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Joint Working Group on Covid-19 Reports

For a Political and Social Pact on an Inclusive Strategy for Recovery and Growth Executive Summary

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**Final report of the Joint Working Group on Covid-19
FOR A POLITICAL AND SOCIAL PACT ON AN INCLUSIVE
STRATEGY FOR RECOVERY AND GROWTH**

EXECUTIVE SUMMARY

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Like many other countries, Spain is undergoing a very complicated situation as a result of the Covid-19 pandemic. Last spring, the virus caused a very serious medical emergency that almost collapsed our health care system and forced the closing of all educational centers. The emergency required severe lockdown measures that have generated serious disruptions in everyday lives and in economic activity. Although the contagion rate declined sharply during the summer, the situation is still complicated and will not be under control until we have access to effective vaccines and/or treatments, which may take some time. For the moment, we are entering into a second wave of the pandemic that threatens economic recovery and could put our health system under severe strain again.

The economic consequences of the health crisis are being dramatic and are straining social protection systems. Many countries are already in the worst recession in many decades, with two-digit drops in income and employment comparable only to those experienced in wartime. Declining economic activity is causing a rapid deterioration of public finances as revenues are falling sharply while expenditure must rise to combat the pandemic and its social and economic consequences. The situation is generating huge public deficits that may be hard to finance for some countries.

The intensity of these problems varies greatly across countries depending on their sectoral structure and initial fiscal situation and on the severity of the pandemic and of the restrictive measures that have been taken to contain it. The activities that been more severely affected by the epidemic are those that require mobility or face-to-face contact and tend to generate agglomerations, like tourism, restaurants, retailing or entertainment. Given the important weight of these activities in our economy, Spain is among the countries that are suffering more. An additional complication is that we entered this crisis with little fiscal room for maneuver as a result of our high level of debt (around 100% of GDP) and a persistent budget deficit that we have not been able to reduce to reasonable levels during the period of recovery that followed the previous crisis.

The magnitude of the crisis is such that minor policy adjustments will not be enough to deal with it. We need a global strategy that makes use of all available tools to achieve three key objectives: i) protect households and firms, maintaining an adequate level of social protection and preserving productive capacity to the extent possible, ii) promote economic recovery and facilitate the necessary reallocation of resources towards sectors and firms with better perspectives and iii) set down the basis for sustained, sustainable and inclusive growth.

It is very important that the core of the country's medium-term economic strategy should have the broadest possible support. We need a political and social pact that should include a multi-year budget plan and set out expenditure priorities and guidelines on how the costs of the crisis are to be shared through tax increases and the rationalization of non-essential expenditure. We should not attempt to give a definite answer to key political questions like the desirable level of public revenues and expenditures, their detailed composition or the degree of income redistribution that we want to have, but it would be very helpful to reach a broad agreement on what we want to do in this respect over the next few years, following a particularly large shock that will require sacrifices from all social groups. In its absence, we can expect an increase in social discontent and political tension that could make the country quite difficult to govern and complicate the recovery from the crisis.

What strategy? i) Short-term policies

The present report sketches the key elements of a strategy for dealing with the current crisis and improving Spain's economic performance in the long term. In addition to controlling the second wave of the pandemic, the main task we face at this point is adapting the protection measures for workers, firms and households that were taken in the early moments of the pandemic in order to promote the recovery of economic activity and avoid the closing of viable firms without hindering the necessary reallocation of resources towards those activities and firms with better future perspectives. An important part of the challenge will be to adapt general measures, such as the temporary layoffs and government-guaranteed loans, to the needs of the different sectors, and to design correctly the specific support measures that may be required to minimize the damage to certain key sectors, such as tourism and car production.

The main issues we have to deal with in the short run are the following:

- Regarding the medical situation, it is urgent to strengthen the healthcare system's capacities to deal with and control the second wave of the pandemic, which is already in full swing. In this area, it is necessary to increase the resources devoted to the diagnosis of new cases and the tracking of their close contacts, to establish a strategic reserve of medical supplies and equipment, to improve the coordination between primary health centers, nursing homes and hospital emergencies, to increase the facilities available for the housing of quarantined patients and to prepare plans for rapidly increasing hospital capacity if necessary.
- We need to design a clear strategy for the gradual scaling down of special furlough schemes (*ERTEs por fuerza mayor*) that should be tailored to the circumstances of the different sectors and to the evolution of the pandemic. Its aim should be to facilitate the survival of viable firms and the reallocation of resources across firms and sectors, and to provide incentives for the return to economic activity. Further extensions of special furloughs are likely to be necessary, but they should be increasingly more selective, with special benefits restricted to sectors that face the longest recovery periods or strong restrictions for health reasons, or to firms heavily dependent on them, and to the areas and sectors affected by new outbreaks. The extension must be accompanied by a clear regulation that should explicitly allow the greatest possible flexibility in relation to the entrance and recall of workers from furlough schemes and facilitate their conversion into standard ERTEs, as well as by a gradual reduction of special benefits, including the reduction of social contributions and the extended duration of unemployment benefits. It is also important to require and/or incentivize the training of furloughed workers and to allow them to temporarily continue to receive part of their benefits when they accept another job or become self-employed.
- The gradual withdrawal of special ERTEs should be complemented with additional labor market measures to facilitate the reallocation of resources and the survival of those firms that cannot afford to keep all of their workers. These measures should include the strengthening of the regional public employment services in order to increase the effectiveness of active labor market policies through the use of tools such as statistical profiling that allow for a personalized treatment of employment seekers. It is also necessary to repeal the current prohibition of fair dismissals for objective reasons linked to Covid and the requirement to maintain employment for at least six months after workers are recalled from furlough.
- It is urgent to revise the regulation of publicly guaranteed loans and of the restructuring and liquidation processes linked to them in order to avoid the disappearance of viable firms and facilitate the rapid and orderly liquidation of the rest. Greater flexibility may be required regarding repayment terms and capital repayment holiday periods, and partial cancellations or other forms of a posteriori aid should be considered, especially in the most affected sectors. Bankruptcy and restructuring procedures should be modified to make them more agile and to

introduce correct incentives for all parties involved, avoiding in particular the risk that banks may be forced to execute public guarantees prematurely because of the danger of losing them in the event of restructuring.

It would be useful to consolidate the debts with all public administrations (social contributions and taxes owed as well as public loan guarantees) into a single mass that can be negotiated as part of a restructuring agreement, with a single representative (that may be the bank, by delegation) and the waiving of the usual privileges of public administrations in these procedures. To facilitate the management of the restructuring process, it may be useful to create a special vehicle for the holding of profit participating loans and capital shares that may incorporate private investors with experience in business management and restructuring.

- We must also reconsider the emergency measures that were taken at the beginning of the crisis to protect vulnerable groups. Many of them sought to avoid that vulnerable households could be evicted from their homes or have their utilities cut off, which makes sense during an emergency but does not solve the underlying problems. Once the emergency has passed and a minimum income program has been established, the current model of specific subsidies whose cost is often born by private parties, should be reconsidered. We should move towards a single mechanism for the global protection of vulnerable households that should be publicly financed. It is questionable whether such a program should include subsidies to the consumption of specific goods or services, such as housing or energy, in addition to supplementing household income.
- In the area of social protection, the focus in the short run should move towards the strengthening of active labor market policies and the school system. Increasing the effectiveness of public employment services could contribute significantly to the fight against poverty and inequality by facilitating the labor market insertion of the long-term unemployed, a numerous group that will grow rapidly as a result of the crisis. As for the school system, it will need additional personnel and resources to be able to function properly in a complicated health situation. Without a determined effort in this area, the damages that the most vulnerable students are already suffering could become permanent, putting at risk their future school and work trajectories and the principle of equality of opportunity.
- Another urgent measure is the adoption of a budget consolidation plan that should include an explicit path of fiscal adjustment from 2022 onward. The plan should incorporate a compromise to reduce the structural component of the public deficit by at least half a point of GDP per year, provided growth does not fall below its potential level. Such a plan is required to reduce uncertainty and anchor the expectations of markets and economic agents in a way that will limit increases in risk premia and the delay of investment, consumption and job creation decisions, as well as to increase our fiscal margin of maneuver for dealing with future crises.
- The fiscal consolidation plan will have to combine tax measures with actions designed to rationalize expenditure and reduce its growth rate in order to gradually return our debt and deficit levels to sustainable values. Once the recovery is firmly under way, it may be advisable to introduce a transitory surcharge on personal income taxes to help finance the extraordinary expenditure required to fight the pandemic. This should be done in the context of a global reform of the tax system to which we will return below.

ii) Thinking about the long run

In the long run, the main objective of our economic policy must be to achieve robust, inclusive and sustainable growth. We must give priority to those measures and reforms that increase the growth potential of our economy and reduce its structural rate of unemployment because they

will translate not only into a higher standard of living and lower inequality, but also into an increase in tax revenues that will help finance the high spending needed to fight the pandemic and will allow us to provide better public services without raising taxes.

To reach these goals we have two main instruments: investment policy, understood in a broad sense to include the accumulation of intangible assets, in particular human capital, and structural reforms designed to improve the functioning of certain key markets and of different elements or tools of the public sector. Regarding this second instrument, the crisis can be an opportunity we should not waste to undertake in depth reforms that would be much harder to implement in normal times.

Our recommendations in these areas can be summarized as follows.

- Making good use of the different European aid mechanisms will be extremely important for accelerating the recovery and establishing solid bases for future growth. The considerable resources that the EU is making available through loans and grants must be used to finance projects and programs carefully chosen on the basis of their social returns, giving priority to those that have an important public goods component and would not therefore be easily carried out by private initiative under market conditions. To ensure the correct selection of projects and the quality of the proposals, a lot of advanced planning will be necessary, together with close coordination among the different administrations and the private sector in the preparation of investment plans. We also need to think about how to generate the resources that will be needed to repay EU loans. In the case of certain infrastructures, it may be advisable to create or increase tolls or charges on their users, which can also help internalize any externalities linked to their use.
- Many of the investments that are necessary to restructure and modernize our economy are profitable projects that can be undertaken by the private sector under market conditions. The Government should facilitate such investments by preserving economic and social stability and by establishing an adequate regulatory framework that guarantees legal security and the agility of administrative procedures and avoids unnecessary red tape.
- As for investment priorities, we concur with the EU's emphasis on the fight against climate change and its consequences, the promotion of digitalization and other new advanced technologies and the accumulation of intangible and human capital, instead of the traditional preference of our country for conventional transport infrastructures.
- These considerations suggest that EU loans and investment grants should be channeled preferentially towards certain areas. Aside from educational investment, to which we will return shortly, some of the priorities should be the following:
 - Certain auxiliary investments or incentives that can help accelerate the process of decarbonization, especially in the transport sector and perhaps in building renovation. This would include R&D+i in new technologies and energy sources, with special attention to energy storage and demand management, possibly part of the charging infrastructure for electrical vehicles and improvements in the energy efficiency of dwellings and other buildings.
 - The construction, maintenance and renovation of water and waste management infrastructures, including the renovation of urban distribution networks to reduce leakage and the modernization of irrigation systems and water treatment plants.
 - Regarding digitalization, measures to be financed or subsidized include investment in improving connectivity and ITC skills, the introduction of advanced capacities in strategic sectors of the administration and public services (education, science, health and justice) and the reduction of the digital gap across territories and social strata.

- As for investment in conventional transport networks, priority should be given to network maintenance, which has not always been adequate, and to the design of efficient mechanisms for its financing, including the generalization of toll charges to the entire network of high-capacity roads, and to areas where there are still capacity shortages, such as commuting and merchandise rail networks.

- The other major component of investment is the accumulation of intangible assets. In contrast with our traditional preference for concrete, investment in human and technological capital should be given increasing weight in the future. Education and training, in particular, must be the first priority because they are key instruments to promote not only growth but also social cohesion and equality of opportunity. To take full advantage of their potential, it is necessary to initiate a sustained process of reform focused on the promotion of excellence and the attraction of talent and aimed at meeting the needs of the productive system.

- Regarding the fight against poverty and inequality, the recently established minimum income scheme (known as *Ingreso Mínimo Vital, IMV*) can be a very useful tool, especially if we manage to combine its cash benefits with effective training and activation programs that help reinsert its beneficiaries into the labor market. To increase the effectiveness of the IMV, it would be necessary to revise its design so as to introduce effective incentives to work, which are now practically non-existent, and to ensure the quality of training and insertion programs, which will require better coordination with the autonomous communities, and in particular with their social and employment services.

- We need a comprehensive tax reform for reasons of both equity and efficiency that have been strengthened by the pandemic. A key priority must be to broaden tax bases by eliminating fiscal benefits, including reduced VAT rates, and special tax regimes, such as the so called *modules regime* and the simplified VAT regime. It is also necessary to reform the Corporate Income Tax to bring it closer to neutrality, improve its integration with the personal income tax and ensure a fair distribution of its revenues across countries in the case of multinational enterprises. There is also agreement on the need for a thorough revision of the taxation of capital income in order to ensure its neutrality across assets, eliminate confiscatory rates and bring it in line with existing rules in other advanced countries. Other necessary changes include an increase in excise tax rates, to bring them closer to European levels, a greater use of environmental taxes within an orderly framework that may be established by a national law, and a greater reliance on revenues based on the benefit principle (tolls, charges, public prices and copayment schemes).

- We must continue to advance toward a more flexible, fairer and more efficient labor market. In order to reduce the degree of duality, it is necessary to simplify the current menu of labor contracts and reduce as much as possible the existing asymmetries between temporary and permanent workers in terms of severance payments and judicial protection. It would also be important to eliminate the existing legal uncertainty regarding the objective causes for justified dismissals and to establish negotiated mechanisms for internal flexibility, preferably at the firm level so as to be able to accommodate the special circumstances of each firm and its economic situation. Finally, it is necessary to start thinking about how our labor market may be adapted to an uncertain future characterized by trends such as digitalization and automation, that may be accelerated by the current crisis.

- The Parliamentary Committee on pensions (the so called *Comisión del Pacto de Toledo*) is currently working on a series of recommendations for a much needed reform of the public pension system that should seek an equilibrium between sufficiency and sustainability. The design of the reform must be based on a realistic analysis of the economic situation of the country and its public finances. The Covid-19 crisis has greatly complicated a situation that

was already delicate due to the precarious financial position of the public pension system in recent years and the negative demographic perspectives we face in the coming decades. Existing plans for reversing the last pension reform involve returning to full inflation indexation and derogating the *sustainability factor* that was meant to tie initial pensions to life expectancy at retirement. These measures did not look very realistic before Covid, and seem now even less prudent.

- A well-functioning public administration is very important for the smooth operation of economic activity. Among other things, the administration must guarantee legal security, market unity and good regulation in order to reduce uncertainty and provide a favorable environment for the activities of households and firms. The different levels of government are also responsible for the regulation and provision of many basic services, including public security, health, education and transport and utility networks.

All this must be done as efficiently as possible, minimizing its cost for taxpayers and the delays and bureaucratic obstacles they face. In this area, there is considerable room for progress, including the extension and improvement of digitalization, the adoption of good practices in the evaluation of public policies, increased coordination among different administrations and their information systems and a reform of the regional financing system that increases the degree of fiscal responsibility of the autonomous communities.