

## ECONOMIC POLICY: THE CHALLENGES FACING JOSÉ LUIS RODRIGUEZ ZAPATERO

- *Newly-elected Prime Minister Zapatero finds himself at the head of a country which, in the last eight years under Popular Party leadership, has experienced robust growth, a significant drop in unemployment (even if numbers remain relatively high), and greatly improved public finances.*
- *Despite the shift in majority, we can therefore expect few changes in economic policy. At least this should be partly the case as the Socialist programme pledges to continue with the tax rate cuts for households and businesses implemented by Aznar's government. There is further continuity in that the new government has shown its desire to maintain budgetary balance by appointing Pedro Solbes, former 'defender' of the Stability Pact in Brussels, as Finance Minister.*
- *However, we already know that the Socialists hope to make up for the previous government's shortfalls in terms of social policy and this will probably come at a price. Not forgetting the other challenges facing the new Prime Minister: controlling a booming housing market but, more importantly, reviving a growth model which is running out of steam due to eroding competitiveness and a slowdown in productivity.*

### Some continuity in fiscal matters

The new government is not expected to make any major changes in terms of fiscal matters. Strong economic growth in recent years is closely linked to the reforms and tax cuts implemented by the Popular Party (PP). The Socialist Party (PSOE) is very unlikely to go back on these. To some extent, the left-wing proposals can actually be seen as a continuation or a completion of previous reforms.

This is certainly true for businesses. There are plans to **reduce corporate tax rates from 35% to 30%** to make up for the elimination of several deductions (in its programme, the PSOE criticised the fact that 50% of the benefits of these deductions only profited 200 businesses).

It is also true for households. The Socialist Party is keen to simplify and trim down previous reforms<sup>1</sup> as it proposes to **reduce the number of income tax brackets and merge the maximum rate and the corporate tax rate**. The introduction of a single tax rate of 30% in 2006 was mentioned several times during and after the electoral campaign. However, at the same time, and to ensure fairness, basic rebates will be raised considerably (to EUR 10,000 + 3,000 per child in care), to reduce the number of low income IRPF taxpayers by half (7 million Spanish people).

The PSOE also hopes, with approval from the European Commission, to **reduce VAT rates for basic food items** from 7% to 4%, **for newspapers, magazines and books** from 4% to 1%, **and for music** from 16% to 4%. The loss in returns would be offset, at least in part, by an increase in tax on alcohol and tobacco.

There is however a major difference with regard to capital gains tax. Today, it stands at a single flat rate of 15%. The PSOE hopes to **increase capital gains tax** and make it incremental as it was before being revised by the PP in 1996. Above a certain threshold, capital gains will therefore be subject to the same tax scales as income.

### Housing: priority to rental housing

J. L. R. Zapatero will soon have to face the problems linked to soaring house prices (p34-35). To tackle these problems, a Housing Minister has been appointed for the first time in the history of Spanish democracy. To end speculation on land prices (cf. February's *Monthly Report* 2003), which essentially explains the surge in house prices, the government should implement land reform.

Furthermore, **tax incentives which help to increase demand for housing** and which were criticised by the IMF **will be eliminated**. However, direct subsidies for non-taxable household buyers are likely to be implemented. Lastly, **development of the rental sector will be a core priority**. The government hopes to launch a plan to build 180,000 protected homes ("VPOs" subject to reduced VAT and price caps) half of which will be for rent. To achieve its objective of almost doubling the stock of rental housing, public aid will primarily go to VPO housing to be rented out.

### Social: making up for the previous government's shortfalls

As we have already said several times, Aznar's government will be a hard act to follow in terms of growth, employment or the handling of public finances. However, these successes were sometimes achieved at the cost of less privileged population groups. The Social Security, for example, currently boasts a record surplus thanks to employment growth and immigration, but also because state pensions (over 80% of Social Security spending) have increased at a much slower rate than contributions. The PSOE therefore proposes to **raise the lowest state pensions** by 26% over four years. Similarly, the decline in unemployment has been remarkable even if the number of wage earners on short-term contracts is still very high at over 30% despite efforts to the contrary. The PSOE aims to respond to this with a major **labour market reform to reduce job insecurity**, improve working conditions and equality between the sexes.

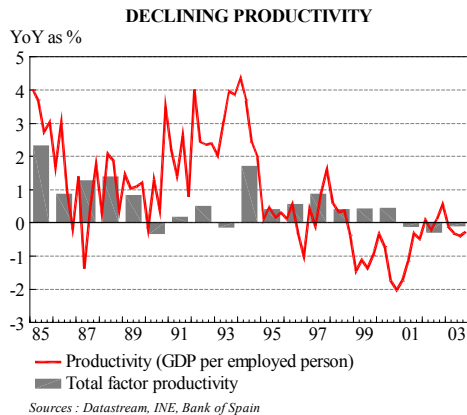
Other projected social reforms include the considerable **increase in the minimum wage (from EUR 460.50 to 600)**, the right to two weeks parental leave for fathers as applies in France, and the possibility for employees to voluntarily defer their retirement along with the abolition of early retirement incentives.

<sup>1</sup> Note that the second stage of the income tax reform (IRPF) implemented in 2003 and 2004 by the PP consisted in reducing the number of tax brackets from 6 to 5 and reducing the maximum rate from 48% to 45% and the minimum rate from 18% to 15%.

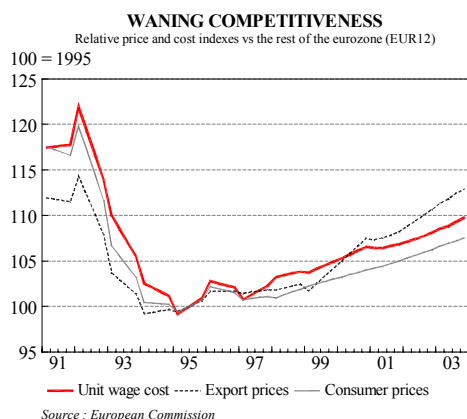
## **Faced with the challenges of globalisation and enlargement, a more ambitious growth model is required**

As we pointed out in a special report in June 2003, Spanish long-term economic growth is far from guaranteed.

Owing to the growth model employed in recent years, productivity is no longer expanding but is actually contracting. Job creations in recent years have primarily benefited unskilled workers (due to the moderate increase in real wages and a large available workforce linked to immigration) working in sectors where productivity is traditionally low: construction, the hotel and restaurant industry, commerce, etc. Specialisation in these low value-added sectors is mainly due to a lack of improvement in human and social capital.



Furthermore, competitiveness is waning, mainly because of the high inflation gap between Spain and the rest of the eurozone, but also because Spain is gradually losing its advantage in terms of unit wage costs given the number of eastern European countries joining the European Union next May. Overall, diminishing competitiveness is proving particularly disadvantageous as the Spanish economy is not specialised in high value-added sectors, which would have withstood the new competition better.



*NB: a rise in indicators shows the drop in Spanish competitiveness in relation to the eurozone*

Moreover, as in most wealthy countries, there is the issue of delocalisation (if often only partial), particularly to Eastern Europe, the Maghreb or Asia. Indeed, the textile sectors, automobile industry (Seat in Slovakia), food-processing and consumer electronics (Samsung in Slovakia, Philips) have been particularly affected.

Faced with the challenges of globalisation and European enlargement, Zapatero has come up with a number of interesting avenues:

- firstly, he has set himself the target of **doubling public spending on research and development (R&D) between now and the next term of office**. Indeed, R&D spending (public and private) represents less than 1% of GDP in Spain compared to almost 2% in the rest of Europe,
- efforts to **develop human capital and improve education** – develop foreign languages training, sciences and new technologies – **and vocational training**,
- **genuine liberalization of network industries** (energy, telecommunications, distribution) and greater independence from regulatory authorities,
- **promoting and supporting exports**. The foreign investment fund will be replaced by an export risk guarantee fund managed by the Spanish export credit insurance company (CESCE). SME exporters will benefit from a number of subsidies,
- **revitalising public administration to ensure greater efficiency, quality and transparency**, via new technologies and improved training.

**Tanguy SIMON – +33 1 42 14 29 72**