The economic consequences of Covid in Spain and how to deal with them

Angel de la Fuente
Fundación de Estudios de Economía Aplicada, Madrid, Spain

Received 16 November 2020
Revised 25 November 2020
Accepted 26 November 2020

Abstract

Purpose – This paper aims to review the economic impact of Covid in Spain and propose policies to deal with them.

Design/methodology/approach – Not relevant.

Findings – The pandemic is having a very severe effect, which varies across sectors and regions. Given the severity of the problem, a comprehensive policy strategy is needed. Specific proposals about such a strategy are made, distinguishing between the short and the long run.

Originality/value – It provides a discussion about the main measures that have been taken to mitigate the economic consequences of Covid in Spain and about what else should be done.

Keywords Spain, Economic impact of Covid

Paper type Research paper

This paper is a reduced and updated version of the final report of the Joint Working Group on COVID-19, a team integrated by over 130 academic researchers and professionals from industry and other organizations to analyze the economic consequences of the pandemic and propose measures to mitigate them. The final report draws on a series of sectoral reports that are listed after the references. The paper was prepared by a large committee. As this journal's rules do not allow all its members to appear as authors, only the coordinator is listed as such. The remaining members of the committee are the following: Anna Balletbó (ArcMed Hotels and Renfe), José Luis Bonet (Cámara de España), José E. Boscá (U. de Valencia and FEDEA), Santiago Carbó (Cunef and Funcas), José Ignacio Conde-Ruiz (FEDEA and UCM), Ginés de Rus (ULPGC and FEDEA), Juan del Alcázar (Banco Santander), José Ramón Díez (Bankia), Rafael Doménech (BBVA Research and U. de Valencia), Florentino Felgueroso (FEDEA), Enric Fernández (Caixabank), María Fernández (ex CNMC), Javier Ferri (U. de Valencia and FEDEA), José Ignacio García Pérez (UNIA and FEDEA), Marcel Jansen (UAM and FEDEA), Juan Francisco Jimeno (U. de Alcalá, CEPR and IZA), Alejandra Kindelán (Banco Santander), Julio López Laborda (U. de Zaragoza and FEDEA), José María Marín Vigueras (U. Carlos III de Madrid), Clara Eugenia Núñez (UNED), Jorge Onrubia (UCM and FEDEA), Luis Puch (UCM), Juan Pablo Riesgo (EY), Diego Rodríguez (UCM y FEDEA), Sofía Rodríguez (Banco Sabadell), Javier Santillán (Economista), Jorge Sicilia (BBVA Research), Eva Valle (QED Economics), Javier Vega de Seoane (DKV Seguros) and Xavier Vives (IESE). As in the original reports, not all members of the committee necessarily agree with all the recommendations made in this document.

Financial support from the Spanish Ministry of Economic Affairs, Industry and Competitiveness under Grant No. ECO2017-87862-P is gratefully acknowledged.

Applied Economic Analysis
Vol. 29 No. 85, 2021
pp. 90-104
Emerald Publishing Limited
2632-7627
DOI 10.1108/AEA-11-2020-0158

1. Introduction

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. The emergency required severe confinement and lockdown measures that have generated serious disruptions in economic activity and in everyday lives, including the closing of all educational centers. Although the contagion rate declined sharply during the summer, the situation is still complicated and will not be under control until effective vaccines and/or treatments can be made available to the entire population, 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.

This paper focuses on the economic consequences of Covid and on what should be done to mitigate them. After briefly describing the channels through which the virus affects economic activity, we provide some data on the evolution of output and employment in Spain during the pandemic and on its incidence on public finances. Finally, we discuss the main measures that have been taken to mitigate the economic consequences of the health crisis and conclude with some reflections on what else should be done. We emphasize the need to build a broad social and political consensus on the key elements of economic policy over the next few years and outline a strategy to deal with the crisis that combines short and long-term measures to speed up the recovery and set the foundations for future growth.

2. The effects of the pandemic on economic activity

The Covid pandemic has generated a profound economic crisis. Many countries, including our own, are in the midst of 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 fall sharply while expenditure must rise to combat the infection and its social and economic consequences. The situation is generating huge public deficits that may be hard to finance for some countries.

The drastic measures taken to contain the first wave of the epidemic in Spain included strict social distancing guidelines and a harsh confinement and lockdown order that closed many important economic activities during many weeks and forced the temporary interruption of many others while workplaces were adapted to the new health requirements. The activities that were more severely affected are those considered “non-essential” that require mobility or face-to-face contact and tend to generate agglomerations, such as non-essential retailing, transport and tourism, restaurants, personal services or entertainment. During the lockdown period, the affected firms and businesses saw their revenues drop sharply, to zero in many cases, but continued to face many costs, a situation, which led to the rapid deterioration of their financial position. In the same manner, many workers suffered important income reductions after losing their jobs or being furloughed or through the impact of the crisis on their volume of business in the case of the self-employed.

The economic effects of the first wave of the pandemic have extended beyond the end of last spring’s formal lockdown and to other sectors that were not directly affected by it. Retailing, bars and restaurants and many personal services were allowed to reopen as the confinement period ended, but they have had to operate since then with capacity restrictions and other costly prevention measures and with reduced demand due to the fear of contagion. The situation is even worse in the case of tourism, which is unlikely to return to normality until a vaccine and/or an effective treatment for the infection are broadly available.

To the sectors that have been directly affected by health restrictions, we have to add their direct and indirect suppliers and clients. For instance, the closing down of most retailing translated into a drastic decline in the demand for durables and non-essential consumer goods, and the problems experienced by intermediate goods producers has generated important disruptions in production and distribution chains in certain sectors, especially in the most globalized ones, like the auto industry. At the macroeconomic level, the loss of labor and business income, the increase in uncertainty and the worsening of expectations have reduced consumption and investment levels. All this has been worsened by negative feedback effects across countries within a context of generalized economic crisis and a sharp drop in international trade, tourism and investment.

A crucial factor will be the duration of the medical crisis. As time passes, more and more firms and households will exhaust their financial reserves and face solvency problems if the return to normal conditions is delayed. Recent news in this regard are not good. In recent weeks, restrictions on mobility and economic activity are being tightened again throughout Europe as a result of a growing number of Covid outbreaks, which have turned into a full-fledged second wave of the pandemic in late October. This setback can be a hard blow for many firms and businesses that were already in a precarious situation after the first wave and can therefore, endanger the recovery process that was vigorously under way during the third quarter.

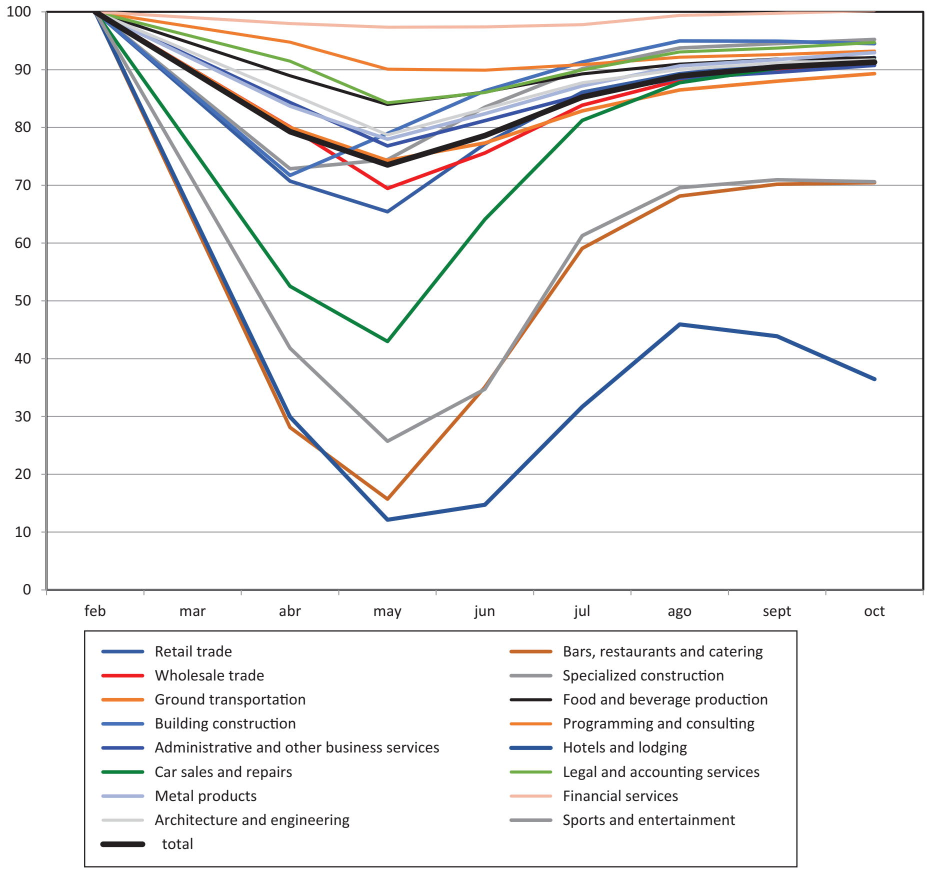
2.1 How bad are things in Spain?

The economic effects of the pandemic vary greatly across countries depending on its severity, the structure of their economies in terms of sectoral composition and the distribution of firm sizes, and the remedial measures that have been taken. Spain is among the countries that are suffering the most due to its heavy reliance on tourism and other badly hit activities, the prevalence of small firms with limited financial reserves and the weakness of its initial fiscal position, which has limited its ability to respond to the crisis. The data that have been published, as the arrival of the pandemic show record, drops in production and employment, very unevenly distributed across sectors and territories, followed by a strong rebound after the end of lockdown. The recovery, however, has been decelerating from July onward and threatens to stall or even reverse itself with the arrival of autumn and the second wave of the epidemic.

Effective employment, measured by the number of workers affiliated to social security that are actually working (and not at home, on a furlough or drawing benefits for self-employed workers who had to interrupt their activity)[1], fell by almost 30 percentage points in the worst moments of the crisis, raising the effective unemployment rate to 36% in April and May. Since then, this indicator has fallen to a still worrisome level of 20%. The evolution of aggregate gross domestic product (GDP) has followed a similar path: the Spanish economy seems to have bottomed out in May, with a drop of 25 points relative to the same month of 2019, which has come down to around five points by October. For the entire year, our calculations point to a drop of GDP of between 10%, 5% and 12% [2].

As can be seen in Figures 1 and 2, the situation varies greatly across sectors and regions. Figure 1 shows the evolution of effective salaried employment in the largest private activities relative to a counterfactual path that captures the expected evolution of this variable in the absence of the pandemic [3]. Employment bottomed out in May in construction and some business services and in June in the other sectors, but it is still quite far from normal levels in many cases. Recovery of the hardest hit activities has stalled in September and October and even those sectors that have suffered the least display a worrisome tendency to stabilize before they reach their pre-Covid employment levels.

Figure 2 shows the evolution of regional GDPs using rough monthly estimates based on the quarterly national accounts and the monthly data on effective employment by region described above. As may be expected, the effects of the pandemic are being especially severe in the two island regions due to the very high weight of tourism in their economies, and in



Note: As some of the required data are not available for March,the relative employment index for that month is approximated by linear interpolation between February and April. The value of the index is set to 100 in February as that was the last normal pre-Covid month in Spain

Figure 1. Evolution of effective employment main private sector activities (two-digit CNAE classification)

particular in the Balearic Islands, whose output remained almost 25 points below last year's level in September and October, after having lost almost 50 points in May. At the opposite end of the distribution, we find the autonomous communities of Extremadura, Murcia and Castilla la Mancha, characterized by a greater weight of the agricultural sector and much less dependent on tourism, whose monthly GDPs never fell by more than 20 points and have reduced their losses to less than two points in October.

2.2 The budgetary and financial situation

An important additional complication is that Spain entered the Covid crisis with little fiscal and budgetary room for maneuver. Our country finished 2019 with a public debt of 95% of GDP, a public deficit of 2.8% and a structural deficit of almost 4% of GDP. Hence, we are going into a new crisis without having completed the necessary process of fiscal consolidation after the previous one. In these conditions, the damage to public finances

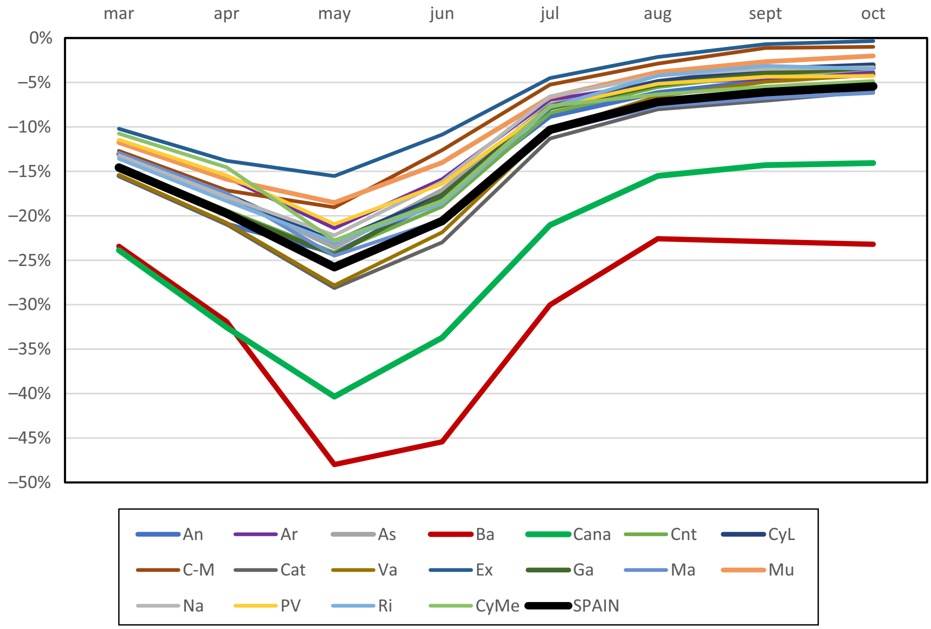


Figure 2. Evolution of monthly GDP during 2020, by region and Spain's total percentage difference with the same month of 2019

caused by Covid will put us in a complicated situation, with very high financing needs. The poor initial situation, moreover, may limit the margin we have to fight the pandemic and mitigate its economic and social consequences.

The update of the 2020 Stability Program that the Spanish Government sent to the European Commission at the end of April foresaw an increase in expenditure of almost €55.000m and a decrease in revenues of over 25.000 million during the current year. This scenario would bring our budget deficit to over 10% of GDP and put our stock of public debt above 115% – figures, which have subsequently been revised upward to 113% and 119%, respectively, in the recent budget plan for next year [4]. Fundación de Economía Aplicada (FEDEA) projections (Felgueroso *et al.*, 2020a, 2020b) substantially increase the loss of revenues foreseen by the government and raise the expected deficit to 12% of GDP or 133,000 million, very close to the European Commission's projection of 12.2% in its recently released Autumn Forecast (European Commission, 2020a). If we add to this amount the debt that will mature during the year and needs to be refinanced, total financing needs for 2020 will be around 300,000 million, a very high figure, which would be complicated to reach without the aid the European Central Bank is giving Spain through its massive debt purchases.

3. The economic and social response to the crisis: what has been done and what remains to be done'

The figures we have reviewed in the previous section add up to a very complicated situation. 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, namely, protect households and firms from the crisis, maintaining an adequate level of social protection and preserving the productive capacity to the extent possible, promote economic recovery and facilitate the necessary reallocation of resources toward sectors and firms with better perspectives and set down the basis for sustained, sustainable and inclusive growth in the medium and long term.

The first objective has been achieved reasonably well, although with some gaps and delays in the introduction and payment of certain emergency benefits. In the months, since the arrival of the pandemic, the Spanish Government has taken quite a few measures to mitigate its economic and social consequences. Most of them have sought to help households and firms survive the acute initial phase of the crisis without irreversible damage, trying to limit its social costs and the destruction of productive capacity. These measures can be divided into three blocks, namely, those that sought to increase labor market flexibility and maintain workers' incomes, liquidity injections and other types of support for firms and businesses and actions taken to protect the most vulnerable groups of the population.

The most important measure within the first block has been the flexibilization of temporary furlough schemes (known as Expediente de Regulación Temporal de Empleo (ERTE) for their Spanish initials), and the introduction of special benefits for affected workers and firms, namely, extended unemployment benefits and rebates on social contributions. These schemes have been very useful to get both workers and firms through the early stages of the crisis by helping workers maintain their incomes and allowing firms to reduce their labor costs while preserving the employment relation, and therefore, their joint investment in specific human capital. Another important measure has been the granting of over €100bn in public guarantees to help financial institutions provide firms and self-employed workers with the liquidity needed to continue to pay their bills in spite of the unexpected drop in revenues. With the same objective, the government has also granted postponements on different taxes and social contributions. Finally, it has taken measures to protect self-employed workers, other groups not covered by ERTEs and households, especially those considered most vulnerable. In this regard, the most important measure has been the belated introduction of a minimum income of last resort, the IMV program (for *Ingreso Mínimo Vital*) but there have also been special subsidies and moratoria to deal with housing and utility expenses and temporary prohibitions on evictions and utility cutoffs.

Although these measures have been very useful for dealing with the first blow of the pandemic, we need to go further. As Blanchard *et al.* (2020) argue, once the acute first stage of the pandemic is over and we enter a second phase of the crisis, the design of public policy becomes more complicated as we face delicate tradeoffs between conflicting objectives and need to begin to worry again about budget constraints and incentive effects. In health matters, we need to find less drastic ways to combat the virus that allow for some degree of normalization of everyday life. In economic matters, we need to go beyond a purely defensive strategy, gradually withdrawing support measures and introducing stimuli for reactivation.

In the remainder of this section, we outline a strategy for dealing with the current crisis and improving Spain's economic performance in the long term.

3.1 Short-term priorities

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 to promote the recovery of economic activity and avoid the closing of viable firms without hindering the necessary reallocation of resources toward those activities and firms with better future perspectives. An important part of the challenge will be to adapt general measures, such as the special furloughs and the government-guaranteed loans, to the needs of the different sectors and to correctly design the specific support measures that will be required to minimize the damage to certain key industries, 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 health care 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 such sectors and to the areas and sectors most 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 rebates on 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 collect part of their benefits if they accept another job or become self-employed. Some progress along these lines has already been made in recent weeks.
- 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 pre-Covid workers. These measures should include the strengthening of the regional public employment services to increase the effectiveness of active labor market policies through the use of digital tools 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 for firms that have benefitted from rebates on social contributions.
- While considerable attention has been paid to the liquidity needs of firms and businesses, direct aid to them has been rather scarce in Spain (Cuadro-Saéz *et al.*, 2020). As the crisis drags on, many of them are beginning to experience solvency problems that may threaten their survival, independently of their long-term viability. To avoid the disappearance of many firms that will be perfectly viable under normal conditions, we need to find ways to help them cover their fixed costs during a relatively long period of inactivity. This is likely to require some combination of non-refundable grants and capital injections– rather than financing

for new investment projects, which seems to be the main form of intervention foreseen in the European Recovery Fund (see below).

- Non-refundable grants have practically not been used in Spain so far, but they should be considered, at least for stressed but clearly viable firms in the most affected sectors. To limit the pressure on an already stretched national budget, it would be important to investigate whether such grants can be financed by any of the existing EU support programs. We also need to find other ways to recapitalize viable firms and businesses under stress. In this regard, it may be useful to create a special vehicle for investment in profit participating loans and capital shares that may incorporate private investors with experience in business management and restructuring. For smaller firms and businesses, we should consider allowing the repayment of government-guaranteed loans through surcharges on taxes on future profits as suggested by Ali *et al.* (2020) for the case of the UK.
- In the same line, it is urgent to revise the regulation of publicly guaranteed loans and of restructuring and liquidation processes 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 relief should be considered, at least in some 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.
- 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 prevent evictions or the cutting off of utilities during an emergency situation, which makes sense but does not solve the underlying problems. Once the emergency has passed and a minimum income program has been established, we should reconsider the use of specific subsidies and ad-hoc prohibitions whose cost is often born by private third parties. We should move toward 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 short-run focus should shift toward 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 both 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 would help 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. It would also be greatly needed 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 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 Covid surcharge on the personal income tax 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.

3.2 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 statutory tax rates.

To reach these goals, we have two main instruments, namely, investment policy, understood in a broad sense to include the accumulation of intangible assets, and 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. It should also be noted that the support schemes the European Union has established to help member states deal with the Covid crisis can be of considerable help on both fronts. The most important of these schemes is the European Recovery Fund that will go under the name of *Next Generation EU* (European Commission, 2020b). This initiative will provide up to €750.000m in grants and loans to finance investment projects and structural reforms over the next six years. Spain's expected allotment amounts to 140.000 million.

Our recommendations in these areas can be summarized as follows.

(1) Making good use of the different European aid schemes 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. While the execution of these projects can provide a welcome demand stimulus that will help accelerate recovery, their main goal must be to improve the productivity, competitiveness and ecological sustainability of the Spanish economy.

(2) A lot of careful planning will be necessary to absorb these funds, together with close coordination among the different administrations and the private sector in the preparation of the required investment plans. Although the tight calendar of the recovery plan will complicate things, to ensure the quality of the selected projects it will be vital to establish some sort of filter, as independent as possible, to ensure that they meet some minimum standards. At the very least, projects should include a discussion of why the proposed solution is better than alternate ways to satisfy the same needs or achieve the same objectives and must pass at least a rough cost-benefit analysis. Projects that involve future streams of maintenance and operation costs in excess of their revenues should be scrutinized with special care.

(3) Careful thought should be given to the sequencing of investment projects and to their form of financing (through grants or loans). An effort should be made to get rapidly under way those projects that are already mature or are technically simple to design to stimulate the recovery, favoring those that may have large employment effects, while allowing more time to complete the design of the more challenging projects. Natural candidates for loan financing would be those investments that can generate steady revenue streams (or cost savings) over time, including many infrastructures that should be financed through new or increased tolls or charges on their users, which can also help internalize any externalities linked to their use.

(4) 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.

(5) 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 the accumulation of intangible and human capital, instead of the traditional preference of our country for conventional transport infrastructures. These priorities should leave room for attention to the adoption of other new advanced technologies and for other measures designed to promote productivity and competitiveness in all sectors and to improve more traditional technologies.

(6) These considerations suggest that EU loans and investment grants should be channeled preferentially toward 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 energy sources and related technologies, 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. New investment should be restricted to areas where additional capacity may have a positive net social value, such as commuting and freight rail networks.
- A good case can also be made for large strategic investments to improve our position in key aspects or components of new technologies and products, including artificial intelligence, electric car batteries and hydrogen cells and microprocessors. These projects should be undertaken through public-private partnerships at the European level.
- As noted in the previous section, grants or loans to finance new investment will be of little use to sectors such as tourism that will experience prolonged periods of inactivity or very low demand or to many other viable firms in financial distress as a result of the crisis. To help address this problem, EU support schemes should also allow the funding of non-returnable grants and the recapitalization of viable firms.

(7) 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. Greater attention should be paid to meeting the needs of the productive system and to facilitating the flow of people and ideas between research centers and universities, industry and the public sector.

(8) Regarding the fight against poverty and inequality, the recently established minimum income scheme (*IMV*) can be a very useful tool, especially if its cash benefits are combined with effective training and activation programs that help reinsert its beneficiaries into the labor market. To increase the effectiveness of IMV, it would be necessary to revise its design so as to introduce effective incentives to work, which are now practically non-existent as a result of the 100% effective marginal tax rate the program imposes on the declared income of its beneficiaries. In the same line, it would be crucial to give the autonomous communities incentives to get actively involved in the program through their social and employment services if we want to ensure the quality of training and insertion programs.

(9) We need a comprehensive tax reform for reasons of both equity and efficiency that have been reinforced by the pandemic. A key priority must be to broaden tax

bases by eliminating ineffective and inefficient tax expenditures, including reduced VAT rates and special tax regimes, such as the so-called *modules regime* of the personal income tax and the simplified VAT regime that are available to small non-corporate businesses. 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 a need for a thorough revision of the taxation of capital income 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 should be established by a national law, and a greater reliance on revenues based on the benefit principle (tolls, charges, public prices and copayment schemes).

(10) We must continue to advance toward a more flexible, fairer and more efficient labor market. To reduce its 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 enterprise level so as to be able to take into account the circumstances of each firm. 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.

(11) We need a realistic reform of the public pension system that will guarantee its sustainability without sacrificing intergenerational equity by placing an unreasonable fiscal burden on younger cohorts that have fared much worse than retirees at least since the previous crisis. The prospects in this area are not good, however. The Parliamentary Committee on pensions (the so-called *Comisión del Pacto de Toledo*) has recently issued a series of recommendations on pension reform that pay lip service to the need to strike a workable balance between pension sufficiency and sustainability but do not always point in a reasonable direction in practice. The government, moreover, has already sketched a reform proposal consistent with these recommendations that will put upward pressure on pension expenditure by returning to full inflation indexation and possibly by derogating the *sustainability factor* that was meant to tie initial pensions to life expectancy at retirement. Due to the precarious financial situation of the public pension system and the negative demographic perspectives we face in the coming decades, these measures did not look very realistic before the Covid pandemic (de la Fuente *et al.*, 2020), and seem even less sensible now that the health crisis has significantly worsened our fiscal perspectives over the medium term. Another questionable aspect of the government's proposal is that it involves "eliminating" the deficit of the Social Security System by the simple expedient of moving it to the General Government budget. This would be achieved through increasing transfers to cover Social Security's administrative costs and to finance certain benefits, which, by and large, are of a contributive nature and should therefore, continue to be financed with social contributions, as well as by turning part of unemployment contributions into pension contributions.

(12) 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 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, social services 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 the 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 to better align the interests of their governments with those of their citizens.

4. Conclusion: the need for a policy consensus and a broad budget agreement

We conclude with a final reflection of a political nature. As we have documented in this paper, the Covid pandemic has brought about a profound crisis of uncertain duration that is having serious economic and social consequences and will require painful decisions to balance needs and available resources. In these circumstances, it is very important that the core of the country's medium-term economic strategy should have the broadest possible support. We call on our political representatives, trade unions and employer organizations to make a determined effort over the next weeks to negotiate an agreement setting out expenditure and investment priorities and guidelines on how to share the costs of the crisis through tax measures and the rationalization and containment of non-essential expenditure. This agreement should then be embodied into a multi-year budget plan supported by the broadest possible majority of Parliament. This does not mean that we should attempt to give now a definite answer to key political questions such as 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.

Notes

1. The data on Social Security affiliation are taken from Seguridad Social (2020a, 2020b). Information on furloughs and benefits for the self-employed come from monthly press releases of the Ministry for Inclusion and Social Security that are posted here: http://prensa.inclusion.gob.es/WebPrensaInclusion/inicio.
2. For further details on the data and projections discussed in this section see Section 3 of Felgueroso, de la Fuente and Jansen (2020b) and de la Fuente (2020a, 2020b).
3. The counterfactual path is constructed by applying to observed salaried employment in each month of 2019 the inter-annual growth rate of the same variable observed in February 2020 that is the past month prior to the arrival of the pandemic. We work with salaried

employment because the data on the equivalent to furloughs for self-employed workers are less precise and the series contains at least a major break at the end of June as certain special benefits expired.

4 Reino de España (2020a, 2020b).

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Corresponding author
Angel de la Fuente can be contacted at: Angel.delaFuente@uab.es