

New regulation of key economic issues: An overview

Antonio Romero Mora and Luis Teijeiro Pita da Veiga¹

The crisis has served as a catalyst for much needed structural reforms in Spain. Key reforms have been implemented to address imbalances and inefficiencies in the real economy, fiscal accounts, and the financial sector. The impact of these measures will be felt over time, thus, it is difficult to determine at this stage whether or not the reforms will be sufficient to help Spain transition to a more sustainable economic model.

The crisis clearly revealed the need to implement structural reforms in Spain. Essentially, the most important planned and already undertaken reforms can be categorized into five main pillars: i) modernization of government; ii) competitiveness reform; iii) financial system reform; iv) fiscal reform; and, v) labour reform. As regards fiscal efforts, measures to modernize the government are already generating fiscal savings, and recent measures to support local authorities and autonomous regions, such as the Supplier Payments Fund and the Regional Liquidity Facility should also improve public authorities' financial and budgetary situation. Additionally, tax reforms have been enacted with the aim of making taxation simpler to administer and more efficient. As regards financial reform, measures were put in place to clean-up and recapitalize the financial system, expand private sector credit, and increase borrower protection. Other key structural reforms include labour market reform, aimed at promoting stable hiring and employability of workers. Overall, progress has been made on the reform agenda and more reforms are in the pipeline. That said, only time will tell if enacted and upcoming reforms will be sufficient to ensure Spain's transition to a new and sustainable economic growth model based on a more flexible and competitive economy.

With much of the current legislative period now behind us, it seems a good time to look back and review the main regulatory changes that have affected the Spanish economy, in particular those aiming to stimulate the recovery. The persistence of the economic crisis and its impact on Spain's model of production clearly revealed the need to

embark on a variety of structural reforms. These formed the core of the various national reform programmes implemented in recent years, and an analysis of these programmes reveals five main pillars of action: modernising government; growth and competitiveness; credit and the financial system; fiscal consolidation and tax

¹ CECA.

reform; and labour reform. This article aims to give an overview of these reforms, focusing in particular on those with the biggest impact on the financial system and public accounts. It also tries to identify the challenges for the immediate future that Spain needs to overcome in order to emerge from the crisis in the best shape possible.

Modernising government

Spain's geopolitical structure, the increased independence of its autonomous regions and the gradual transfer of powers over the last few decades has resulted in a striking proliferation of public institutions, enterprises and other bodies whose functions overlap. It is therefore necessary to design a public sector free of overlaps, duplication and unnecessary expenditure, which is fully able to stimulate and support economic development.

On the basis of these premises, a large share of the reform programme has been supervised by the Comisión para la Reforma de la Administración [Public Sector Reform Commission] (CORA), which is subdivided into four subcommissions (in charge of duplication, administrative simplification, managing shared services and resources, and institutional administration). Of the 221 measures identified in CORA's report, 63 have been completed, the rest being in the process of implementation. CORA's efforts are now focused on promoting the regulatory changes that many of the measures identified require before they are implemented.

In any event, the measures are beginning to bear fruit. According to Spain's 2013 National Reform Programme, the measures promoted by CORA have already produced savings of around 1.29 billion euros. On top of this comes the effect of the other measures the government has been backing in this area, which according to this same report are estimated to have brought savings of 9.51 billion euros in the period to March 2014, of which over 57% were in the autonomous regions.

Government modernization measures have already produced savings of around 1.29 billion euros. On top of this comes the effect of the other measures the government has been backing in this area, which according to this same report are estimated to have brought savings of 9.51 billion euros in the period to March 2014.

Of the set of measures adopted in the government reform area, the following merit highlighting given their potential impact on the real economy:

- **Rationalisation and elimination of duplication.** As noted, one of the fundamental concerns guiding government reform lies in the proliferation of government institutions, taking the form of a multitude of agencies of a wide range of types and with areas of competence that sometimes overlap with those of other public bodies. CORA has taken a two-pronged approach: firstly, identifying optimal legal models in order to simplify and harmonise the regulation of the different types of bodies depending on general government; and secondly, an individual analysis of each body to determine whether its legal structure is the most appropriate for its function and whether its activity is in the public interest and deserves protection.

A first consequence of this work has necessarily been the reduction in the number of state companies and foundations. Thus, in 2014, following the resolutions of the Council of Ministers of March 2012 and September 2012, 18 foundations and one company were wound up. Additionally, in order to avoid future proliferation of institutional bodies, the 2013 National Reform Programme announced an amendment to the Law on the Legal Framework for General Government and Common Administrative Procedures in order to apply stricter rules to the creation of new public bodies.

Under the future reform, the establishment of a new body must be accompanied by a strict justification assessing the existence of overlaps and detailing the human, material and financial resources it will need in order to operate.

- **Improving central government financial management.** The CORA report includes various measures intended to improve the State's treasury management, two of which stand out in particular: (1) centralising the bank accounts held by ministries and state agencies in credit institutions (of which there were more than 4,000 as at December 31st, 2013); and (2) changing the calendar of public income in the treasury (as the reform to the Tax Collection Regulation that sought to balance peak treasury needs of the state coffers is now in force). Along the same lines, the preparation of the 2015 State Budget will start to apply the "zero base" budgeting principle for certain central government operating expense items.
- **More efficient management of public employment.** The draft law on the Civil Service Statute will introduce improvements on issues such as planning public employment, reforming careers, performance evaluation, training, structure and elements of the organisation of public employment, and the extension and measurement of effectiveness and efficiency. Additionally, the Public Professional Executive Statute will regulate posts of this kind in line with OECD-country practices.
- **Local government rationalisation and sustainability.** Law 27/2013 of December 27th, 2013, on local government rationalisation and sustainability, establishes precise mechanisms for the exercise of local government powers under the principles of budgetary stability and financial sustainability. Some of the key measures provided in this law are, for example, the clarification of the distribution of powers according to the principle of "one administration, one competence," and the obligation to calculate and publish the actual cost of municipal services. The government

estimates that this law will enable savings of 8.02 billion euros over the period 2014-2020.

- **Transparency and trust in institutions.** One of the backbones of the National Reform Programme as regards the public authorities is rebuilding citizens' trust in the functioning of institutions. The measures envisaged to achieve this goal include the new Law on the financing of political parties; amendment of the Penal Code on transparency and combating tax evasion; the Law on transparency, access to public information and good governance; the draft Organic Law on controlling the economic/ financial activities of political parties; and the draft Law regulating the holding of senior central government offices.

Growth and competitiveness

The different reform programmes propose a comprehensive approach to action on the main structural frictions in the Spanish economy. Eliminating these rigidities is the idea behind a set of measures to improve the functioning of markets for goods, services and factors, so as to ensure a framework for continued growth.

Indexing, intended as a mechanism against high and volatile inflation, is one of the practices the National Reform Programmes aim to combat, given its distorting effect, leading to a continuous loss of competitiveness due to the build-up of price differences with the other countries in the European Monetary Union (EMU). The future Law on de-indexing the Spanish economy (currently undergoing parliamentary debate) aims to eliminate this practice in the public sector, so that it serves as a model for the private sector. Following a similar logic to the pension revaluation index, the Law will create what it terms a competitiveness guarantee index, which will serve as a basis for price updates (and will tend to moderate when Spain has accumulated an inflation rate higher than that in the EMU as a whole).

Indexing, intended as a mechanism against high and volatile inflation, is one of the practices the National Reform Programme aims to combat, given its distorting effect, leading to a continuous loss of competitiveness due to the build-up of price differences with the other countries in the European Monetary Union (EMU).

Law 20/2013 of December 9th, 2013, guaranteeing the *unity of the market* (LGUM) addresses the problems caused by the proliferation of heterogeneous regulations, which is an obstacle for economic operators rolling out their business across the whole of the country. The LGUM lays down the principles to be observed by all levels of government in the exercise of their regulatory and executive powers over economic activity, bolsters administrative cooperation, and provides mechanisms to protect economic operators against possible infringements of the principle of market unity. The Regulation Rationalisation Plan, approved following LGUM, has identified some 7,500 national and regional regulations that may be having a negative impact on market unity. Measures to address over 2,500 regulations are planned.

Support to *entrepreneurship* is another of the priority pillars of action to promote competitiveness and growth. This support revolves around two basic goals: improving finance and promoting international expansion. In the case of finance, the measures include strengthening the role of the Instituto de Crédito Oficial (ICO) as a counter-cyclical agent; the future law to encourage business finance, which will pursue further disintermediation of finance and promote a new model of relationship between SMEs and credit institutions; and improvements in the regulation of venture capital entities. To promote international expansion a 2014-2015 National Strategic Plan has been devised, which has support from the

European Regional Development Fund (ERDF). In addition to the foregoing measures, there are initiatives to cut red tape (including “entrepreneur service points” or the new rapid on-line procedures to set up a company) and tax benefits.

The draft Professional Services and Associations Law also aims to eliminate rigidities that may potentially weigh upon the Spanish economy’s competitiveness. This draft law aims to cut the number of instances where membership of a professional association is compulsory; improve the transparency of their public statements; clearly delimit the activities that professional associations perform as a public body from those that they conduct as a private entity; stimulate the role of associations in certifying quality; and regulate association fees, including a prohibition on access fees and caps on periodic fees.

Improving the competitiveness of certain *strategic markets* involves a wide range of different measures. The structural reform of the electricity sector stands out, the process of deregulating rail transport, the modification of the management model of the public port system, protection of intellectual property rights in the digital environment, improving the regulation of pension funds and plans, or strengthening certain regulatory bodies such as the National Markets and Competition Commission and the National Securities Market Commission (CNMV). All this is against the backdrop of the aim of environmentally friendly growth and the fight against climate change.

The commitments to *human capital and technology* are the last two focal points of actions to stimulate competitiveness and growth. In the case of human capital, the priority is the educational and training system. In this regard, the gradual reform of the educational system stands out (focused, among other things, on reducing early school leaving); the design of a new model of vocational training that responds to the needs of business and the labour market, and managing public resources more

efficiently; the creation of a Spanish framework of qualifications for life-long learning, which will entail the implementation of a structure of qualifications recognised in Spain and described in a way that is consistent and comparable with the rest of Europe; promoting efficiency, excellence and internationalisation of the Spanish university system, for which a panel of experts has been appointed who have issued a report with proposals for reform and improvement to the quality and efficiency of the Spanish university system [“Propuestas para la reforma y mejora de la calidad y eficiencia del sistema universitario español”]; and promoting digital literacy and skills in the educational setting. In relation to innovation and new technology, the Digital Agenda for Spain constitutes the frame of reference, with initiatives such as the central government’s e-Government Action Plan or the Digital Public Services Plan. Another priority objective is to promote R&D as part of the Europe 2020 strategy.

Credit and the financial system

The financial system has perhaps been the main focus of regulatory activity in recent years, both in terms of the number and significance of the provisions enacted and the urgency they were given. The financial origin of the crisis that broke out in 2008 put the financial system, and particularly the banking system, under the regulatory spotlight. Whereas the previous government’s main aim was to substantially increase the quantity and quality of institutions’ capital, the current government has undertaken an exhaustive clean-up of financial institutions’ balance sheets. But its measures went beyond solvency. Thus, within the numerous measures affecting the financial system *three main pillars of action* stand out: firstly, the urgent measures to *recapitalise and clean-up* the financial system, aimed at dispelling doubts as to its health; secondly, initiatives to ease the *flow of credit to the real economy*, by providing alternatives to promote companies’ access to capital markets;

finally, measures to *alleviate the effects of the crisis on the most vulnerable segments of the population*.

Whereas the previous government’s main aim was to substantially increase the quantity and quality of institutions’ capital, the current government has undertaken an exhaustive clean-up of financial institutions’ balance sheets.

Urgent clean-up and recapitalisation measures

As noted above, whereas the previous government’s initiatives opted to *raise credit institutions’ capital requirements* significantly, the new government elected in late 2011 focused efforts on *cleaning up banks’ balance sheets*. In a challenging international context, with the sovereign-debt crisis raging, the aim was to allay uncertainties about the state of Spanish banks’ balance sheets. To this end, two Royal Decree-Laws were passed in quick succession, obliging banks to increase their provisions substantially, particularly in the case of assets associated with the property sector.

Firstly, in February 2012, Royal Decree-Law 2/2012 of February 3rd, 2012, on balance sheet clean-up of the financial sector was passed. The reform, which aimed to improve the credibility of, and trust in, the financial sector took a four-pronged approach: cleaning up credit institutions’ portfolios of property assets; creating incentives for integration processes; measures on the corporate governance of the savings banks, and regulation of the remuneration of directors and executives of entities receiving financial aid from the Fund of Orderly Restructuring of the Banking Sector (FROB).

The clean-up focused on exposures linked to the property development segment, applying both to doubtful loans (substandard, doubtful and foreclosed) and those that were up-to-date on payment as of December 31st, 2011. The process involved new generic and specific provisions and the setting aside of an additional core capital buffer.

In order to encourage consolidation in the sector, extra time was given for compliance in the case of institutions that had embarked on integration processes during 2012.

Shortly afterwards, Royal Decree-Law 18/2012 of May 11th, 2012, on write-downs and sales of the financial sector's real-estate assets was passed. The main objective of this piece of legislation was to raise the level of coverage of loans for development land, building and property development and to separate property assets from purely banking assets by compulsory transfer to privately owned asset management companies. This Royal Decree-Law was repealed in October with the promulgation of Law 8/2012 of October 30th, 2012, which retained its fundamental characteristics.

What these pieces of legislation had in common was the limited public money earmarked to support the process (none at all in the case of the first asset management companies) and numerous voices in the sector warned that without public money there would not be a substantial improvement in entities' solvency, and that they would therefore not help solve what had turned into a systemic crisis.

The persistence of the sovereign-debt crisis led the government to sign a Memorandum of Understanding (MoU) with the European Commission (EC) on July 23rd, 2012, whereby the EC undertook to support the recapitalisation of the Spanish financial system in exchange for compliance with a battery of regulatory measures, many of which affected the financial system. This kicked off a new stage in which regulatory activity

was oriented towards fulfilling the commitments signed in the MoU.

Thus, Royal Decree-Law 24/2012 of August 31st, 2012, on restructuring and resolution of credit institutions was published in the BOE on August 31st, 2012, and entered into force on the same day, with the purpose of regulating the processes of early action, restructuring and resolution of credit institutions, and establishing a new legal framework for the FROB and its general rules of operation, so as to underpin the stability of the financial system while minimising the use of public funds.

This legislative instrument was subsequently superseded with the passing of Law 9/2012 of November 14th, 2012, on restructuring and resolution of credit institutions. This incorporated some significant new features, such as the creation, as required by the MoU, of the Bank restructuring asset management company, *SAREB*. This therefore introduced the concept of a "bad bank" in Spain's legal framework, something which the sector had been calling for as a key tool for cleaning up institutions' balance sheets. Unlike the Asset management companies (SGAs in their Spanish initials) mentioned above, the SAREB was to be financed with a combination of public and private money, the latter coming exclusively from healthy institutions. This achieved the goal of substantially improving the Spanish financial system's risk profile by markedly reducing its exposure to the property development and construction sector. Arguably, the signing of the MoU and the reforms accompanying it marked a turning point that made it possible for Spain's banking system to embark on the process of recovery on a firm footing.

Arguably, the signing of the MoU and the reforms accompanying it marked a turning point that made it possible for Spain's banking system to embark on the process of recovery on a firm footing.

Promoting business finance

A second line of action during the current legislative period has focused on *facilitating finance for economic activity outside traditional banking circuits*. There has been an intense process of deleveraging of the Spanish financial system, which in conjunction with the lack of solvent demand, has translated into a considerable contraction in credit since pre-crisis levels.

In this vein, the government recently presented the aforementioned *draft law to promote business finance*, which is currently undergoing parliamentary debate. Its objective is to make bank credit more accessible and flexible for SMEs and also to lay the groundwork for stronger non-bank sources of business finance. To this end, measures have been taken such as implementing a system whereby credit institutions must give SMEs at least three-months' advance notice of any cancellation or significant reduction in their credit, together with various improvements in the securitisation market and alternative stock market. The rules for bond issues have also been simplified to make this form of debt instrument easier to use.

Another of the priority lines of action has been the promotion of the Instituto de Crédito Oficial's credit lines (ICO lines), with a view to giving them a more prominent role as a countercyclical instrument. Thus, the main lines implemented in recent years have aimed at financing companies and suppliers, with a particular emphasis on the export business.

Borrower protection

Finally, the legislation *protecting mortgage borrowers and promoting transparency in the marketing of financial products* should be mentioned. A number of significant initiatives were carried out in the previous legislative period, such as Order EHA/2899/2011 of October 28th, 2011, on banking service transparency and customer protection.

With a view to protecting vulnerable customers, Royal Decree-Law 6/2012 on urgent measures to protect mortgage borrowers lacking resources was published in the Official State Bulletin (BOE) on March 10th, 2012. This legislative instrument established mechanisms allowing borrowers in extreme difficulties to restructure their mortgage debt and made foreclosure more flexible. These mechanisms were set out in a voluntary *code of good practice* for credit institutions, and made various tools available, in order to avoid foreclosures, as far as possible, and the accompanying evictions.

This was subsequently complemented by Law 1/2013 of May 14th, 2013, on measures to strengthen the protection of mortgage borrowers, debt restructuring, and rented social housing. The key features of this law were the flexible application of the code of good practice and a *two-year moratorium on evictions of people in situations of particular vulnerability*. It also introduced improvements in the regulation of the mortgage market, limiting interest on arrears and improving the mechanism for out-of-court sales. It also amended the Civil Procedure Law in order to improve the protection of mortgage borrowers during foreclosure proceedings. Lastly, it stated that the government should work with the financial sector in order to create a stock of social housing to meet the needs of people who have been evicted from their principal residence as a result of their defaulting on their mortgage.

Consolidation and tax reform

Fiscal consolidation

The most significant piece of legislation in this area is undoubtedly Organic Law 2/2012 of April 27th, 2012, on Budgetary Stability and Financial Sustainability, originating in the reform of Article 135 of the Constitution in September 2011. This amendment enshrined a spending limit in the Constitution with a threefold aim: ensuring the financial sustainability of all of Spain's levels of

government; bolstering confidence in the stability of the Spanish economy; and underlining Spain's budgetary stability commitments to the European Union (given that, ultimately, the reform aims to comply with the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union of March 2nd, 2012).

Another key change in the area of fiscal consolidation (apart from the modernisation and rationalisation initiatives covered in the section on modernizing government above), are the various different measures to support the *financing of local authorities and autonomous regions*.

Firstly, Royal Decree-Law 7/2012 of March 9th 2012 created the Fund for Financing of Supplier Payments as a means of managing this extraordinary financing mechanism for sub-national governments. Its aim was to contribute to providing liquidity for businesses and the self-employed, reducing defaults by public authorities, sustaining basic public services managed by the autonomous regions and local government bodies, and by means of the adjustment programmes associated with the mechanism, improve public authorities' financial and budgetary situation.

Also, in response to the worsening of the market crisis, in July 2012, Royal Decree-Law 21/2012 of July 14th, 2012, on liquidity measures for the General Government and on financial issues was passed, setting up the *Regional Liquidity Fund*. This fund is a line of credit through the ICO whereby the government provides financial support to those autonomous regions that have difficulty tapping the markets for funds, in exchange for commitments to implement a fiscal adjustment plan that will enable them to balance their accounts in the medium-term.

Tax reform

One of the key reforms of this legislative period is undoubtedly that affecting the tax system. Given the complexity of the subject, the government commissioned a report from a panel of experts

chaired by Manuel Lagares. Based on the panel's findings, the government put forward reforms to the tax system in the form of four draft bills, which were approved by the Council of Ministers on June 20th, 2014. The objectives of the reform are to stimulate economic growth and create jobs, cut taxes (particularly those for middle and low incomes), improve equity (benefiting families and the disabled in particular), stimulating medium and long-term savings, improving business competitiveness and encouraging the fight against tax evasion.

Three of these draft bills (the reform to the General Tax Law is still pending) were subsequently approved by the government as bills and submitted to the Spanish parliament for debate. In terms of the main taxes, the key changes are as follows:

Personal income tax (IRPF, in its Spanish initials): various changes have been made, with the threefold aim of reducing the tax burden on workers (whether salaried or self-employed), encouraging long-term savings, and improving the tax treatment of families. The specific measures include reducing the number of steps and marginal rates, increasing the personal and family exemptions and improving the tax treatment of certain types of savings instruments. Conversely, a number of exemptions have been eliminated; in particular, severance pay is now taxable when it passes a 180,000 euro threshold.

Company income tax (IS in its Spanish initials): changes have been made to the general tax system affecting the way the tax base is assessed, the treatment of double taxation, tax rates, tax incentives, and special schemes. The cut in the nominal tax rate stands out, having been brought down from 30% to 28% for 2015 and to 25% for 2016 (except for credit institutions), which is partially offset by the elimination of various deductions, with the hope that it will make the tax simpler to administer.

Value added tax (IVA in its Spanish initials): the changes focus on bringing the law governing this

tax closer into line with European legislation, and fulfilling the obligation to implement various rulings of the Court of Justice of the European Union that have a direct bearing on Spanish legislation. It also introduces measures to strengthen the fight against fraud and to relax the tax rules on certain operations.

Labour reform

Reviving the labour market was another of the priorities of the reforms undertaken in recent years, and efforts included 2012 Royal Decree-Law 3/2012 of February 10th, 2012, on urgent measures to reform the labour market (subsequently ratified as Law 3/2012 of July 6th, 2012). Its main aims were to foster workers' employability, create incentives for permanent contracts (with particular emphasis on hiring of young people and hiring by SMEs), promote internal flexibility in firms as an alternative to job destruction, and improve the efficiency of the labour market as a factor in narrowing the gap between temporary and permanent employees.

This piece of legislation was subsequently complemented with the publication of Royal Decree-Law 16/2013 of December 20th, 2013, of measures to enhance the stable hiring and employability of workers.

One of the main measures adopted is the *limitation on the automatic extension* of collective labour agreements to one year; company agreements being given priority over sector-wide agreements; the possibility of *opt-out clauses* on certain issues (such as wages and hours) promoting companies' internal flexibility as an alternative to redundancies, the reduction in severance pay for unfair dismissal; and measures to encourage hiring on open-ended contracts, particularly of young people and by SMEs, through rebates on social security contributions and other tax incentives. The range of *types of contract* has also been considerably simplified.

Conclusions

Many of the legislative changes reviewed here represent major structural changes in their respective spheres, such that their effects will manifest themselves over the course of the coming years. However, in some of the areas of action looked at it is likely that there will be further changes in the next few months. For instance, the challenges of labour reform to reduce the duality between permanent and temporary workers still need to be faced. There have also been long-standing calls to bring down Spain's social contributions, which are among Europe's highest and represent a barrier to hiring new employees. Nevertheless, it is clear that significant progress has been made in a range of areas. Time will tell whether these reforms are sufficient to ensure the transition to a new economic model based on a more flexible and competitive economy.

