

Chapter 2

Structural challenges facing the Spanish economy

The Spanish economy's growth capacity over the years ahead will be influenced by a number of far-reaching structural challenges

- The structural challenges facing the Spanish economy are linked to sluggish productivity growth (which in turn is associated with the need to build up human and technological capital and strengthen the institutional framework), population ageing and the sustainability of public finances, and the green transition, all in a setting in which pockets of vulnerability persist among certain groups.
- If these challenges are to be successfully addressed, rigorous analysis of the different areas, together with design and implementation of a comprehensive strategy of ambitious and lasting structural reforms, based on broad consensus, is needed.
- The Next Generation EU (NGEU) programme and the Spanish Recovery, Transformation and Resilience Plan (RTRP) present a unique opportunity to develop this strategy, via a rigorous selection of the investment projects to be funded through the NGEU and ambitious implementation of the other reforms and milestones pending under the RTRP.

Productivity, firm size and firm demography

- In recent decades, the Spanish economy has seen a productivity slowdown that has been significantly more pronounced than in other developed countries.
- The factors behind the slow aggregate productivity growth in the most recent period notably include the small contribution of net firm entry – compared with other European countries – on account of the lower business churn rate.
- However other factors, such as the small size and low growth of active firms in Spain, also limit aggregate productivity dynamics, while the reallocation of resources between firms and sectors has played a more minor role in recent years.
- The recent initiative to create a National Productivity Board could be an important lever to enhance analysis of the productivity of the Spanish economy and foster proposals for policies to boost productivity, although if it is to be effective, it will need to ensure the independence and professional expertise of its members and be endowed with sufficient resources to undertake rigorous analyses.

Human capital

- Despite the improvement observed in recent decades, the educational attainment level of the Spanish population remains below the European average, so structural measures must be adopted to continue to encourage students to remain in education.
- There appears to be some mismatch between the supply of and demand for places at conventional (classroom-based) public universities.
- It is essential to ensure that Spanish firms have the right incentives to create sufficient places for students on the dual vocational training system.

Capital investment and innovation

- In recent decades, the low level of innovation and technological capital in the Spanish economy is a key explanatory factor of the relative sluggishness of Spanish productivity.
- In this setting, although there has been strong growth in intangible investment in recent years, this momentum has not been sufficient to close the gap with average euro area levels.
- To encourage business investment and innovation, providing a regulatory framework and a stable institutional environment, smoothing access to external financing and reviewing the efficiency and design of the system of tax incentives for innovation would all be desirable.

Institutional framework

- According to different indicators available, institutional quality and trust have deteriorated since the financial crisis and this has had a negative impact on long-term growth.
- Action is needed to boost the efficacy and efficiency of Spanish general government; this would help lift productivity and would have a positive spillover effect on private sector expenditure, investment and innovation decisions.

Population ageing

- In recent decades, demographic trends in Spain have been marked by a significant drop in both fertility and mortality rates. As a result, life expectancy has increased and is now higher in Spain than in other developed countries, although this is not the case in terms of healthy life expectancy.
- In this setting, the population ageing process has gathered considerable pace, and will continue to do so over the coming decades, more so in Spain than in other European countries.
- Migration flows have surged in recent years, but it seems unlikely that this will offset population ageing in Spain or effectively smooth any mismatches that might arise in the Spanish labour market.

Inequality and pockets of vulnerability among households

- In recent years, income inequality has declined significantly in Spain, against a backdrop of strong employment growth. However, some pockets of vulnerability, largely linked to housing affordability difficulties, have been observed among some groups.
- The correlation between parents' level of educational attainment and that of their adult offspring decreased in the second half of the 20th century, suggesting greater intergenerational mobility and, therefore, more equality of opportunity.

Public finances

- The public finances imbalance remains very high, both by historical and international standards, and has even worsened since 2019, as the notable growth in public revenue has been more than offset by the sharp increase in public expenditure.
- The pension system is one of government's most important expenditure items and one that has seen the most growth in recent years. An overall analysis of the major regulatory changes introduced between 2021 and

2023, while subject to considerable uncertainty, points to higher long-term expenditure obligations that are not fully offset on the revenue side.

- In this setting, the macroeconomic and fiscal dynamics of the Spanish economy highlight the need to implement, without delay, a medium-term fiscal consolidation plan that strengthens the sustainability of public finances.
- Moreover, it is essential that the Spanish economy take advantage of economic upturns to build up fiscal space that will allow it to counter the recessionary effect on activity of any future adverse macro-financial shocks.
- In this respect, the new European fiscal governance framework will require, in the coming years, significant fiscal adjustments in some countries in the form of medium-term budgetary plans prepared by Member States setting a multi-year expenditure path.

Green transition

- The fight against climate change and the transition to a more sustainable economy is one of the key challenges facing society today. In particular, the Iberian Peninsula could be significantly affected by the physical risks associated with climate change.
- The energy transition will not only require large-scale deployment of renewable energy sources and improved energy interconnections within the EU, but also a determined commitment to energy efficiency gains.
- The green transition also presents a considerable challenge for central banks and the financial system, insofar as this profound structural change could significantly affect monetary policy conduct and pose considerable risks to financial stability.