

# 1. Executive Summary

The financial year 2010 looks set to be well-and-truly difficult for Spain. *Círculo de Empresarios*, aware of the gravity of the situation and of how much is at stake, wishes to contribute through this document to divulging the reality of the situation to society at large. We would also like to convey the message that **we can reverse this situation through a brave political programme and with the efforts of all Spaniards. For now, in our view, the government's policies, our politicians' attitude and the direction in which the unions are drifting do not appear to point us toward the right path, unfortunately.** However, we are still in time if they join forces and accept the inevitable costs of a more solid recovery and greater well-being for all in the medium term.

**The gravity of the economic situation demands, unlike what we have seen so far, clarity in both the diagnosis and the evaluation of the efficiency of possible treatments.** Furthermore, it requires the announcement of transparent policies, to avoid generating even greater uncertainty. Although in the short term there are no miraculous solutions, a substantial cutback in current expenditure would lay the groundwork for a recovery. Accordingly, some sacrifices will have to be accepted in return for greater future well-being. We must not succumb to the temptation of trying at all costs to recover quickly, as we would run the risk of the recovery actually being premature and we could forfeit the chance of more vigorous and healthy future growth. At all events, we must act firmly and immediately, in order to create conditions conducive to developing a more balanced and flexible growth model with a medium- and long-term view.

Fiscal stability is an essential component of this desired economic framework. In barely two years, **Spain's public accounts have endured a spectacular and sharp decline.** It would be a mistake to blame this problem solely on the crisis punishing Spain's economy from inside the country and abroad. The sizeable and growing public deficit is, largely, the result of **political errors made not just since the crisis began, but also during the boom years that preceded it,** in which, as *Círculo de Empresarios* has often remarked, the necessary structural reforms were not carried out, and neither was there enough effort for austerity and containment in public expenditure, especially at regional government (Autonomous Communities) level.

Against this backdrop, **fiscal policy** now faces a **clear dilemma** between the **capacity of certain measures to mitigate the effects of the crisis in the short term** and the **consequences which these measures could have in the longer term**. Policies to stimulate demand through spending are increasingly less efficient and create greater long-term difficulties in the form of imbalances, of which the public deficit is a clear example. To ease this dilemma, it is necessary **not to constrain the action of fiscal policy to spending and demand measures**, but to **act also on the supply side**. This is especially true considering that the scope for fiscal actions is running out, and so is its power to trigger demand. Furthermore, **Spain's current economic problems are a symptom of structural defects that will not be corrected merely as a result of the effects of recovery in other economies**.

**For a real transformation, supply-side policies are needed:** in other words, policies that expand aggregate supply. We need measures and reforms that enable the Spanish economy to obtain more and better productive resources, as well as mechanisms for a more efficient use of these resources; reforms that create the conditions for Spanish society to define and generate this new competitive model. *Círculo de Empresarios* has often referred to these measures: education, labour market, energy, regulatory framework, regional government financing, etc.

**The structural reform must include measures to correct the imbalances in public accounts over the next few years.** There are two reasons for this: commitments with the European Union (Stability and Growth Pact) and, above all, the health of the Spanish economy itself.

A major problem in achieving this objective is that the **deficit** becomes **structural** because many revenues (those from construction and imports, for example) are not going to bounce back to previous levels, and neither would it be a good thing if they did in the context of a more balanced growth model. Accordingly, **fiscal consolidation means:**

- **Structural reforms:** from the strictly budgetary standpoint, these reforms boost the economy's growth potential and with it its capacity to collect tax, thereby helping to overcome the macroeconomic and fiscal challenges.
- **Substantial cutbacks in spending and more efficiency in management:** evidence shows that lasting fiscal consolidation processes are those that come after non-productive spending is cut, while those based on tax increases end

up failing. However, the current spending cuts the government might make are probably not enough either. The imbalance could, then, increase in volume and become more persistent, dampening hopes of sustained and healthy growth.

**The real problem is the increasing spending produced by the Autonomous Communities model in Spain and the lack of fiscal discipline among regional governments,** which is growing the public deficit and causing it to develop into a cyst. In short, the way Spain is structured into a State of autonomies is actually castrating its ability to generate wealth.

Based on this argument, **the solution is a sensible model of State structuring, with efficient decentralization and tax collection capacity, to put an end to the increasing hypertrophy of Public Administrations and promote responsible fiscal policies.** To start with, governments of the Autonomous Communities absolutely must contain and rationalize spending. But the model itself must be completed once and for all, rather than continue in a process of decentralization that responds to party-political whims. Spain is already more decentralized than the major federal nations but, unlike these, which have maintained a State structure for much longer, Spain still does not know where it is going or how to get there. On the way, the lack of fiscal discipline rules.

- **Reform of the fiscal system:** a tax increase would at all events be a supplementary measure, insufficient in itself and damaging in the absence of other measures. The key is not to increase taxes, but to design the best possible fiscal reform, establishing where there is scope to increase/reduce taxes and what the consequences of doing so would be.

**The economic policy plan** entailed by the General State Budget for 2010 **does not respond to the measures that must be demanded of our leaders,** and is therefore another chapter in the mistaken line set by the 2009 Budget. As usual, **there is further insistence on demand-side policies, without positing reforms** that could lead to the development of a more competitive productive model.

And nor are the demand policies proposed the right ones. It is a **grave mistake** to resort to **increasing taxes as a means of fiscal consolidation, relinquishing more severe cutbacks in current expenditure.** The announced austerity in spending is no

such thing, since the Budget for next year actually factors in an increase in expenditure of almost 20% with respect to 2009. The unbridled optimism on which the macro projections for this year's budget were based is now taking a heavy toll. **To make matters worse, the chosen route is to cut spending on items that are vital to any attempt to boost the competitive model of Spain's economy, such as investment in innovation, research and development.**

**The composition of the tax increases also merits criticism.** The government is wrong to increase tax on saving, since it is precisely saving that the Spanish economy needs to redress the imbalances (surplus expenditure, foreign indebtedness, household indebtedness, problems on financial institutions' balance sheets) that got us into such a difficult situation in the first place. Although the increase in VAT was accompanied by other measures, such as the revision of the premiums on workplace accidents and professional diseases insurance, which will cut labour costs, these measures are insufficient. Moreover, application of a 5-point cut on Corporations Tax, which would have given a break to companies obliged to trim margins due to higher indirect taxes, was designed under excessively strict conditions. Consequently, the increase in indirect taxes will undermine demand and jeopardise many companies.

In short, the absence of structural reform and the grave budget imbalances are a threat to the **Spanish economy, which will probably lag behind** in the recovery that is beginning elsewhere. ***Círculo de Empresarios* trusts that there is (albeit shrinking) scope to turn this situation around.** However, we need **the awareness and efforts of all**, as well as an **economic policy with a true vision of the future to efficiently guide the economy to recovery.** This is what a democratic and advanced society such as Spain must demand of those who run its economic policy.

Our politicians, both those in government and those in the opposition, have the obligation, each in their own capacity, to make every effort to help Spain emerge strengthened from this crisis. The permanent derogatory remarks, the mutual accusations, the fact the party-political interests prevail over those of the citizens, is quite simply unacceptable. Spanish society needs and must demand State Pacts immediately.