financial markets have stabilised and financing conditions for the private sector have loosened, but the country remains vulnerable to sudden changes in global investor sentiment. A clear return of market confidence in Spain was manifested in the narrowing of sovereign debt yields spreads vis-à-vis the core Member States of the euro area, surging stock market prices and the resumption of foreign financing. After the completion of the programme for recapitalisation of the financial sector, balance sheet restructuring of the sector continued. These factors have led to a greater availability and a lower cost of financing for the Spanish private sector. Nevertheless, Spain remains sensitive to swifts in markets confidence that translate quickly into changes in risk premia.

Graph 1.1: **Real GDP growth and contributions**

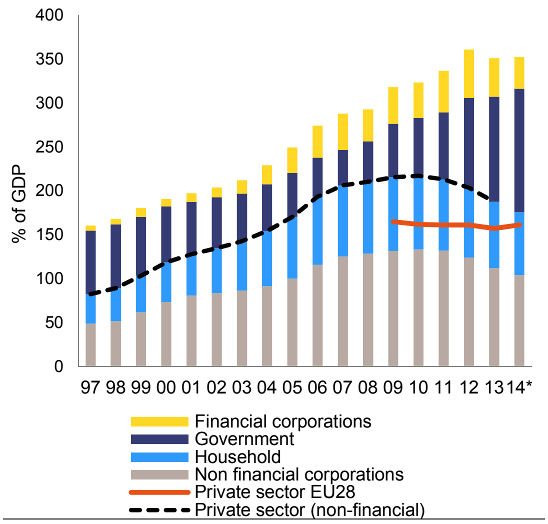


Source: European Commission

After seven years of correction, housing prices seem to be bottoming out. The cumulative fall between Q3-2007 and Q1-2014 amounted to 36.2 % in nominal terms. Some indicators suggest that housing prices might have bottomed out in 2014, and residential investment is foreseen to start growing again in 2015. However, the large stock of unsold houses limits the potential for fast price increases. The housing market and the construction sector are discussed in detail in section 3.2.

Deleveraging by the private sector remains on track, but is far from complete. Credit contraction continues to be the main driver behind the reduction in private sector indebtedness, while, contrary to previous years, positive nominal GDP growth did not hinder deleveraging in 2014 (Graph 2.2). Negative inflation did impede a faster aggregate adjustment though. Recent data show some deceleration of credit contraction and that aggregate deleveraging is to some extent taking place selectively, with the financial sector ready to fund healthier corporations with positive growth prospects. Both households and non-financial corporations are expected to maintain positive net lending positions (Graph 1.3) even when consumption and investment are forecast to keep registering relatively high growth rates.

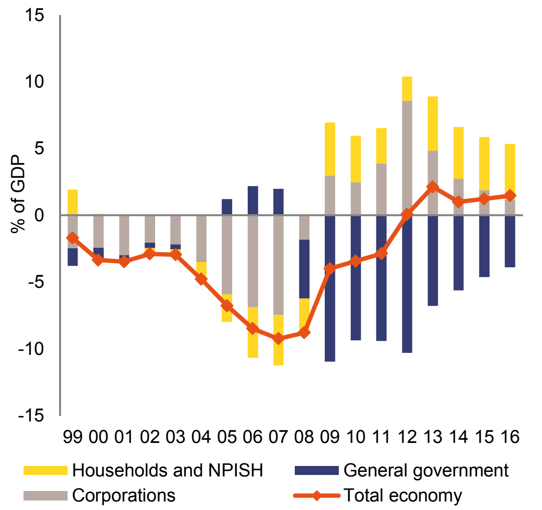
Graph 1.2: **Breakdown of debt by sector (non-consolidated)**



Source: European Commission

While the annual public deficit continues on a declining trend, overall public debt will keep rising. Public finances continued to improve in 2014, and, according to the Commission winter 2015 economic forecast, the deficit for the year as a whole would narrow to around 4.5 % of GDP, net of bank recapitalisations in both years. Going forward, the deficit reduction relies more on the improving economic outlook than additional consolidation measures. While pension expenditure is forecast to continue rising, falling unemployment should limit the amount of social transfers in the near future. The public debt ratio, which increased very rapidly during the financial crisis and its aftermath, is expected to continue to grow and reach around 102.5 % of GDP by 2016. Deleveraging pressures in the private and public sectors are also discussed in section 3.2.

Graph 1.3: **Net lending (+)/net borrowing (-) by sector**

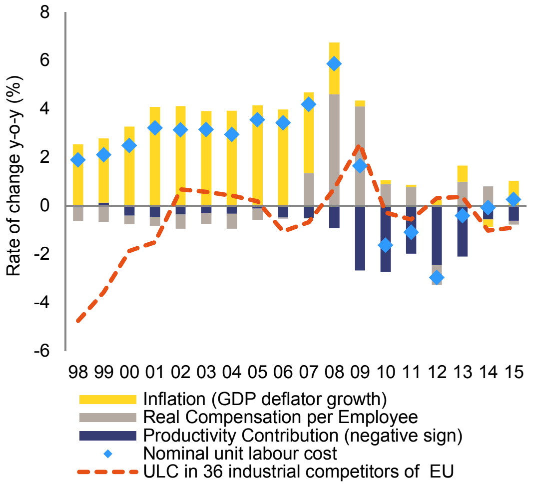


Source: European Commission

After a sizeable adjustment, the current account is expected to have turned negative again in 2014, mainly due to weak external demand and temporary factors, but is expected to post small surpluses in 2015 and 2016. After almost two decades of negative balances, the current account registered a surplus of 1.5 % of GDP in 2013. However, the slowdown of emerging economies in the second half of 2013 added to the deceleration in the EU in the first half of 2014, thereby dragging exports. By contrast, rising domestic demand fuelled imports, also pushed by some transitory factors such as car-scrapping schemes and retained consumption and investment in previous years. This led to a sharp deterioration in the trade balance, partly offset by a rising surplus in the balance for services. Moreover, the balance of primary income was very negative due to the large stock of external liabilities and rising return of assets in Spain. However, the current account balance is set to become positive again in the coming years, based on a recovery in the trade balance due to a combination of higher exports and the decline in oil prices.

Exports are forecast to gain momentum but, given their high import content, they will also raise imports. The most dynamic demand components in 2015 are expected to be exports, as a result of ongoing improvements in price and non-price competitiveness and the projected recovery in Spain's main export markets, and equipment investment. As both elements embed a high share of imported content, total imports are also expected to remain robust.

Graph 1.4: **Breakdown of the change of unit labour costs in Spain**



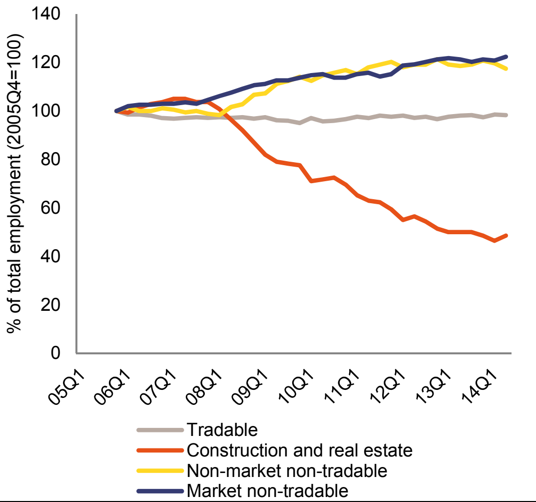
Source: European Commission

The process of internal devaluation continues, resulting in further progress in price and cost competitiveness, but negative euro area inflation is hindering the adjustment. The fall in domestic demand and soaring unemployment experienced during the crisis eased inflationary and wage pressures, reversing cost and price competitiveness losses that accumulated in the boom years vis-à-vis other euro area countries. Since 2009, the real effective exchange rates (REERs) and nominal unit labour costs have fallen by 13.2 % and 4.5 %, respectively. Productivity gains, together with ongoing wage moderation explain most of progress in restoring price competitiveness between 2009 and 2013 (Graph 1.4). Structural reforms in product and services markets are now starting to bear fruit, and have contributed to recent improvements in competitiveness. However, very low or even negative inflation in the euro area might be an obstacle for further progress in restoring price competitiveness even despite wage moderation in Spain. Headline inflation was negative and core inflation fell to around zero in the second half of 2014. Negative headline inflation rates are expected to prevail over most of 2015 and to remain very low thereafter.

Spain's export capacity has improved. Exports have increased due to both the increase in the number of exporting companies, and the value exported by exporting company. Considering the fixed costs associated with penetration in foreign markets, it is unlikely that these gains will be reversed easily in the near future. Moreover, a noticeable geographical diversification has taken place, which helped sustain Spanish exports in the run-up to, and during, the crisis.

Despite the sizeable current account adjustment in recent years, the net international investment position as a ratio of GDP deteriorated slightly more because of negative valuation effects. While this reflects increased confidence in the Spanish economic outlook, the high level of external debt (especially in the form of loans) remains a source of concern, as it leaves the economy highly vulnerable to negative shocks. The external performance and overall competitiveness are discussed in detail in section 3.1.

Graph 1.5: **Share of employment in tradable and non-tradable sectors**

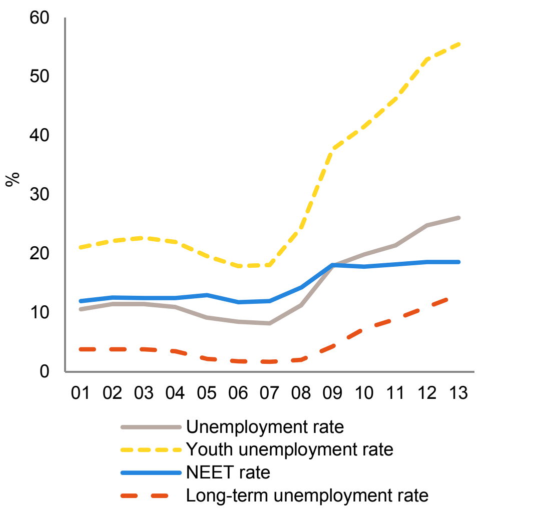


Source: European Commission

The adjustment process has produced a sharp change in the composition of employment and value added. In relative terms, tradable sectors as a proportion of value added have interrupted their long declining trend and the same applies when looking at total employment (Graph 1.5). The change in the sectorial composition of the economy was mainly driven by the collapse of the construction sector and real estate development and to a lesser extent by the downsizing of the financial sector (this mainly in value added terms).

Employment growth was been stronger than expected during 2014, and the unemployment rate - although it remains very high - decreased in 2014 for the first time since 2007. As the Spanish economy gathered pace during the course of 2014, job creation responded positively, in part due to the increased flexibility introduced by labour market reforms enacted in recent years, and also to wage moderation. Activity rates increased (albeit slightly) for all age groups, including the young, and the rate of young people not in employment, education or training, remains broadly stable (Graph 1.6). However, the very high unemployment rate, namely youth and long-term unemployment, and elevated segmentation, remain major challenges.

Graph 1.6: **Labour market indicators**

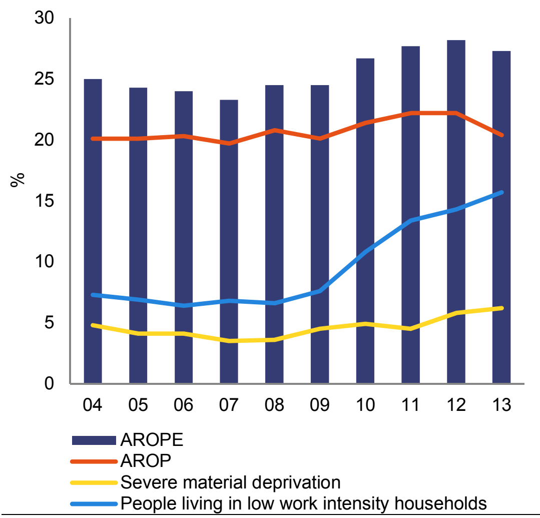


Source: European Commission

High structural unemployment rates have negative consequences on employability, skills development, social conditions and wage developments. Sustained high structural unemployment rates could bring upward wage pressures in the medium term, which could reverse gains in competitiveness achieved in recent years and bring to a halt the necessary external adjustment process. Moreover, after a period of substantial increases, productivity is only expected to record modest increases in the coming years, resulting in less a favourable evolution of unit labour costs. Therefore, enhancing labour productivity growth is essential to preserve competitiveness.

Social indicators have seen a drastic deterioration since the crisis, although the recent positive evolution of labour markets may lead to some improvement over the coming years. The percentage of the population at-risk-of-poverty ([1]) and at-risk-of-poverty or social exclusion ([2]) rose sharply between 2007 and 2012 (Graph 1.7). It is estimated that 12.6 million people were at risk of poverty or social exclusion in 2013. ([3])

Graph 1.7: **Poverty indicators in Spain**



Source: European Commission

([1]) At-risk-of poverty rate (AROP): share of people with disposable income below 60 % of the national median income.

([2]) People at-risk-of poverty or social exclusion (AROPE): are individuals who are at-risk-of poverty (AROP) and/or suffering from severe material deprivation (SMD) and/or living in household with zero or very low work intensity (LWI).

([3]) The methodology on income based indicators (AROP and AROPE) changed in Spain in 2013, making difficult the comparison with previous years. The indicators on material deprivation and people living in household with low work intensity are not affected by this methodological change.

Box 1.1: Economic surveillance process

The Commission's Annual Growth Survey, adopted in November 2014, started the 2015 European Semester, proposing that the EU pursue an integrated approach to economic policy built around three main pillars: boosting investment, accelerating structural reforms and pursuing responsible growth-friendly fiscal consolidation. The Annual Growth Survey also presented the process of streamlining the European Semester to increase the effectiveness of economic policy coordination at the EU level through greater accountability and by encouraging greater ownership by all actors.

In line with streamlining efforts this Country Report includes an In-Depth Review — as per Article 5 of Regulation no. 1176/2011 — to determine whether macroeconomic imbalances still exist, as announced in the Commission's Alert Mechanism Report published on November 2014.

Based on the 2014 IDR for Spain published in March 2014, the Commission concluded that Spain was experiencing macroeconomic imbalances requiring specific monitoring and decisive policy action, in particular, developments in the areas of household debt, linked to the high levels of mortgage debt and structural characteristics of the housing market, as well as unfavourable developments in export market shares.

This Country Report includes an assessment of progress towards the implementation of the 2014 country-specific recommendations adopted by the Council in July 2014. The country-specific recommendations for Spain concerned public finances and taxation, financial sector reform and access to finance, labour market reforms, youth policies, education and training, social inclusion, product and services markets reforms, network industries, and the reforms of public administration and the judiciary.

Table 1.1: **Key economic, financial and social indicators**

	2008	2009	2010	2011	2012	2013	Forecast 2014	2015	2016
Real GDP (y-o-y)	1.1	-3.6	0.0	-0.6	-2.1	-1.2	1.4	2.3	2.5
Private consumption (y-o-y)	-0.7	-3.6	0.3	-2.0	-2.9	-2.3	2.3	2.7	2.6
Public consumption (y-o-y)	5.9	4.1	1.5	-0.3	-3.7	-2.9	0.5	0.3	0.1
Gross fixed capital formation (y-o-y)	-3.9	-16.9	-4.9	-6.3	-8.1	-3.8	3.2	4.7	5.2
Exports of goods and services (y-o-y)	-0.8	-11.0	9.4	7.4	1.2	4.3	4.5	5.4	6.0
Imports of goods and services (y-o-y)	-5.6	-18.3	6.9	-0.8	-6.3	-0.5	7.7	6.9	6.7
Output gap	1.4	-3.3	-4.4	-5.5	-7.2	-7.7	-6.1	-3.9	-1.9
Contribution to GDP growth:									
Domestic demand (y-o-y)	-0.5	-6.2	-0.7	-2.7	-4.2	-2.7	2.0	2.6	2.6
Inventories (y-o-y)	0.1	-0.2	0.3	0.0	-0.1	0.0	0.2	0.0	0.0
Net exports (y-o-y)	1.6	2.8	0.5	2.1	2.2	1.4	-0.8	-0.3	0.0
Current account balance (% of GDP), balance of payments	-9.3	-4.3	-3.9	-3.2	-0.3	1.4	.	.	.
Trade balance (% of GDP), balance of payments	-5.1	-1.1	-1.3	-0.2	1.6	3.4	.	.	.
Terms of trade of goods and services (y-o-y)	-2.4	5.1	-2.3	-3.7	-1.5	1.5	-0.7	1.8	-0.2
Net international investment position (% of GDP)	-79.3*	-93.8*	-89.1*	-91.4*	-90.0	-92.6	.	.	.
Net external debt (% of GDP)	76.2*	88.3*	92.0*	94.6*	91.6*	89.7*	.	.	.
Gross external debt (% of GDP)	153.7*	167.9*	164.0*	166.7*	167.9*	159.7*	.	.	.
Export performance vs advanced countries (% change over 5 years)	-4.6	-1.3	-4.4	-0.2	-8.3	-2.6	.	.	.
Export market share, goods and services (%)	2.1	2.2	1.9	1.9	1.8	1.9	.	.	.
Savings rate of households (net saving as percentage of net disposable income)	2.6	9.5	4.6	6.0	3.5	4.9	.	.	.
Private credit flow, consolidated, (% of GDP)	11.9	-1.4	0.9	-4.2	-9.9	-10.8	.	.	.
Private sector debt, consolidated (% of GDP)	196.6	202.4	201.5	195.3	184.8	172.1	.	.	.
Deflated house price index (y-o-y)	-4.8	-5.6	-3.6	-9.9	-16.9	-10.4	.	.	.
Residential investment (% of GDP)	10.4	8.1	6.9	5.7	5.0	4.3	.	.	.
Total financial sector liabilities, non-consolidated (y-o-y)	-3.2	4.6	-3.7	-1.0	-1.7	-3.6	.	.	.
Tier 1 ratio[1]	.	.	.	.	.	.	.	.	.
Overall solvency ratio[2]	.	.	.	.	.	.	.	.	.
Gross total doubtful and non-performing loans (% of total debt instruments and total loans and advances)[2]	.	.	.	.	.	.	.	.	.
Change in employment (number of people, y-o-y)	0.2	-6.3	-1.7	-2.5	-3.7	-2.6	1.5	2.1	2.3
Unemployment rate	11.3	17.9	19.9	21.4	24.8	26.1	24.3	22.5	20.7
Long-term unemployment rate (% of active population)	2.0	4.3	7.3	8.9	11.0	13.0	.	.	.
Youth unemployment rate (% of active population in the same age group)	24.5	37.7	41.5	46.2	52.9	55.5	53.2	.	.
Activity rate (15-64 year-olds)	72.7	73.1	73.5	73.9	74.3	74.3	.	.	.
Young people not in employment, education or training (%)	14.3	18.1	17.8	18.2	18.6	18.6	.	.	.
People at risk of poverty or social exclusion (% of total population)	24.5	24.7	26.1	26.7	27.2	27.3	.	.	.
At-risk-of-poverty rate (% of total population)	20.8	20.4	20.7	20.6	20.8	20.4	.	.	.
Severe material deprivation rate (% of total population)	3.6	4.5	4.9	4.5	5.8	6.2	7.0	.	.
Number of people living in households with very low work-intensity (% of total population aged below 60)	6.6	7.6	10.8	13.4	14.3	15.7	.	.	.
GDP deflator (y-o-y)	2.1	0.3	0.2	0.1	0.2	0.7	-0.7	0.2	1.0
Harmonised index of consumer prices (HICP) (y-o-y)	4.1	-0.2	2.0	3.1	2.4	1.5	-0.2	-1.0	1.1
Nominal compensation per employee (y-o-y)	6.8	4.4	1.1	0.9	-0.6	1.7	0.5	0.7	0.8
Labour productivity (real, person employed, y-o-y)	0.9	2.9	1.8	2.0	1.7	1.4	.	.	.
Unit labour costs (ULC) (whole economy, y-o-y)	5.9	1.6	-1.6	-1.1	-3.0	-0.4	-0.2	0.2	0.3
Real unit labour costs (y-o-y)	3.7	1.4	-1.8	-1.2	-3.2	-1.1	0.5	0.0	-0.7
REER[3] (ULC, y-o-y)	4.4	-1.0	-3.9	-1.3	-6.6	0.2	-0.9	-2.4	-0.4
REER[3] (HICP, y-o-y)	0.5	1.1	-4.0	0.4	-1.8	1.5	0.4	-2.3	-0.7
General government balance (% of GDP)	-4.4	-11.0	-9.4	-9.4	-10.3	-6.8	-5.6	-4.5	-3.7
Structural budget balance (% of GDP)	.	.	-7.0	-6.2	-3.5	-2.2	-2.1	-2.3	-2.7
General government gross debt (% of GDP)	39.4	52.7	60.1	69.2	84.4	92.1	98.3	101.5	102.5

(1) Domestic banking groups and stand-alone banks.
(2) Domestic banking groups and stand-alone banks, foreign-controlled (EU and non-EU) subsidiaries and branches.
(3) Real effective exchange rate
(*) Indicates BPM5 and/or ESA95

Source: European Commission, 2015 winter forecast; ECB

Table 1.2: **The Macroeconomic Imbalance Procedure scoreboard**

			Thresholds	2008	2009	2010	2011	2012	2013
External imbalances and competitiveness	Current Account Balance (% of GDP)	3 year average	-4%/6%	*-9.5*	*-8.1*	*-6.3*	*-4.3*	-2.5	-0.7
		p.m.: level year	-	*-9.6*	*-4.8*	-3.9	-3.2	-0.3	1.4
	Net international investment position (% of GDP)		-35%	*-79.3*	*-93.8*	*-89.1*	*-91.4*	-90.0	-92.6
	Real effective exchange rate (REER) (42 industrial countries - HICP deflator)	% change (3 years)	±5% & ±11%	5.2	4.6	-0.3	-2.5	-5.3	-0.4
		p.m.: % y-o-y change	-	2.5	0.4	-3.1	0.2	-2.4	1.9
	Export Market shares	% change (5 years)	-6%	*-13.6*	*-7.1*	*-10.5*	*-8.6*	*-15.2*	*-7.1*
		p.m.: % y-o-y change	-	*-4.9*	*3.5*	*-9.1*	-0.6	-5.6	4.4
	Nominal unit labour costs (ULC)	% change (3 years)	9% & 12%	13.7	11.8	5.7	-1.2p	-5.6p	-4.6p
		p.m.: % y-o-y change	-	5.7	1.6	-1.6	-1.1p	-2.9p	-0.6p
Internal imbalances	Deflated House Prices (% y-o-y change)		6%	-4.8	-5.8	-3.6	-10.1	-16.8	-9.9
	Private Sector Credit Flow as % of GDP, consolidated		14%	12.0	-1.4	0.9	-4.2p	-9.9p	-10.7p
	Private Sector Debt as % of GDP, consolidated		133%	196.6	202.4	201.5	195.3p	184.8p	172.2p
	General Government Sector Debt as % of GDP		60%	39.4	52.7	60.1	69.2	84.4	92.1
	Unemployment Rate	3-year average	10%	9.3	12.5	16.4	19.7	22.0	24.1
		p.m.: level year	-	11.3	17.9	19.9	21.4	24.8	26.1
	Total Financial Sector Liabilities (% y-o-y change)		16.5%	2.8	4.6	-2.3	3.1	2.8	-10.2

Flags: e: estimated. p: provisional.
Note: Figures highlighted are the ones falling outside the threshold established by EC Alert Mechanism Report. For REER and ULC, the first threshold concerns Euro Area Member States.
(1) Figures in italic are according to the old standards (ESA95/BPM5).
(2) Export market shares data: the total world export is based on the 5th edition of the Balance of Payments Manual (BPM5).
(3) House Price indicator: e = Eurostat estimates.

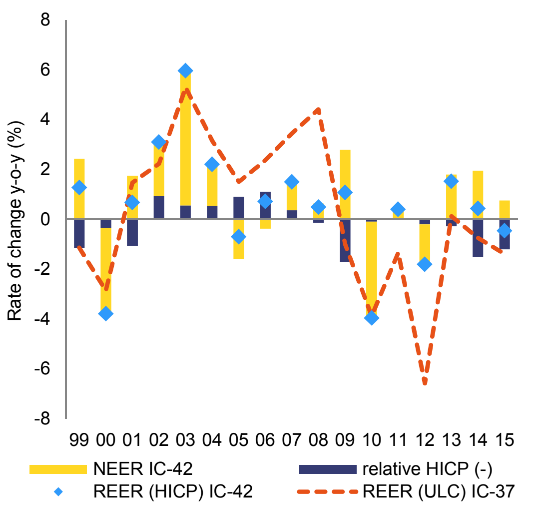
Source: European Commission

2. IMBALANCES, RISKS AND ADJUSTMENT

2.1. EXTERNAL SUSTAINABILITY AND COMPETITIVENESS

The sizeable current account deficits accumulated during the expansionary phase led to a sharp increase in external debt. Slack financial conditions led investment expenditures by households and non-financial corporations to expand significantly. A great deal of this went into residential investment, bringing about a brisk increase in the prices of dwellings and a worrying housing bubble. Buoyant growth in domestic demand coupled with increasing resources diverted to non-tradable sectors fuelled imports, while exports could not keep pace. At the same time, fast growing domestic demand brought about sustained wage and price increases which, combined with subdued productivity growth, translated into a sharp deterioration of competitiveness. Nevertheless, the resulting current account deficit was easily financed by foreign capital inflows (mainly debt) due to the disappearance of the country risk premium, despite the large accumulation of foreign liabilities.

Graph 2.1.1: **Evolution of price competitiveness in Spain**

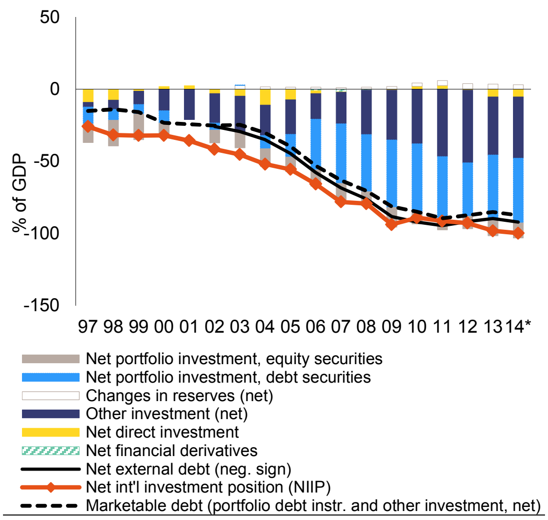


Source: European Commission

The outbreak of the financial crisis precipitated the burst of the housing bubble, while prompting a sharp current account adjustment. The collapse of domestic demand dragged down Spanish imports of goods and services down from 31.7 % of GDP in 2007 to 28.1 % in 2013. In turn, exports of goods and services, which had already performed remarkably well in the run-up to the crisis despite accumulating price competitiveness losses, rose from 25.7 % to 31.6 % of GDP over the same period. This was a result of both the contraction of GDP and the improvement in competitiveness indicators, in particular the drop in unit labour costs (Graph 2.1.1).

Despite the sizeable adjustment in the current account, the negative net international investment position (NIIP) keeps increasing and remains a major risk. From a peak deficit of 9.6 % of GDP in 2007, the current account turned into a surplus of 1.5 % of GDP in 2013. However, the adjustment in the current account has not yet translated into a reduction of external liabilities. The net international investment position deteriorated sharply until 2009 and has remained since then at around 15 percentage points higher than before the crisis (Graph 2.1.2). Despite a positive net lending position of the economy vis-à-vis the rest of the world in 2013 of 2.1 % of GDP, the negative net international investment position rose further by more than 5 percentage points, to above 95 % of GDP as a result of valuation effects that partly reflect an improvement of investor's confidence.

Graph 2.1.2: **Breakdown of the net international investment position**

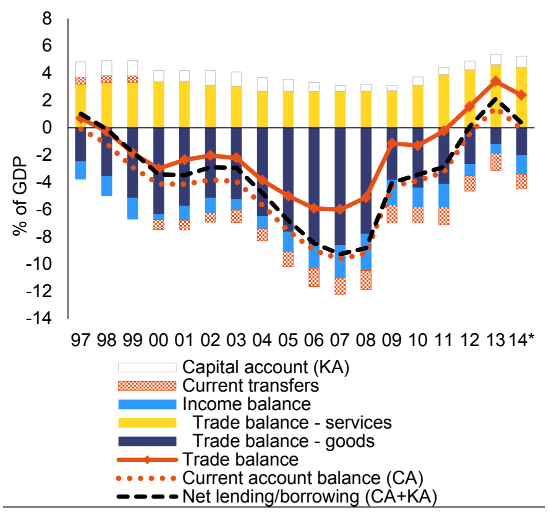


Source: European Commission

A significant negative net international investment position is a cause of concern as it exposes Spain to adverse shocks or shifts in market confidence. Reducing the large stock of external liabilities would require Spain to record larger current account surpluses than at present over sustained periods of time. Even under relatively benign growth and inflation scenarios, Spain would still need to achieve a record current account surplus of 1.7 % of GDP on average over the 2014-24 period in order to halve its NIIP-to-GDP ratio by 2024. This compares to the 0.1 % deficit and 0.6 % surplus forecast for 2014 and 2015, respectively.

The adjustment in the current account stems mainly from the trade balance of goods. The improvement in the current account balance was due to both a higher surplus in the balance of services and, more importantly, a reduction in the trade deficit of goods. Although the trade balance of goods remained in deficit, the correction between 2007 and 2013 amounted to 7.4 percentage points of GDP (see Graph 2.1.3).

Graph 2.1.3: **Adjustment in the current account**



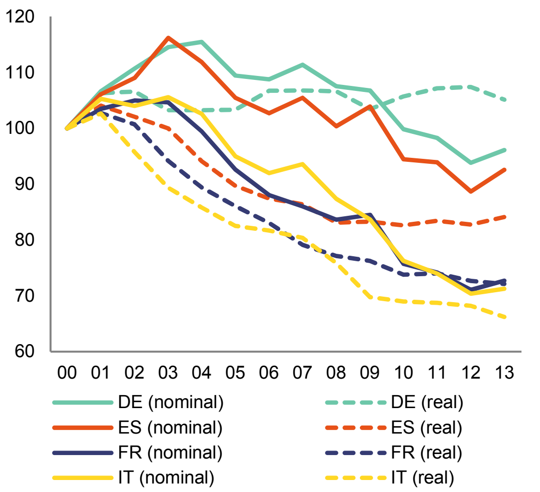
Source: European Commission

The Spanish exports-to-GDP ratio is similar to other large euro-area economies. While still well below the figure for Germany, Spanish exports of goods as a percentage of GDP in 2013 (22.3 %) are in line with those in France or Italy, and above the UK. Moreover, at 9.3 % of GDP in 2013, exports of services were above the levels in the largest euro area economies and stood close to the UK (11.9 % of GDP).

Since the crisis, Spanish market shares of world exports have advanced relatively better in terms of volumes rather than values, outperforming most other major EU economies. The Spanish market share of world exports of goods in value terms (nominal) decreased by only 0.1 percentage points since 2007, to 1.7 %, whereas more sizeable declines were observed in most euro area and EU economies, including the largest ones. Advanced countries' nominal shares of world exports tend to evolve relatively better than real shares. As competition in more standard products intensifies, these countries usually export more sophisticated and high-quality products characterised by higher unit-values. This was also the case of Spain before 2007, where export shares fell more in volumes (real) than in value (nominal) terms, partly due to increasing export prices. However, since the outbreak of the crisis, the world market share of Spanish exports in volumes has remained broadly constant, indicating that exports in volume have behaved relatively better than in values, and that there has been an implicit reduction in unit values of exports (Graph 2.1.4). This suggests both structural competitiveness gains derived from price and wage moderation and a trend towards exports of products of medium and medium-low quality.

Despite the overall positive evolution of the external sector in recent years, the current account surplus is forecast to have turned into a deficit of 0.1 % of GDP in 2014. The slowdown in the euro area, along with the deceleration of emerging economies that started in the second half of 2013, has weakened the external demand for Spanish exports, despite which exports keep registering relatively high growth rates (4.6 % year-on-year in Q3-2014). Given that more than half of Spanish exports are destined to the euro area, with exports to France, Italy, and Portugal combined accounting for almost 30 % of total exports, negative inward spillovers to the Spanish economy from the slowdown of the euro area have been significant. At the same time, strong domestic demand keeps pushing imports, which grew by 8.2 % year-on-year in the third quarter. This is due to strong growth in private consumption and investment, but also to the high dependence of Spanish industry on imports of intermediate and energy goods and technology, as explained in section 3.1.3. Accordingly, the positive growth contribution from the external sector turned negative again in 2014, resulting in a current account deficit of EUR 3.6 bn. until November, compared with the EUR 12.3 bn. surplus over the same period of 2013.

Graph 2.1.4: **Market shares in world exports of goods in the main EU economies in volume and in value (2000=100)**



Source: IMF WEO and European Commission Calculation

However, the current account is forecast to record a surplus again in 2015. Short-term prospects are that the deterioration observed in 2014 could be temporary. According to the Commission winter 2015 economic forecast, the current account will register surpluses of around 0.6 % and 0.5 % of GDP in 2015 and 2016 respectively, based on the envisaged recovery of Spanish external markets, which, jointly with ongoing competitiveness gains would push exports up. Likewise, the fall in oil prices are set to alleviate the energy bill, while transitory factors — such as some retained demand during the crisis and the incentives to buy motor vehicles that explained the brisk pick-up in imports in 2014 — should phase out.

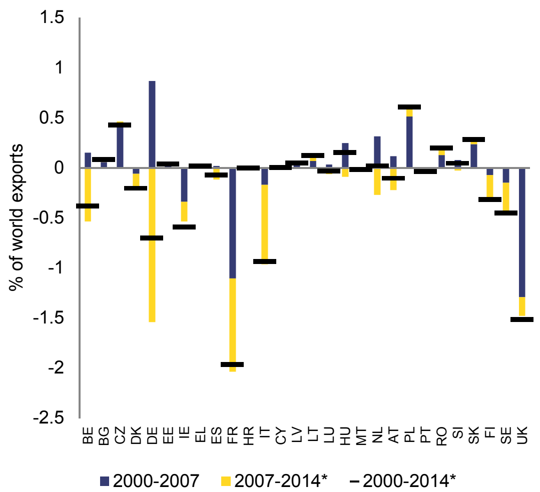
Although much of the current account adjustment has been permanent, the cyclically adjusted current account remains in deficit. In cyclically-adjusted terms, the current account deficit narrowed significantly until 2013, indicating that most of the external adjustment has been of a structural nature. This said, the non-cyclical current account remains in deficit, and worsened somewhat in 2014. This fact highlights the problem that the Spanish economy typically brings about current account deficits in recovery and expansionary phases. This trend seems to prevail.

The adjustment in the current account brought the economy back to net lending vis-à-vis the rest of the world. From a net borrowing peak of 9.2 % of GDP in 2007, Spain registered a net lending of 2.1 % of GDP in 2013. This was in parallel with the private sector also moving from net borrowing to net lending positions, partly offset by the net borrowing recorded by the general government.

Drivers of export performance

Despite accumulating competitiveness losses over the expansion phase, Spanish exports have proved quite resilient. The real effective exchange rate recorded a sustained appreciation between 2001 and 2007. This was due to both nominal effective exchange rate appreciation and persistently positive inflation and unit labour costs differentials. Notwithstanding such price competitiveness losses, the loss of export market share in real terms (volumes) was less acute than in the main EU economies, as discussed in the previous section (Graph 2.1.5), in a context of global increases of world trade flows.

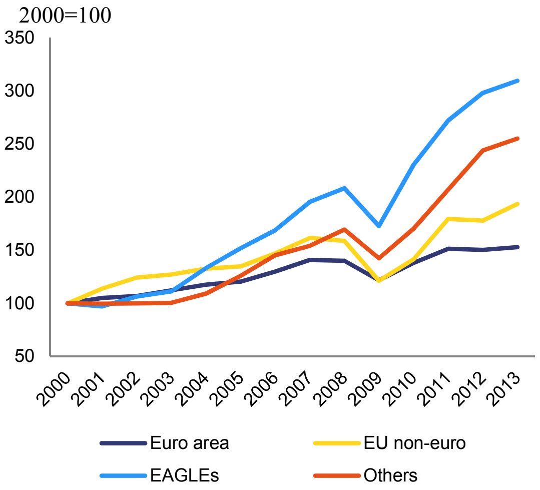
Graph 2.1.5: **Changes in share of exports of goods in EU economies (volume)**



Source: European Commission

Resilience of exports is closely linked to progressive openness to international trade flows. At the beginning of the previous decade the European market was by far the main destination for Spanish exports of goods, with 60 % going to the euro area and around 12 % to other EU economies. While exports to European markets remained the lion's share, this geographical pattern started to show significant changes towards a higher degree of international diversification (Graph 2.1.6) after the outbreak of the crisis. The share of exports in value going to the euro area declined by some 7 percentage points since 2007 as other destinations gained prominence. Exports to the emerging and growth-leading economies (EAGLEs) have been the most dynamic, rising by almost 1.5 percentage points since 2007, from 6.8 % to some 8.2 % in 2014. Accordingly, this geographical diversification contributes to explaining why Spain benefited from the increase in world trade, and managed to partly offset losses in price/cost competitiveness in the run-up to the crisis.

Graph 2.1.6: **Geographical specialisation of Spanish exports**



Source: DataComex

Spain has benefited from the growth in world trade in recent years. The elasticity of Spanish exports of goods with respect to world income growth (which is an important factor behind the growth in world trade) is above 1, in line with estimates for other advanced economies.([4]) In the case of Spain, this is usually associated with its opening to international trade flows and its reorientation to products with medium-high technological content, with typically higher income elasticity than products embedding a lower technological content.

Price competitiveness gains during the crisis have played a positive but limited role to explain recent improvements. Spanish exports of goods have a relatively high (negative) long-term relative price elasticity compared with other advanced economies. Nevertheless, the real exchange rate typically explains well below 10 % of the variance in (country-specific) exports, as opposed to world trade, which explains about 80 %.([5]) The remaining residual at some 10 % is deemed to capture other unspecified factors (non-cost determinants), which may have more than compensated the dynamics of relative costs and prices.

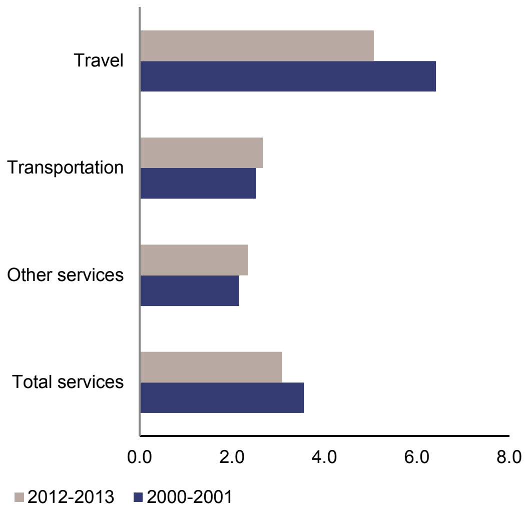
The performance of services exports has also been positive. Spain's share in global exports of services is significantly greater than its share in exports of goods (3.3 % against 1.6 % in 2012), mainly on account of its large tourism sector. The share of Spain in world tourism has been decreasing in the last decade as its tourism model relies mainly on coastal seasonal tourism, which is subject to increasing competition from cheaper destinations. However, Spain has been able to expand its world share of exports in other services

([4]) Evidence on income and price elasticities of imports and exports can be found in: Buisán, A., Caballero, J.C. and Jiménez, N., *Determinación de las exportaciones de manufacturas en los países de la UEM a partir de un modelo de oferta-demanda'* Boletín Económico, Banco de España, (2003) and Martínez Mongay, C. and Maza, L.Á., *Competitiveness and growth in EMU: the role of the external sector in the adjustment of the Spanish economy* Economic Papers 355, European Economy, (2009); García, C., Gordo, E., Martínez Martín, J. and Tello, P., *Una actualización de las funciones de importación y exportación de la economía española*, Banco de España, Documentos Ocasionales, 0905, (2009); Murata, K., Turner, D., Rae, D. and Le Fouler, L., 'Modelling Manufacturing Export Volumes Equations: A System Estimation Approach', OECD Economic Department Working Papers, n.º 235, (2000); Ortega, E., Burriel, P., Fernández, J.L., Ferraz, E. and Hurtado, S., *Actualización del Modelo Trimestral del Banco de España*, Documentos de Trabajo, n.º 0717, Banco de España, (2007); Orsini, K., *Imports' adjustment in Spain: cyclical or structural?*, ECFIN Country Focus, European Commission (2015, forthcoming).. Hooper, P., Johnson, K. and Márquez, J., *Trade elasticities for G-7 countries*, International Economics, 87, Princeton Studies, (2000) provides international evidence for these elasticities.

([5]) Crespo Rodríguez, A., Pérez-Quirós, G. and Segura Cayuela R., *Competitiveness Indicators: The Importance of an Efficient Allocation of Resources*, Banco de España, Economic Bulletin, January, pp. 103-111, (2012). They also provide evidence that bigger firms typically export a higher proportion of their production.

– mainly services to businesses – characterised by higher value added and possibly higher future growth potential (Graph 2.1.7). The share of turnover in foreign markets increased in most subsectors related to services to businesses, especially in software publishing, computer programming, consultancy and related activities, engineering activities and related technical consultancy. Significant penetration in foreign markets also occurred in accounting, bookkeeping and auditing activities, tax consultancy and management consultancy activities. Whereas the increase in the export markets for goods mainly occurred in the emerging and growth-leading economies, the expansion of export of services was concentrated in North America and in the UK.

Graph 2.1.7: **World market shares for Spanish exports of services**



Source: WTO and European Commission Calculation.

Much of the positive export performance has been due to price and cost competitiveness developments in the largest firms. The distribution of firms by size typically explains a large part of the export penetration of a given sector, as bigger firms typically export a higher proportion of their production than smaller firms. Moreover, over the last decade, largest firms have witnessed more favourable unit labour costs behaviour due to higher productivity growth. The recent price and cost competitiveness gains should pave the way for further positive export developments in the medium term. It thus appears that the behaviour of large Spanish companies has in some instances allowed them to overcome structural weaknesses vis-à-vis their peers in other countries. For example, the proportion of high-skilled employees is lower in Spanish firms, although the presence of managers with international experience and of employees participating in training courses is high. In addition, the proportion of large Spanish firms that invest in R&D is lower, but Spain scores better in the generation of process innovations.([6])

The export base is widening but the small size of firms acts as a drag on the export capacity of the economy. The extensive margin (i.e. the growing number of companies exporting) also plays a significant role in explaining the resilience of exports. The number of Spanish exporting firms grew by around 50 % between 2007 and 2013, including regular exporters (those that have exported for at least four consecutive years). Considering the fixed costs of entering foreign markets, these trends are unlikely to reverse. However, 70 % of them export only occasionally and more than 85 % of total exports are undertaken by the largest 5 000 companies. Besides, the small average size of Spanish firms compared with their European peers is a limiting factor affecting export capacity (the intensive margin, or the average quantity exported by exporting firms), as larger firms tend to be more productive and export a higher share of their output.([7]) Moreover, and contrary to their larger peers, Spanish SMEs perform below the EU average in terms of product/ process innovations, according to the European Commission 2014 Innovation Union Scoreboard.

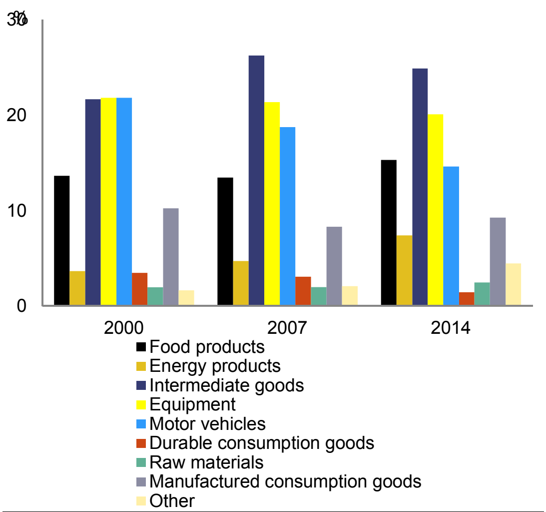
The high price-elasticity of Spanish exports reveals a specialisation pattern skewed towards labour-intensive products but with medium-high technological content. High price elasticity is typically associated to a high share of labour-intensive industries, are usually more sensitive to relative price developments. Despite the large share of food and primary products, Spanish exports of goods are mainly concentrated on

([6]) Antras, P, Segura Cayuela, R. and Rodríguez Rodríguez, D., *Firms in International Trade (with an Application to Spain),* SERIEs Invited Lecture at the XXXV Simposium of the Spanish Economic Society, (2010).

([7]) Altomonte, C., Barba Navaretti, G., di Mauro F. and Ottaviano, G., *Assessing competitiveness: how firm-level data can help*, Bruegel Policy Contribution, No 16, (2011); Correa Lopez, M. and Doménech R., *The Internationalisation of Spanish Firms*, BBVA Working Papers, No 12/30, (2012).

intermediate goods, the bulk of which are chemical products (around 14 % of total exports), equipment goods (transport equipment amounts to some 5 % of total exports), and motor vehicles, whose importance is on a clearly downward trend (Graph 2.1.8). Motor vehicles and transport equipment account for around 20 % of total exports. While Spanish exports in these categories mainly correspond to mature demand segments, they typically involve medium to medium-high technological content (Graph 2.1.9). However, when compared to other advanced economies, the proportion of exports of high and medium-high technology goods, Spain ranks relatively low. Moreover, the import content of Spanish exports is comparatively high. In sum, the participation of Spanish firms in global value chains is lower and predominantly passive (as a recipient of inward foreign direct investment flows).

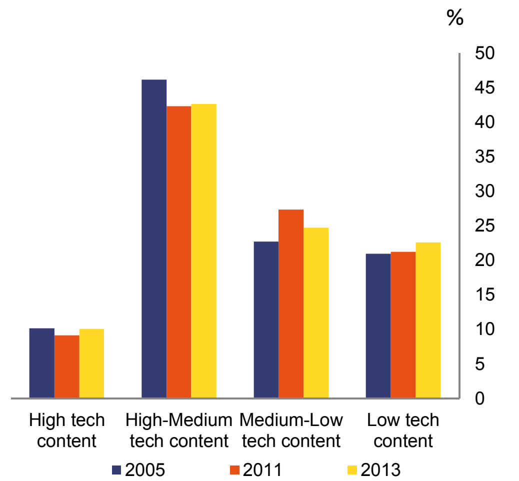
Graph 2.1.8: **Structure of Spanish exports of goods**



Source: DataComex

Spain is also specialized in exports of medium-low quality products. Despite their technological content, the quality of Spanish exports of goods ranks relatively low compared with other EU and OECD countries (Graph 2.1.10).[8] Furthermore, the average quality of Spanish exports decreased in relative terms between 2007 and 2011, with such decline being especially striking in exports of top-quality products (Graph 2.1.11). This reduction in average quality is likely to be linked to the increasing presence of small Spanish firms — typically less productive — in foreign markets during the crisis, which may conceal improvements in overall quality. This 'left-hand side- skewed quality distribution resembles somewhat those of Portugal, Poland, the Czech Republic, Slovakia, Bulgaria, Romania and Lithuania in the EU but also China. Cost competition is stronger in low and medium-low quality segments, which is consistent with the relatively high price/cost elasticity estimated for Spanish exports. Hence, in order to safeguard the resilience of exports with this pattern of specialisation, Spain is forced to rely heavily on cost and wage moderation, which underscores the need to move upwards along the export-quality ladder and increase labour productivity.

Graph 2.1.9: **Breakdown of Spanish exports by technological content**



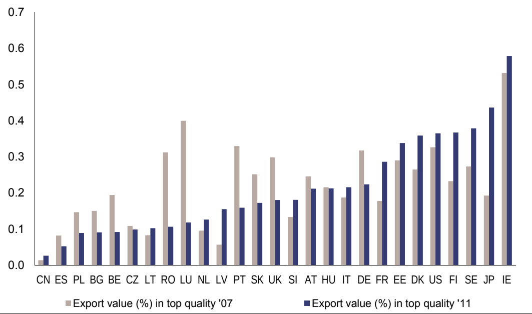
Source: Ministry of Economic Affairs and Competitiveness and Banco de España

The deceleration in exports in 2014 is explained by the slowdown of external demand, but is reckoned to be fleeting. After having grown by 7.3 % in real terms on the year in the second quarter of 2013, exports of goods and services started to lose momentum, due to the deceleration of emerging economies and followed by the main euro area economies over the first half of 2014. However, price competitiveness gains continued on account of the negative growth of unit labour costs and very low or even negative inflation. Positive signals are observed though. In particular, a significant acceleration was observed in the third

([8]) Vandenbussche, H., *Quality in Exports*, European Economy, Economic Papers, No 528, (2014).

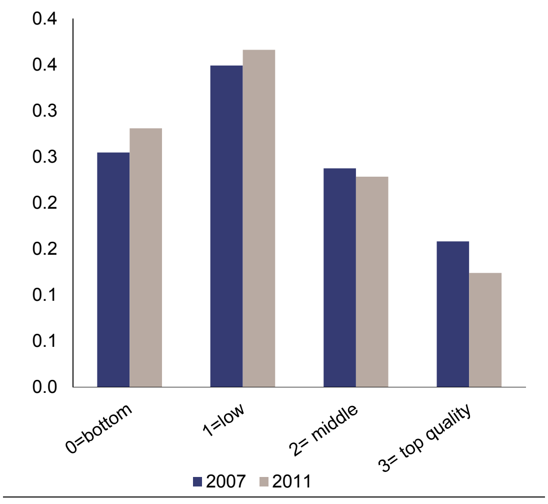
quarter of 2014, with exports of goods and services growing by 4.6 % on the year compared to 1.5 % in the preceding quarter. Looking forward, the euro depreciation along with the envisaged recovery of Spanish external markets should add to previously accumulated competitiveness gains, thereby paving the way for enhanced export performance in the short-to-medium term.

Graph 2.1.10: **Shares of top-quality exports by country (value)**



Source: European Commission Calculation based on Comext and Orbis data

Graph 2.1.11: **Share of export products by quality rank**



Source: European Commission Calculation based on Comext and ORBIS data.

Drivers of imports

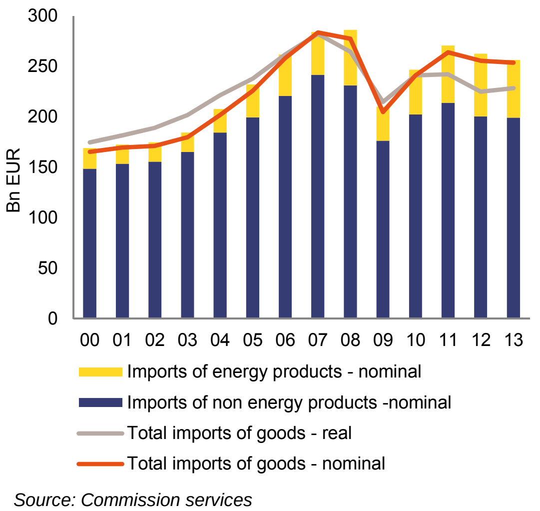
The decline in final demand during the crisis triggered a sizeable fall in imports, although not all of this reduction has been of a permanent nature. As the crisis entailed a downward adjustment of potential output, part of the adjustment in imports is deemed to be permanent. Despite the fall in domestic demand, the strong export resilience sustained imports due to their high import content. In constant prices, total imports fell by almost 24 % between 2007 and 2013, while final demand did so by 10.5 %. These figures suggest a long-term final demand elasticity of imports above 2 (in line with available estimates in the literature), which is high compared to the main euro area Member States. However, part of the reduction in imports may just obey to cyclical factors. Recent developments corroborate this assessment, as the increase in imports witnessed over 2014 has been driven by the incipient recovery and the pick-up in final demand. Insofar as the recovery becomes firmer, imports are expected to remain buoyant, in line with their historical pattern.

The Spanish industry is highly dependent both on imports of intermediate and energy goods and on technology, which are less responsive to relative price developments. The price elasticity of imports is rather low (between -0.02 and -0.6). The low sensitivity to prices is consistent with a high dependency on imports of intermediate goods and the structurally elevated dependence on energy products (Graph 2.1.12), in particular oil and gas as sources of primary energy. Likewise, Spanish imports depend considerably on goods involving more advanced technological developments, for which income elasticity is typically high while price elasticity is low. In general, import intensity in manufacturing sectors is almost 20 % higher in Spain than in the other main euro area economies.([9]) In particular, automotive and chemical industries, the main export industries in Spain, have very high import content (63.3 % and 54.8 % respectively), mostly intermediate goods. A high demand for imported intermediate inputs cannot per se be considered as a sign of inefficiency in the national industrial sectors. High import penetration of intermediate goods could be due to a better integration in international value chains and a more efficient use of the comparative advantages. However, the difference in import content compared with the most advanced EU

([9]) Gordo, E., Gil, M. and Pérez, M., *La industria manufacturera española en el contexto europeo*, Banco de España, Boletín Económico, March, pp. 33-39, (2003); Cabrero, A. and Tiana, M., *The import content of the industrial sectors in Spain*, Economic Bulletin, April, Banco de España, (2012).

economies is especially salient in manufacturing industries grouped under the headings of high and medium-high technology (Graph 2.1.13), which might suggest a structural shortcoming in domestic technology.

Graph 2.1.12: **Energy dependency of the Spanish economy**

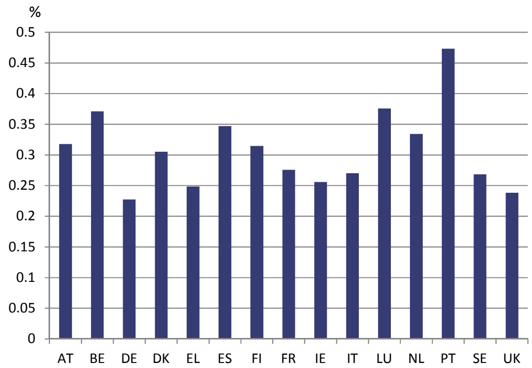


Source: European Commission

Foreign direct investment and the relative weight of subsidiaries of foreign firms in production can help explain the high import dependency. There appears to be a positive relationship between foreign direct investment and import intensity, and Spain shows by far the highest ratio of stock of foreign direct investment to GDP amongst large euro area economies (almost 55 % in 2014). This seems to be mostly the case for the large automotive industry.

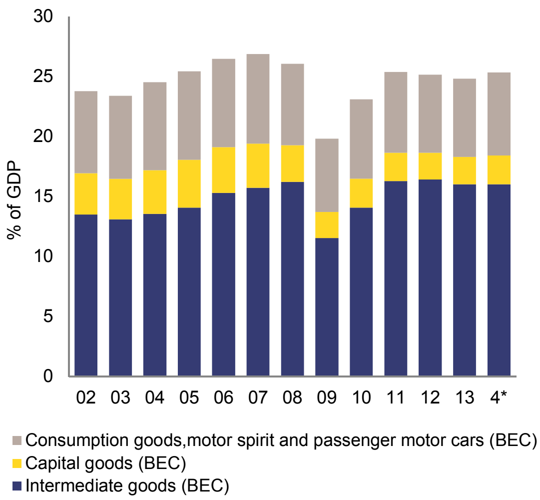
Despite its limited potential, the process of internal devaluation could also foster import substitution. In particular, if restored competitiveness translates into lower prices on domestic markets, import substitution could also occur — at least for import goods that are subject to higher price elasticity. The impact is therefore likely to occur more in consumer goods, typically more responsive to relative prices, in spite of their limited weight in total imports (Graph 2.1.14).

Graph 2.1.13: **Import content of exports of medium-high and high technology products**



Source: OECD Stan database

Graph 2.1.14: **Spanish imports by broad economic category**

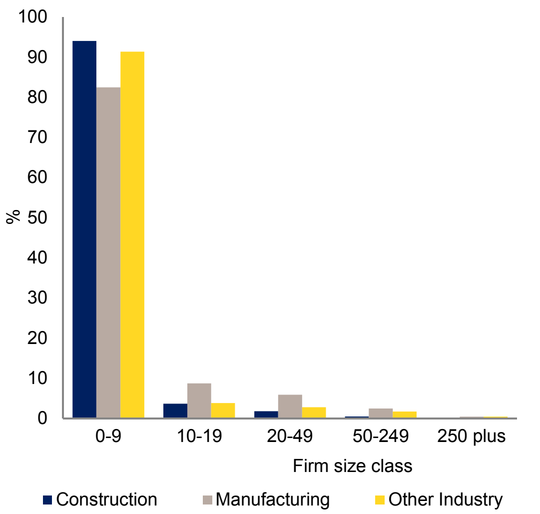


Source: European Commission

Assessing the evolution of competitiveness

Average company size in Spain is below other European countries. Over 90 % of firms are micro-firms (less than 9 employees) (Graph 2.1.15**)**. More than half of workers in Spain are employed in small companies (below 50 employees) compared to 23 % in Germany and 32 % in France. This applies to both the manufacturing and services sector. Sectorial specialisation may partly explain the average firm size, but there is evidence that institutional and technological factors also influence the size of firms.([10]) Indeed, Spanish SMEs provide almost three quarters of all private sector jobs and 64 % of value added, rates that significantly surpass the EU average. This is in particular because of the group of microenterprises that account for 40 % of the Spanish private sector workforce and 28 % of value added.

Graph 2.1.15: **Average industrial firm size in Spain (2011)**

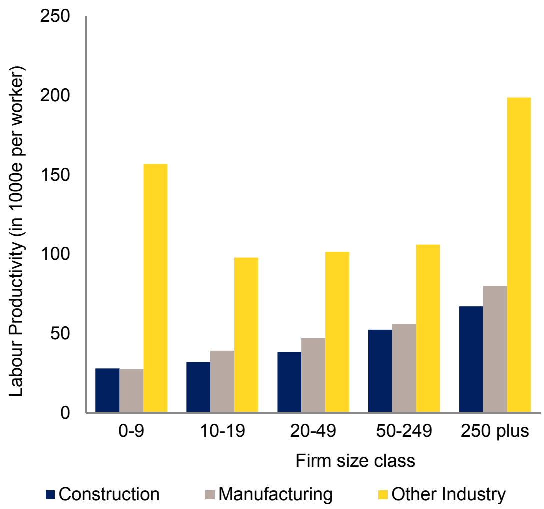


Source: European Commission

The small size of Spanish firms plays a decisive role in explaining lower productivity. Very small companies tend to be characterised by lower levels of productivity than larger ones (Graph 2.1.16), as the latter invest more in R&D, especially in sectors in which scale effects are more important, such as manufacturing. Moreover, larger companies may also benefit more from investments in information and communications technologies. Hence, an increase in firms' size could spur aggregate productivity growth.

Economic policy has actively supported, in Spain and elsewhere, the creation, survival and expansion of small and medium sized companies (SMEs). Policy intervention aims at addressing market failures for those companies, such as difficulties in accessing credit and their lack of resources to optimise their tax burden. This should not come as a big surprise. SME represent a sizeable share of overall business activity. The employment creation of small firms (by both new firms and of small established firms) in Spain is much larger than their corresponding share in employment, a pattern that broadly holds across sectors.([11]) However, new Spanish firms seem to grow more slowly than in other European countries. The high proportion of small firms and the low presence of larger businesses might therefore reflect two features: start-ups are often small and there is a large proportion of more mature businesses that do not grow.

Graph 2.1.16: **Labour productivity distribution by firm size class (2011)**



Source: European Commission

The challenge for SMEs policy is to support company creation while at the same time setting out the conditions for company growth. To this end, easing the barriers for businesses to be created, operate and grow, would result in increased investment and growth opportunities. This would support the ongoing internal and external rebalancing process by facilitating the reallocation of resources from the non-tradable to the tradable sectors of the economy, thereby enhancing economic efficiency.([12])

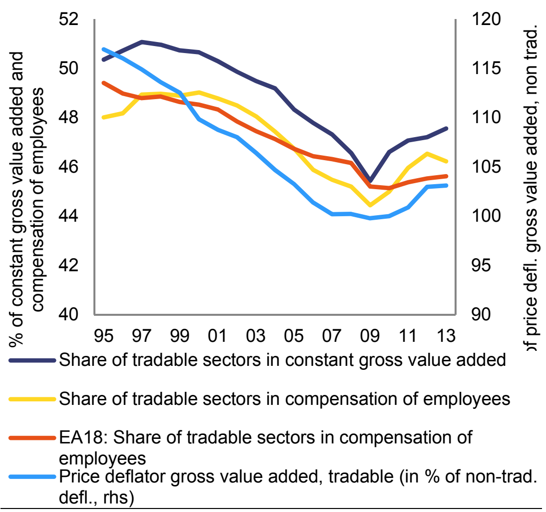
([10]) Kumar, K.B., Rajan, R.G. and Zingales, L., *What Determines Firm Size*, NBER Working Papers, No. 7208, National Bureau of Economic Research, (1999).

([11]) López García, P. Puente, S. and Gómez, Á.L.,, *Employment generation by small firms in Spain*, Banco de España. Documentos ocasionales no. 0903, (2009).

([12]) Almunia, M. and D. Lopez-Rodriguez, (2013), *Firms' Responses to Tax Enforcement Strategies: Evidence from Spain*, MPRA Paper, No. 44153, University Library of Munich; Garicano, L., C. Lelarge and J. Van Reenen (2012), *Firm Size Distortions and the Productivity Distribution: Evidence from France*, CEP Discussion

Investment in equipment and other products evidences the reallocation of resources towards tradable sectors, thereby paving the way for a more sustained growth model. In the run-up to the crisis Spanish growth relied excessively on the production of non-traded goods, especially construction and real estate activities, with small contributions to overall productivity growth. This pattern implied an inefficient allocation of resources that precluded funds from flowing into activities with a higher value added and hampered a more dynamic export performance. The brisk adjustment undergone by the housing market has entailed an implicit reallocation of resources towards tradable sectors (Graph 2.1.17) and to investment in equipment and others, as opposed to construction, which should underpin export performance and external rebalancing

Graph 2.1.17: **Evolution of the share of tradable sectors**



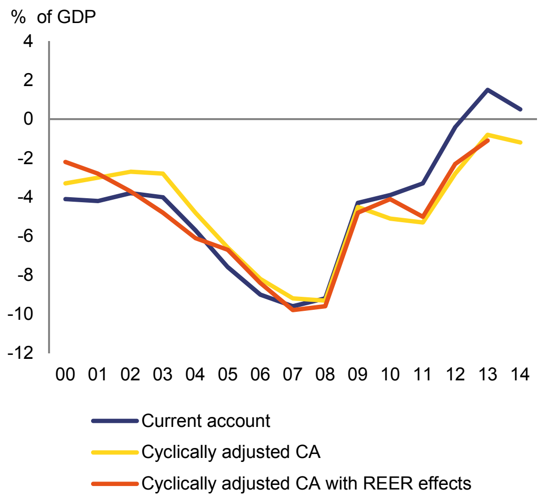
Source: European Commission

The cyclical component of the current account remains important. Insofar as the fall in demand is itself permanent, a part of the corresponding fall in imports observed in previous years can be considered as permanent. Yet, the output gap remains very high, at -6.1 % of potential GDP according to the Commission autumn 2014 economic forecast. Based on these estimates, the cyclically adjusted current account balance would amount to -1.2 % of GDP in 2014, compared to the envisaged headline deficit of 0.1 % of GDP (Graph 2.1.18). These estimates are subject to some uncertainty related to the estimation of potential output and might therefore underestimate the potential for a rebound in imports when demand firms up further and/or potential output growth reverts to normal values.

Papers, No. 1128, Centre for Economic Performance, London School of Economics and Political Science.

Further reforms aimed at enhancing labour productivity are essential for a faster current account adjustment. The still underlying current account deficit unveils structural weaknesses in Spanish competitiveness, linked to high import dependency but also to insufficient export penetration. Therefore, stepping up the pace of the reform agenda in the areas of business environment, and in labour and product markets would help overcoming such weaknesses, while leading to more balanced growth in recovery phases.

Graph 2.1.18: **Non-cyclical current account balance**



Source: European Commission

Income balance, capital transfers and financial account

Spain has traditionally recorded a negative income balance with the rest of the world, reflecting a large negative net international investment position (NIIP). After peaking in 2008, the negative contribution of the income balance to the current account has decreased by three quarters, reaching -0.7 % of GDP in 2013, mainly driven by lower return on foreign portfolio investments on Spanish assets in the 2008-13 period.

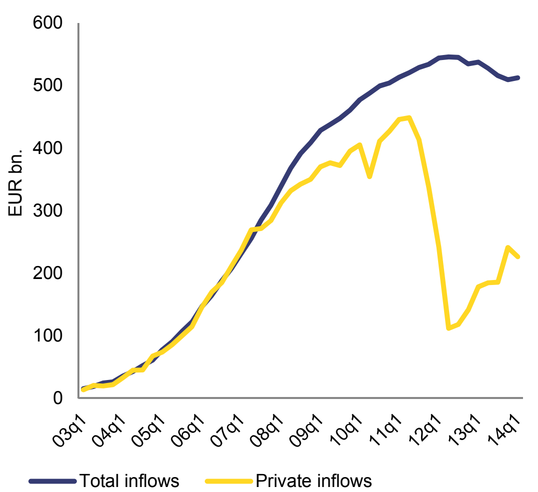
The income balance is expected to deteriorate slightly in 2014, to -1.4 % of GDP. This is the consequence of several offsetting effects, one driven by lower risk premia on Spanish assets, and the another driven by higher returns on assets. On the one hand, as a large part of Spain's external liabilities are made up of debt instruments, lower interest rates have reduced the cost of debt servicing. Moreover, the overall level of gross external debt during the course of 2013 and 2014 declined. On the other hand, returns on Spanish assets have improved throughout 2013 and 2014, thereby raising the overall income assigned to remunerate foreign financial assets has increased. So far, the 'return on assets effect' has prevailed over the 'interest rate effect', resulting in a deterioration of the income balance in 2014. Over the medium term, the evolution of the income balance will mainly depend on the returns on Spanish assets held by foreign agents (and the return on foreign assets held by Spanish agents), and the speed of the reduction in the stock of external liabilities.

The contribution of current transfers to the current account has also been negative in Spain since the early 2000s, and it is expected to remain so. This is mainly the consequence of the negative net contribution of workers' remittances, reflecting the fact that Spain hosts a large foreign population. Over the medium term, the contribution of current transfers could deteriorate slightly, as the net receipts from the EU budget will decrease from 2014 onwards, and as the labour market gradually improves, potentially resulting in increased migrant workers' remittances abroad. The balance of capital transfers has traditionally been positive, (about 0.5 percentage points of GDP between 2008 and 2013) on account of capital transfers from the EU. However, these transfers are also likely to decline in absolute and relative terms in the years to come.

In 2014, the Spanish financial account recorded a positive value of 1.0 % of GDP, reflecting a net lending position vis-à-vis the rest of the world. In terms of lenders, as Spanish financial institutions have gradually regained market access, private flows have been flocking again into Spain, meaning that the reliance of official flows has been reduced even further (Graph 2.1.19).

Looking at the different components of the financial account, it appears that the reduction in debt instruments has been substantial. This reduction comes mainly from the reduction in Target II balances, which have been partly compensated with net positive private debt inflows. At the same time, the pace of equity flows has not changed significantly since 2012.

Graph 2.1.19: **Private and total capital inflows**

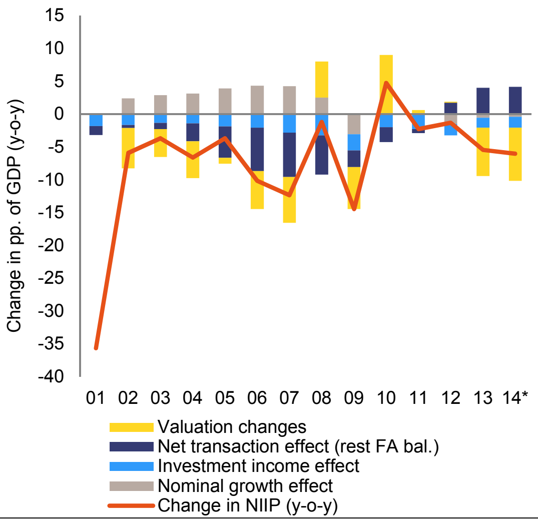


Source: European Commission and IMF

Structure and prospects for the net international investment position

Spain's net international investment position continued to deteriorate throughout 2013, until reaching almost -100 % of GDP in Q1-2014. This deterioration has mainly been driven by negative valuation effects, as a consequence of rising asset prices in Spain, which have increased the value of external liabilities. These have been partly offset with by a net lending position vis-à-vis the rest of the world (see 'net transaction effects' in Graph 2.1.20). Much of the increase in the net lending position has been achieved through a reduction in investment, both by corporations and households (mainly residential). In terms of financing needs by institutional sector, both households and corporations have recorded a positive net lending position, which has been partly offset by a net borrowing position for the general government (Graph 2.1.21).

Graph 2.1.20: **Contribution to changes in the NIIP**

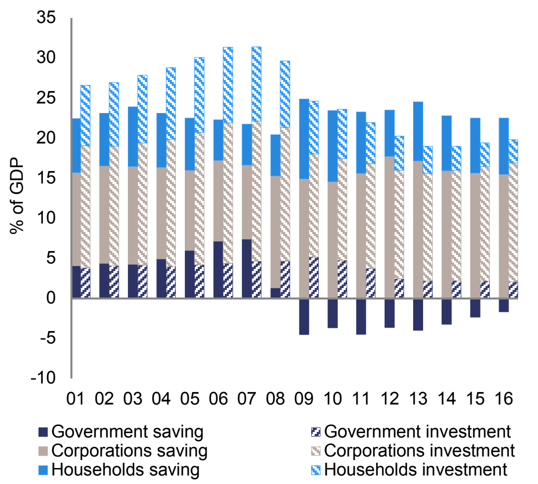


Source: European Commission

A large share of Spain's external liabilities is made of debt, which increases the vulnerability to external shocks. These instruments are more volatile and sensitive to changes in investor confidence, and, unlike equity, they have to be serviced regardless of the economic situation of the debtor. On the positive side, the net level of external debt decreased during the course of 2013 and 2014 in the context of the ongoing deleveraging process in the private sector. However, part of this decrease was offset by growing public sector debt, resulting in an only modest reduction of external debt. Over the medium term, the net level of external debt is expected to continue on a downward trajectory, as deleveraging needs in the private sector are estimated to be still significant, and as fiscal consolidation limits any further increases in public sector external debt.

Although Spain has improved its external position in recent years, further external adjustment is needed to put the net international investment position (NIIP) on a downward trajectory. Even under relatively benign growth and inflation scenarios, it would call for larger current account surpluses than at present to reduce the large negative net international investment position by 2024 (Table 2.1.1). For instance, assuming a baseline scenario of a 3.9 % nominal GDP growth on average over the 2015-24 period (an average of 2.2 % real growth and 1.7 % GDP deflator per year)([13]), it would be sufficient for Spain to achieve a 3,7 % current account deficit to stabilise its net international investment position at -95 % of GDP by 2024. However, if it were to bring down its net international investment position to -50 % of GDP by 2024, Spain would need to achieve a record current account surplus of 1.7 % of GDP on average over 2014-24. This compares with a forecast current account deficit of 0.1 % in 2014, and an estimated cyclically adjusted current account deficit of -1.2 % in 2014. Under more pessimistic scenarios, such as a 2 % nominal GDP growth over the same period (for instance, an average real GDP growth of 1 % and a GDP deflator of 1 %), Spain would need to achieve a 3 % of GDP current account surplus on average over the same period in order to bring down its net international investment position to -50 % of GDP. These simulations illustrate that Spain is still vulnerable to changes in economic conditions, and that larger external surpluses need to be achieved to bring down decisively its large stock of external liabilities.

Graph 2.1.21: **Savings and Investment by Sector**



Source: European Commission

([13]) European Commission, Fiscal Sustainability Report (2012).

Table 2.1.1: **Current account and net international investment position scenarios (2015-24)**

	Low nominal GDP growth (2% avge. 2015-24)	Baseline scenario (3,9% avge. 2015-24)	High nominal GDP growth (5% avge. 2015-24)
NIIP Stabilisation	-1.9	-3.7	-4.6
NIIP at -75% of GDP	0.3	-1.3	-2.2
NIIP at -50% of GDP	3	1.7	0.9
NIIP at -25% of GDP	5.7	4.6	4

(1) The table above shows the current account balance needed to achieve different NIIP values by 2024, based on several nominal GDP growth scenarios
(2) NIIP stabilisation implies a NIIP level of -95 % of GDP by 2024
(3) These simulations do not take into account REER and valuation effects
(4) Other assumptions are average yields (nominal effective) over the 2015-24 of 3.1 % for domestic yield, and of 3.5 % for foreign yield
(5) Domestic yield is the long term interest rate (as in AMECO and long-term projections)
(6) Euro area / foreign yield is the underlying long-term interest rate on foreign assets, and the spread "external liability-domestic yield" is based on the median 2004-12 spread between returns of foreign liabilities and the long-term interest rate
Source: European Commission Calculation

Inward, outward and euro area spillovers

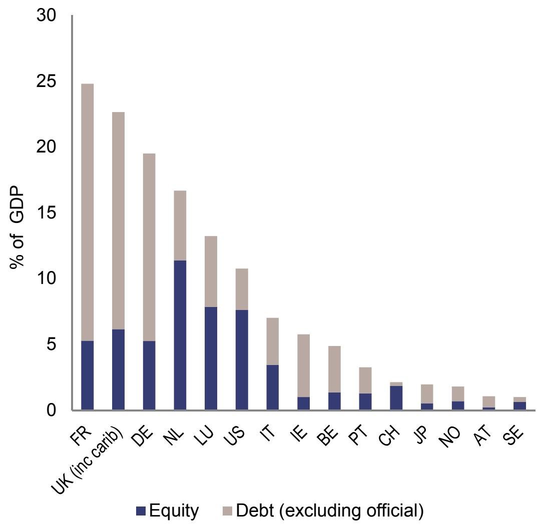
Spanish exports rely heavily on markets where growth has been weak in recent years. The three largest markets for Spanish exports are France, accounting for more than 4.5 % of Spanish GDP, Germany (3.4 %) and the UK (also 3.4 %). Exports to Italy, Portugal and the United States, are also significant, implying that inward spillovers to the Spanish economy from the slowdown in some of these markets have been significant.

Spain has a large financial exposure to non-euro area countries, implying that, beyond price effects, it is also exposed to exchange rate movements. Spanish foreign financial assets are largest in the UK (17 % of Spanish GDP), but also the USA, France and the Netherlands (about 8 % of Spanish GDP each). However, Spain also has a large exposure to Latin American countries, with a combined exposure to Mexico, Chile, Argentina, and Brazil of almost 12 % of its GDP.

Foreign claims of Spanish banks are also the largest in non-euro area countries. According to BIS data, the Spanish banking sector was highly exposed to the UK, with claims worth approximately 30 % of Spanish GDP, which were concentrated on the non-bank private sector. Banking sector exposure to the USA, Brazil and Mexico is also high.

However, most of the main investors in Spain are euro area countries, which — given the recent overhaul of the euro area architecture, including the Banking Union — could be a relative shield from sudden capital flow reversals (Graph 2.1.22). The main gross investors in Spain were France (25 % of Spanish GDP), followed by the UK (23 %), Germany (19 %), the Netherlands (17 %, including large equity investments), and Luxembourg (13 %). As regards financing specifically from foreign banking sectors, the main players are, once more, France, Germany and, to a lesser extent, the UK.

Graph 2.1.22: **Spain's funding dependence on partner countries (2012)**



(1) Gross Spanish foreign liabilities as a % of Spanish GDP
Source: European Commission Calculation

At the same time, the Spain is a significant source of trade and financial outward spillovers. The Spanish market is an important export destination for Portugal, representing more than 6 % of Portuguese GDP and 3% of its value added. Large share of service exports to Spain are also observed in Luxembourg, Ireland and Malta. In turn, gross financial exposures to Spain were highest in Ireland (36 % of Irish GDP), the Netherlands (29 %), Malta (23 %) and Portugal (21 %). Specifically, the exposures of the banking sectors of EU countries to the Spanish economy are largest for Portugal, at close to 10 % of Portuguese GDP, and to a lesser extent the Netherlands and France.

Spain is a major funding partner and investor in Portugal and Ireland. Debt and equity claims amount to 32 % of Portuguese GDP and 25 % of Irish GDP, respectively. Spain is also a significant investor in the Netherlands, Hungary, Malta and the UK.

Spillovers from simultaneous growth enhancing reforms at the euro area level can be significant for all euro area Member States. Structural reforms lead to higher aggregate demand, which, if adopted simultaneously by all Member States, have a small effect on the trade balance. However, they have a positive effect for output and employment.

Medium-term prospects for external adjustment

Although a significant part of the current account adjustment is likely to be permanent, imports are expected to respond to faster growth in the short-to-medium term. Exports have been quite resilient helped by the growing internationalisation of export companies and further geographical diversification. Considering the fixed costs of entering foreign markets, these trends are unlikely to reverse. The narrowing current account surplus during 2014 is explained by the slowdown in external markets, but also by high import growth linked to the pick-up of final demand. In particular, the reallocation of resources towards tradable sectors, namely manufacturing, is likely to push imports as the import content of tradable production is higher than in other non-tradable sectors such as construction or real estate. Accordingly, while current account surpluses are envisaged in the medium term, their magnitude might not be great.

Large current account surpluses would be needed over long periods of time in order to bring down the large stock external liabilities. The substantial external financial dependence will remain a source of vulnerability, both due to its size and its composition (mainly debt). The ongoing private sector deleveraging process is expected to continue over the medium term, as deleveraging needs are still considerable. So far, all the external adjustment has been undertaken by corporations and households, mainly through a reduction in investment, having detrimental effect on potential growth. The external adjustment will need to be supported by cost dynamics, via higher productivity and appropriate wage dynamics. The process of internal devaluation would also support increased import substitution, although its contribution could be limited given the large dependency on imports of energy and intermediate goods, with typically a lower sensitivity to relative prices. In particular, the external reliance on imported energy products could be mitigated by reforms and tax policies geared to reduce energy intensity and the high oil dependence.

Spain needs to preserve price competitiveness gains and enhance production of quality goods. Spain is mainly active in in market segments of mature demand and low quality, where competition is stronger than for high-quality products and products embedding a high technological content. Therefore, is of the utmost importance for Spain to keep production costs, including labour costs, under control. In this respect, Spain would benefit from moving towards higher quality segments by promoting innovation further. Quality upgrading would help downplay the relevance of cost competitiveness, thereby delivering higher mark-ups while allowing higher wage increases, for which enhancing labour skills is key. Moreover, enhancing R&D and innovation would help increase the technological content of Spanish manufacturing, while reducing import dependency. To this end, legal and economic barriers to company growth seem to be key factors hindering the export capacity of the Spanish economy, both in terms of exports volumes, and in terms of unit values.

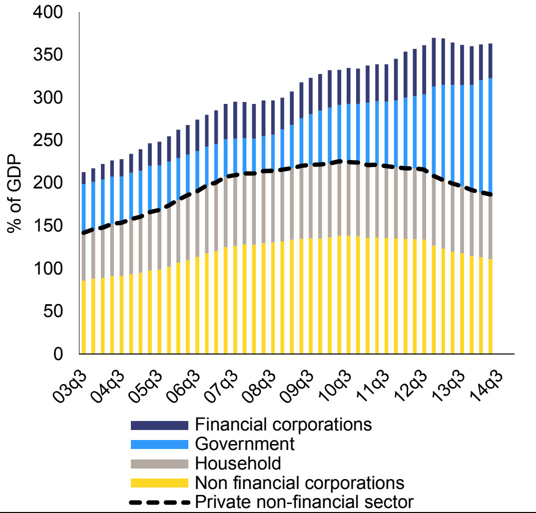
2.2. INDEBTEDNESS AND DELEVERAGING

The household and corporate sectors are reducing their debt overhang. Spain's private sector considerably increased its debt burden in the years before the crisis. Still in Q3-2014, the total stock of private sector debt amounted to 182 % of GDP in non-consolidated terms (72.4 % household debt and 109.7 % non-financial corporations debt), some 36.8 % of GDP lower than the peak in Q2-2010.([14]) Most of the reduction is due to the fall in debt of non-financial corporations (NFCs) since the peak of 24.5% of GDP (Graph 2.2.1). Credit contraction has been the main channel of private sector deleveraging, with aggregate bank lending on a declining path since 2010. Recent data show some deceleration in this contraction and confirm previous evidence that aggregate deleveraging is, at least to an extent, taking place selectively, with the financial sector ready to fund healthier corporations with positive growth prospects. On the household side, deleveraging continues to progress more gradually. Gross disposable incomes have been stagnating, also to support competitiveness of the Spanish economy and its external adjustment.

In contrast to the private sector, general government debt has been on an increasing trend. In the wake of the crisis, the private sector in Spain moved in a short period from a net borrowing to a net lending position, at the same time squeezing consumption and investment. In order to cushion the social effects of the structural adjustment in the economy, the public sector ran higher general government deficits leading to an increase in the public debt of around 60 percentage points of GDP compared with 2007.

Private sector deleveraging has been going in parallel with restructuring in the banking sector. The implosion of the real estate bubble caused a sharp deterioration in banks asset portfolios. Systemic concerns about the banking sector and the capacity of the sovereign to support it came to a head in the summer of 2012. The ensuing financial assistance programme for the banking sector set the basis for cleaning up bank balance sheets in order to provide new lending to the real economy and support the economic recovery. Meanwhile, after several years of price correction the housing market seems to have passed the turning point.

Graph 2.2.1: **Breakdown of debt by sector**



Source: European Commission

Financial sector developments

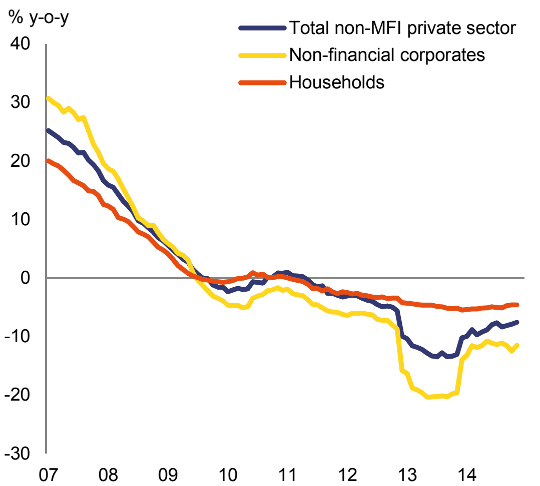
The burst of the real estate bubble and the economic recession that followed has altered both the quality and composition of bank assets, forcing banks to restructure their activity and clean up their balance sheets. In the wake of the crisis, lending to non-financial corporations contracted especially quickly, and has to a certain extent been replaced by the holding of government securities.([15]) Following the return of confidence to the Spanish economy, government financing from domestic banks declined gently in Q2/Q3-2014, although the total stock of credit to the private sector was still contracting by 7 % year-on-year in December 2014. In particular, credit to households was declining by around 4.7 % year-on-year while credit to non-financial corporations was still shrinking by about 9.6 % (Graph 2.2.2). In line with the economic recovery, the decline in lending activity has decelerated in recent months. In November 2014, for the first time in more than four years, month-on-month growth in the stock of loans to firms was observed. Banks managed to double their pre-tax profits in the first nine months of 2014 relative to the previous year due to lower

([14]) In consolidated terms, the non-financial corporations debt decreased from 119 % in Q2-2010 to 95.1 % in Q3-2014. Financial derivatives are excluded from debt calculations.

([15]) Spain's Banks: *Boom/Bust and Beyond – a Long-Term Perspective of the System*, IMF, Spain. Selected Issues, July 2014.

provisioning following an improvement in asset quality. Nevertheless, reduced credit volumes and an environment of low interest rates exert a downward pressure on bank interest income. The future development of the real estate market will have an important impact on bank profitability.

Graph 2.2.2: **Bank loans to the private sector**

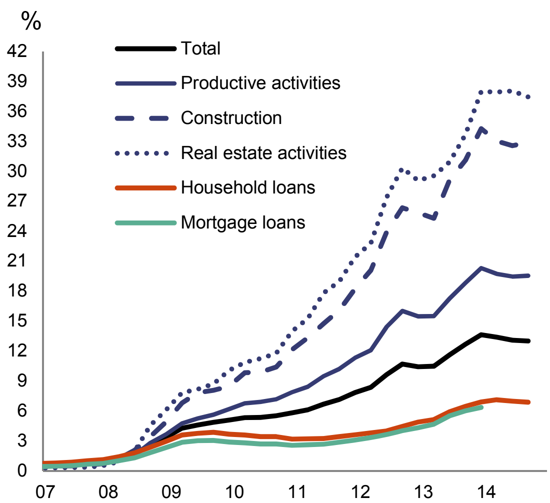


Source: Banco de España

In some segments of bank lending, notably lending to SMEs, new credit is growing, supported by declining nominal interest rates to firms. As regards the flow of new lending, a steady improvement can be noticed in the case of credits below EUR 1 million (a proxy of credit to SMEs) which have been growing since Q4-2013. ()By contrast, the dynamic of new credits of above EUR 1 million has still been negative and remains volatile, because larger companies have increasingly resorted to the issuance of corporate bonds and external loans. The demand for loans is sensitive to the level of lending rates, and bank lending rates to firms have been following a downward trend,([16]) so a further gradual recovery in lending is expected. As higher financing costs for SMEs in Spain also reflect sovereign spread, it is expected that, with sovereign upgrades, corporate ratings will also improve, making banks less reluctant to lend at lower rates.

After a steady deterioration in the aftermath of the crisis, the average quality of bank assets started to improve as of late 2013. The non-performing loans (NPLs) ratio increased steadily between 2008 and 2013, reflecting deterioration in the quality of loans after the burst of the real estate and construction bubble and the recession that followed. Non-performing loans ratios varied across different types of loans, with doubtful loans representing more than one third of the loan portfolio to the real estate and construction activities in the beginning of 2014. The total volume of doubtful loans reached its peak in late 2013 and has been declining ever since. As the volume of the non-performing loans has been falling more rapidly than the total volume of bank loans, the non-performing loans ratio decreased from 13.6% in December 2013 to 12.7% in November 2014, a still high proportion (Graph 2.2.3).

Graph 2.2.3: **Non-performing loans ratio**



Source: Banco de España, European Commission

Banks still seem unwilling to engage more actively in the restructuring of their loan portfolios. Restructured or refinanced loans accounted for 14.2 % of total loans to the private sector at the end of June 2014, a rate similar to that in March 2013.([17]) Based on the classification

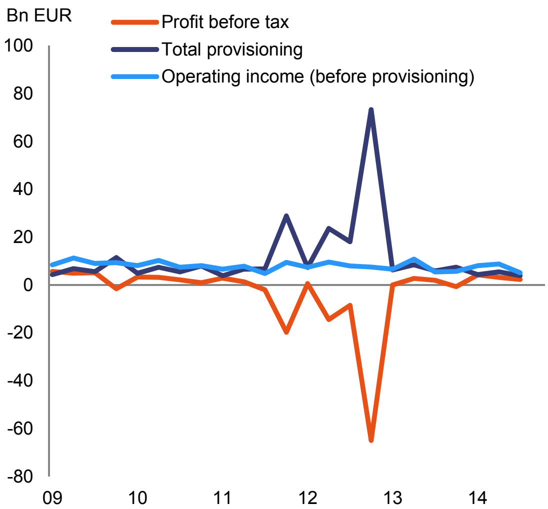
([16]) The average interest rate for loans to non-financial corporations above EUR 1 million dropped by 67 basis points to 2.43% as from April 2013 to November 2014, whereas the rate for loans below EUR 1 million recorded a bigger decline of around 154 basis points to 4.33% over the same period.

([17]) The proportion was 12% for large firms and 16% for SMEs in March 2013: Financial Stability Report 2013, Banco de España, p. 27. http://www.bde.es/f/webbde/Secciones/Publicaciones/InformesBoletinesRevistas/InformesEstabilidadFinancera/13/IEF_Ing_Noviembre2013.pdf criteria of Banco de España (BdE), 49.5 % of restructured or refinanced loans were classified as doubtful, 18.7% as substandard and 31.9% as performing loans. Similar to the case of non-performing loans, refinanced and restructured loans show a high degree of concentration in real estate (23.3 % in construction and 25.5 % in mortgages).

The liquidity situation and the access to funding of the banking sector improved further in 2014. After the access of Spanish banks to the interbank and wholesale markets was severely curtailed at the peak of the crisis in July 2012, the situation has gradually normalised, including during 2014. Net borrowing from the Eurosystem declined to EUR 141bn at the end of December 2014, about EUR 61bn less than a year before. The total amount of deposits in banks was declining at a rate of about 2 % year-on-year in December 2014, but due to the faster reduction in the stock of loans, the loan-to-deposit ratio of the banking sector improved substantially to 91.4 %, around 2.1 percentage points less than year before. The decline in household deposits reflects a recovery in consumption and a growing preference for alternative investment vehicles, such as mutual and pension funds, in a context of low bank deposit interest rates. Although banks have regained access to wholesale markets, their reliance on this source of funds declined due to their favourable liquidity situation in the context of reduced lending.

Provisioning needs and financial assets impairments were weighing on banks' earnings in recent years, but bank profitability started to improve again in the first nine months of 2014. Financial assets impairments had a particularly negative impact on banks profitability in 2012 when the banking sector recorded a significant loss, but they have been declining since. On the other hand, since 2012, bank non-interest income was boosted thanks to falling sovereign yields, which contributed to capital gains on bank holdings of government securities. Spanish banks increased their profits in the first nine months of 2014 in year-on-year terms, mainly due to an improved profitability in the first quarter of the year. Improved earnings were driven primarily by a further reduction in financial asset impairment compared with the first half of 2013 (Graph 2.2.4). Operating income before provisioning was similar to the previous year.

Graph 2.2.4: **Bank sector profitability**



Source: Banco de España, European Commission

The solvency of Spanish banks was further strengthened in 2014. The improvement in the solvency ratio is due to both higher capital (the numerator effect) and lower risk-weighted assets (the denominator effect). Spanish bank capital levels rose further during the first half of 2014. The common equity tier 1 capital under the new capital requirement regulation stood at 11.6 % in June 2014. Total regulatory own funds ratio increased to around 13.5%. In view of the results of the asset quality review and the stress test, and in order to shore up further their capital levels, some banks have managed to raise equity or other non-core capital instruments, such as subordinated debt or contingent capital instruments that qualify as own funds. In addition to this, BdE extended its recommendation on a maximum 25% of paid-in-cash to be also applied during 2014, leading to a strengthening of the core capital of Spanish banks.

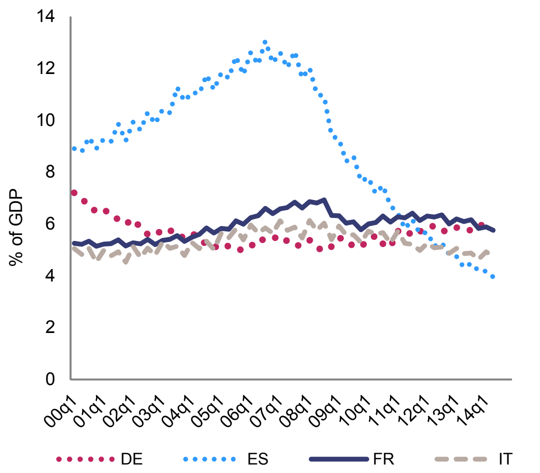
Overall, the comprehensive assessment has highlighted that the restructuring that the sector has undergone has brought Spanish banks back on track. On 26 October 2014, the European Central Bank and the European Banking Authority disclosed bank-by-bank results of their comprehensive assessment of the major European institutions, including the 15 most significant Spanish banks. The reference date for the assessment was 31 December 2013. As of that date, only one former savings bank — Liberbank — failed to be above one of the three capital thresholds envisaged in the European Central Bank methodology, showing a very small shortfall of EUR 32 million stemming from the asset quality review. However, Liberbank managed to raise fresh equity amounting to EUR 637 million already during the first half of 2014 and therefore needs no additional capital to meet the comprehensive assessment minimum requirements. The other 14 Spanish banks were, after asset quality review adjustments as of December 2013, assessed to be well above the critical threshold of 8 % for the common equity tier 1 capital ratio and remained above 7.5 % under the adverse scenario, thus exceeding the minimum 5.5 % required. Five institutions were above 9 %, including BFA-Bankia. The results confirm that the restructuring helped to recover solvency of the Spanish banking sector at large, which is a necessary condition for a resumed growth in lending.

Only a well-capitalised and solvent banking sector can reconcile the deleveraging process with the provision of new lending to the viable part of the economy. The performance and resilience of the banking sector have continued to strengthen in the wake of the financial assistance programme. Nevertheless, shrinking credit volumes across the main areas of business are putting a potential strain on the prospective profitability of banks. Looking forward, unless they strengthen further their capital positions, and given lack of restrictions on dividends, banks will have only a limited margin to support the cleaning up of their balance sheets and to provide sufficient credit to productive sectors of the economy.

Adjustment in the housing market

The correction of the Spanish housing market after the burst of the construction bubble has been sharp. Spain witnessed a construction boom prior to the crisis. The share of residential investment exceeded 10 % of GDP each year between 2003 and 2008. In the crisis, it fell from the peak of around 12.5 % in 2006 to 4.1 % in the first half of 2014 (Graph 2.2.5), and is now lower than the average for the euro area. Nominal house prices have decreased by 36 % from the peak in Q3-2007 (Graph 2.2.6).

Graph 2.2.5: **Residential investment as percentage of GDP**

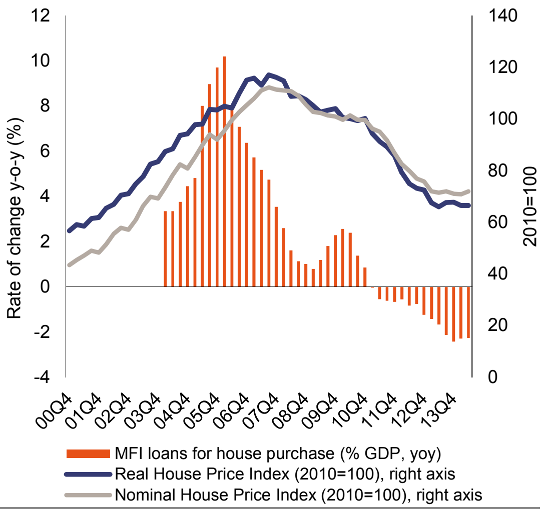


Source: European Commission

Housing prices seem to have reached a trough, but further movements in prices cannot be excluded. While it is difficult to forecast future house price developments, on balance, available studies suggest that the degree of overvaluation is much reduced.([18]) Standard valuation metrics suggest that housing prices might have reached a trough in 2014, registering growth of 0.8 % year-on-year in Q2-2014 and 0.3 % in Q3. However, some long-lasting downward pressure on demand for housing might delay price recovery. Despite the recent drop, Spain still has one of the highest home ownership rates in Europe. According to the Spanish statistical institute INE, the annual increase in the number of households is projected to slow down to around 60 000 in the next 15 years, compared with much higher increases observed prior to the crisis.

([18]) Cuerpo, C. and Pontuch, P., *Spanish housing market: adjustment and implications*, Directorate-General for Economic and Financial Affairs, Country Focus, Vol. 10, Issue 8, December 2013.

Graph 2.2.6: **Evolution of House Price Index and MFI loans for house purchase**



Source: ECB, European Commission

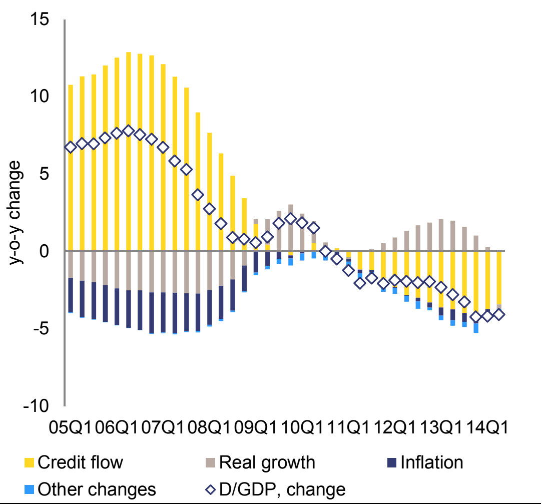
Recent rental market reforms support the adjustment process in the housing market. In 2013 Spain amended its legislation to create a larger and more efficient housing rental market. Law 4/2013 on the promotion of the rental housing market strengthened the legal rights of owners but also provided greater flexibility in ending rental agreements. A more flexible and efficient rental market should facilitate the conversion of vacant units into rental accommodation. Together with the elimination of tax-deductible mortgage payments from the beginning of 2013, in the long term it is expected to reduce the bias towards home ownership and the volatility of house prices.

Drivers of indebtedness and deleveraging in the households sector

Household deleveraging is mainly affected by the stock of mortgage loans. The majority of household loans are long-term (around 96 % of the total stock of loans in household liabilities) and related to housing (over 78 % of the stock), primarily mortgages. The composition of household debt was slightly affected by the crisis, as the stock of short-term loans declined by more than a quarter after the peak in Q2-2008, while long-term loans reached their peak only two years later, and have since declined by 15 %. The decline in long-term loans was more muted despite the prevalence of variable-rate mortgages, which have helped to make low interest rates available to households and thereby contain their interest burden.([19])

Negative credit flows have been the main driver of household deleveraging. Nominal income growth has been less supportive than in other episodes of house price busts, and GDP growth contributed negatively to household deleveraging in 2012-13 (Graph 2.2.7). With the pick-up in the labour market and increasing economic confidence supporting household demand for loans, one can expect that negative net credit flows will play a smaller role in deleveraging from now on. In Q2-2014, household debt still remained on average at least 10 percentage points of GDP higher than in the euro area and should be reduced further to reach equilibrium level.

Graph 2.2.7: **Breakdown of year-on-year changes in debt-to-GDP ratios, households**



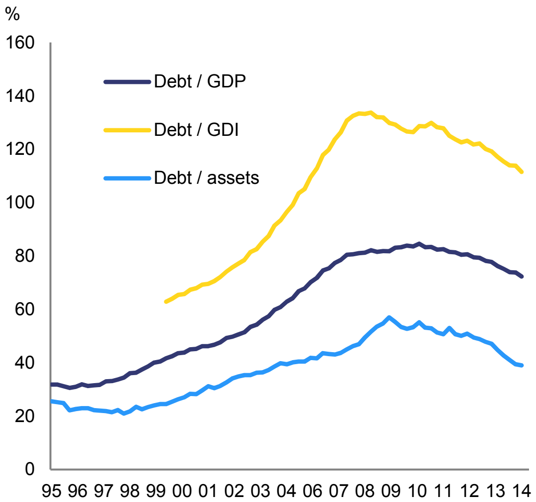
Source: European Commission

Indebted Spanish households are among the most financially fragile in the euro area. Indebted households in Spain have one of the highest debt-to-income ratios in the euro area (at 145.9 %), and are particularly sensitive to an interest rate shock. As adjustable rate loans prevail in Spain, after a hypothetical 300 basis points increase in the interest rate, the median debt-service-to-income ratio of indebted Spanish

([19]) *Housing Recoveries – Cluster Report on Denmark, Ireland, Netherlands, and Spain*, IMF Country Report no. 15/1, January 2015.

households would increase from around 25 % to 30 %, and 36 % of indebted households would face a ratio greater than 0.4. Moreover, a combined interest rate and income shock (a 5 percentage point increase in unemployment rate) would lead to an increase in the proportion of indebted households having a positive probability of default by more than one third, to 9.1 %.([20])

Graph 2.2.8: **Household leverage in Spain**



Source: BdE, European Commission

The decline in household debt-to-assets ratio in 2014 was more pronounced than the decline in debt-to-gross disposable income ratio. Since Q2-2013, the outstanding financial assets of Spanish households have been considerably boosted by favourable developments in financial markets. In Q2-2014, household holdings of equity and investment fund shares were back to the levels last seen in the beginning of 2008. However, as the country remains vulnerable to sudden changes in global investor sentiment, one cannot exclude some fluctuations in the debt-to-assets ratio in the future. Moreover, the debt-to-gross disposable income ratio is much higher than the debt-to-assets ratio. Since its peak, it has improved to a lesser extent given the significant drop in employment and wage restraint during the long recession in Spain (Graph 2.2.8).

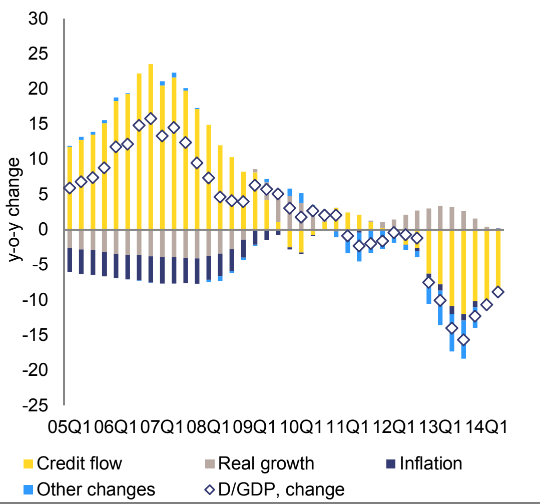
([20]) Ampudia, M., van Vlokhoven, H. and Zochowski D., *Financial fragility of euro area households,* Working Paper Series, No 1737, ECB, October 2014.

The authorities oppose further reforms of the personal insolvency framework following those implemented in 2013, which could already to some extent support household deleveraging. Following the adjustment in house prices after the boom, a significant proportion of households still remain in negative equity. Nevertheless, the rate of non-performing loans on mortgages has until recently remained very subdued, for various reasons including conservative credit standards, lower original loan-to-values ratios, and the environment of low interest rates. Spain does not have a personal insolvency procedure in place that would force creditors to negotiate a settlement agreement or repayment plan with debtors, consumers and entrepreneurs, when they are unable to service their debts. Some improvements have been put in place by the authorities to force creditors to enter into such negotiations, such as the implementation by banks of the 'Code of Good Practice on protection of low-income mortgage borrowers', which has facilitated several agreements (i.e. payment in kind for properties). Spain relies heavily on enforcement procedures (such as the mortgage enforcement procedure) that do not provide the same guarantees and possibilities for debtors as personal insolvency procedures. In 2013 and 2014, the Court of Justice of the EU declared certain Spanish procedural rules incompatible with EU law, as they did not provide sufficient protection for mortgagors against unfair terms in consumer contracts. To address the rulings, the authorities have revised the mortgage legislation. They are of the view that further reforms of the mortgage foreclosure legislation at this time could impair the existing solid payment culture and should take into account the proper functioning of the mortgage market, including mortgage-backed securities and the stability of the banking sector. Despite the recent efforts to improve enforcement procedures, the lack of a personal insolvency framework remains an obstacle for financially responsible individual debtors to receive a fresh start.

Drivers of indebtedness and deleveraging in the non-financial corporations sector

Seen from a macroeconomic perspective, the deleveraging process in Spain has been successful so far. The stock of domestic credit to non-financial corporations (NFCs) declined by more than 35% since the peak in Q1-2009, and total financing to firms (including not only loans, but also their other liabilities) decreased by less than 25%. This is because firms increasingly resort to foreign borrowing and issuing securities. The bulk of deleveraging took place in construction and real estate sectors, which have been responsible for around 75 % of the decline in the stock of domestic credit to non-financial corporations.

Graph 2.2.9: **Breakdown of year-on-year changes in debt-to-GDP ratios, non-financial corporations**



Source: European Commission

Negative credit flows have so far been the main driver of the fall in corporate debt-to-GDP ratio. Net negative credit flows can have significant knock-on effects on economic activity. As in the case of household debt, the reduction of the debt-to-GDP ratio resulting from negative net credit flows was partially offset in 2012 and 2013 by contracting GDP (Graph 2.2.9). With the turnaround in economic activity, real GDP growth started to contribute positively to reducing the relative indebtedness of non-financial corporations. In contrast, inflation under the harmonised index of consumer prices is expected to remain negative in the short term; the GDP deflator will therefore constitute a headwind for corporate deleveraging.

The remaining deleveraging needs in Spain are still high. Despite the fact that Spain has already seen a significant reduction in private indebtedness, private sector deleveraging needs are probably still well in excess of 30 % of GDP, with debt liabilities (loans and debt securities) of Spanish non-financial corporations at least 10 percentage points of GDP higher than the euro area average in Q2-2014. The deleveraging pressures imply that private debt will continue to weigh on economic activity in the years to come.

Table 2.2.1: **Distribution of the stock of corporate debt in Spain, according to the leverage of firms, 2013 (1)**

Debt / EBITDA	< 0.7	0.7 to 0.9	> 0.9
> 12	8.6	6.8	12.8
6 x to 12 x	14.3	14.8	1.2
< 6x	24.8	16.5	0.3
	Debt / Capital employed		

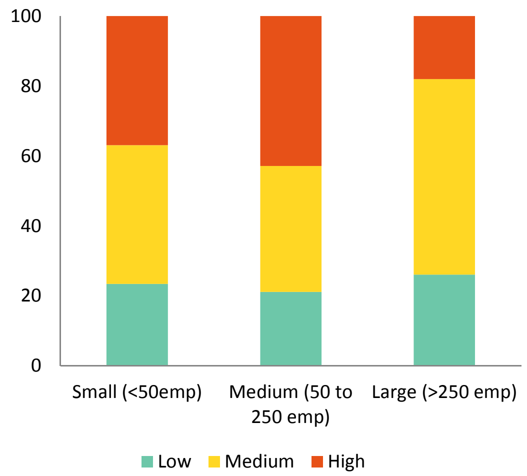
(1) The results on the distribution of corporate debt are based on a firm level dataset from the Bureau Van Dijk's Orbis database. The data refer to the fiscal year 2013, which on the date of the download (December 2014) were available in Orbis for a large majority of firms, but not for all. Subsidiaries of resident companies with consolidated financials were excluded to avoid double-counting. Firms operating in finance and insurance, public administration, health and social services, and education were excluded. Debt is defined as the sum of loans and non-current liabilities. Capital employed is the sum of debt and equity. Earnings before interest, taxes, depreciation and amortisation (EBITDA) are directly taken from the database. The thresholds for debt/capital employed (70% and 90%) and the debt/EBITDA (6x and 12x) are approximately equal to the 75th and 90th percentile across the pooled sample of firms from fifteen EU countries (which include vulnerable and core countries). Reported figures represent the share of debt held by firms in a given solvency bucket, as a percentage of the total amount of debt.
Source: Orbis, European Commission

High debt levels have been exerting downward pressure on demand for domestic loans. Credit supply constraints and the relatively high spread on interest on corporate loans compared with the core euro area have eased in recent quarters, suggesting that negative credit growth in Spain has primarily been reflecting weak demand for loans. When looking at the entire range of financing instruments available to Spanish non-financial corporations, the decline in their total financing is slowing and is lower than the decline in domestic bank financing to non-financial corporations. This is because Spanish firms increasingly resort to foreign borrowing (the total stock of external loans to non-financial corporations increased significantly in the first half of 2014, growing by 11.8 % year-on-year in December 2014), and issuing securities (the stock of securities issued by non-financial corporations was 2.4 % higher than in December 2013).

Despite the recent correction, there are still pockets of highly indebted firms. A significant proportion of non-financial corporations remain highly indebted both with respect to their assets as well as their capacity to repay debt. Analysis of microeconomic distribution of debt suggests that in 2013 almost 30% of the stock of corporate debt in Spain was held by firms for which the ratio of debt to capital employed exceeded 90%, or the ratio of debt to earnings before interest, taxes, depreciation and amortisation (EBITDA) was higher than 12 (Table 2.2.1). Firms which register both a high ratio of debt to EBITDA, or debt to capital employed, face the highest risk of insolvency. The problem of potentially insolvent firms is particularly acute in the construction and real estate sector, but hotels and restaurants or other services are also significantly affected (Graph 2.2.11). Moreover, the debt of SMEs is potentially at higher risk of insolvency than the debt of large firms (Graph 2.2.10). Also, aggregate figures on debt service capacity hide a growing divergence among non-financial corporations, especially SMEs, as a large proportion of firms have earnings before interest, taxes, depreciation and amortisation lower than their interest expense (Graph 2.2.10). Some of the firms had temporary liquidity problems, abating with an improving economic environment in 2013, but others have become insolvent.

Several corporate insolvency reforms have recently been adopted because small firms rarely file for bankruptcy and an excessive proportion of firms entering insolvency end up being liquidated. The number of insolvencies in Spain increased in the wake of the crisis, but is still relatively low. Due to the severity of the crisis, and the fact that Spanish firms usually delay entering insolvency for too long, the firms that ultimately initiate the proceedings are on average in a much more difficult financial situation than their European peers. Spain made some progress in removing the remaining bottlenecks in the corporate insolvency framework. In September 2013, the Entrepreneurship Law (Law 14/2013) established a new type of out-of-court procedure suitable primarily for SME debtors. In March 2014, refinancing agreements, a pre-insolvency procedure suitable for bigger debtors, were also subject to considerable reform (Royal Decree-Law 4/2014, approved by the Spanish Parliament as Law 17/2014). Finally, in September 2014, the government made the proper insolvency procedures more flexible (Royal Decree-Law 11/2014). If the recent reforms are at least partially successful, one should expect not only a higher proportion of insolvent firms avoiding liquidation, but also a higher incidence rate of pre-insolvency and insolvency, as firms will be less reluctant to start the proceedings.

Graph 2.2.10: **Distribution of corporate debt in Spain by firm size, according to the insolvency risk of the firm holding the debt, 2013 (1)**



(1) For the definition of the level of insolvency risk see the table above.
Source: Orbis, European Commission

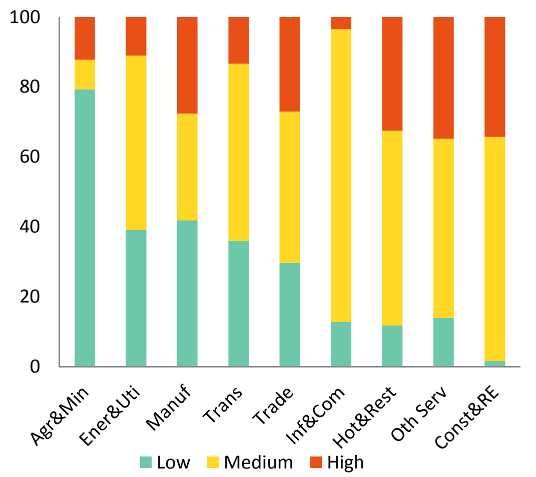
Insolvency reforms should support a restructuring of corporate debt. Debt write-offs and debt-to-equity swaps have been facilitated; however the impact of the reforms on debt restructuring was not visible until June 2014, when the latest data became available. There are concerns whether the out-of-court agreements is fully suitable for smaller debtors, the refinancing agreements fully attractive for debtors and whether the institutional capacity of the insolvency framework is at its maximum. The authorities are nevertheless convinced that, after the September 2014 reform, creditors have greater incentives to reach agreements in the pre-insolvency phase.

The overall deleveraging of the private sector is accompanied by an ongoing reallocation of financial resources. Despite the strong decline in the bank financing of the private sector in recent years, a significant proportion of Spanish firms did not reduce their bank financing during the crisis. Between 2004 and 2007, more than half of firms were increasing or keeping stable their bank financing. In 2012 and 2013, this proportion fell below 40 %, and even to lower levels in energy, construction and real estate, the sectors that had experienced investment bubbles. The differences between sectors point towards an ongoing reallocation of financial resources in the economy.([21]) In line with the incipient economic recovery, the proportion of SMEs increasing or keeping stable their financing increased slightly in 2013. The 2013 results for large firms are not as clear cut, but need to be treated with caution, as those firms have better access to alternative sources of financing, such as bonds, equities, or foreign loans.

Most SMEs still face onerous financing conditions despite the improving availability of bank financing and progress in completing the ongoing measures to widen the access to finance for firms. A fragmented corporate structure of the Spanish economy has been exacerbating problems with bank financing during the crisis, as SMEs are more affected by cyclical funding conditions, and — due to their limited transparency — they have problems in tapping capital markets directly. This situation is aggravated by long delays in receiving payments, particularly from the public sector. While the availability of equity and mezzanine financing remains limited, new measures have been taken to foster venture capital and the credit lines of Spain's development bank (ICO) have also been strengthened. Currently, a draft law to further facilitate the financing of businesses is being discussed in the Spanish Parliament.

([21]) Martínez, C., Menéndez, A. and Mulino, M., *A disaggregated analysis of recent developments in lending to corporations*, Economic Bulletin, Banco de España, June 2014.

Graph 2.2.11: **Distribution of corporate debt in Spain by sector, according to the insolvency risk of the firm holding the debt, 2013 (1)**

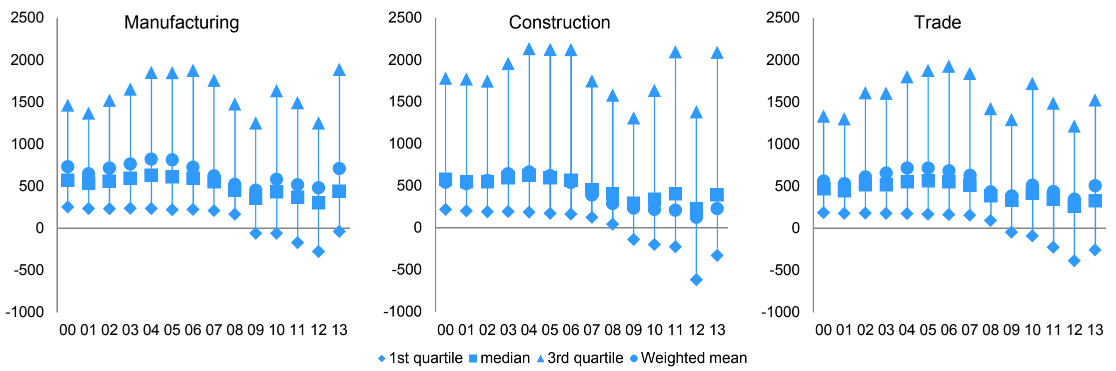


(1) For the definition of the level of insolvency risk see the table above.
Source: Orbis, European Commission

The debt bias in corporate taxation has been partially reduced. In 2014, the gap between the effective marginal tax rate on investment financed with retained earnings and that financed with debt remained wide. The general reduction in the corporate income tax rate approved in 2014 will diminish the level of the debt bias, and will be supported by some additional measures that have been adopted since 2012. On one hand, the corporate income tax reform maintained the general limitation to deduct financial expenses at 30 % of the earnings before interest, taxes, depreciation and amortisation (EBITDA), though EUR 1 million is deductible without limits. On the other hand, to support equity financing, in a given year the tax base will be reduced by an amount equal to 10 % of the equity increases other than partner contributions to the company's capital. It is difficult to ascertain at this stage whether the measures adopted since 2012 might have contributed to the ongoing deleveraging in the corporate sector. Depending on the progress in deleveraging, further efforts to reform the tax system may be required.

Going forward, one can expect economic growth to be a major driver of the reduction of debt-to-GDP ratio, but negative net credit flows will still contribute to deleveraging for some time. Deleveraging by the private sector has

Graph 2.2.12: **EBITDA over interest on financial debt, Spanish SMEs**



Source: BACH-ESD

advanced further, but is far from complete. Counting from the peak of the debt-to-GDP ratio in 2010, the fall in GDP has constituted a negative contribution to deleveraging, while the inflation contribution has been positive, but almost negligible. Due to deflationary pressures in the short to medium term, inflation will slow down the process. Provided that Spain maintains economic momentum, GDP growth should contribute more to a gradual deleveraging. In the medium term it is possible to reconcile net negative credit flows with growth in new lending, as long as credit repayments consistently exceed new credit activity.

Effective structural reforms would accelerate adjustment. The deleveraging process will continue to constrain growth in Spain. In this context, the overall assessment of recent structural reforms to promote growth and competitiveness is positive. By facilitating debt restructuring, the reformed corporate insolvency framework has created an opportunity for accelerated deleveraging, even if recent reforms will play mainly a temporary role as a driver of deleveraging. Given the high dependence of Spanish firms on bank credit, recent measures to promote access to non-bank financing have — at least partially — improved access to finance for firms. Full implementation of these reforms and tackling their remaining shortcomings are crucial for facilitating the reallocation of resources and supporting the ongoing adjustment.

Public sector debt

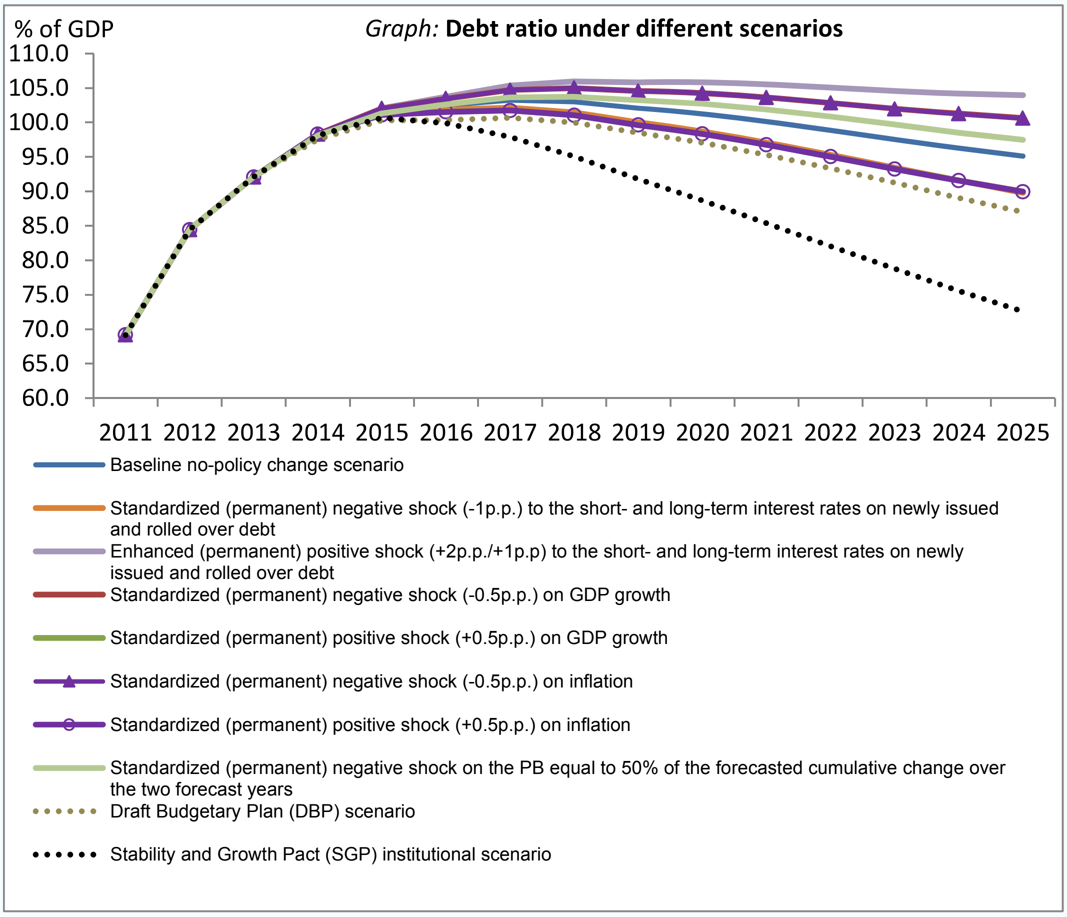
Public debt dynamics were significantly affected by the economic and financial crisis. The outbreak of the crisis reversed the trend of declining general government debt in Spain. The collapse of tax bases, surging unemployment and the fiscal stimulus in the early years of the crisis caused large general government deficits and a rapid debt increase, also spurred by the bank recapitalisations and contributions to the EU and euro area financial assistance institutions. Public debt increased from 35.5 % of GDP in 2007 to 92.1 % of GDP in 2013, and — under a no-policy change assumption — it is expected to reach a peak of 103.2 % of GDP in 2017.

Further fiscal consolidation will be needed in the medium term to bring down government debt. In 2014, inflation had a negative effect on public sector deleveraging. The negative effect of interest expenditure on the evolution of public debt-to-GDP ratio is projected to be on average offset from 2015 onwards by the positive impact of GDP growth and inflation. Under the no-policy change assumption, Spain is projected to register a primary general government surplus as from 2018, the year when the public debt-to-GDP ratio should start its slow decline. Without further consolidation measures, the debt would still be at 95.1 % of GDP in 2025 (Box 2.2.1).

Box 2.2.1: Long-term projections of general government debt

The public debt trajectory has been simulated under alternative scenarios. The baseline scenario has been derived from the Commission's winter 2015 economic forecast, where short and long-term interest rates have been set to be consistent with the forecast implicit interest rate, the shares of short-term and long-term public debt, and data on maturing debt.

This baseline scenario has a number of technical assumptions. First, the structural primary balance is set constant at the value of 2016 beyond the forecast horizon. The cyclical component of the primary balance is calculated using (country-specific) budget balance sensitivities to the cycle over the period until output gap closure is assumed (2019). Second, the long-term interest rate on new and rolled-over debt is assumed to be 3 % in real terms by the end of the projection horizon (2025), while the short-term interest rate reaches an end-of-projection value that is consistent with the 3 % long-term interest rate and the value of the euro area yield curve. Third, the inflation rate of the GDP deflator is assumed to change linearly until it reaches 2 % in 2019 and remain constant thereafter. Fourth, a short-run temporary feedback effect on GDP growth is introduced in the consolidation scenario (a 1 percentage point of GDP consolidation effort impacts negatively on baseline GDP growth by 0.5 percentage points in the same year). Fifth, the stock-flow adjustment is set to zero after 2016. Medium-term growth projections are based on the T+10 methodology agreed with the Economic Policy Committee and is assumed to average 1.3 % between 2013 and 2020 and to increase to 1.7 % on average between 2020 and 2025.



(Continued on the next page)

Box (continued)

Sensitivity tests around the baseline are performed:

(i) a standardised (permanent) negative shock (-1 pp.) to the short and long-term interest rates on newly issued and rolled-over debt;

(ii) an enhanced (permanent) positive shock (+2 pps./+1 pp.) to the short- and long-term interest rates on newly issued and rolled over debt;

(iii) a standardised (permanent) negative shock (-0.5 pps.) on GDP growth;

(iv) a standardised (permanent) positive shock (+0.5 pps.) on GDP growth;

(v) a standardised (permanent) negative shock (-0.5 pps.) on inflation;

(vi) a standardised (permanent) positive shock (+0.5 pps.) on inflation; and

(vii) a standardised (permanent) negative shock on the PB equal to 50% of the forecast cumulative change over the two forecast years.

The simulations show that general government debt is likely to peak and then gradually decline in the medium term. The debt ratio would be on an increasing path in the baseline scenario until 2017 and then decline thereafter to about 95 % of GDP in 2025. Favourable assumptions on interest rates and growth would lead the debt ratio to peak at a slightly lower value and then to decline to a level close to 90 % of GDP by the end of the projection horizon. By contrast, under unfavourable assumptions on interest rates or inflation, debt would peak a year later and not fall below 100% of GDP by the end of the projection horizon.

The 'Stability and Growth Pact (SGP) institutional scenario' in the graph assumes that adjustments to the structural primary balance are set in compliance with the fiscal efforts recommended by the Council (which imply improvements in the structural primary balance by 0.8 % and 1.2 % of GDP in 2015 and 2016 respectively) until the excessive deficit is corrected, and thereafter an additional structural consolidation effort is maintained (+0.6 percentage points of GDP) until the medium-term objective is reached. Under this scenario, the debt ratio would start decreasing steeply after 2015 to reach 74 % of GDP in 2025.

The 2013 pension reform will help to contain long-term pressure on expenditure. Pension and healthcare expenditure have an important impact on long-term public debt dynamics. The 2013 pension reform revised the indexation of pensions and introduced, as from 2019, the so-called sustainability factor, which will be an automatic adjustment of future retirees' new pensions to take account of changes in life expectancy. In December 2014, based on the new law, the government adopted a nominal indexation of pensions of 0.25 % for 2015. In the first half of 2015, the Commission and the Economic Policy Committee's Working Group on Ageing Populations and Sustainability will publish an updated version of long-term pension and healthcare expenditure projections, based on the latest demographic and economic assumptions.

Spain has increased cost-effectiveness of the healthcare sector, but challenges remain. The most recent reforms build on a comprehensive framework that has been developed since 2012 to increase the efficiency of healthcare expenditure. The reforms include further rationalisation of public procurement policy and institutional administration, and clearing public arrears. The measures implemented since 2012 have already helped to reduce expenditure and to increase cost-effectiveness, but the pace of budgetary adjustment has moderated in 2014. Moreover, pharmaceutical spending started to grow again, and might rise even further due to the the introduction of some innovative medicines. In the area of long-term care, Spain is one the countries with a higher proportion of informal carers but, at the same time, the implementation of the *Ley de Dependencia* has led to a large increase in coverage and expenditure over the last few years. Extending the formal sector may have benefits for the quality of care and the labour participation and protection of carers. However, the regional financing system does not foster the responsibility and efficiency of public provisions, and as institutional care is considerably more expensive than home care, strategies to formalise care and to improve the quality of home and community-based services can have a significant budgetary impact.

As regards further improvements in the efficiency of health-care, there seem to be consensus about the following measures: promoting prevention; clinical management and career development of healthcare personnel, including incentives for mobility throughout the entire national health system; e-health solutions; integrated clinical approaches to chronic conditions; integration of primary, specialised, long-term health and social care; and health technology assessment to promote effective medical interventions and prevent the use of those that are less effective or unnecessary. Regarding access to healthcare for vulnerable groups, according to a recent report of the national Ombudsmen, a progressive increase in waiting lists has been observed as well as irregular access for undocumented migrants. The government introduced an insurance scheme for those not covered under the healthcare system; a few hundred such insurance contracts have been signed to date.

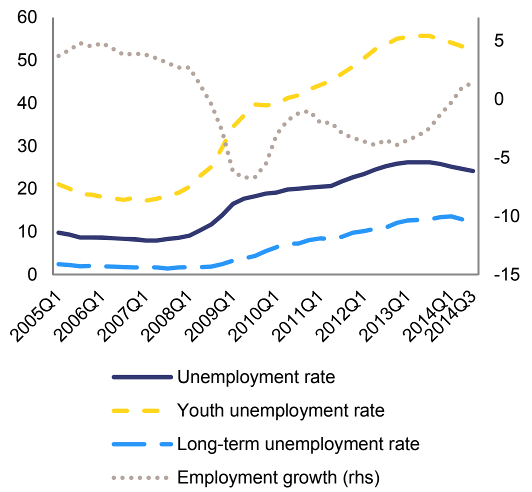
Managing the growing public debt is a significant challenge for the Spanish economy. Continued reduction in sovereign spreads observed since 2012 gave the government a possibility to partially refinance public debt at a lower cost, thereby containing the interest burden. Nevertheless, growing levels of public debt make the country more vulnerable to sudden changes in global investor sentiment. Public debt is still increasing and bringing it back to the neighbourhood of 60 % of GDP will require a protracted and sizeable fiscal effort. Without further progress on fiscal consolidation, there is a risk of potential future market sell-offs. Given the high degree of decentralisation in Spain, a combined effort by all levels of administration will be important for the success of fiscal consolidation. The risks linked to the overall indebtedness of the economy have not evolved and still require decisive policy action.

2.3. LABOUR MARKET

Labour market conditions are improving, supported by economic activity gaining steam and moderate wage developments, but unemployment remains very high. (Graph 2.3.1) Labour Force Survey data for Q4-2014 report an increase in employment (56.8 %) and activity (74.5 %) rates. After having grown unabated since 2008, the increase in unemployment came to a halt in 2013 and reductions in joblessness have occurred since then, even despite a moderate GDP growth (Graph 2.3.1). At the end of 2014, unemployment remained at 23.7 %, about 2 percentage points (or 477 900 unemployed people less) below the all-time peak of one year earlier. However, with 5 457 700 jobless, unemployment remains very high. The fall of unemployment - mainly linked to falling separation and slightly improving job finding rates - was matched by an increase in employment as from the beginning of 2014. After a cumulative decline of about 18 % during the 2008-2013 period, by the end of 2014, overall employment had increased by 2.5 % over the previous 12 months, supported in part by ongoing wage moderation.

Activity rates are improving, in response to a reversal of migration flows, discouragement effects, and the fact that young adults are staying in the education system longer (Graph 2.3.2)**.** Since the onset of the crisis, the evolution of the activity rate has been particularly favourable for prime age (25-54) workers, especially second earners (a so-called, added worker effect). However, developments in the aggregate activity rate also need to be seen alongside the evolution of the working age population (the denominator of the activity rate), which has been shrinking during the crisis, mostly due to a reversal in net migration flows. The worsening labour market conditions after 2008 also triggered a noticeable withdrawal of discouraged workers from the labour force, notably young adults.

Graph 2.3.1: **Employment and unemployment evolution**



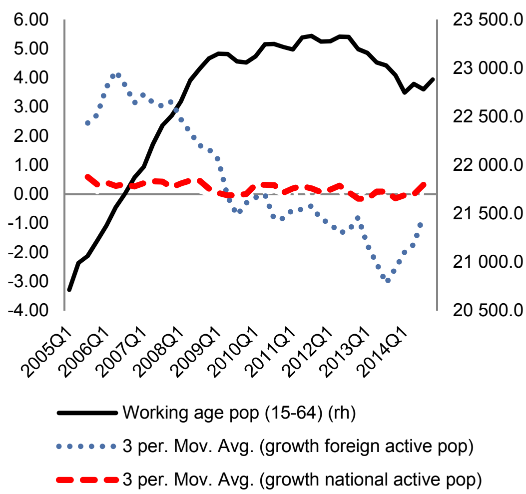
Source: European Commission

Employment gains in manufacturing and some service sectors are supporting the reallocation of labour towards tradable sectors. Job creation in 2014 was mainly driven by industry (4.2 %) and services (2.7 %), and the construction sector also witnessed its first job gains since the start of the crisis (4 %). In contrast, job losses continue to be recorded in agriculture (-6.3 %). Overall in 2014, there was a net increase of 415 700 posts in the private sector, and a net increase of 18 100 posts in the public sector. The reallocation of labour towards the sectors producing exportable goods and services is part of the adjustment necessary to guarantee the sustainability of the current account and the net international investment position in the medium-term. However, this process is still marked by cross-regional differences, particularly occupational, skills and geographical mismatches.

Notwithstanding the incipient labour market recovery, youth and long-term unemployment remain the most urgent challenges. Youth unemployment is decreasing slightly, but remains the highest in the EU (51.8 % in Q4-2014), particularly for the age group 20-24 (48.9 %). The duration of the crisis has exacerbated the long-term unemployment rate, which extends to 12.9 % of the active population; over half of the unemployed have been jobless for more than one year. The very long-term unemployed (2 years or more) have reached about 2.4 million, and represent more than 35 % of the total number of unemployed (Graph

2.3.3). Low job-finding rates and skills obsolescence may contribute to explaining the duration of joblessness, particularly among older unemployed (aged over 50), whose share of long-term unemployment is already 15 percentage points higher than the overall rate, and continues to increase rapidly.

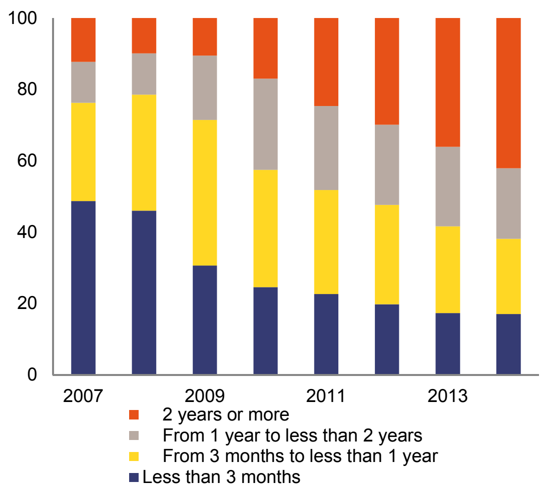
Graph 2.3.2: **Activity rates**



Source: European Commission

The persistence of long-term unemployment contributed to the worsening of poverty indicators, particularly among the low-skilled, those with no previous working experience and the older population. The surge of long-term unemployment in Spain has had a direct impact on poverty or social exclusion, also as a consequence of the increasing number of unemployed individuals exhausting their benefits entitlements. Indeed, long-term unemployment appears to be the most significant driver of severe material deprivation and anchored at-risk-of-poverty rates, along with income per capita. The persistence of unfavourable labour market conditions significantly increased the number of people on low income after benefits - by more than 642 000 over pre-crisis years. The numbers of people living in jobless households have more than doubled in proportion, reaching 15.7 % in 2013. These trends have led to poverty rises among the working age population, which is affecting more than 6.1 million people (20.4 %) in 2013.

Graph 2.3.3: **Unemployment by duration**

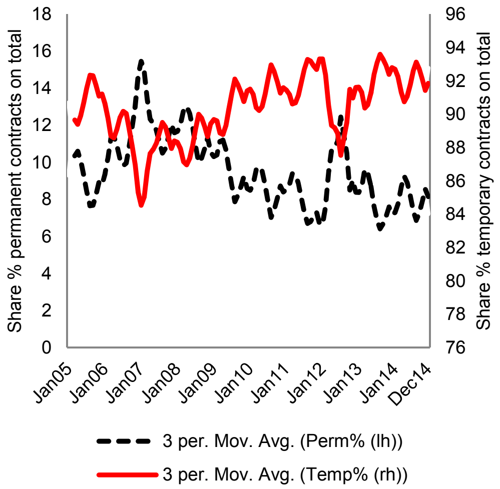


Source: European Commission

Drivers of labour market performance

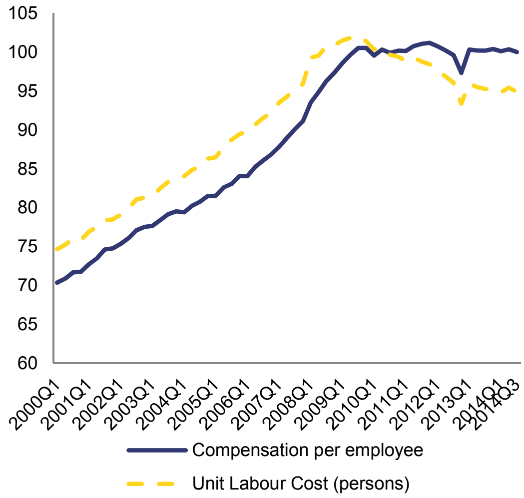
High levels of labour market segmentation – comprising permanent employees against temporary - continue to hold back Spain, in part due to the persistent macroeconomic uncertainty. After the massive disappearance of temporary contracts since 2008, the share of temporary employment started to increase once again in 2014, reaching 24.6 %, despite the recent regulatory reform. Labour market segmentation remains thus a feature of the Spanish labour market, with greater incidence on some groups of workers, namely the young and low-skilled, and possible negative repercussions on productivity and working conditions. Although new permanent employment has witnessed an encouraging increase of 19 % over the previous year in 2014, of the over 16.7 million new contracts signed during 2014, the majority (91.9 %) are fixed-term (Graph 2.3.4). The high share of new temporary contracts may be influenced by the broad economic uncertainty and the productive structure of the country, as it is reflected by the fact that over half of temporary contracts are shorter than three months. Moreover, the use of new contractual forms and incentives to favour open-ended hiring seems to be faced with administrative barriers for the employers. In this respect, the envisaged streamlining of hiring subsidies may have a positive impact by increasing transparency and reducing information costs for the employers.

Graph 2.3.4: **Open-ended and fixed-term contracts**



Source: National Public Employment Service

Graph 2.3.5: **Wages and unit labour costs**



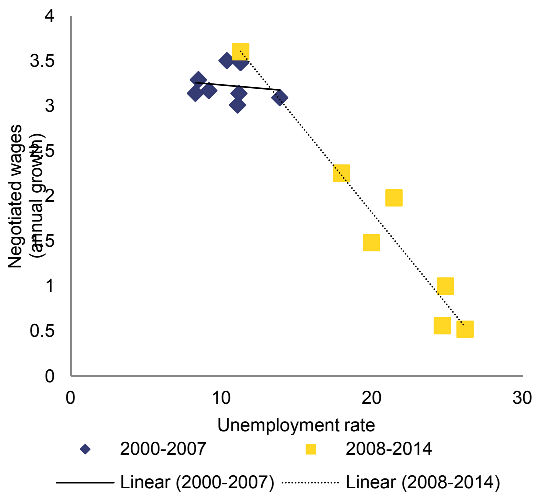
Source: European Commission

Part-time employment has broadened its presence in the Spanish labour market, but remains below the EU average. At the end of 2014, part-time reached 16.1 % of overall employment (EU average: 19.3 %). About half of all new open-ended contracts were part-time, partly reflecting the use of new tools put in place at the end of 2013 to promote stable, part-time employment. Part-time contracts tend to be more present among low-skilled workers (41 % of total part-time workers) and women, and are predominantly concentrated in the services sector, where part-time represents 17.4 % of the total sectoral employment. Besides its potential for job creation, the spread of part-time work – which seems largely not to be by choice - ([22]) is also accompanied by a higher risk of in-work poverty.

([22]) 66.23 % of part-time workers declared to be involuntary in 2013. OECD Statistics.

Nominal wages have responded to the protracted slack in the labour market and contributed to supporting job creation. In 2014, wage in nominal terms remained subdued, declining in the first three quarters of the year at an average of 0.1 % with respect to the same period of one year earlier. The downward adjustment of unit labour costs also continued in 2014 as a result of the weak dynamics of wages and improvements in productivity, thereby contributing to the absorption of external imbalances (Graph 2.3.5). The 2012 reform and the inter-confederal social partners' agreement of 2012-14 contributed to these moderate wage developments. The agreed wage increase for 2014, calculated provisionally with the information available on the collective agreements registered up to November 2014, now stands at 0.57 % (0.43 % for firm-level agreements-covering 319 186 workers- and 0.58 % for higher-level agreements – covering 4 098 945 workers). Derogations from collective agreements, mostly on wages and working hours, have increasingly been used as a way of adapting to the conditions of the company and avoiding redundancies.

Graph 2.3.6: **Negotiated wages**

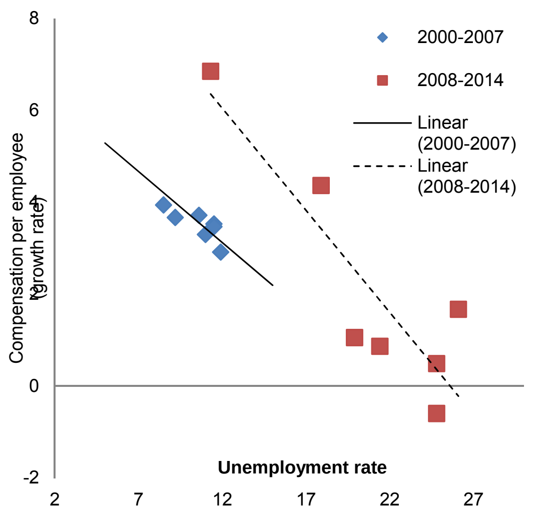


Source: Ministry of Labour and Social Security

Reforms of the wage bargaining system have contributed to the responsiveness of wages to unemployment conditions. Graphs 2.3.6 and 2.3.7 depict Phillips curves, relating the unemployment rate to the growth of negotiated and actual wages, respectively. Before the crisis negotiated wages were quite insensitive to changes in the degree of economic slack. The wage response was driven mainly by a negative wage drift (i.e. a compression of the variable components of wages). The same adjustment was achieved during the crisis years, but the Phillips curve flattened in the more recent years at low levels of inflation. Such flattening suggests that wage growth falls at a declining rate as unemployment increases. This could reflect an increase in structural unemployment, so that high unemployment does not correspond to a more intense competition for vacancies among suitable workers and to more moderate wage claims. However, some fraction of the unemployment is likely to be cyclical, even with higher structural unemployment. This is corroborated by the stronger response of negotiated wages to unemployment in the period 2009-2014, which was spurred not only by a market-driven adjustment related to the sheer size of the unemployment shock, but also by wage bargaining policy as a result of the 2010 and 2012 labour market reforms.

While wage agreements have been supportive of job creation, the persistence of inter-firm productivity differentials in the context of low inflation may be a challenge for further positive developments in 2015. The social partners are discussing a new 'Agreement for Employment and Collective Bargaining' for 2015-2017, which is expected to replace the one in force, which expired in 2014. The increase of salaries is on the discussion table as evidence of productivity gains by companies could give rise to differentiated wage increases to promote employment. The difficulty of achieving market wage-driven adjustments in a low inflation environment highlights the importance of wage developments consistent with the objective of promoting employment. In the meanwhile, the Supreme Court has challenged the one-year validity limit of expired collective agreements (so called *ultra-actividad*) by ruling that agreed wage conditions remain valid for incumbents. It remains to be seen how the social partners will follow up on this decision.

Graph 2.3.7: **Compensation per employee**



Source: European Commission

The labour market is also characterised by a mismatch of labour demand and supply – both from a skills and a geographical perspective. Mismatches between labour demand and supply are amplified by the adjustment process. Underemployment has been fuelled in recent years([23]) by the weak employment demand, and now stands at 7.2 % of the labour force (the second highest in EU28). Four years after graduation, about half of young graduates work in occupations that do not require their level of qualification, evidencing a serious problem of skills mismatch, particularly in branches such as social sciences.([24]) The progressive reform of the higher education system may help to counterbalance this problem (see chapter 3.2). There is also a high degree of cross-regional differences in the incidence of job mismatches in Spain. The process of labour reallocation from downsized sectors to tradable sectors would be accelerated by, among others, appropriate developments in labour costs, enhanced mobility of workers both across sectors and geographically, and enhancing skill-match.([25])

Policy response and medium-term prospects

The 2012 labour market reform has contributed to the incipient employment recovery, but reductions of unemployment and of the two-tier labour market remain pressing challenges. A two-tier labour market (by imposing lower incentives to invest in human capital and skills and concentrating the most of hiring and firings on fixed-term contracts) continues to negatively affect productivity growth and medium growth potential.([26]) The 2012 reform aimed at favouring open-ended contracts, for example by reducing the gap in severance costs vis-à-vis fixed-term contracts, and subsidising social contributions for open-ended contracts. As discussed above, open-ended contracts have slightly increased, but temporary contracts still account for over 90 % of the new recruitments. The use of the 2012 open-ended contract for support to entrepreneurs (*SME contract*) diminished slightly to 11.6 % of the total open-ended contracts in 2014. Moreover, there is no clear, recent evidence about the survival rates of jobs formalised with the SME contracts after the one-year probation period, the legal conformity of which to the EU Charter of Social Rights has recently been challenged.([27])

The current system of hiring incentives still presents some efficiency barriers impeding the promotion of stable employment. Spain has traditionally relied on an extensive set of incentives to stimulate new recruitments and the conversion of temporary contracts into open-ended contracts. The system was streamlined in 2012, but the structure of incentives applying to different contractual forms remains very complex and increases the administrative burden for employers; and their actual effectiveness has not been proved in all cases. To ease the use of hiring incentives, the existing work contracts have been divided into 4 types (open-ended; fixed-term; training and apprenticeship; and traineeship contract), with various contractual options remaining unchanged. This is a step in the right direction; yet, this change has not been accompanied by further rationalisation of existing hiring incentives. Moreover, in 2014, a new incentive was introduced consisting of an employer's EUR 100 flat contribution (the so- called *tarifa plana*) applying to each new open-ended contract signed until March 2015. (Box 2.3.1)

([23]) According to Dolado et al, 2013, Spain ranks has one of the countries with the highest degree of qualification mismatch in the EU, showing also great variations in the share of over-qualified and non-employed university graduates over the business cycle.

([24]) *National report on employment rate of university graduates*, 2014. Against an average share of 44.5% among the total graduates, 55.3 % of graduates in social sciences and law have jobs not requiring a university degree (23.4 % requiring medium level education, 31.9 % have jobs requiring low level education or manual abilities).

([25]) Orsini, K. and Vila, S., *The impact of the Spanish labour market reform on the on-the-job search rate*, ECFIN Country Focus, Issue 11, Volume 7, European Commission, 2014.

([26]) Cabrales, A. et al., Dual Labour Markets and (Lack of) on-the job training: PIAAC Evidence from Spain and other EU Countries, IZA Discussion paper 8649, November 2014.

([27]) The resolution of the Constitutional Court 119/2014 of 16 July confirmed the constitutional conformity of the major parts of the Law 3/2012 (Labour Market reform), but there were three votes disagreeing on the constitutionality of the 12-month probation period of the SME contract on the grounds of its disproportionality. On 27 November 2014 the Juzgado de lo Social no. 1 of Toledo, stated that the one-year trial period is not in line with the EU charter on Social Rights, or the national law, as it is estimated to be too long for some types of professions. The impact of this Court resolution on the application of the SME contract is still to be evaluated by the national authorities once the full argumentation is made available.

Box 2.3.1: The tax reform and its impact on the tax wedge

In November 2014, the Spanish parliament adopted a tax reform, with a focus on personal income taxation and corporate income taxation. The personal income taxation reform includes a widening of the amount of income exempted from tax, which will go up to EUR 12 000, and a lowering of rates. The number of tax brackets is lowered from 7 to 5 and many taxpayers, especially at the lower end of the scale, will benefit from a lower average tax rate (See Graph 3.1.1. in chapter 3.1., on fiscal framework and taxation). The government estimates that the average tax cut will amount to 12.5 % and that 20 million taxpayers will enjoy higher disposable income as a result of the reform.

In due course, the tax cut is expected to lead to higher employment. The fact that the tax cut is focused on low-income earners makes it likely to have a bigger impact on employment than a more evenly distributed tax cut would have had, as labour demand elasticity are higher for low-skilled workers and elasticity of labour supply tend to be lower amongst low-income households (in the majority composed of low skilled workers). (1) When fully implemented in 2016, the cuts in personal income tax are expected to have a total impact of about EUR 4.5 billion on government revenues (about 0.4 % of GDP).

The temporary and non-targeted nature of recently introduced social security contribution rebates may reduce or retard their impact on employment creation. This is because nominal wages tend to adjust more slowly downwards as a result of nominal rigidities. Recently, the government extended by three months the temporary flat rate of EUR 100 in the employer's contribution to social security for new permanent contracts, a measure that was introduced in February 2014 and originally due to expire at the end of that year. New indefinite contracts, and temporary contracts converted into indefinite contracts are eligible, and it applies to all firms (regardless of their size), (2) all workers (irrespective of age) and all types of indefinite contracts (full time and part-time). The flat rate applies for two years, provided the hiring is maintained for three years (otherwise, the amounts saved by the company will be recovered, totally or partially). The measure, which does not affect the benefits to which workers are entitled, does not form part of the tax reform as such, but is introduced more or less in parallel with the latter. By the end of December 2014, about a quarter of all new indefinite contracts signed since the introduction of the measure, or 177 731 contracts, had benefited from the flat rate. Being a flat rate, its magnitude rises with income, which could make it a relatively expensive way to promote employment for the reasons outlined above. (3) The government expects a positive impact of 0.3 % on both GDP and employment in the first year, and projects that the measure will be budgetary neutral.

(1) See NIESR Discussion Paper No. 404, January 2013: http://niesr.ac.uk/publications/modelling-demand-low-skilledlow-paid-labour-exploring-employment-trade-offs-living-wage
(2) Micro firms may benefit from an additional reduction of 50 % of the standard social security contribution once the application of the flat rate has expired.
(3) See European Commission Country Focus, February 2014: http://ec.europa.eu/economy_finance/publications/country_focus/2014/cf-vol11_5_en.htm

Spain has strengthened the strategic orientation of activation policies and their link with income support, but training and re-skilling could make a bigger contribution to reducing the large share of long-term unemployment. The 2014-16 Spanish Strategy for Activation and Employment sets new short-term and long-term objectives, while consolidating the result-oriented allocation of public resources distributed to the Autonomous Communities (60 % of total funds in 2015). However, the 2014 Annual Employment Plan (PAPE) – which is to set annual objectives-prioritises hiring incentives it its expenditure on active labour market policies, accounting for over one third of the total resources allocated for 2014. In the 2015 Budget, hiring incentives and rebates in Social Security contributions make up for 44 % of the total budget allocated to promoting insertion and employment stability. Following the tripartite agreement signed in July 2014, a new activation programme for employment for the long-term unemployed was adopted.[28] The programme targets the long-term unemployed who have exhausted unemployment benefits and who are no longer covered by the other support programmes (PREPARA, PRODI or the active insertion income). It combines a financial support of EUR 426 during six months with an individualised pathway for labour integration and it will cover around 400 000 people, at a cost of about EUR 1 million. Beneficiaries will be assigned an individual tutor for individual assistance to activation. The commitment for activation of this programme is greater than in other policy measures addressed to the long-term unemployed as these will have to accept an adequate offer of employment made by the Public Employment Service. Moreover, it will be possible to combine the financial support with work, yet only up to a maximum of 5 months. While the precise targeting of the measure at the long-term unemployed goes in the right direction, the effectiveness of the linkages with activation measures strictly depends on the actual administrative capacity of national and regional employment services to design and offer integrated pathways to the beneficiaries.

In the medium term, implementation of the reforms tackling shortcomings in Spain's education systems will be also important. Early school-leaving remains very high (see section 3.2) and Spain is still far from converging with the EU as regards the population with higher secondary education, mainly vocational education and training. In the long term, skill mismatches can only be fully addressed by reforms in the education and training systems, and flanking labour market measures. The ongoing reform of the vocational education and training system (including the development of a dual vocational training system) and the reform of the higher education system have a key role to play in this regard (see also chapter 3.2).

[28] Royal Decree Law 16/2014 of 19 December.

3. OTHER STRUCTURAL ISSUES

3.1. FISCAL FRAMEWORK AND TAXATION

Fiscal framework

Spain's independent fiscal authority (AIReF) is now operational. Its legal framework is virtually complete. AIReF's recruitment of staff, other than its managing board – i.e., president and three directors – took place during the summer of 2014, eight months after its establishment. However, this has not prevented the authority from publishing various reports and opinions, including on the macroeconomic and budgetary forecasts for 2015. Recommendations given by AIReF in its reports and opinions are not legally binding on addressees. However, if the addressee of an AIReF report decides to ignore its advice, it must explain why. Nevertheless, the effectiveness of AIReF's recommendations is weakened by the lack of an explicit legal obligation on the addressee to publish such explanations, as recommended by the common principles on national fiscal correction mechanisms.

The implementation of the budget stability law at regional level was softer than in 2013. Despite visible deterioration in regional public finances throughout 2014, none of the preventive measures set out in Spain's Budgetary Stability Organic Law were enforced on regions at risk of non-compliance. This was in spite of Spain's independent fiscal institution (AIReF) recommending to the central government the activation of such measures in early December 2014. In addition, compared with 2013, the adoption of corrective measures was slow, with the majority of the economic and financial plans only approved at the end of 2014. Admittedly, the Budgetary Stability Law sets out a two-year period – i.e., the current and subsequent year – to achieve compliance with the targets, and earmarked revenues to regional governments under the current financing system have increased in 2015. However, any deviation in the budget outcome will carry over on to 2015, thus making it difficult for regional governments to comply with a demanding deficit target of 0.7 % of GDP. Against this backdrop, in December 2014 the central government adopted measures to improve financing conditions for sub-central governments.([29]) These measures will help regional governments reach their 2015 deficit targets, but they risk weakening fiscal discipline and creating moral hazard on them.

The enforcement of Spain's legal provisions on late payments has started with the publication of comparable data on public sector commercial arrears. Late payments have detrimental effects on the business environment, by exacerbating the burden of already financially-constrained firms which can ultimately push them out of business.([30]) To that end, throughout 2012-2014 Spain's central government implemented a scheme to repay regions and local entities' commercial arrears (i.e., the suppliers' payment scheme). An additional scheme (the regional liquidity fund), still in place, was set up to help regions' meet their public deficit financing needs. Spain's stability law was also amended in December 2013 so that all general government subsectors comply with the 30-day average payment rule for commercial transactions set out by Directive 2011/7/EU, in force since March 2013.([31]) The amendments, whose implementation is currently being evaluated by the Commission services, mandate all administrative bodies to publish regularly on their website their average payment period and set out a procedure to monitor compliance by the Ministry of Finance. The first data for average payment periods calculated according to a standard methodology and covering all general government sub-sectors was published in October 2014. This publication triggered the launch of the procedure to ensure compliance with the above-mentioned legal obligation, albeit more than ten months after the entry into force of the law. According to the latest published data referred to November 2014, Spain's social security administration boasts the lowest average payment period of all general government subsectors, followed by the central government. Local entities have on average shorter payment periods than regions, although both of them are well above the 30 day limit. Other private sector institutions publish data measuring the length of public sector payments.([32]) Discrepancies

([29]) Royal Decree Law 17/2014, to ease liquidity to regional governments.

([30]) European Economy, *The economic impact of late payments*. Economic papers 531. September 2014.

([31]) Directive 2011/7/EU of of 16 February 2011 on combating late payment in commercial transactions.

([32]) These include i) CEPYME (Spanish SMEs business organisation) via a late payment report carried out with the collaboration of the Spanish Ministry of Industry; ii) ATA (self-employed association); iii) Plataforma multi sectorial contra la morosidad (confederation of business with official data are due to methodological issues, namely the fact that official figures report average payment delays in excess of the 30 day legal limit. Complying with the 30-day average payment rule remains a challenge, in particular, at sub-central government level.

The government set up in June 2014 a taskforce looking into expenditure reduction in Spain's regions. The working group has looked into ways to further rationalise spending in areas such as healthcare, education, social spending and public administration. To be effective, measures have to be agreed at the meeting of the Financial and Fiscal Policy Council (a forum gathering representatives from the regions and central government's finance departments), and then be legislated. At the time of writing, measures had been identified but these have not been published and no agreement has been reached at the Financial and Fiscal Policy Council on their adoption.

Despite improvements, several features in the region's budget process fall behind best practice. Transparency of budget execution has increased considerably in Spain. This follows the publication of more systematic and higher-frequency regional and local government budgetary data, both in terms of cash and national accounts and the creation of the Ministry of Finance's database gathering budgetary and economic information. However, there is considerable room to improve budgetary practices and transparency at regional level. Firstly, several mandates of Spain's Stability Law have not been observed at that level. To illustrate, some regional governments([33]) still do not prepare their respective multiannual budget frameworks, with among other things, specification of revenues and expenditures for the years covered. Moreover, virtually all regions keep failing to include in their draft budgets and general accounts information on the entirety of entities coming within the scope of the stability law. Furthermore, the 2015 draft budgets of regional governments did not contain enough relevant information to allow verification of compliance with the expenditure rule and public debt targets.([34]) Secondly, a greater degree of convergence of budgetary and public accounting practices at region's level would facilitate the comparison and the consolidation of budget data for all public administrations, in particular as regards the economic classification of expenditure and revenue items and the classification by expenditure programmes.([35]) Lastly, there is a case for tightening the conditions governing the use of extra-budgetary accounts (such as the 413/409 account) at sub central government level, in the interest of transparency and to avoid cumulating public sector commercial arrears.

Taxation

Spain has made its tax system more conducive to growth and job creation, but failed to make it contribute more to the preservation of the environment and the stability of revenues. The 2014 tax reform is centred on corporate income taxation, where a broadening of the tax base is more than compensated for by a lowering of tax rates, and on personal income taxation, where rates are reduced across the board. The reform, which is planned to be phased in over 2015-16, is not fully funded. Spanish authorities estimate it will involve an *ex ante* fiscal cost of some EUR 9 billion (0.9 % of GDP) by 2016, falling to EUR 6.7 billion *ex post* when (quite significant) estimated second-round effects on growth and employment are accounted for. Although many of the elements of the reform constitute steps in the right direction, the reform could have been more ambitious, better targeted and more supportive of Spain's efforts to revamp its economy and meet its fiscal consolidation requirements.

The reform of personal income taxation lowers the tax burden primarily for the individuals with very low or very high income. The reform

associations); and iv) Intrum Justitia (credit management company).

([33]) Andalusia, Asturias, Extremadura, Galicia and Madrid.http://www.minhap.gob.es/Documentacion/Publico/PortalVarios/FinanciacionTerritorial/Autonomica/ProyectoPresupuesto/Resumen_ejecutivo_presupuestos_2015.pdf

([34]) http://www.airef.es/system/assets/archives/000/000/394/original/Report_on_the_Draft_Budgets_and_Main_Budgetary_Lines_of_the_General_Government_2015.pdf?1422350298

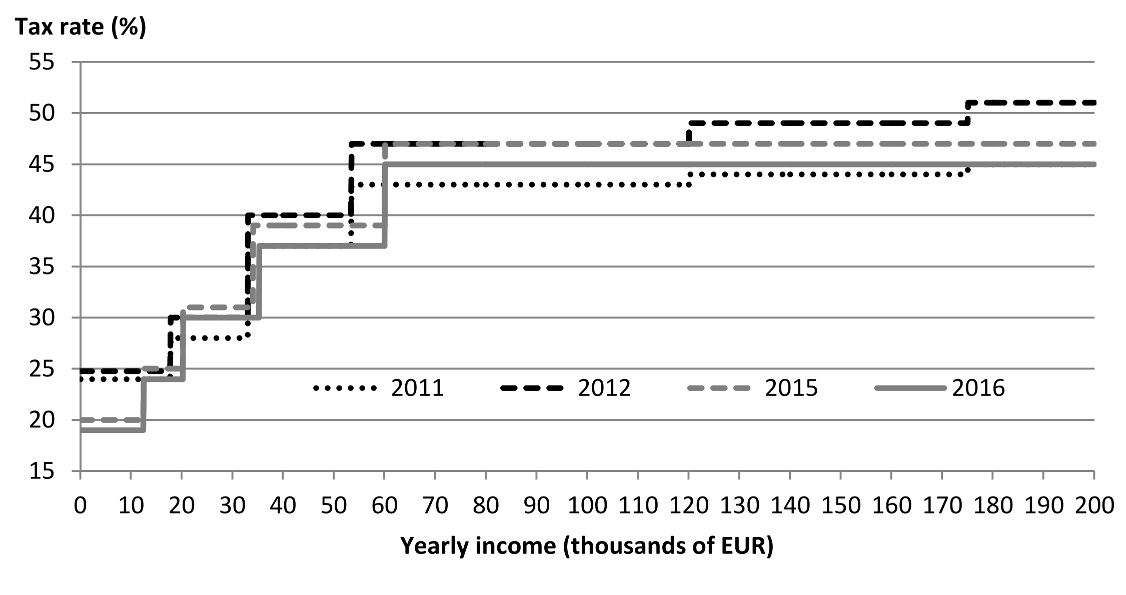
([35]) *Opinion on changes in the budgetary cycle*, Autoridad Independiente de Responsabilidad Fiscal - AIReF, July 2014. http://www.airef.es/system/assets/archives/000/000/058/original/opinionaboutchangestobudgetarycycleprocedures-140721121648-phpapp02.pdf?1412180958 takes into account some social concerns, e.g. through higher allowances for children (Box 3.3.1). The number of personal tax rates will be lowered from 7 to 5 and many taxpayers will benefit from a lower average tax rate. The government estimates that 20 million taxpayers will enjoy higher disposable income as a result of the personal income taxation cuts. The changes to marginal tax rates, however, present a less consistent picture, with marginal tax rates falling most for those individuals earning either very low or very high incomes (Graph 3.1.1). The lowest tax rate drops from 24.75 % to 20 - % in 2015 and then to 19 % from 2016. The highest tax rate drops from 52 % to 47 % in 2015 and then to 45 % in 2016. Although middle-income earners benefit from lower average income tax rates, those earning between EUR 20 200 and 33 000 a year actually face a temporary increase in the marginal tax rate from 30 % to 31 % in 2015, before the rate falls back to 30 % in 2016, which is two percentage points higher than the pre-crisis marginal rate. Whereas individuals earning more than EUR 175 000 a year see their marginal tax rate falling back to where it was before the crisis, income earners in the EUR 60 000-175 000 range only see a partial reversal of the 2012 tax hike.

The personal income tax reform goes some way to reduce the tax wedge on labour. The tax wedge is reduced by exempting income up to EUR 12 000 from personal income tax and by lowering rates. However, a bigger and more immediate impact on employment would probably have been achieved if the still relatively high employer social security contributions had been reduced instead. Recently, the government extended by three months the temporary EUR 100 flat rate employer contribution to social security for new permanent contracts, a measure it had originally introduced for the period end-February 2014 to end-December 2014. The rate is applicable for two years provided the hiring is maintained for three years. By the end of December 2014, the flat rate had been applied to 177 731 new indefinite contracts (approximately 25 % of all such contracts signed between end-February and end-December 2014). The measure is not targeted at any particular group and, being a flat rate, its incentive effect rises with income, which could make it an expensive way of promoting employment.

The savings income tax schedule is gradually reverting to the rates prevailing before the 2012 tax hikes, with the exception of incomes above EUR 50 000, which will be taxed at 23 % as from 2016, i.e. two percentage points above the pre-crisis rate. Thus, some of the increased progressiveness introduced in 2012 is maintained. The higher-than-pre-crisis rate should also be seen in connection with the reduction in the corporate income taxation rate, which implies a shift of taxation from the corporate to the individual level.

In corporate income taxation, the statutory rate is lowered and the base is broadened. The basic rate of corporate income taxation is reduced from 30% to 28% on 1 January 2015 and to 25% in 2016, a rate close to the euro area average. This could increase competitiveness, as in 2014 Spain had one of the highest marginal effective tax rates on new investment in the EU (both for investment financed by debt and equity). The lower rate will also reduce the debt bias in corporate taxation. To broaden the base and to reduce the relatively high debt bias, the deductibility of impairments losses is reduced and the limit on financial costs deductibility is maintained.

Graph 3.1.1: **Tax rates in personal income taxation**



Source: Ministry of Finance

Some progress has been made in reducing the high level of tax expenditure in direct taxation. Tax expenditure in personal income taxation is still high at 37.4 % of estimated revenues. The main tax benefits are the deduction for labour income, the deduction for families, the transitional arrangements for the housing tax credit and the deductions for contributions to pension plans. The housing deduction is, however, being phased out and the tax reform reduced the ceiling for pension plan contributions. Tax expenditure in corporate income taxation amounts to about 10 % of estimated revenue, the main drivers being the reduced rate for SMEs, the R&D tax credit, the deduction for SME reinvestment of profits and the reduced rate for new companies. The reform has repealed some of the SME tax advantages — e.g. the 25 % preferential tax rate as a consequence of the reduction in the general statutory rate and the accelerated depreciation in case of reinvestment in assets — and a number of tax credits — e.g. reinvestment of profits and staff training.

Boosting productive investment remains a challenge. One of the objectives behind the tax reform was to stimulate investment and competitiveness given that Spanish capital formation contracted sharply during the crisis. The general reduction of the statutory tax rate will reduce the cost of capital and could contribute to enhancing investment. Some tax incentives, in particular the R&D tax credit, are also tax features aimed at supporting productive activities. The uptake of the R&D tax incentives in the past has been low due to complexity and uncertainty, while the scheme has been very generous.([36]) The changes introduced with the Entrepreneurship Law in September 2013 go in the right direction to facilitate access, in particular for younger and smaller companies, but the efficiency of the instrument is yet to be seen.

The overall reductions in direct taxation have not been accompanied by any significant increases in indirect taxation. This could jeopardise the scheduled achievement of fiscal consolidation targets, hamper the necessary rebalancing of growth away from domestic demand, and limit the improvement in efficiency of the Spanish tax system. Apart from some minor technical changes to VAT, prompted by infringement procedures launched by the European Commission, such as the exclusion of notary services from VAT exemption and the application of the standard rate to some medical equipment,

([36]) Bravo-Biosca, A., C. Criscuolo and C. Menon, 2013, What drives the dynamics of business growth? OECD Science, Technology and Industry Policy Papers 1.

not much has been done to broaden the base in indirect taxation. The VAT revenue ratio in Spain remains among the lowest in the EU.

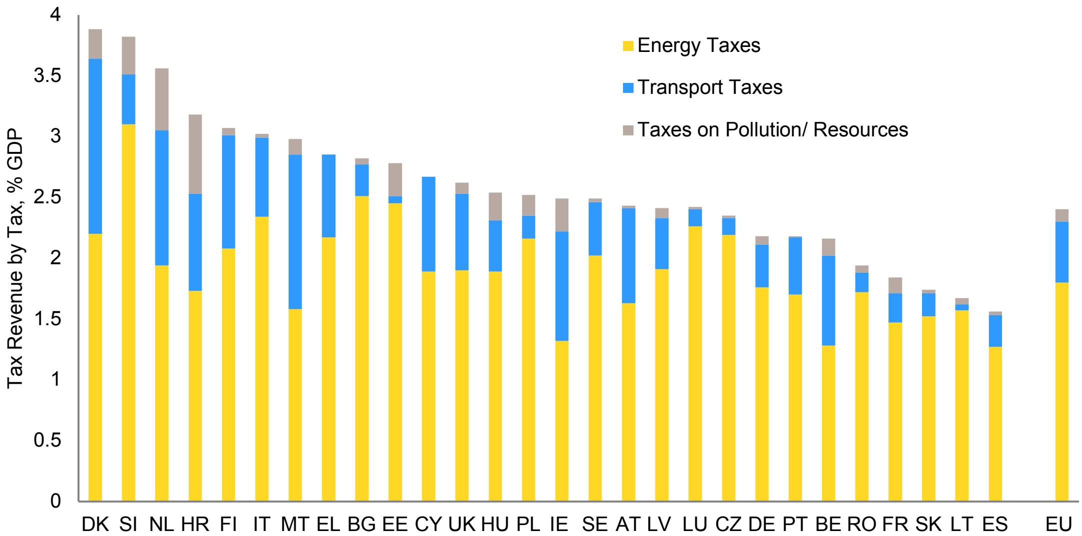
Spain remains among the Member States with the lowest proportion of environmental taxes in GDP. While a number of environmental taxes on electricity, nuclear energy and fluorinated greenhouse gases had been introduced in 2012 and 2013, and a hydroelectric royalty created, the tax reform is expected to imply only a limited change to environmental taxation. Spain is expected to remain among the countries with the lowest environmental taxation.([37]) In particular, taxation on motor fuel did not increase in 2014. Energy taxation seems to be underused as a growth-friendly revenue source([38]) especially in the context of falling fuel prices which have eroded the incentive for efficient energy use. However, it must be said that in December 2014 the government has submitted to parliament a draft law including new taxes on the exploration and production of hydrocarbons. Equally, no progress has been made to shift property taxation from high — and relatively distortionary — transaction-based taxes to less distortionary recurrent property taxation.

Spain has adopted new measures aimed at fighting tax fraud and evasion. Lists of tax evaders will be made public, the tax haven list will be updated annually, and more flexibility has been introduced in the assessment of taxes in cases of tax crime, so as to avoid tax evasion becoming embroiled in lengthy procedures. In the context of the reform, there are new legal rules on corporate income taxation. They limit the deduction of financial costs linked to elusive intra-group transactions, address hybrid mismatches leading to double non-taxation, and broaden the scope of the legislation on foreign-owned companies to capture new tax avoidance schemes. In personal income taxation, there has been a reduction in the scope of business activities where the tax base is estimated by referring to parameters such as the size of facilities, number of employees or others, which reduces the chances of fake invoicing. Some anti-fraud measures in the field of VAT have also been taken, e.g. a reduction of the scope of the exemption for goods in tax warehouses, a wider application of the 'reverse charge mechanism' for, for example, mobile phones and electronic devices, and new inspection procedures. According to the Spanish Ministry of Finance, the tax collection arising from the fight against fraud has increased steadily in the last ten years, the amounts collected in 2014 - €12.3 billion - being twice as large as those in 2006. The Inland Revenue does not estimate the tax gap as an indicator of the tax revenue forgone due to, among others, tax evasion and fraud. Estimates of the tax gap can be useful tools to monitor and evaluate the operational performance of tax administrations. In spite of the recommendation from the Committee of Experts for the tax reform, no new data matching tools have been put in place; notwithstanding that, the Spanish authorities refer to a number of reporting obligations approved in the last years (which should contribute to an improvement of the fight against fraud) and to specific tax control activities linked to the legislation limiting payments in cash (more than 4000 tax inspection interventions which led to 1034 sanction procedures). In its latest report referred to years 2010 to 2012 the Spanish Court of Auditors pointed out that the Inland Revenue has scope to improve its strategic planning, coordination and systematization of the auditing plans. Notwithstanding that, the report acknowledges that the results of the fight against fraud grew significantly year after year and that outcomes were better than expected.

([37]) In 2012 environmental **taxes** in Spain amounted to 1.6 % of GDP against an EU average of 2.4 %. See also: http://ec.europa.eu/taxation_customs/resources/documents/taxation/gen_info/economic_analysis/tax_papers/taxation_paper_48.pdf.

([38]) E.g. Spain taxes diesel used as propellant at the EU minimum level.

Graph 3.1.2: **Environmental tax revenue by type of tax (2012, percentage of GDP)**



Source: Eurostat

Some progress has been made in fighting undeclared work. Complementing the 'Plan against undeclared work and fraud' (adopted in April 2012), the government created in January 2014 a special unit that will collaborate with and support tribunals and the General State Attorney in the fight against undeclared work and social security fraud. As a result of measures taken, the working situation of 320 000 workers had been regularised by November 2014, of which 200 000 had not even been registered in the social security system. Reinforced actions to fight undeclared work have also unveiled that during 2014, infringements of agreed working hours between employer and employee were found in 60 % of the cases investigated, meaning an increase of 20 percentage points from 2013. It is important to monitor the effect of these measures closely.

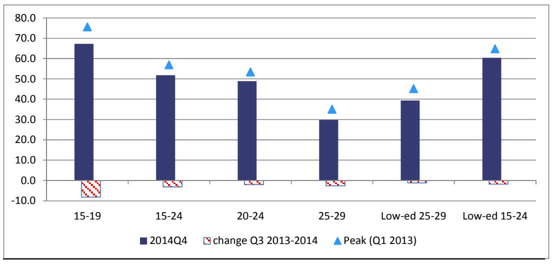
Progress has been slow in removing tax-related obstacles to the smooth functioning of Spain's internal market. A minimum tax rate of 0.03 % has been introduced for the bank deposits tax, which could improve harmonisation of taxation among the Autonomous Communities. However, no specific measures have been adopted to address the wide differences in taxation that still remain throughout the regions such as in wealth-related taxes.

3.2. LABOUR MARKET, EDUCATION AND TRAINING AND SOCIAL POLICIES

Labour market

The benefits of the incipient employment recovery have only marginally benefited the more disadvantaged groups, such as young people and women. For the first time since 2008, youth unemployment has started to decline, although it remains at exceptionally high levels. As of Q4-2014, the unemployment rate for the 15-24 age group stood at 51.8 %, down from 54.9 % in 2013, and a more consistent decrease of unemployment has been recorded for the 25-29 age group. However, unemployment continues to particularly affect young people with low education attainment (60.4 % in Q4-2014) (Graph 3.2.1). In addition, the rate of young people not in education, employment or training remained stable during 2013 and 2014, with more than 71.2 % of them actively looking for a job, and 35.5 % declaring themselves not to be registered in the employment services. The employment rate of women has increased to 50.1 % (Q4-2014), albeit with a wide differentiation across education levels. Female employment in Spain continues to be predominantly characterised by part-time work, although far from by choice, in particular due to difficulties to reconcile work with family life. Moreover, the recently adopted tax reform is already being implemented, and fiscal disincentives for low-income second earners to enter the labour market remain, as joint declarations are still an option for couples. ([39])

Graph 3.2.1: **Youth unemployment**



Source: European Commission

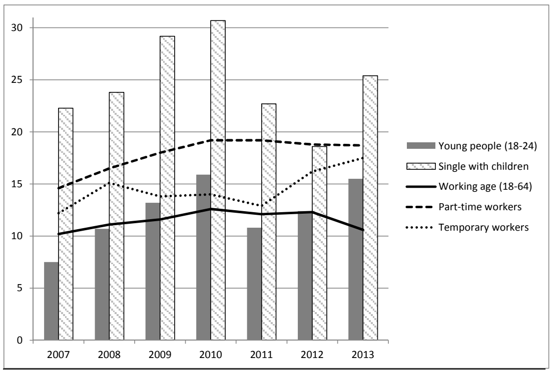
New hires, in particular young people, have borne a substantial part of the brunt of adjustment through the erosion of earnings from work. Recent labour market reforms have increased internal and external flexibility and enhanced the responsiveness of wages to prevailing market conditions; in addition, several new measures aim specifically at facilitating the entry of young and unqualified workers into the labour market. Nevertheless, evidence suggests that wage adjustment has been achieved initially for young people employed with temporary contracts to a large extent through wage cuts at moment of renewal of new temporary contract. Between 2008 and 2013, the first salary of full-time new hires has dropped in real terms by 17 % for men and 13 % for women. For part-time workers, their decrease of first salaries in real terms is double: 23 % and 16 % for men and women, respectively. Among young people, the entry salary has dropped from EUR 1 210 in 2008 to EUR 890 in 2013 (-35 % in real terms).

In-work poverty continues to affect 10.5 % of the working population, particularly among women, the low-skilled and temporary workers. In terms of labour market status, recent years marked a significant increase in poverty amongst the adult unemployed and an increase in poverty rates amongst the employed, the latter partially explained by decreasing earnings and the spillover of the household's labour market status. Some 19.6 % of young workers (aged 18-24) were at risk of poverty in 2013 (10 percentage points more than in 2007). Gender also plays a role, mostly owing to the incidence of part-time work: in the same age group, women faced an increased risk of poverty, 5.8 percentage points more than men. The in-work poverty rate is higher most notably for employed single parents with dependent children, low-skilled

([39]) Joint declarations have a special tax relief (EUR 3 400) and are favoured through the 'incomes accumulation' scheme. When both individuals work, their incomes are added and the second earners (generally women) are taxed with increasingly higher marginal rates. In fact, the sustainment of the EUR 3 400 deduction is proportionally lower in a context of a generalized tax rates decreases (especially for low-earners). Moreover, the increase in the exemption of labour income earners with income below EUR 12 000 (previously: EUR 11 162) is only expected to affect 3 % of total contributors.

and temporary workers, and workers with a part-time contract (Graph 3.2.2).

Graph 3.2.2: **In-work poverty**



Source: European Commission

Self-employment has maintained similar levels as in 2013, supported by the steady use of incentives. On 31 December 2014 there were 3 078 000 self-employed workers in Spain, an increase of 1.4% year-on-year. The majority of self-employed workers are not employers (67 %). Young self-employed are also increasing, partly due to the measures introduced in 2013 to promote entrepreneurship and self-employment among the young. According to data from the Ministry of Labour and Social Security, the flat rate in the contributions to social security for new, young self-employed has benefited more than 300 000 people, of which more than 100 000 are aged under 30. The government is weighing the possibility of broadening the scope of the beneficiaries of the flat rate to those already constituted self-employed that create a first job hiring a young worker under 30, as long as he/she maintains the level of employment for the whole period in which he/she will benefit from the flat rate. The measure may also be extended to self-employed that constitute a trading company.

The geographical labour mobility of workers remains comparatively low and concentrated among particular groups such as young people and migrants. Labour mobility picked up in 2014, but remains predominantly concentrated among young people (with 4.4 % of employed people aged between 16 and 34, more than 200 000 people) and workers of foreign origin. The positive labour market effects of inter-regional mobility are hindered by the overall low mobility of the unemployed, as 81.4 % of the jobless have been living in the same municipality for at least five years and only 14.1 % of them has moved to another region to search for a job.

The modernisation of the public employment service is still lagging behind and risks having negative effects for the implementation of activation policies. Spain has taken a number of actions to coordinate the functioning and offer of the Public Employment Service across the regions. The 2015 budget has increased the investment on the modernisation of the Public Employment Service by EUR 85 million over 2014. Spain has started to implement a new coordination system between regional employment services and consolidated the allocation of resources to the regions based on performance indicators. Moreover, a common services catalogue (still to be effectively implemented by the regional employment services)([40]) and a best practices exchange programme among the national and regional public employment services are set, to promote mutual learning and guarantee minimum service standards across the country to all unemployed. To improve the circulation of job vacancies across the country, the Single job portal has been operational since July 2014, although posted job vacancies have not seemed to be expanding significantly since the start-up phase. Cooperation of public employment services with private placement agencies has also been strengthened. With a budgetary allocation of EUR 30 million for 2014 and EUR 110 million for 2015, the Public Employment Service funds private agencies providing intermediation services.([41]) Moreover, law 18/2014 of 15 October broadened the scope of the intermediation activity of placement agencies and temporary work agencies. It includes extending their functions to the provision of training services for professional qualification, counselling and human resources consulting services. Nevertheless, administrative inefficiencies risk halting the full roll-out of the public-private cooperation, as evidenced by a recent court case. No plans to evaluate placement agencies' performance have been announced for the time being. Furthermore, the overall reduction

([40]) Royal Decree 7/2015 of 16 January 2015

([41]) The private agencies will receive between EUR 1 000 and EUR 3 500 for each unemployed person they place in employment for, at least, 6 months.

of staff reduction between 2011 and 2014 may undermine the ability of regional employment services to provide individualised assistance to jobseekers remains at risk and might have a negative impact also on the implementation of the Youth Guarantee, and the newly adopted programme for activation of the long-term unemployed.

The national Youth Guarantee system still needs to demonstrate its effectiveness in stimulating youth employment. Spain deployed a number of measures between 2013 and 2014 under the 2013-16 Youth Employment and Entrepreneurship Strategy. According to national data, until December 2014 almost 365 000 young people benefited from the actions developed under the Strategy, most of them from employment subsidies. In parallel, the national Youth Guarantee system was set up in July 2014,([42]) but since then only limited numbers of the target population have registered in the system. Although some actions have been taken at regional level to improve outreach to non-registered young people not in employment, education or training and regional employment services are expected to scale-up their involvement, delays in the implementation of these measures raise strong concerns about the coverage of the national Youth Guarantee system. Additionally, the lack of complementary national funding to the European Social Fund and the European Employment Initiative could undermine the implementation of the Youth Guarantee in the medium and long-term.

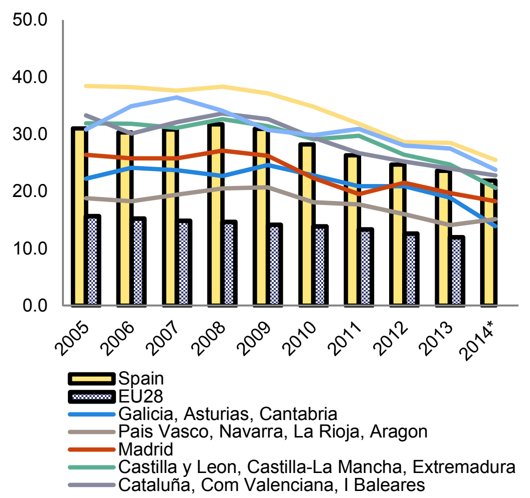
The training and apprenticeship contract saw encouraging results in 2014. The use of this contract increased by 31.8 % between 2013 and 2014, (+33 763 contracts). Further measures were adopted in January 2015 to incentivise employers to finance training costs and the tutoring of young workers in the context of the Youth Guarantee (while specifying the functions of the company's tutor) and making public funds available for complementary training needs.

The reform of the professional training system, which promotes market unity in training services, is on-going. It envisages a single training model for all the competent (national and regional) administrations. In 2014, the national Public Employment Service launched a pilot call for tenders for professional training, which included already some of the innovations that are provided for in the reform, such as the allocation of 50 % of funding open to competitive tendering (compared with 20 % in 2013) and the sectorial orientation of the training courses. The draft reform also includes some positive elements, such as the definition of effective training on the basis on a multiannual forecast and prospective analysis of the labour market. However, the enhancement of a coordinated information system, and permanent evaluation of its effectiveness through the capacity to track an individual's training record (the 'training account', introduced by the 2012 labour market reform) seems to be a major challenge.

Education and training

Early school-leaving and the mismatch between the education and training programmes and the labour market continue to be two of the main challenges facing education and training. Spain maintains one of the highest rates of early school-leaving, although it has continued to decrease – with substantial regional differentiation - from 23.6% in 2013 to 22.3 % in Q3 2014 (Graph 3.2.3).

Graph 3.2.3: **Early school leaving in Spain, break-down by macro-regions**



Source: Ministry of Education, Culture and Sport, January 2015

The decrease in early school leaving can be attributed, inter alia, to the effectiveness of specific regional programmes. Further positive

([42]) Law 18/2014 of 15 October.

developments are expected through the implementation of a two-year initial vocational training (*Formación profesional básica FPB*) set up by the Organic Law for the Improvement of the Quality of Education. This new approach adds flexibility to the educational pathways, and intends to upgrade the quality of basic vocational education and training, compared with the former vocational programmes for which the abandonment rate was over 50 %. Only nine regions have developed the relevant legislation to implement the basic initial vocational training, resulting in a provisional enrolment of 34 684 students in the school year 2014/2015, far below the government's initial expectations. The withdrawal and retention rate at the beginning of next school year will provide critical information to assess the real impact of this new scheme.

The low level of basic skills has negative impacts in the quality of education and remains an obstacle for the employment prospects of young people. The performance of Spanish 15-year-olds in basic skills (mathematics, reading and science) remains below the EU average, and with further significant geographical disparities. The situation is also worrying for the older cohort among adults. In addition, in some study areas, increasing of the labour market relevance of the programmes continues to be a challenge for Spain.

To tackle shortcomings in skills development, the implementation of the new Organic Law for the Improvement of the Quality of Education (LOMCE) during the present school year will be crucial. The Organic Law for the Improvement of the Quality of Education has set up new curricula to improve basic skills in primary, secondary and vocational education and training. It also foresees the reinforcement of cross-cutting skills, particularly, language, entrepreneurship and ICT skills, at all education levels, which calls for specific training for teachers. Central and regional expenditure on education policies in the 2014 budget represents an increase of 10.6 % compared with 2013. However, the replacement of retiring teachers, which has been a challenge since 2009 and which dramatically increased the turnover of interim teachers at school level, remains an issue of concern.

Some progress is being made to increase the labour relevance of skills through actions at secondary level and in lifelong learning. Participation in vocational education and training increased by more than 12 % in one year and almost by 30 % over the last two years, with a particular interest for the dual modality. However, the definition of the roles and responsibilities of each of the stakeholders (vocational education and training providers and firms) in dual vocational education and training remains unclear across the different regions. This can complicate the design and implementation of the tutor training at company level. Moreover, to address adults' skills shortcomings, Spain has elaborated a Strategic Plan for Lifelong Learning that aims at improving the quality of training, with an ultimate goal to upgrade the professional, social and personal skills. The use of ICT tools is promoted and supported, to allow citizens to reconcile training with their personal and work life.

Spain is devising a National Skills Strategy, led by the Ministry of Education. The exercise, together with the OECD and the European Commission, brings together seven different ministries and hosts a multi sectorial dialogue between the government, the regions and the social and economic stakeholders on how to improve the quality and labour market relevance of education outcomes to support economic growth.

The reform of the higher education system aims to improve the excellence, innovation, competitiveness and internationalisation of the Spanish universities. The reform, to be progressively implemented from 2015, envisages the effective implementation of the National Qualification Framework, encouraging universities to focus on particular fields of expertise, reforming the access to the teaching profession and increasing the campus autonomy to establish the amount of credits dedicated to a degree. However, some critical issues, such as the dispersion of the offer against the quality remain yet unaddressed.

Social policies

Despite the recent improvements in the labour market, a high number of people remain at risk of poverty or social exclusion in Spain. More than 12.6 million people were at risk of poverty or social exclusion in 2013. In addition, Spain was among the EU countries where income inequality registered higher figures in 2013([43]) and the poverty gap had increased substantially since 2007.([44]) Children and young adults remain the groups most affected by poverty,([45]) and single-parent households face also a higher risk. The number of people suffering from severe material deprivation has increased to 6.2 % in 2013 from 5.8 % one year earlier (+154 000). The situation of specific groups traditionally more affected by poverty and social exclusion (such as migrants, Roma population and people with disabilities) has significantly worsened during the crisis. In the case of non-EU migrants, unemployment rates reached 38.1 %, 54.1 % were at risk of poverty or social exclusion, and severe material deprivation for this group was 11.5 pp higher than for the overall population in 2013. In this same year, 72 % of the Roma population were in a situation of social exclusion and 54% in severe exclusion, more than double the figure of 2009 (26 %).

The social protection system remains challenged in terms of coverage and efficiency and shows limited redistributive effects across income groups. In the back of the persistent unemployment, the number of households with no income has reached 740 500 in Q2-2014 (almost double than in 2008). There has been some improvement, but the impact of social protection in reducing poverty, in particular child poverty, remains low in Spain (27.6 % as compared with 41.3 % for the EU in 2013). In Spain, the average spending per child increases with household income. This regressive distribution of benefits is partly due to the focus of the measures on new-borns and young children, who tend to be over-represented in higher income quintiles. Affordability and availability remain obstacles in accessing early childhood education and care. Moreover, the allocation of income support schemes and benefits are scattered across many different institutions and levels of government, and unified criteria and a national information database are lacking. In the case of regional minimum income schemes, the varied eligibility criteria and systems, combined with difficulties to transfer rights between regional systems may both impact negatively on incentives to take up work and on labour mobility.

Limited progress was made in ensuring an integrated approach between social protection and activation strategies. The National Action Plan for Social Inclusion 2013-2016 aims at fostering inclusion through the employability of those further away from the labour market through measures such as the provision of individualized integrated pathways; ensuring an income scheme system to financially support those facing bigger difficulties and ensuring the provision of basic services, with a focus on vulnerable groups in the case of social services, education, healthcare and housing. However, there is still uncertainty on its effective implementation and no evaluation or impact assessment has been made available. In addition the plan needs to be complemented by the Integrated Family Support Plan (PIAF), announced in the 2014 National Reform Programme.

Limited progress has been made on strengthening coordination between employment and social services for adapting active labour market policies to those at risk and to support transitions between social protection and the labour market. The July 2014 agreement signed by the government and the social partners sets out the intention to assess, together with the Autonomous Communities, the various models of income schemes in terms of coverage and their link to employability. If translated into concrete measures, the agreement could be a basis for boosting the efficiency of the social protection system in order to overcome the challenges related to coverage and adequacy. An activation programme was set up for the long-term unemployed. It targets the long-term unemployed who have exhausted unemployment benefits and are no longer covered by assistance schemes.([46])

([43]) S80/S20 income quintile share ratio stood at 6.3 in 2013, the fourth highest in the EU.

([44]) EU Employment and Social Situation Quarterly Review (supplement September 2014): Real incomes in the first and second quintiles have declined the most and remain almost 20 and 10 points lower than in 2003. Real median incomes of individuals in richer quintile groups have also declined, but not as much and are no lower than in 2003. Also the population share in households in the lowest income quintile reporting financial distress (45.8 % in Q2-2014) has increased by 7.7 percentage points in one year, the highest increase in the EU.

([45]) 27.5 % amongst children aged up to 17 and 28.2 % amongst people aged 18-24.

([46]) The PREPARA programme provides financial support for long-term unemployed people who have no further right to unemployment benefit or insurance, and who are receiving job-search-related training and guidance related to job search. The Temporary Unemployment Protection and Insertion Programme (PRODI) launched in 2009, provided

The programme combines a financial support of EUR 426 during six months with individualised pathways for labour integration. While highly necessary, this new programme adds on an additional layer to the already highly fragmented system of existing schemes of income support, thereby reducing the effectiveness of the social protection system.

Finally, limited progress has been made to improve the situation of low-income households with children, despite some modest initiatives. A special allocation of EUR 17 million was included in the 2014 national budget intended to tackle severe material deprivation of families with dependent children, including Roma. The budget of the 2nd National Strategic Plan for Infancy and Adolescence 2013-2016 (PENIA II) adopted on 5 April 2013 has been increased by 20.5 % for 2015 and a specific new allocation of EUR 32 million for combatting child poverty has been included in the 2015 budget. Also the recent tax reform includes changes in the personal income tax such as tax reliefs for large families (deductions have increased particularly for families with five or more children) and other groups facing specific needs (such as people with disabilities). However, these measures do not represent a comprehensive framework to counter the persistent high levels of child poverty.

---

for an economic support to the unemployed having exhausted their benefits. Finally the Active Insertion Income (RAI) provides financial support to people aged 45 or more, who are unemployed for at least 1 year and have exhausted their benefits and/or the unemployment subsidy and who lack income of more than 75 % of the minimum wage.

3.3. PRODUCTS AND SERVICES MARKETS

Business environment

Reforms in product markets are crucial to foster the reallocation of resources towards more productive and sustainable sectors. The challenge facing Spain's product market reforms consist of removing obstacles to competition, including on professional services, addressing regulatory fragmentation, reducing red tape and barriers to business growth (see section 2.1) and putting in place innovation-friendly framework conditions. These policies are also needed as a complement to the labour market reform, to avoid that competitiveness gains from wage moderation are diluted by rising profits in competition-sheltered markets.

The implementation of the law on market unity is behind schedule. The law aims at removing measures that may directly or indirectly obstruct the free movement of goods and services and the establishment of economic operators throughout Spain.([47]) It addresses regulatory fragmentation in Spain's internal market, originating from disparities in central and sub-central government legislation governing access to and exercise of economic activities. As of September 2014, all articles of the law had entered into force. The law sets a period of six months to amend provisions in sector-specific legislation that are in direct opposition with it. However, this deadline has not been met and around 400 proposals for amendments (covering mostly regional legislation on tourism, agriculture, manufacturing, health, social services and gambling) were still being processed at the time of writing. This delay raises concerns about the effective and timely implementation of this law. In parallel, 20 sectoral conferences - i.e., bodies with central and regional government representatives working to adapt regulatory frameworks to principles of the law on market unity- had been convened. 34 technical groups on specific policy areas reporting to them have been created and tasked with the review of regional authorisation schemes and the requirements for access to and exercise of economic activities. The findings and proposals of the working groups have to be discussed and agreed at the corresponding sectoral conferences, and then, be legislated by the central and regional governments. However, no such agreement had been reached at sectoral conference level at the cut-off date of this report other than in the area of gambling. Moreover, with regional legislatures coming to an end in the first half of 2015 and lengthy decision-making processes, the outcome of these conferences remains uncertain. While the Council for Market Unity, a central-government body for monitoring the application of the law, agreed in late January 2015 on measures to speed up its implementation, further delays cannot be excluded.

In spite of recent progress, it is still relatively cumbersome to start up a business in Spain. Several measures have been adopted in recent years to simplify business start-ups. Combined, these changes have helped to improve Spain's position in international rankings on company creation. The 2015 edition of the World Bank's *Doing Business* report ranks Spain at 74th position for the ease of starting up a company (it was 115th in the 2014 edition). Despite considerable progress, it is still more cumbersome to start a business in Spain than in other European countries sharing similar legal systems, a fact that could translate into lower firm dynamics.([48]) Other measures have been adopted to ease business licensing, such on environmental permits. With these measures now in force, the focus is on implementing them, including at regional level. A forthcoming study measuring the ease of getting licences shows that time needed, costs incurred and number of permits required to carry out selected economic activities is relatively high in

([47]) See *Market reforms at work*. European Economy 5/2014, September 2014. This report estimates the potential impact of selected reforms in Spain Italy, Portugal and Greece. It shows that reforms implemented by mid-2013 are estimated to boost labour productivity in the sectors affected by the Directive by around 5.7 % in Spain. Given that the directive covers an average of 40 % of GDP in the four countries, the full economy-wide effects should be considerable. Similarly, an ambitious implementation of the law on market unity, which is broader in scope than the Services Directive and on which it is modelled, could have a positive effect on productivity growth.

([48]) *Business dynamics and red tape barriers* European Economy Economic Papers 532, September 2014. The study aims at estimating the impact of changes in the administrative cost of starting a business and/or exporting on entry dynamics in 17 European countries over 2004-2011. It shows that the higher the level of red tape barriers, the lower entry dynamics. In the case of Spain, the decrease in the cost to start a new firm over the period 2010-2014 is predicted to increase start-up rates from 7.9 % to 9.2 %.

Spain, thus underpinning the case for sustained simplification efforts.([49])

Some measures have been taken to reduce administrative burdens, but it is early to assess their impact. An excessive administrative burden is a significant impediment for businesses, particularly SMEs due to lower resources and internal expertise than larger companies to face compliance costs. Most recently available data point to government regulations in Spain being more burdensome than in the EU average.([50]) Recent measures in this field include the signature in June 2014 of an agreement between the government and the two major business associations (CEOE, Cepyme) to cooperate in the identification and elimination of administrative burdens. The draft law amending Spain's framework law on administrative procedure (see section 4.5) provides for an *ex-ante* evaluation of administrative burdens imposed by draft regulations within regulatory impact assessments. Lastly, the implementation of the 'one-in one-out' principle for administrative burden reduction set out in the September 2013 entrepreneurship law has started, albeit recently, following the approval of guidelines by the Spanish cabinet at the end of January 2015. Its application can cap the level of burdens and avoid that unnecessary ones are inadvertently added.

There has been no progress in the implementation of the 2014 country specific recommendation on regulated professions. The implementation of the Services Directive in Spain reduced barriers to the access and exercise of various services activities, including for regulated professions (see Graph 3.3.2). However, this does not weaken the case for reforming professional services still further. Firstly, some professional activities are protected from competition by rights to provide services to the exclusion of other services providers with relevant professional qualifications. Secondly, a reform is overdue from a legal perspective. Law 25/2009, applicable since end-December 2009, calls on the Spanish government to submit to Parliament -within the twelve months following its entry into force- a draft law spelling out which professions require membership in the relevant professional bodies. This internal legal requirement has not been observed to date. Thirdly, there is scope for improving the allocation of labour resources within the professional services sector. The Allocative Efficiency index([51]) for Spain's professional services stands on average at -12 % (see Graph 3.3.2). This implies that average labour productivity is 12 % below the benchmark and is suggestive of factors hindering competition, such regulation or rent-seeking. Lastly, professional services are inputs for business, with their quality and competitiveness having considerable spill over effects across the whole economy. Given relatively high forward linkage effects, the price moderating effect through profit margin compression([52]) of a competition-enhancing reform in professional services is likely to benefit the rest of the economy. A first draft law to reform professional services and professional associations was published on 2 August 2013. The draft law aimed to: i.limit the number of professions with mandatory membership to cases where this is justified and proportionate; ii.ensure that registration and membership fees to those professional associations do not create barriers to competition; iii.increase the transparency and accountability of professional associations *vis-à-vis* consumers of professional services and its own members; and iv.ensure market unity in the access to and exercise of professional services in Spain.

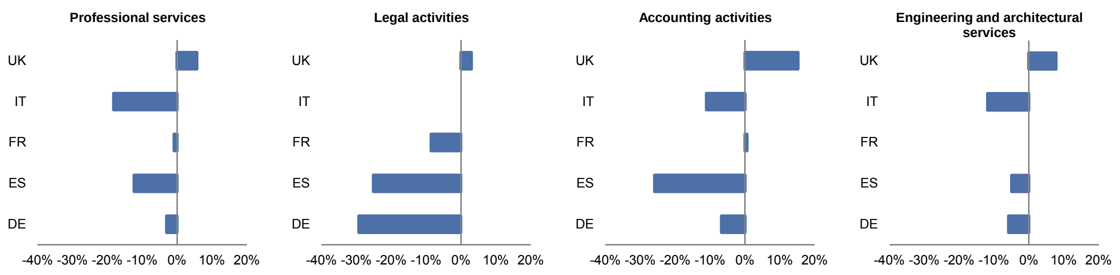
([49]) European Commission (forthcoming), Study on the compliance by Member States on the time needed to get licences and permits to take up and perform the specific activity of an enterprise as from beginning of 2014

([50]) See page 8 at http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/performance-review/files/countries-sheets/2014/spain_en.pdf

([51]) The Allocative Efficiency (AE) indicator compares labour productivity and market shares of firms in different size classes. A positive (negative) number for AE means that resources are allocated in a more (less) efficient way relative to the baseline, which assumes that market shares of the firms in the various size classes are uniformly distributed.

([52]) *The Economic Impact of Professional Services Liberalisation* European Economy Economic Papers 533, September 2014. The study evaluates the effects of regulatory barriers in four professions - legal, accounting, architectural and engineering- in the EU over 2008-2011. It concludes that regulation that is less strict improves their allocative efficiency in the professional services sector and reduces its larger-than-average profitability through intensified business dynamics. In the case of Spain, the decrease of OECD Product Market Reform indicator from 2011 to 2013 increases the degree to which resources are efficiently allocated (allocative efficiency index) by 1.89 percentage points and decreases profit rates by 1.78 percentage points in legal services and by 0.99 in architectural services.

Graph 3.3.1: **Allocative efficiency in selected professional services and countries, 2011**



Source: European Commission Calculation

However, submission to parliament of the reform of professional services keeps being delayed. As the current legislature nears its end, these delays raise concerns about the timely adoption of this law.

The July 2014 retail reform aims to facilitate the opening or expansion of retail trade establishments. In addition to capping the fees charged on the use of credit and debit cards, the reform increased by ten the number of cities with designated areas of total freedom of opening hours for all types of retail establishments (the so-called areas of large tourist turnout). Moreover, it eased licensing requirements by further limiting the number of instances where public bodies can condition the establishment, sale and expansion of a retail outlet on the granting of a permit, by setting out the principle of single authorisation and by halving the length of the licensing procedure. The amendments therefore go in the right direction. As in other policy areas, smooth implementation at sub-central government level will be crucial for these actions to deliver the expected results. The reform does not challenge other potential hurdles to retail trade (and other business) activities originating from land use and land classifications under applicable urban planning rules.([53]) Tackling these restrictions would in any case require a separate legal intervention beyond retail trade policy.

([53]) *Problemas de Competencia en el mercado del suelo en España*. Comisión Nacional de Mercados y de la Competencia – CNMC-, 2013.

Innovation policy

In spite of progress made, insufficient funding and structural weaknesses in the research and innovation system keeps limiting Spain's growth potential. The latest performance indicators, albeit coming with a certain lag, show falling R&D intensity over time for all sectors of performance,([54]) lower creation of start-ups and technology-based SMEs,([55]) fewer SMEs in R&D-intensive industries and knowledge-intensive services,([56]) fewer firms introducing innovations,([57]) lower employment rates for highly-skilled researchers and total business spending on R&D not being commensurate with the generosity of R&D tax breaks.

Available evidence also points to relatively weak cooperation between the public and business R&D sector, to duplications and gaps between national and regional research and innovation programmes, and generally speaking, to a lack of innovation-

([54]) Total R&D intensity fell to 1.24 % of GDP in 2013. Business R&D intensity stood at 0.67% in 2013, down from 0.72 in 2008.

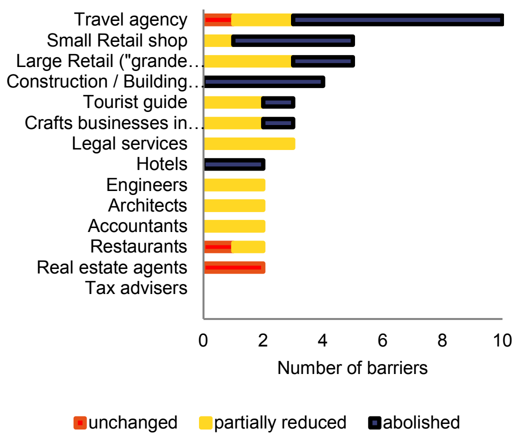
([55]) Venture capital investment fell to 0.14 % of GDP in 2012, with an average annual decrease of -12.5% since 2007. The European Knowledge Transfer Indicator Survey 2011-2012 (UNU-MERIT) estimates 1.4 start-ups per 1 000 research staff in 2011 (1.7 for EU average, 2.4 for NL, 4.7 for SE).

([56]) 2014 Small Business Act fact sheet for Spain, European Commission (http://ec.europa.eu/enterprise/policies/sme/facts-figures-analysis/performance-review/files/countries-sheets/2014/spain_en.pdf).

([57]) The Survey on Technological Innovation carried out by the National Statistics Institute in 2013 shows that in 2010-2012 the number of innovative firms in Spain –i.e., companies having introduced product or process innovation- was 20 815 (13.2 % of the total number of firms with 10 or more employees). This number is less than half of the stock of innovative firms (49 415, or 25.3 % of total) in 2004-2006.

friendly framework conditions. Spain's research and innovation system needs greater financial and human resources. However, these would also have to be accompanied by structural reforms ensuring a more effective and efficient use of these resources. To that end, a recent independent review of Spain's research and innovation system([58]) revealed that its functioning has been inhibited by various factors. These included institutional rigidities in public research institutions and universities coupled with an insufficient use of performance criteria in fund allocation decisions, a low use of international panels to evaluate projects and weak incentives for science-industry cooperation. The review also pointed to weak coordination between national and regional research and innovation strategies and the lack of an effective system of impact evaluation at policy, programme and institutional levels. So far, the government has not presented a concrete follow-up response to the recommendations of the review. The latest R&D policy developments include an increase (from 10 % to 50 %) in the replacement rate of publicly employed researchers in 2015 and new programmes to support human resources such as '*Predoctoral fellowships in excellence centres*'. Research and Innovation Strategies for Smart Specialisation (RIS3) have been adopted at central and regional government level. However, there still remain overlaps, and monitoring mechanisms and proper coordination are not optimal. The government is also set to implement the national strategy for science, technology and innovation, but funding in the 2015 budget is insufficient.([59]) Moreover, the creation of the central government's research agency keeps being delayed. Lastly, adequate funding and the implementation of reforms are preconditions for ensuring an efficient use of available EU funding([60]).

Graph 3.3.2: **Existing restrictions before and after the implementation of the services directive**



Source: European Commission

([58]) The report can be found at http://www.mineco.gob.es/stfls/MICINN/Prensa/FICHEROS/2014/140801_final_report_public_version.pdf

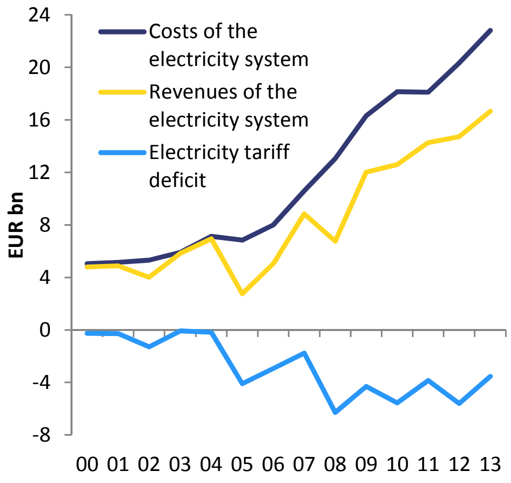
([59]) The 2015 central government budget law increases R&I financial and non-financial spending by 4.8 %, giving EUR 291 million more than in the 2014 budget, of which EUR 263m are additional financial assets (chapter 8) and the remaining EUR 29 million are additional non–financial spending (chapters 1 to 7). A substantial share of that increase is due to military R&I spending (up by EUR 220 million vis-à-vis 2014) while another amount is earmarked to cover the second and third year arrears of R&D project grants (of three-year duration) committed in previous exercises. In practice, this leaves only a small portion of the public R&I budget increase to support the national strategy for science, technology and innovation.

([60]) Under the Partnership Agreement with Spain on using EU Structural and Investment Funds for growth and jobs in 2014-2020, adopted by the Commission in October 2014, some EUR 4.6 billion from the European Regional Development Fund and the European Agricultural Fund for Rural Development will be invested in strengthening research, technological development and innovation in Spain.

Energy

Spain's high dependence on imported energy sources has a significant impact on its current account. In 2012, Spain imported 73 % of its energy sources, but its security of energy supply is mitigated by the country's well-diversified energy mix and the large set of countries from which Spain imports fuels. Oil, which is entirely imported, represents the largest source of energy used in Spain (accounting for 42 % of gross inland consumption), reflecting a very high share of road transport in the modal split. In 2013, Spain's energy trade deficit amounted to 3.4 % of GDP and was larger than the EU average. The high share of energy products in trade exposes Spain to energy price shocks, even if the significant improvement in primary and final energy consumption over recent years has contributed to reducing Spain's energy dependence. According to the latest data available, Spain is on track to meet its national energy efficiency and renewable energy targets, although there are risks as economic growth picks up. **The completion of electricity and gas interconnectors with France is crucial to increase security of supply and stimulate competition in energy markets.** The low interconnection capacity between the Spanish and French gas systems has been identified as an important infrastructure bottleneck, impeding a full integration of the Iberian gas market into the Western European market. A new underground electricity interconnector between France and Spain (Baixas-Santa Llogaia) has doubled the existing connection capacity between these countries, but it is still far away from the minimum interconnection capacity threshold necessary for integration of the Spanish, Portuguese and French electricity markets. Higher capacity would improve the security of electricity supply, exert downward pressure on electricity prices, and enable a better integration of renewable energy sources into the network, giving households and businesses from other Member States a better access to clean electricity from Spain.

Graph 3.4.1: **Evolution of the electricity tariff deficit in Spain, 2000-2013**



Source: CNMC, CNE, European Commission

The 2013 reform of the electricity sector helped to contain the tariff deficit, and the 2014 deficit should be smaller than in previous years. Energy policy choices in Spain over the last decade have resulted in an increase in regulated costs of the electricity system (Graph 3.4.1) and have been, to a large extent, passed on to electricity consumers. The electricity tariff deficit (i.e. the gap between the levies paid by consumers and various regulated costs — including distribution costs and subsidies for renewable energy production) reached EUR 3.54bn in 2013,([61]) and the accumulated tariff debt amounted to EUR 28.5bn at the end of 2013, almost 3 % of GDP. The increase in levies and the reduction in various costs of the electricity system applied with the 2013 reform helped to bring the system closer to balance in 2014. The energy regulator, CNMC, expects that, in 2014, the system was closer to equilibrium in structural terms than in previous years, but a cyclical deficit cannot be excluded as demand for electricity was still decreasing and consumers were contracting less power to reduce their costs. The final deficit outcomes in 2014 are still to be seen. New concerns about the competences of the energy regulator have emerged, notably in the light of amendments to the

([61]) In December 2012, the government adopted Royal Decree 1054/2014 which provides that the five major electric utilities will finance the 2013 deficit.

Electricity Law introduced in December 2014 as regards the setting of access tariffs.

In June 2014, the authorities adopted a new remuneration scheme applying to existing and future renewable energy sources (RES), a major outstanding element of the 2013 electricity reform. While the new remuneration scheme has been in force since July 2013 (the date of entry of the Royal Decree-Law 9/2013), renewable energy operators have only known since June 2014 which remuneration standards are applied to their particular installations, and what remuneration they can expect. There is a pressure on the authorities to act carefully to re-establish investment confidence in the medium and long term and to promote the most cost-efficient renewable energy technologies, also with the view of achieving the 2020 national renewable energy target. Clarity regarding the regulatory regime for cost-effective development of self-consumption or distributed generation (i.e. renewable energies, cogeneration, waste-based) is, however, missing.

There competition in the wholesale and retail electricity markets is not yet sufficient. The national competition authority claimed that the degree of competition in the wholesale electricity market has been insufficient,([62]) despite the fact that the measure of concentration in the market (the market power of generators with more than 5 % market share) has followed a decreasing trend since 2009. Nevertheless, the cumulative share of smaller players in the market (the so-called 'other' ordinary regime players) has been reduced compared with 2009. Similarly, the retail electricity market is still highly concentrated and the number of retailers decreased from 459 in 2008 to 121 in 2012. As a result, the cumulative market share of the main suppliers (with more than 5 % market share) remained very high (89 %), even if the switching rate increased from 5.2 % in 2009 to 12.1 % in 2012.

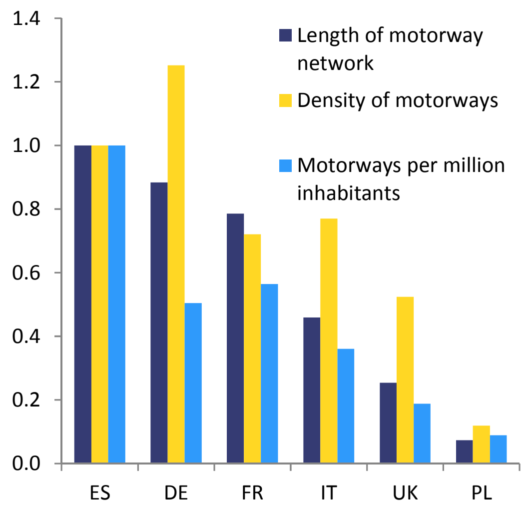
In July 2014, the government adopted a reform to prevent gas price increases for consumers and to reduce the potential liability for public finances stemming from the gas tariff deficit. Weak demand for gas and the need to maintain an extensive gas network have recently pushed up the gas tariff deficit (i.e. the gap between the network access tariffs paid by consumers and the regulated costs of the gas system). According to the energy regulator, CNMC, the accumulated deficit was equal to EUR 326 million in 2013, and would have reached EUR 800 million by the end of 2014, if no action had been taken.() The Royal Decree-Law 8/2014 proposed that, at the end of 2014, the accumulated deficit be recognised as a system debt and that gas companies will recover it from customers in the next 15 years, with annuities appearing in the system's costs. Looking forward, the law intends to halt the increase in the debt by revising downwards the remuneration of regulated activities (system costs), and by introducing the principle of system sufficiency. According to the energy regulator, the overall annual savings under the law could amount to EUR 230 million, and should put the gas tariff deficit on a decreasing path.

Transport

The authorities are taking some steps to use the stock of transport infrastructure more efficiently. First, the gradual process of opening railway passenger services to competition has been launched, but the effects — in terms of better use of the extensive infrastructure stock — still have to be seen. From 2015, a licensed provider will be able to compete with the incumbent operator *Renfe Operadora* on the network between Madrid, Valencia, Alicante and Murcia. After seven years of licence validity, the corridor will be fully opened to competition. For the moment, there is no official schedule to open other parts of the network with a significant passenger potential. In December 2014, a railway safety agency was set up and will be also responsible for granting licences to providers of rail services. Second, in July 2014, the formation of a fund to improve land accessibility of seaports was announced. The fund, based on obligatory contributions from port authorities, is to improve land accessibility of ports by road and rail. But the regulatory framework of the fund still needs to be developed. In addition, the maximum length of port concessions will be extended from 35 to 50 years to promote investments in ports.

([62]) CNC, IPN 103/13 *Anteproyecto de Ley del sector eléctrico*. The report pointed to some structural weaknesses preventing competition in the Spanish electricity market.

Graph 3.4.2: **Features of the motorway network in Spain compared with other Member States, 2011**



Source: European Commission

The effectiveness of mechanisms to limit potential liabilities for public finances stemming from transport infrastructure is uncertain. An over-sized transport network is creating liabilities for public finances (Graph 3.4.2). When selecting transport projects, Spain seems to have given higher priority to increasing geographical cohesion than improving efficiency, and investment plans still include high-speed railway lines and motorways in areas with negligible traffic. Investment policies have been focused on extending infrastructure rather than on maintenance, and have favoured an extended network for passenger transport to the detriment of better connectivity of production poles with consumption/export sites and interconnectivity with bordering markets. Following the creation of an Observatory of Transport and Logistics, as a tool for a more efficient diagnosis, the government has started to set up an advisory council on future infrastructure projects. Given that reports from the council will be based on data coming from the Ministry and will not be binding, it is doubtful whether the council will be able to assess effectively any infrastructure projects with potentially overoptimistic traffic estimates.

Some obstacles to the development of air transport have been identified and the government is proceeding with the privatisation of airport infrastructure. The costs of airport services in individual airports operated by AENA, the operator of the network of 46 airports and two heliports, are not transparent. Some progress has been made with the setting up of an independent regulator and a more independent slot coordinator, but enforcement will be crucial. In July 2014, by the Royal Decree-Law 8/2014, the government announced that a 49 % stake in AENA would be sold to private investors. In particular, 21 % of shares have been offered to strategic investors and at least 28 % will be placed on the stock exchange. In October, the privatisation plans were postponed until 2015.

The government is exploring ways to minimise the negative impact of unprofitable motorways on public finances. Operators of toll motorways with low traffic flows and which have been declared insolvent represent a non-negligible contingent liability for the state. In mid-October, the government presented an official proposal to bail out the insolvent motorways in concession, thus requiring the negotiating parties to reach an agreement, which should subsequently be approved in court.

The digital economy

Insufficient levels of digital skills, unequal coverage and high costs limit the benefits from information and communication technologies (ICT). Coverage of high-speed fixed basic broadband is above the EU average in Spain as a whole, but quite unequal between regions, ranging from 94 % in the Basque Country to 22 % in Extremadura. Moreover, broadband subscriptions continue to lag behind due to the high cost of broadband connections for users. E-commerce is often disregarded by Spanish firms, particularly SMEs, and take-up by the Spanish population of e-commerce is also much lower than the EU average. ICT skills are still insufficient, with 37 % of the labour force having no or only low digital skills. Coordination between digital strategies set up at different levels of administration is crucial to guarantee interoperability between the implemented systems.

Climate change and environment

Spain risks missing its greenhouse gas emissions target. Under the Europe 2020 strategy, Spain committed to reduce its emissions not covered by the EU Emission Trading Scheme (ETS) by 10 %

below 2005 levels by 2020. According to the latest national projections based on existing measures, non-ETS emissions will decrease only by 2 % between 2005 and 2020. In the case of no further mitigation measures in the buildings, transport and agriculture sectors, the 2020 target would therefore be missed by 9 percentage points.([63])

Spain also faces considerable challenges in the areas of water and waste management and air quality. Spain is a water-stressed country, meaning that water demand exceeds the available water resources under sustainable conditions. An adequate water-pricing policy to recover the cost of water services, together with promotion of wastewater reuse, higher transparency of prices and subsidies or modernisation of irrigation systems, could all harness water saving potential, especially in agriculture, the major consumer of water. Moreover, desalinisation plants built primarily on the Mediterranean coast with EU funding support have clearly been underused. Also, the opportunities for waste prevention and recycling are not yet fully developed in Spain, and a still high proportion of incinerated and landfilled municipal waste is preventing transition to a circular economy. Finally, personal transport exacerbates seasonal problems with air quality and traffic congestion in the major Spanish cities, leading to health and economic costs.

([63]) Kyoto Progress Report COM(2014) 689.

3.5. PUBLIC ADMINISTRATION AND JUDICIAL SYSTEM

Public administration reform

The efficiency of public administration is an important factor for firms' productivity and growth and Spain is gradually implementing a public administration reform. The reform aims to achieve efficiency gains and fiscal savings. It does so by i. reducing duplicated administrative structures within the central government and between central and regional governments; ii. reducing administrative burdens; iii. streamlining overheads; and iv. rationalising the central government's 'institutional' administration.

As at end-December 2014, 129 of 222 public administration reform measures had already been implemented (58.1 % of the total), while 61 others were at an advanced stage of implementation. The remaining 32 were, with a few exceptions, at an intermediate degree of implementation, with measures to remove duplicated administrative structures accounting for the lion's share and presenting greater difficulties for their adoption. As the current legislature is nearing its end, there is a risks related to the implementation of the remaining actions. Moreover, a considerable number of public administration reform measures target the sub-central government level. Ownership of the reform at this level of government is therefore critical to its success.

Despite progress made in previous years, Spain's law-making process falls behind best practice. Available data points to a relatively low use of 'evidence-based instruments'in Spain's lawmaking process. Moreover, there is no legal requirement to publish regulatory impact assessments (*memoria del análisis de impacto normativo*) and these fail to pursue a proper analysis of policy options linked to objectives, including by carrying out cost-benefit analyses of alternatives. Furthermore, while stakeholders are given the opportunity to provide their input in the drafting of some legislation, this is not done systematically for all relevant regulations, and certainly not early enough in the process.[64]

Lastly, there is little *ex post* assessment of enacted legislation, although the impact of some flagship policy interventions (e.g. the 2012 labour market reform) has been evaluated. This is particularly important as attention now shifts to the implementation of reforms adopted recently. Against this backdrop, Spain's Council of Ministers adopted in early January 2015 a first draft law (*anteproyecto de ley*) amending Spain's framework law on administrative procedure. It aims, among other things, to set out a common regulation at all government levels covering annual legislative planning, common commencement dates for legislation, *ex-ante* regulatory impact assessments (including for the first time an SMEs and competitiveness test), *ex post* legislative planning evaluations and public consultations. The planned amendments are a step in the right direction, although they address only in part the above-mentioned shortcomings.

Transparency of administrative decisions

Steps have been taken to improve transparency of administrative decisions, but challenges remain. The 2014 Country Specific Recommendations called on Spain to strengthen control mechanisms and increase the transparency of administrative decisions, in particular at regional and local level. The main recent legislative development in Spain was the entry into force in December 2014 of the 2013 law on transparency, public access to information and good governance at central government level. The transparency portal provided for by the law was set up and the Council for Transparency and Good Governance, which is in charge with monitoring the implementation of the law took office. Moreover, two draft bills announced in 2013 in the framework of the package of measures for the 'revival of democracy' were adopted by the Government in February 2014 and were still being discussed in Parliament at the time of writing. A third set of measures, also before Parliament, relates to the revision of the Criminal Code, most notably by criminalising illegal party funding and extending the statute of limitations for corruption-related crimes. These initiatives are complemented by a significant increase in the activity of the Special Public Prosecutor's Office against Corruption and Organised Crime. In 2013, the number of allegations received doubled, and the number of investigations started, indictments and

[64] OECD *Better Regulation in Europe: Spain* OECD publishing, 2010, and OECD *Spain: from administrative reform to continuous improvement*, OECD public governance reviews, OECD publishing, 2014.

final sentences with convictions also went up compared with the previous year.([65]) The trend appears to have continued in 2014 with several high-profile cases initiated involving a high number of defendants. These developments go in the right direction, although there are other areas of improvement, on which there has been no progress. These include addressing corruption risks, enhancing transparency and control mechanisms in public procurement and urban development processes at regional and local level.

The number of cases of alleged wrongdoings relating to public procurement has increased considerably over the past few months. These cases affect the central, regional and local levels. The most frequent breaches of EU public procurement rules are the illegal modifications of contracts, the artificial splitting of contracts and the abusive use of urgent procedures and public-public cooperation mechanisms. These are indicative of defective control mechanisms during the tender and the execution of public contracts and after their performance, with the current sanctioning arrangements failing to deter either the contracting authorities or the economic operators concerned from their deviating practices.

Judicial reform

Improving the efficiency of the judicial system is an important path for increasing cost-competitiveness and economic performance in the Spanish economy.([66]) Table 3.5.1 shows that reforms leading to reductions of average disposition time and case backlog are positively related with business dynamics (as measured by sectorial entry and churn rates)([67]) and with net inflows of foreign direct investment. However, Spain has made limited progress in implementing the 2014 Country Specific Recommendation on judicial reform. The announced reform on the structure of the judiciary and on the judicial map has not yet been adopted. In April 2014 the government approved a first draft bill to modify the structure of the judiciary to ensure a more efficient division of workload, in particular through the creation of the '*tribunales provinciales de instancia*'. Further to the opinions of consultative bodies and to the change in political leadership of the Ministry of Justice, a revised draft bill is expected to get government approval in the first quarter of 2015. Information received indicates that the revised draft may be more limited in scope than the original one. Other legislative work includes proposals for amending the rules governing the management of the legal aid system and non-litigious cases, currently before Parliament. The government is also preparing a revision of the criminal procedural rules to render them more effective. A first draft organic law amending the Code of Criminal Procedure was adopted by the government in first round on 5 December 2014 and is now under consultation. In parallel, the *Oficina Judicial*, a common pool of resources to assist judges, which was created in 2003, continues its gradual implementation throughout Spain. Efforts to progress in the digitalisation of justice and to develop better links between the electronic case management systems of regions to avoid problems of interoperability have also been pursued. On the duration of judicial proceedings, national statistics available to the public([68]) show that there was a general improvement as regards the length of proceedings in the first three quarters of 2014, notably in first and second instance for most type of cases (except for first instance labour cases). However, the perception of the independence of justice in 2014 has worsened according to World Economic Forum data, where Spain compares unfavourably with most euro area countries.([69])

([65]) See Spain's General Public Prosecutor Office's 2014 Annual Report https://www.fiscal.es/memorias/memoria2014/FISCALIA_SITE/index.html.

([66]) European Economy 5/2014, *Market Reforms at Work in Italy, Spain, Portugal and Greece*. European Commission. DG Economic and Financial Affairs. To note: improving efficiency is not the sole objective of judicial reforms, as these should also target enhanced quality and independence of the system.

([67]) The entry rate is defined as the ratio of new firms to the total number of firms in a sector. The churn rate is defined as the sum of the entry rate and the exit rate (ratio of firms' deaths to total firms in a sector). The latter can be considered as a proxy of businesses' turnover.

([68]) *Indicadores clave del tercer trimestre 2014 a nivel nacional*, www.poderjudicial.es. The Spanish authorities did not provide data to the Council of Europe's European Commission for the Efficiency of Justice to complete the replies to questions collected for the 2015 EU Justice Scoreboard, nor to other questionnaires submitted directly by the Commission for this exercise.

([69]) *The Global Competitiveness Report 2014 – 2015*, World Economic Forum. To note: WEF data measures citizen's perceptions of independence and not independence *per se*.

Table 3.5.1: **Out-of-sample predictions for the impact of efficiency-enhancing judicial reforms on business dynamics and FDI**

	Disposition time			Impact on	Backlog ratio		
	2010	2012	% change	entry rate	2010	2012	change
Spain	289	264	-8.1	0.86 p.p.	3128.4	2720.1	-408.3

Source: European Economy 5 | 2014, 'Market Reforms at Work in Italy, Spain, Portugal and Greece'. European Commission.

Management of European Structural and Investment Funds (ESIF)

The implementation of the European Structural and Investment Funds (ESIF) in Spain is impeded by deficiencies. In the period 2007 – 2013, Spain has benefited extensively from investments financed through Structural and Cohesion funds (total of EUR 35.2 billion), however, implementation of these funds has been suboptimal. Over the past few years recurring deficiencies in the management and control systems of several Operational Programmes persist. As a consequence a significant number of programmes, covering considerable amounts of funding, are subject to procedures of interruption or suspension of payments. Problems have been identified at all levels of implementing bodies and authorities, originating from a complex multi-layered system resulting in weak accountability. Throughout the 2014-2020 programming period, Spain will receive EUR 37.4 billion from the four ESI Funds, but the adoption of programmes is lagging behind and negotiations are still ongoing in 2015.

ANNEX A
Overview Table

Commitments	Summary assessment([70])
2014 Country specific recommendations (CSRs)	
CSR 1: Reinforce the budgetary strategy as of 2014, in particular by fully specifying the underlying measures for the year 2015 and beyond, to ensure the correction of the excessive deficit in a sustainable manner by 2016 through achieving the structural adjustment effort specified in the Council Recommendation under the Excessive Deficit Procedure. A durable correction of the fiscal imbalances requires a credible implementation of ambitious structural reforms to increase the adjustment capacity and boost growth and employment. After achieving the correction of the excessive deficit, pursue a structural adjustment towards the medium-term objective of at least 0.5 % each year, and more in good economic conditions or if needed to ensure that the debt rule is met in order to put the high general government debt ratio on a sustained downward path. Ensure that the new independent fiscal authority becomes fully operational as soon as possible and ensure a full implementation of the preventive, corrective and enforcement measures in the Budgetary Stability Organic Law at all levels of government, including on the elimination of public sector commercial arrears. Carry out by February 2015 a systematic review of expenditure at all levels of government to underpin the efficiency and quality of public spending going forward. Continue to increase the cost-effectiveness of the healthcare sector, in particular by further rationalising pharmaceutical spending, including in hospitals and strengthening coordination across types of care, while maintaining accessibility for vulnerable groups. Adopt by the end of 2014 a comprehensive tax reform to make the tax system simpler and more conducive to growth and job creation, preservation of the environment and stability of revenues. To that end, shift revenues towards less distortive taxes, such as consumption, environmental (e.g. on motor fuels) and recurrent property taxes; remove inefficient personal and corporate income tax expenditures; consider lowering	Spain has made **some progress** in addressing CSR 1 of the Council recommendation. This overall assessment of CSR 1 excludes an assessment of compliance with the Stability and Growth Pact. Substantial progress was achieved in ensuring that the new independent fiscal authority becomes fully operational as soon as possible. AIReF is now operational. Limited progress is recorded in ensuring a full implementation of the preventive, corrective and enforcement measures in the Budgetary Stability Organic Law at all levels of government: the majority of Economic and Financial plans for regions having not complied with the 2013 deficit target were adopted late in 2014: in July 2014, the Fiscal and Financial Policy Council (FFPC) approved the Economic and Financial Plan of Aragón only. On 23/12/2014, it approved those of Catalonia, Valencia, Murcia and Cantabria and Castilla-La Mancha. Moreover, no preventive measures were taken last year on regions at risk of non-compliance with the 2014 deficit target, despite visible deterioration in regions' budget execution. Some progress is recorded on elimination of public sector commercial arrears: on 25/11/2014, the Ministry of Finance published for the first time data on average payment periods covering all general government levels. Some progress was made in the systematic review of expenditure at all levels of government. Proposals to review healthcare, education, social and public administration regional spending have been discussed in

([70]) The following categories are used to assess progress in implementing the 2014 CSRs of the Council Recommendation: No progress: The Member State has neither announced nor adopted any measures to address the CSR. This category also applies if a Member State has commissioned a study group to evaluate possible measures. Limited progress: The Member State has announced some measures to address the CSR, but these measures appear insufficient and/or their adoption/implementation is at risk. Some progress: The Member State has announced or adopted measures to address the CSR. These measures are promising, but not all of them have been implemented yet and implementation is not certain in all cases. Substantial progress: The Member State has adopted measures, most of which have been implemented. These measures go a long way in addressing the CSR. Fully addressed: The Member State has adopted and implemented measures that address the CSR appropriately.

employers' social security contributions, in particular for low-wage jobs; continue to tackle the debt bias in corporate taxation; take measures to avoid that taxation hinders the smooth functioning of Spain's internal market. Step up the fight against tax evasion.	2014 at the Financial and Fiscal Policy Council meetings. The spending review has not been published, though. Some progress was made in increasing the cost-effectiveness of the healthcare sector. Reforms to increase the efficiency and monitoring of healthcare expenditure continue, since 2012, in addition to public administration reforms that contributed further to rationalise the sector and to improve its efficiency. Some progress was achieved as regards comprehensive tax reform to make the tax system simpler and more conducive to growth and job creation. The tax reform was adopted on 20/11/2014, covering personal income taxation and corporate income taxation, to be implemented from January 2015 onwards. Some progress was also made as far as the fight against tax evasion is concerned, but there was no progress in the area of environmental taxation.
CSR 2: Complete the reform of the saving banks sector, as regards the adoption of secondary legislation and complete the restructuring of state-owned savings banks in order to accelerate their full recovery and facilitate their return to private ownership. Promote banks' efforts to sustain strong capital ratios, monitor the asset management company Sareb's activity in order to ensure timely asset disposal while minimising the cost to the taxpayer. Complete the ongoing measures to widen SMEs access to finance, in particular by finalising the ongoing measures to improve non-bank financial intermediation. Remove remaining bottlenecks in the corporate insolvency framework, in particular by enhancing the expertise of insolvency administrators and the capacity of the judicial system to handle insolvency cases, and develop a permanent framework for personal insolvency, paying due attention to balanced creditor/borrower rights and financial stability considerations.	Spain has made **some progress** in addressing CSR 2 of the Council recommendation. Some progress was made as regards the reform of the savings bank sector. A new solvency law approved on 4/06/2014, and discussion on the first draft of the act implementing the savings banks law started in October 2014. Substantial progress was made in promoting bank efforts to sustain strong capital ratios. Some progress is recorded in monitoring the activity of the asset management company Sareb. Sareb continues divesting its assets at a moderate pace, concentrated in key areas, such as Barcelona, Madrid, Malaga and Alicante. A draft law on a new system for the restructuring and resolution of credit institutions was adopted by the government on 28/11/2014. Substantial progress was made in completing the ongoing measures to widen SMEs access to finance. The plan for growth, competitiveness and efficiency, (including

	measures to boost credit lines of Spain's development bank, ICO, in 2014 and to improve SME access to finance by strengthening bank guarantees managed by ICO) was adopted on 6/06/2014. The Royal Decree that sets out the regulation of the so-called internationalisation bonds was adopted on 4/07/2014. Furthermore, the government adopted a draft law on promoting corporate financing on 3/10/2014. Some progress was made in removing the remaining bottlenecks in the corporate insolvency framework. Royal Decree-Law 11/2014 on urgent measures in the area of insolvency was adopted on 5/09/2014 (a special working group will monitor its implementation and will issue annual reports). On 30/09/2014, Law 17/2014 was adopted revising pre-insolvency proceedings and enhancing the system of insolvency administrators.
CSR 3: Pursue new measures to reduce labour market segmentation to favour sustainable, quality jobs, for instance through reducing the number of contract types and ensuring a balanced access to severance rights. Continue regular monitoring of the labour market reforms. Promote real wage developments consistent with the objective of creating jobs. Strengthen the job-search requirement in unemployment benefits. Enhance the effectiveness and targeting of active labour market policies, including hiring subsidies, particularly for those facing more difficulties in accessing employment. Reinforce the coordination between labour market and education and training policies. Accelerate the modernisation of public employment services to ensure effective personalised counselling, adequate training and job-matching, with special focus on the long-term unemployed. Ensure the effective application of public-private cooperation in placement services before the end of 2014, and monitor the quality of services provided. Ensure the effective functioning of the Single Job Portal and combine it with further measures to support labour mobility.	Spain has made **some progress** in addressing CSR 3 of the Council recommendation. Spain has done limited progress pursuing new measures to reduce labour market segmentation to favour sustainable, quality jobs. On 25/02/2014, the Government introduced a temporary reduced form of employer contribution to social security for net indefinite employment, and extended it on 26/12/2014 until 31/03/2015 (Royal Decree-Law 17/2014). No other relevant measures have been taken. Some progress was made in continued regular monitoring of the labour market reforms. Some progress is recorded promoting real wage developments consistent with the objective of creating jobs. At the cut-off date for this document, the new multi-annual agreement on employment and collective bargaining for 2015, 2016 and 2017 was not yet adopted by the social partners. Some progress was made strengthening the job-search requirement for unemployment benefits. The 2014-2016 Activation Strategy adopted on 5/09/2014 intends, among other

	things, to improve the links between active and passive labour market policies by enhancing the activation requirement of unemployed receiving an unemployment benefit or subsidy. Some progress was made in enhancing the effectiveness and targeting of active labour market policies. A new temporary programme of activation and support for the long-term unemployed was adopted on 19/12/2014 (Royal Decree-Law 16/2014). There is limited progress in reinforcing the coordination between labour market and education and training policies. The new basic vocational education and training is being implemented, and the government is currently working on broadening the dual vocational training framework. Limited progress is recorded in accelerating the modernisation of public employment services. The 2014-2016 Activation Strategy adopted on 5/09/2014 envisages common set of services to be provided to all unemployed by the Public Employment Service, which was set by Royal Decree adopted on 16 January. Some progress is recorded in ensuring the effective application of public-private cooperation in placement services. The framework agreement with private agencies was formalised at the end of 2014. Bilateral agreements are now to be signed by regional and national public employment services with employment agencies. The agreement between the national Public Employment Service and private agencies related to the beneficiaries of the PREPARA programme was signed at the end of 2014, but the process is likely to be delayed due to a recent administrative court judgement. Substantial progress was made ensuring the effective functioning of the Single Job Portal. This is operational since 17/07/2014 (www.empleate.gob.es). However, a continuous update of vacancies is not effective in all regions yet.
CSR 4: Implement the 2013-2016 Youth	Spain has made **some progress** in addressing

Entrepreneurship and Employment Strategy and evaluate its effectiveness. Provide good quality offers of employment, apprenticeships and traineeships for young people and improve the outreach to non-registered unemployed young people, in line with the objectives of a youth guarantee. Effectively implement the new educational schemes to increase the quality of primary and secondary education. Enhance guidance and support for groups at risk of early school leaving. Increase the labour-market relevance of vocational education and training and of higher education, in particular by enhancing the cooperation with employers and supporting the training of trainers and tutors.	CSR 4 of the Council recommendation. Some progress was made in implementing the 2013-2016 Youth Entrepreneurship and Employment Strategy and evaluating its effectiveness. Most of strategy's short-term measures are already implemented; however many of the medium and long- term measures, and the first evaluation, are still pending. Some progress was achieved in setting the national legal framework for delivery of the Youth Guarantee. Limited progress was made in providing good quality offers of employment, apprenticeships and traineeships for young people and improving the outreach to non-registered unemployed young people, in line with the objectives of a youth guarantee. Some progress was done implementing the new educational schemes to increase the quality of primary and secondary education. The Law on Quality of Education (LOMCE) is gradually being implemented, starting from the 2014/2015 school year, including the new basic course for vocational education and training (designed also as a measure to address early school- leaving), and the new evaluation of pupil performance. Limited progress is recorded in enhancing guidance and support for groups at risk of early school-leaving. Limited progress was done in increasing the labour-market relevance of vocational education and training and of higher education. A specific committee has been set up in the labour market sectorial conference, which will examine, among other things, the relevance of education and training curricula to labour market needs. However, the efforts to enhance cooperation of higher education institutions with employers are lagging behind. There are plans for an extension of the dual vocational training in 2015, but there are still substantial divergences in the implementation across the regions.
CSR 5: Implement the 2013-2016 National Action	Spain has made **limited progress** in

Plan on Social Inclusion and assess its effectiveness covering the full range of its objectives. Strengthen administrative capacity and coordination between employment and social services in order to provide integrated pathways to support those at risk, and boost, among the Public Administrations responsible for the minimum income schemes, streamlined procedures to support transitions between minimum income schemes and the labour market. Improve the targeting of family support schemes and quality services favouring low-income households with children, to ensure the progressivity and effectiveness of social transfers.	addressing CSR 5 of the Council recommendation. Limited progress was done in implementing the 2013-2016 National Action Plan on Social Inclusion. Limited progress was achieved in strengthening administrative capacity and coordination between employment and social services. The July 2014 agreement signed by the government and social partners includes specific measures to assess, together with the regions, the various income schemes in Spain, in terms of coverage and link to employability. (See CSR 3 as regards the new temporary programme of support and activation for the long-term unemployed). Limited progress is recorded in improving the targeting of family support schemes and quality services favouring low-income households with children, to ensure the progressiveness and effectiveness of social transfers. The Action Plan on the Spanish Strategy on Disability, Action Plan on Equality in the Information Society and Youth Strategy 2020 were adopted on 12/09/2014. The Integrated Family Support Plan (PIAF) is still under negotiation. A special allocation of EU 17 million was included in the 2014 national budget to tackle severe material deprivation of families with dependent children, including Roma. The allocation was increased to EU 32 million in the 2015 budget.
CSR 6: Ensure an ambitious and swift implementation of Law No 20/2013 on Market Unity at all levels of administration. Adopt an ambitious reform of professional services and of professional associations by the end of 2014, defining the professions requiring registration in a professional organisation, and the transparency and accountability of professional bodies, opening up unjustifiably reserved activities and safeguarding market unity in the access to and exercise of professional services in Spain. Further reduce the time, cost and number of procedures required for setting up an operating business. Address unjustified restrictions to the establishment of large-scale retail premises, in particular through a revision of existing regional planning regulations. Identify sources of financing	Spain has made **some progress** in addressing CSR 6 of the Council recommendation. Some progress is achieved on the implementation of Law No 20/2013 on Market Unity, which is lagging behind, mostly due to delays at sub-central government level. No progress has been done as regards the adoption of the reform of professional services and professional associations. Some progress has been done in further reducing the time, cost and number of procedures required for setting up an operating business. Implementation of Law

for the new national strategy for science, technology and innovation and make operational the new State Research Agency.	14/2013 on entrepreneurship continues, although the law on environmental assessment, adopted in December 2013, is not yet being fully implemented by various regions. Despite progress, the most recent indicators measuring ease to start-up a business show that it is more cumbersome to start-up a business in Spain than in other European countries sharing similar legal systems. Substantial progress is recorded in addressing unjustified restrictions to the establishment of large-scale retail premises, following the adoption on 4/07/2014 of Royal Decree-Law 8/2014, which facilitates licensing procedures for the establishment, sale and expansion of retail outlets. Smooth implementation at sub-central government level of this reform is however needed for the amendments to deliver the expected results. Limited progress is achieved in identifying sources of financing for the new national strategy for science, technology and innovation. The Royal Decree 475/2014, adopted on 13/06/14, allows businesses to deduct 40 % from their social security contributions if they employ full time workers to carry out R&D and innovation activities. The 2015 national budget increases public spending on research and innovation by 4.8 %. However, this is partly due to a high rise in military research and innovation spending. Moreover, a substantial part of the increase is earmarked to reimburse multiannual research and innovation project grants committed in previous exercises. In practice, this leaves only a small portion of the public research and innovation budget increase to support the national strategy for science, technology and innovation. No progress has been done in setting up a new State Research Agency.
CSR 7: Following the reform of 2013, ensure the effective elimination of deficit in the electricity system as of 2014, including by taking further structural measures if needed. Address the problem of insolvent toll motorways so as to minimise costs for the State. Set up an independent body to	Spain has made **some progress** in addressing CSR 7 of the Council recommendation. Some progress was achieved in ensuring the effective elimination of deficit in the electricity system as of 2014. On 06/06/2014,

contribute to the assessment of future major infrastructure projects by the end of 2014. Take measures to ensure effective competition in freight and passenger rail services.	the government adopted a new remuneration system for existing and new renewable power plants, affecting revenues for already operating plants. On 4/07/2014, the Council of Ministers adopted Royal Decree-Law 8/2014 to tackle the increasing gas tariff deficit. On 12/12/2014, the government approved Royal Decree 1054/2014, to finance the 2013 tariff deficit by the five major electric utilities, estimated at EUR 3 540 million, and to address the 'cyclical imbalances' for future years. Some progress was achieved in addressing the problem of insolvent toll motorways so as to minimise costs for the state. In March 2014, the authorities proposed to set up a public company taking over the motorways and presented a restructuring plan to creditors. On 17/10/2014, the authorities initiated the insolvency procedure by presenting an official proposal to bail out the motorways, requiring the negotiating parties to reach an agreement, which should subsequently be approved in court. Limited progress is recorded in setting up an independent body to contribute to the assessment of future major infrastructure projects. On 30/06/2014, a Ministerial Order was adopted to set up an advisory council on infrastructure projects. Some progress was made in taking measures to ensure effective competition in freight and passenger rail services. On 4/07/2014, the Council of Ministers adopted Royal Decree-Law 8/2014, creating a fund to improve land accessibility of seaports. On 13/06/2014, the Council of Ministers announced that a licence (to be operational in 2015) will be provided to compete with the incumbent Renfe on the rail network between Madrid, Valencia, Alicante, Murcia, and Castellón. After seven years under this licence, the corridor will be fully opened to competition.
CSR 8: Implement at all government levels the recommendations of the committee for the reform of the public administration. Strengthen control mechanisms and increase the transparency of administrative decisions, in particular at regional and	Spain has made **some progress** in addressing CSR 8 of the Council recommendation. Some progress is achieved in implementing at all government levels the recommendations of

local levels. Complete and monitor closely the ongoing measures to fight against the shadow economy and undeclared work. Adopt pending reforms on the structure of the judiciary and on the judicial map and ensure implementation of adopted reforms.	the committee for the reform of public administration. As at end-December 2014, 129 of 222 public administration reform measures had already been implemented (58.1 % of the total number of measures) while 61 others were at an advanced stage of implementation. Spain has done some progress in strengthening transparency of administrative decisions. The provisions on transparency and public access to information became effective in December 2014 at central government level; they will enter into force in December 2015 at sub-central government level. The following draft laws were in parliament at the time of writing: a draft organic law on the control of political parties' economic and financial activities, a draft law on the exercise of duties of senior officials in Spain's central administration and amendments to the Penal Code to criminalise illegal party funding and extend the statute of limitations for corruption-related crimes. No progress was recorded in strengthening control mechanisms in particular at regional and local levels. There have been no initiatives to enhance these powers in the public procurement and urban planning areas. Some progress was done in completing and monitoring closely the ongoing measures to fight against the hidden economy and undeclared work. Limited progress was achieved as regards the adoption of pending judicial reforms: a first draft of a law on the structure of the judiciary was approved by the government on 14/04/2014; the draft is being reviewed in the first quarter of 2015 to limit its scope. Draft bills on legal aid and on voluntary jurisdiction were submitted to parliament on 21/02/2014 and on 1/08/2014, respectively. Some progress was achieved in implementing adopted reforms –i.e., the so-called *Oficina Judicial* and improving interoperability between regions' electronic case management systems.

Europe 2020 (national targets and progress)	
Employment rate target set in the 2013 NRP: 74 % of those aged 20-64	The employment rate (for 20-64 year-olds) went from 59.6 % in 2012 to 58.6 % in 2013 and 60.4 in Q3-2014. The Spanish economy gathered pace during the course of 2014, and job creation responded positively. This was in part due to the increased flexibility introduced by labour market reforms enacted in recent years, and to wage moderation.
R&D target set in the 2013 NRP: 3 %	Gross domestic expenditure on R&D (as a percentage of GDP) stood at 1.27 % in 2012 and 1.24 % in 2013.
National greenhouse gas emissions target: -10 % below 2005 levels in 2020 in the non-emission trading system (non-ETS) sectors	According to the latest national projections submitted to the Commission and taking into account existing measures, it is expected that the target will be missed: -2 % in 2020 as compared with 2005 (i.e. a projected shortfall of 8 percentage points).
Renewable energy target set in the 2013 NRP: 20 %	The share of renewable energy in gross final energy consumption in 2011, 2012, and 2013 was respectively 13.2 %, 14.3 % and 15.5 % (Eur'Observ'ER). Spain has been on track in increasing the share of renewable energy in gross final energy consumption, but due to recent policy changes, there is a risk the 2020 target will be missed.
Energy efficiency: Spain's 2020 target is to consume 121.6 Mtoe in terms of primary energy (82.9 Mtoe in terms of final energy consumption)	Primary and final energy consumption have been decreasing in 2012-15 and Spain is on track to meet its national energy efficiency target. However, there are risks when economic growth picks up.
Early school leaving target: 15 %	Although decreasing, the share of early leavers from education and training (percentage of the population aged 18-24 with at most lower secondary education and not in further education or training) decreased from 27.7 % in 2012 to 23.6 % in 2013 and 22.3 % in Q3-2014, albeit with substantial regional differentiation. Good progress on reducing early school-leaving can be partly attributed to the effectiveness of specific programmes and their implementation in the regions.

Tertiary education target: 44 %	Spain's tertiary educational attainment rate is well above the EU average, having reached 41.5 % in 2012 and 42.3 % in 2013, but the quality and labour market relevance of the higher education system shows shortcomings.
Target on the reduction of population at risk of poverty or social exclusion in number of persons: - 1.4 / 1.5 million	The number of people at-risk-of-poverty or social exclusion (AROPE) reached 12.6 million in 2013. (Note: Due to a change in the methodology used to calculate income-based indicators in Spain, the data of people at risk of poverty or social exclusion in 2013 is not comparable with previous years). Two of the three components of the AROPE, however, (people living in households with very low work intensity and severely materially deprived people) have shown a sharp increase since 2011. The number of the severely materially deprived people has risen by 762000 since 2011, affecting more than 2.8 million in 2013 (3.2 million in the provisional data for 2014). Similarly, the number of people living in households with very low work intensity has increased by 794 000 people from 2011 to 2013, reaching 5.6 million people.

ANNEX B

Standard Tables

Table B.1: **Macroeconomic indicators**

	1996-2000	2001-2005	2006-2010	2011	2012	2013	2014	2015	2016
Core indicators									
GDP growth rate	4.1	3.4	1.1	-0.6	-2.1	-1.2	1.4	2.3	2.5
Output gap [1]	0.1	2.7	0.0	-5.5	-7.2	-7.7	-6.1	-3.9	-1.9
HICP (annual % change)	2.6	3.2	2.5	3.1	2.4	1.5	-0.2	-1.0	1.1
Domestic demand (annual % change) [2]	4.5	4.2	0.5	-2.7	-4.2	-2.7	2.3	2.6	2.6
Unemployment rate (% of labour force) [3]	16.0	10.8	13.2	21.4	24.8	26.1	24.3	22.5	20.7
Gross fixed capital formation (% of GDP)	23.7	27.8	27.7	21.4	19.7	18.5	18.7	19.2	19.7
Gross national saving (% of GDP)	22.1	23.0	20.9	18.7	19.8	20.4	19.2	20.5	20.8
General government (% of GDP)									
Net lending (+) or net borrowing (-)	-2.9	0.0	-4.1	-9.4	-10.3	-6.8	-5.6	-4.5	-3.7
Gross debt	62.3	48.1	45.3	69.2	84.4	92.1	98.3	101.5	102.5
Net financial assets	-50.0	-35.5	-26.6	-46.9	-58.1	n.a.	n.a.	n.a.	n.a.
Total revenue	38.0	38.4	37.8	36.0	37.0	37.5	38.2	38.4	38.3
Total expenditure	40.9	38.5	41.9	45.4	47.3	44.3	43.8	42.9	42.0
of which: Interest	4.0	2.3	1.7	2.4	2.9	3.3	3.3	3.2	3.2
Corporations (% of GDP)									
Net lending (+) or net borrowing (-)	-1.0	-3.9	-1.9	3.6	8.1	5.3	3.6	3.0	2.0
Net financial assets; non-financial corporations	-92.4	-106.7	-140.3	-129.6	-129.3	n.a.	n.a.	n.a.	n.a.
Net financial assets; financial corporations	0.7	3.0	7.1	14.1	14.8	n.a.	n.a.	n.a.	n.a.
Gross capital formation	14.0	15.6	15.5	13.2	13.7	13.6	13.5	14.1	14.7
Gross operating surplus	20.1	19.7	22.1	22.2	23.1	23.1	22.7	22.1	21.8
Households and NPISH (% of GDP)									
Net lending (+) or net borrowing (-)	3.0	-0.3	-0.8	3.0	2.3	3.6	2.3	2.6	2.6
Net financial assets	113.4	95.7	81.5	77.0	84.7	n.a.	n.a.	n.a.	n.a.
Gross wages and salaries	n.a.	36.7	37.0	37.1	35.4	34.5	34.7	34.8	34.6
Net property income	3.9	4.1	3.3	3.5	3.4	3.6	3.7	3.7	3.7
Current transfers received	20.0	19.0	20.0	22.6	23.5	23.8	23.2	22.9	22.6
Gross saving	8.1	7.3	6.5	7.8	6.1	6.8	5.8	6.0	6.1
Rest of the world (% of GDP)									
Net lending (+) or net borrowing (-)	-1.0	-4.2	-6.8	-2.9	0.1	2.1	0.3	1.0	0.9
Net financial assets	28.9	44.3	79.1	86.7	89.2	n.a.	n.a.	n.a.	n.a.
Net exports of goods and services	-1.1	-3.1	-3.9	-0.2	1.6	3.4	2.4	2.6	2.4
Net primary income from the rest of the world	-0.7	-1.1	-2.0	-1.7	-0.8	-0.7	-1.4	-0.8	-0.6
Net capital transactions	0.9	0.9	0.4	0.4	0.5	0.7	0.4	0.4	0.4
Tradable sector	49.3	46.1	42.7	43.5	44.0	44.1	n.a.	n.a.	n.a.
Non-tradable sector	42.1	44.4	48.5	48.5	47.8	47.2	n.a.	n.a.	n.a.
of which: Building and construction sector	8.6	9.9	9.7	6.9	5.8	5.2	n.a.	n.a.	n.a.

(1) The output gap constitutes the gap between the actual and potential gross domestic product at 2010 market prices.
(2) The indicator of domestic demand includes stocks.
(3) Unemployed persons are all those who were not employed, had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. The unemployment rate covers the age group 15-74.
Source: European Commission 2015 winter forecast; Commission calculations

Table B.2: **Financial market indicators**

	2009	2010	2011	2012	2013	2014
Total assets of the banking sector (% of GDP)[1)]	329.2	332.0	346.1	347.9	308.1	297.5
Share of assets of the five largest banks (% of total assets)	43.3	44.3	48.1	51.4	56.2	n.a.
Foreign ownership of banking system (% of total assets)	10.1	9.6	9.5	9.1	8.0	n.a.
Financial soundness indicators:						
- non-performing loans (% of total loans)[2)3)]	4.1	4.7	6.0	7.5	9.4	n.a.
- capital adequacy ratio (%)[2)]	12.2	11.9	12.1	11.6	13.3	n.a.
- return on equity (%)[2)4)]	9.2	8.0	1.5	-21.0	5.3	n.a.
Bank loans to the private sector (year-on-year % change)[1)]	-1.0	1.3	-1.9	-7.4	-8.6	-6.0
Lending for house purchase (year-on-year % change)[1)]	0.1	0.9	-1.2	-3.3	-4.1	-4.0
Loan to deposit ratio[1)]	110.8	108.8	108.7	108.1	98.7	94.1
Central Bank liquidity as % of liabilities[5)]	3.1	2.1	5.8	12.8	8.0	6.8
Private debt (% of GDP)	202.4	201.5	195.3	184.8	172.1	n.a.
Gross external debt (% of GDP)[6)] - public	28.8	27.5	26.2	25.2	41.7	45.0
- private	60.7	58.6	55.7	39.6	50.1	51.4
Long-term interest rate spread versus Bund (basis points)*	75.7	150.8	283.3	435.1	299.2	156.0
Credit default swap spreads for sovereign securities (5-year)*	87.2	168.9	250.0	325.7	185.5	71.4

(1) Latest data November 2014.
(2) Latest data Q4 2013. Basel II.
(3) Includes loans to private sector, public administration, other credit institutions, and nonresidents.
(4) After extraordinary items and taxes. Includes only the net income attributable to the group.
(5) Latest data September 2014.
(6) Latest data June 2014. Monetary authorities, monetary and financial institutions are not included.
* Measured in basis points.
Source: IMF (financial soundness indicators); European Commission (long-term interest rates); World Bank (gross external debt); ECB (all other indicators).

Table B.3: **Taxation indicators**

	2002	2006	2008	2010	2011	2012
Total tax revenues (incl. actual compulsory social contributions, % of GDP)	34.1	36.8	32.9	32.2	31.8	32.5
Breakdown by economic function (% of GDP)[1]						
Consumption	9.5	9.9	8.2	8.8	8.5	8.6
of which:						
- VAT	5.8	6.5	5.1	5.6	5.4	5.5
- excise duties on tobacco and alcohol	0.9	0.8	0.8	0.9	0.9	0.9
- energy	1.7	1.4	1.3	1.4	1.3	1.3
- other (residual)	1.1	1.1	1.0	1.0	0.9	0.9
Labour employed	15.7	15.6	16.0	16.0	16.0	15.7
Labour non-employed	0.8	0.8	1.0	1.4	1.5	1.5
Capital and business income	5.9	7.1	5.5	4.3	4.2	4.6
Stocks of capital/wealth	2.9	3.8	2.8	2.6	2.4	2.8
p.m. Environmental taxes[2]	2.1	1.9	1.7	1.7	1.6	1.6
VAT efficiency[3]						
Actual VAT revenues as % of theoretical revenues at standard rate	52.4	59.2	44.5	42.1	40.6	41.6

(1) Tax revenues are broken down by economic function, i.e. according to whether taxes are raised on consumption, labour or capital. See European Commission (2014), Taxation trends in the European Union, for a more detailed explanation.
(2) This category comprises taxes on energy, transport and pollution and resources included in taxes on consumption and capital.
(3) VAT efficiency is measured via the VAT revenue ratio. It is defined as the ratio between the actual VAT revenue collected and the revenue that would be raised if VAT was applied at the standard rate to all final (domestic) consumption expenditures, which is an imperfect measure of the theoretical pure VAT base. A low ratio can indicate a reduction of the tax base due to large exemptions or the application of reduced rates to a wide range of goods and services ('policy gap') or a failure to collect all tax due to e.g. fraud ('collection gap'). It should be noted that the relative scale of cross-border shopping (including trade in financial services) compared to domestic consumption also influences the value of the ratio, notably for smaller economies. For a more detailed discussion, see European Commission (2012), Tax Reforms in EU Member States, and OECD (2014), Consumption tax trends.

Source: European Commission

Table B.4: **Labour market and social indicators**

	2008	2009	2010	2011	2012	2013	2014
Employment rate (% of population aged 20-64)	68.5	64.0	62.8	62.0	59.6	58.6	59.9
Employment growth (% change from previous year)	0.2	-6.3	-1.7	-2.5	-3.7	-2.6	0.7
Employment rate of women (% of female population aged 20-64)	58.9	56.8	56.3	56.1	54.6	53.8	54.8
Employment rate of men (% of male population aged 20-64)	77.9	71.0	69.2	67.7	64.6	63.4	65.0
Employment rate of older workers (% of population aged 55-64)	45.5	44.0	43.5	44.5	43.9	43.2	44.3
Part-time employment (% of total employment, age 15 years and over)	11.8	12.5	13.0	13.6	14.5	15.8	15.9
Part-time employment of women (% of women employment, age 15 years and over)	22.0	22.4	22.7	22.9	23.9	25.3	25.4
Part-time employment of men (% of men employment, age 15 years and over)	4.2	4.9	5.3	5.9	6.6	7.8	7.9
Fixed term employment (% of employees with a fixed term contract, age 15 years and over)	29.1	25.2	24.7	25.1	23.4	23.1	23.9
Transitions from temporary to permanent employment	20.1	17.8	15.9	10.8	14.4	14.4	n.a.
Unemployment rate[1] (% of labour force, age group 15-74)	11.3	17.9	19.9	21.4	24.8	26.1	24.5
Long-term unemployment rate[2] (% of labour force)	2.0	4.3	7.3	8.9	11.0	13.0	13.0
Youth unemployment rate (% of youth labour force aged 15-24)	24.5	37.7	41.5	46.2	52.9	55.5	53.2
Youth NEET rate (% of population aged 15-24)	14.3	18.1	17.8	18.2	18.6	18.6	n.a.
Early leavers from education and training (% of pop. aged 18-24 with at most lower sec. educ. and not in further education or training)	31.7	30.9	28.2	26.3	24.7	23.6	n.a.
Tertiary educational attainment (% of population aged 30-34 having successfully completed tertiary education)	41.3	40.7	42.0	41.9	41.5	42.3	n.a.
Formal childcare (from 1 to 29 hours; % over the population aged less than 3 years)	22.0	18.0	20.0	20.0	21.0	n.a.	n.a.
Formal childcare (30 hours or over; % over the population aged less than 3 years)	16.0	18.0	18.0	19.0	15.0	n.a.	n.a.
Labour productivity per person employed (annual % change)	0.9	2.7	2.7	2.0	2.4	2.1	0.7
Hours worked per person employed (annual % change)	0.5	0.4	-0.5	0.4	-0.7	-0.3	0.2
Labour productivity per hour worked (annual % change; constant prices)	0.4	2.5	2.3	1.6	2.5	1.7	-0.3
Compensation per employee (annual % change; constant prices)	4.6	4.1	0.9	0.8	-0.8	1.0	1.2
Nominal unit labour cost growth (annual % change)	5.6	1.4	-1.8	-1.0	-3.0	-1.7	n.a.
Real unit labour cost growth (annual % change)	3.2	1.3	-1.8	-1.0	-3.0	-2.3	n.a.

(1) Unemployed persons are all those who were not employed, but had actively sought work and were ready to begin working immediately or within two weeks. The labour force is the total number of people employed and unemployed. Data on the unemployment rate of 2014 includes the last release by Eurostat in early February 2015.
(2) Long-term unemployed are persons who have been unemployed for at least 12 months.

Source: European Commission (EU Labour Force Survey and European National Accounts)

Table B.5: **Labour market and social indicators (continued)**

Expenditure on social protection benefits (% of GDP)	**2007**	**2008**	**2009**	**2010**	**2011**	**2012**
Sickness/healthcare	6.4	6.8	7.3	7.2	7.1	6.7
Invalidity	1.5	1.6	1.7	1.7	1.8	1.8
Old age and survivors	8.7	9.1	10.1	10.7	11.1	11.6
Family/children	1.3	1.4	1.5	1.5	1.4	1.4
Unemployment	2.0	2.3	3.6	3.4	3.7	3.6
Housing and social exclusion n.e.c.	0.2	0.2	0.2	0.2	0.2	0.1
Total	20.3	21.5	24.7	25.0	25.5	25.4
of which: means-tested benefits	2.7	2.9	3.4	3.7	4.1	3.7
Social inclusion indicators	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**
People at risk of poverty or social exclusion[1] (% of total population)	24.5	24.7	26.1	26.7	27.2	27.3
Children at risk of poverty or social exclusion (% of people aged 0-17)	30.6	32.0	33.3	32.2	32.4	32.6
Elderly at risk of poverty or social exclusion (% of people aged 65+)	27.7	24.9	22.9	21.2	16.5	14.5
At-risk-of-poverty rate[2] (% of total population)	20.8	20.4	20.7	20.6	20.8	20.4
Severe material deprivation rate[3] (% of total population)	3.6	4.5	4.9	4.5	5.8	6.2
Proportion of people living in low work intensity households[4] (% of people aged 0-59)	6.6	7.6	10.8	13.4	14.3	15.7
In-work at-risk-of-poverty rate (% of persons employed)	11.2	11.7	10.9	10.9	10.8	10.5
Impact of social transfers (excluding pensions) on reducing poverty	17.5	24.2	28.1	31.3	28.5	32.0
Poverty thresholds, expressed in national currency at constant prices[5]	7367.1	8288.7	8202.2	7666.6	7406.3	7050.6
Gross disposable income (households)	717149.0	720999.0	702619.0	702336.0	682498.0	n.a.
Relative median poverty risk gap (60% of median equivalised income, age: total)	24.4	25.7	26.8	27.4	30.6	30.9
Inequality of income distribution (S80/S20 income quintile share ratio)	5.7	5.9	6.2	6.3	6.5	6.3

(1) People at risk of poverty or social exclusion (AROPE): individuals who are at risk of poverty (AROP) and/or suffering from severe material deprivation (SMD) and/or living in households with zero or very low work intensity (LWI).
(2) At-risk-of-poverty rate (AROP): proportion of people with an equivalised disposable income below 60 % of the national equivalised median income.
(3) Proportion of people who experience at least four of the following forms of deprivation: not being able to afford to i) pay their rent or utility bills, ii) keep their home adequately warm, iii) face unexpected expenses, iv) eat meat, fish or a protein equivalent every second day, v) enjoy a week of holiday away from home once a year, vi) have a car, vii) have a washing machine, viii) have a colour TV, or ix) have a telephone.
(4) People living in households with very low work intensity: proportion of people aged 0-59 living in households where the adults (excluding dependent children) worked less than 20 % of their total work-time potential in the previous 12 months.
(5) For EE, CY, MT, SI and SK, thresholds in nominal values in euros; harmonised index of consumer prices (HICP) = 100 in 2006 (2007 survey refers to 2006 incomes)
(6) 2014 data refer to the average of the first three quarters.

Source: For expenditure for social protection benefits ESSPROS; for social inclusion EU-SILC.

Table B.6: **Product market performance and policy indicators**

	2004-08	2009	2010	2011	2012	2013	2014
Labour productivity1 in total economy (annual growth in %)	0.1	3.1	1.8	2.4	1.9	1.5	n.a.
Labour productivity[1] in manufacturing (annual growth in %)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Labour productivity[1] in electricity, gas (annual growth in %)	-0.1	-8.7	12.8	2.4	-6.8	-2.4	n.a.
Labour productivity[1] in the construction sector (annual growth in %)	-1.1	19.4	-2.0	2.8	4.0	4.3	n.a.
Labour productivity[1] in the wholesale and retail sector (annual growth in %)	-0.2	3.6	3.0	0.7	3.1	0.6	n.a.
Labour productivity[1] in the information and communication sector (annual growth in %)	0.1	1.3	5.0	-1.6	4.7	-0.5	n.a.
Patent intensity in manufacturing[2] (EPO patent applications divided by gross value added of the sector)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Policy indicators	**2004-08**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
Enforcing contracts[3] (days)	515	515	515	515	510	510	510
Time to start a business[3] (days)	77.6	61	52	29	29	23	13
R&D expenditure (% of GDP)	1.2	1.4	1.4	1.3	1.3	1.2	n.a.
Total public expenditure on education (% of GDP)	4.3	5.0	5.0	4.8	n.a.	n.a.	n.a.
(Index: 0=not regulated; 6=most regulated)	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**
Product market regulation[4], overall	1.59	n.a.	n.a.	n.a.	n.a.	1.44	n.a.
Product market regulation[4], retail	3.48	n.a.	n.a.	n.a.	n.a.	2.88	n.a.
Product market regulation[4], professional services	2.74	n.a.	n.a.	n.a.	n.a.	2.43	n.a.
Product market regulation[4], network industries[5]	1.65	1.65	1.68	1.63	1.60	1.59	n.a.

(1) Labour productivity is defined as gross value added (in constant prices) divided by the number of persons employed.
(2) Patent data refer to applications to the European Patent Office (EPO). They are counted according to the year in which they were filed at the EPO. They are broken down according to the inventor's place of residence, using fractional counting if multiple inventors or IPC classes are provided to avoid double counting.
(3) The methodologies, including the assumptions, for this indicator are presented in detail here: HYPERLINK "http://www.doingbusiness.org/methodology"
(4) Index: 0 = not regulated; 6 = most regulated. The methodologies of the OECD product market regulation indicators are presented in detail here: HYPERLINK "http://www.oecd.org/competition/reform/indicatorsofproductmarketregulationhomepage.htm"
(5) Aggregate OECD indicators of regulation in energy, transport and communications (ETCR).

Source: European Commission; World Bank — Doing Business (for enforcing contracts and time to start a business); OECD (for the product market regulation indicators)

Table B.7: **Green growth**

Green growth performance		2003-2007	2008	2009	2010	2011	2012
Macroeconomic							
Energy intensity	kgoe / €	0.16	0.14	0.14	0.14	0.14	0.14
Carbon intensity	kg / €	0.46	0.40	0.38	0.37	0.36	0.37
Resource intensity (reciprocal of resource productivity)	kg / €	0.96	0.82	0.69	0.62	0.54	n.a.
Waste intensity	kg / €	n.a.	0.15	n.a.	0.15	n.a.	0.13
Energy balance of trade	% GDP	-2.6	-3.7	-2.4	-3.0	-3.8	-3.8
Energy weight in HICP	%	9.3	9.9	10.4	10.2	10.8	11.6
Difference between energy price change and inflation	%	1.0	6.3	-1.6	4.3	12.6	7.4
Ratio of environmental taxes to labour taxes	ratio	11.9%	9.8%	9.8%	9.6%	9.1%	9.1%
Ratio of environmental taxes to total taxes	ratio	5.5%	5.1%	5.4%	5.2%	5.0%	4.8%
Sectoral							
Industry energy intensity	kgoe / €	0.19	0.17	0.16	0.15	0.15	0.14
Share of energy-intensive industries in the economy	% GDP	9.6	8.7	7.7	8.4	8.6	8.6
Electricity prices for medium-sized industrial users**	€ / kWh	n.a.	0.10	0.11	0.11	0.11	0.12
Gas prices for medium-sized industrial users***	€ / kWh	n.a.	0.03	0.03	0.03	0.03	0.04
Public R&D for energy	% GDP	n.a.	0.03	0.03	0.03	0.03	0.01
Public R&D for the environment	% GDP	n.a.	0.04	0.05	0.03	0.03	0.02
Recycling rate of municipal waste	ratio	37.6%	48.3%	42.1%	37.8%	37.0%	36.7%
Share of GHG emissions covered by ETS*	%	n.a.	41.0	38.1	35.0	38.3	39.7
Transport energy intensity	kgoe / €	1.07	1.06	1.04	0.96	0.90	0.78
Transport carbon intensity	kg / €	2.79	2.69	2.61	2.39	2.18	1.88
Security of energy supply							
Energy import dependency	%	79.3	81.3	79.1	76.8	76.4	73.3
Diversification of oil import sources	HHI	0.06	0.05	0.06	0.06	0.05	0.06
Diversification of energy mix	HHI	n.a.	0.32	0.32	0.31	0.29	0.27
Renewable energy share of energy mix	%	6.4	7.4	9.5	11.5	11.5	12.6

Country-specific notes: 2013 is not included in the table due to lack of data.
General explanation of the table items:
All macro intensity indicators are expressed as a ratio of a physical quantity to GDP (in 2000 prices)
Energy intensity: gross inland energy consumption (in kgoe) divided by GDP (in EUR)
Carbon intensity: Greenhouse gas emissions (in kg CO2 equivalents) divided by GDP (in EUR)
Resource intensity: Domestic material consumption (in kg) divided by GDP (in EUR)
Waste intensity: waste (in kg) divided by GDP (in EUR)
Energy balance of trade: the balance of energy exports and imports, expressed as % of GDP
Energy weight in HICP: the proportion of "energy" items in the consumption basket used for the construction of the HICP
Difference between energy price change and inflation: energy component of HICP, and total HICP inflation (annual % change)
Environmental taxes over labour or total taxes: from DG TAXUD's database 'Taxation trends in the European Union'
Industry energy intensity: final energy consumption of industry (in kgoe) divided by gross value added of industry (in 2005 EUR)
Share of energy-intensive industries in the economy: share of gross value added of the energy-intensive industries in GDP
Electricity and gas prices for medium-sized industrial users: consumption band 500–2000MWh and 10000–100000 GJ; figures excl. VAT.
Recycling rate of municipal waste: ratio of recycled municipal waste to total municipal waste
Public R&D for energy or for the environment: government spending on R&D (GBAORD) for these categories as % of GDP
Proportion of GHG emissions covered by ETS: based on greenhouse gas emissions (excl LULUCF) as reported by Member States to the European Environment Agency
Transport energy intensity: final energy consumption of transport activity (kgoe) divided by transport industry gross value added (in 2005 EUR)
Transport carbon intensity: greenhouse gas emissions in transport activity divided by gross value added of the transport sector
Energy import dependency: net energy imports divided by gross inland energy consumption incl. consumption of international bunker fuels
Diversification of oil import sources: Herfindahl index (HHI), calculated as the sum of the squared market shares of countries of origin
Diversification of the energy mix: Herfindahl index over natural gas, total petrol products, nuclear heat, renewable energies and solid fuels
Renewable energy share of energy mix: %-share of gross inland energy consumption, expressed in tonne oil equivalents
* European Commission and European Environment Agency
** For 2007 average of S1 & S2 for DE, HR, LU, NL, FI, SE & UK. Other countries only have S2.
*** For 2007 average of S1 & S2 for HR, IT, NL, FI, SE & UK. Other countries only have S2.

Source: European Commission, unless indicated otherwise. European Commission Calculation

OCCASIONAL PAPERS

Occasional Papers can be accessed and downloaded free of charge at the following address: http://ec.europa.eu/economy_finance/publications/occasional_paper/index_en.htm.

Alternatively, hard copies may be ordered via the “Print-on-demand” service offered by the EU Bookshop: http://bookshop.europa.eu.

HOW TO OBTAIN EU PUBLICATIONS

Free publications:

- one copy:
  via EU Bookshop (http://bookshop.europa.eu);

- more than one copy or posters/maps:
  - from the European Union's representations (http://ec.europa.eu/represent_en.htm);
  - from the delegations in non-EU countries (http://eeas.europa.eu/delegations/index_en.htm);
  - by contacting the Europe Direct service (http://europa.eu/europedirect/index_en.htm) or calling 00 800 6 7 8 9 10 11 (freephone number from anywhere in the EU) (*).

(*) The information given is free, as are most calls (though some operators, phone boxes or hotels may charge you).

Priced publications:

- via EU Bookshop (http://bookshop.europa.eu).

KC-AH-15-216-EN-N

Publications Office