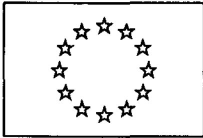

COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 30.1.2002
SEC(2002) 115 final

RESTRICTED EU

**Recommendation for a**

# COUNCIL OPINION

**in accordance with the third paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997**

**on the updated stability programme of Spain, 2001-2005**

(presented by the Commission)

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# EXPLANATORY MEMORANDUM

Council Regulation (EC) No. 1466/97, on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], stipulated that countries participating in the single currency were to submit stability programmes to the Council and the Commission by 1 March 1999. In accordance with Article 5 of this Regulation, the Council had to examine each stability programme based on the assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). The Commission adopted a recommendation on each programme. On the basis of this recommendation and after having consulted the Committee set up by Article 114, the Council delivered an opinion, following its examination of the programme.

Spain's first stability programme covering the period 1998-2002 was submitted on 30 December 1998 and assessed by the Council on 15 March 1999[2].

According to the Regulation, the updated stability programmes, to be presented annually, may also be examined by the Council in accordance with these same procedures. The first annual update covering the period 1999-2003 was submitted on 25 January 2000 and assessed by the Council on 28 February 2000[3]. The second update, covering the period 2000-2004, was submitted on 23 January and assessed by the Council on 12 March 2001[4].

Spain submitted its third updated stability programme, covering the period 2001-2005, on 9 December 2001. The Commission services have carried out a technical evaluation of this updated programme, which warrants the following assessment:

> The information provided in the updated programme is broadly in line with the new Code of conduct on the content and format of stability and convergence programmes[5]. Nevertheless, there are some weaknesses and omissions in the data. The latest update provides year-by-year macroeconomic projections for the later programme period (2003-2005 in this case). However, since these are obtained by projecting the same growth rate over the period this does not apparently provide additional information compared to the yearly average presented in earlier programmes. The programme also fails to provide the optional breakdown of general government revenues and expenditure, which would have allowed a fuller understanding of the adjustment path. However, the main weakness in data concerns the absence of long-term projections for government expenditure, especially on pensions. The resulting lack of a proper assessment of the long-term sustainability of public finances had already been singled out by the Council in its last year's opinion as the main information gap in the previous update.
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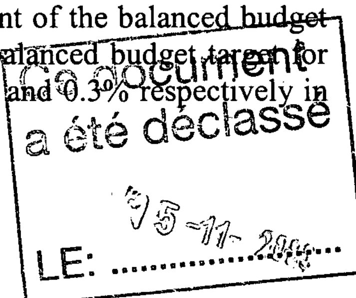
> The updated programme confirms the expected achievement of the balanced budget target set for 2001 and extends it to 2002 and 2003 (the balanced budget target for 2002 and 2003 compare, however, with surpluses of 0.2% and 0.3% respectively in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1 OJ L209, 2.8.1997.
2 OJ C124, 5.5.1999.
3 OJ C98, 6.4. 2000.
4 OJ C109, 10.4.2001.
5 *"Revised Opinion of the Economic and Financial Committee on the content and format of the stability and convergence programmes"*, document EFC/ECFIN/404/01-Rev 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

the previous update). The targets for 2004 and 2005 are general government surpluses of 0.1% and 0.2% of GDP, respectively. The primary surplus is set to remain broadly unchanged close to 3% of GDP through the programme period. The debt-to-GDP ratio is set to continue its decline, although at a slower pace than in the previous update, reaching 50% of GDP by 2005.

Despite significantly weaker growth, the implementation of the previous update has been broadly on track. After a deficit of 0.3% of GDP in 2000, the target of a general government balanced budget in 2001 is expected to have been reached and the debt ratio objective overachieved. Structural reforms implemented through the year essentially stem from the package approved in June 2000 aiming at further deregulating markets and strengthening the competition authority. There has been no significant positive reform of the pension system since the measures adopted in April 2001 did not address the main problems.

Taking into account the worsening in the international environment, the update's central macroeconomic scenario shows GDP growth, after slowing down to 2.4% in 2002, resuming at a 3% rate, close to potential, from 2003. Although somewhat optimistic in the short term, the medium-term outlook is plausible, given recent performance and the ongoing catching-up process. The inflation projection also seems attainable, the recently adopted wage agreement fails to end indexetion as recommended in last year's Council Opinion.

The fiscal consolidation strategy remains unchanged from previous programmes, relying on restraint of primary current expenditure while strengthening public investment and enabling a modest reduction in the tax burden. Current primary expenditure is set to decrease by 0.5 percentage points of GDP (from 31.2% in 2001 to 30.7% in 2005) consistent with an increase in the government investment ratio (from 5.0% in 2001 to 5.5% in 2005). Interest payments are projected to fall from 3.1% of GDP in 2001 to 2.7% in 2005. The total expenditure ratio declines from 39.3% in 2001 to 38.9% in 2005.On the revenue side, total revenues are set to remain broadly stable, declining by only 0.1 percentage point of GDP between 2001 and 2005, and embracing from 2003 a personal income tax reform, not detailed in the update but of which the net cost is estimated to be modest. The projections overall appear prudent, with cautious estimates of revenue growth and reductions in interest charges, giving some room of manoeuvre in case less positive developments materialise.

By general government sub-sectors, the State is expected to reduce gradually its deficit to 0.3% of GDP in 2005 from an estimated deficit of 0.5% in 2001. The social security accounts are projected to maintain a surplus of 0.5% of GDP during the entire period. Finally, the accounts of territorial governments, within the framework of the recently approved General Law of Budgetary Stability, are expected to be in balance as from 2001. This is important given their increasing weight in Spanish public finances. The involvement of all government sub-sectors in maintaining budgetary discipline is welcome, since fiscal decision-taking is now highly decentralised, especially after the 2002 budget reforms which have transferred important tax and spending powers to regional authorities.

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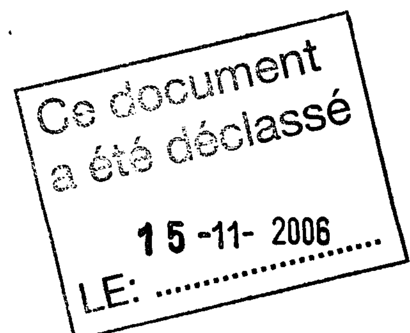
Based on the GDP growth rates and the actual government balances presented in the update, cyclically-adjusted balances calculated by the Commission services show a continuous improvement, from an estimated deficit of 0.5% of GDP in 2001 to a

projected surplus of 0.2% in 2005. According to these estimates, the targets in the programme, including their evaluation in cyclically-adjusted terms, respect the "close-to-balance" objective of the Stability and Growth Pact throughout the period.

The updated programme gives no detailed information on measures to be taken so as to strengthen the long-term sustainability of the public finances. This is of concern, given Spain's particularly exposed demographic profile and the implied adverse budgetary consequences of ageing. The updated programme contains projections to 2015 of pension expenditure and social security contributions. However, the budgetary effects of Spain's adverse demographic developments will become particularly apparent only after 2020. The negative budgetary consequences of ageing are not therefore reflected in the update. The announced intention of pursuing the reform of the pension system lacks a detailed calendar. So far, the main measure adopted to deal with ageing remains the social security fund created in 2000 to finance future liabilities, assets of which are planned to reach 1% of GDP in 2004. This target could be more ambitious in the light of the fact that the current social security surpluses are not being fully allocated in the fund.

Finally, the update acknowledges the important role to be played by other structural policies, particularly in the market for goods and services, in ensuring non-inflationary employment-oriented growth. The actions considered in the update stem mainly from the June 2000 package. They are consistent with the 2001 Broad Economic Policy Guidelines. However, the measures implemented so far should be closely monitored and strengthened if necessary.

Based on this assessment, the Commission has adopted the attached recommendation for a Council opinion on the Stability Programme update of Spain and is forwarding it to the Council.



Recommendation for a

**COUNCIL OPINION**

**in accordance with the third paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997**

**On the updated stability programme of Spain, 2001-2005**

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council regulation (EC) N° 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], and in particular Article 5(3),

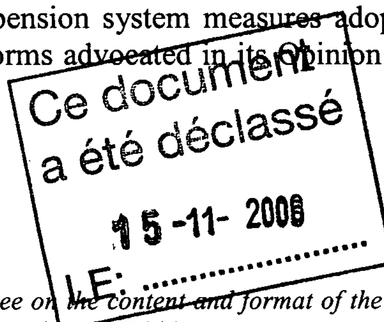
Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [12 February 2002] the Council examined Spain's updated stability programme covering the 2001-2005 period. The information provided in the updated programme is broadly in line with the revised "*Code of conduct on the content and format of stability and convergence programmes*[2]". Nevertheless, there are weaknesses and omissions, particularly the absence of adequately long-term projections for pensions and public expenditure as a whole. The Council's Opinion on the previous update[3] already drew attention to this issue; future updates should be more complete.

The Council notes with satisfaction that implementation of the previous update has been broadly on track despite weaker growth. After a deficit of 0.3% of GDP in 2000, the target of a general government balanced budget in 2001 is expected to have been reached and the debt ratio objective overachieved. The achievement of the fiscal targets for 2001 was helped by stronger than planned containment of expenditure and presumably by higher than expected inflation. Structural reforms implemented through the year essentially stem from the package approved in June 2000 aiming at further deregulating markets and strengthening the competition authority. The Council considers that the pension system measures adopted in April 2001 did not represent the significant positive reforms advocated in its Opinion on the previous update.




1 OJ L 209, 2.8.1997.

2 *"Revised Opinion of the Economic and Financial Committee on the content and format of the stability and convergence programmes"*, endorsed by the Ecofin Council on 10.7.2001.

3 OJ, C 109 10.4.2001.

Taking into account the worsening in the international environment, the update centrally projects GDP growth slowing to 2.4% in 2002 but to resume at a 3% rate, close to potential, from 2003. Although somewhat optimistic in the short term, the medium-term outlook is plausible, given recent performance and the ongoing catching-up process. The inflation projection also seems attainable, though it would be advisable to end indexation in wage bargaining in line with last year's Council Opinion.

Budgetary consolidation for the period 2002-05 is based on primary current expenditure restraint and lower interest charges while government investment is set to increase and the tax burden to moderate slightly. Despite the current economic slowdown, the update extends a balanced budget target to 2002 (and 2003) and targets small surpluses in 2004 and 2005, of 0.1% and 0.2% of GDP respectively. The debt ratio is set to continue declining, reaching 50% of GDP by 2005. For the period 2002-04 these projections are slightly less ambitious than those of the previous update.

The medium-term budgetary projections overall appear prudent, with cautious estimates of revenue growth and reductions in interest charges, giving some room of manoeuvre in case less positive developments materialise; intentions on implementing the necessary control of primary current expenditure are not, however, detailed.

The targets in the programme, including their evaluation in cyclically-adjusted terms, respect the "close-to-balance or surplus" objective of the Stability and Growth Pact throughout the period. The Council therefore considers that the updated Stability Programme is in conformity with the provisions of the Stability and Growth Pact, with the targets indicating respect of the objective with an increasingly comfortable margin. The fiscal stance, defined as the change in the cyclically-adjusted balances, implies a mild tightening, broadly in line with the recommendations in the 2001 Broad Economic Policy Guidelines.

The Council notes important developments in Spain's institutional budgetary setting, notably the recently approved General Law of Budgetary Stability and the 2002 budget reforms which have transferred important tax and spending powers to regional authorities. Although the Council does not advocate any specific form regarding the necessary internal co-ordination between central and territorial governments, the involvement of all government sub-sectors in maintaining budgetary discipline is welcome, and it is important that the existing co-ordination should also operate efficiently under the new arrangements.

The Council regrets that the updated programme gives no detailed information on measures to be taken to strengthen the long-term sustainability of the public finances. This is of particular concern given Spain's particularly exposed demographic profile and the adverse budgetary consequences of ageing. The risk of serious imbalances in the medium term cannot be excluded. The budgetary impact of ageing is not adequately reflected in the update's projections of pension expenditure and social security contributions which extend only to 2015. The announced intention to reform the pension system lacks a detailed calendar. So far, the main measure adopted to deal with ageing remains the social security fund created in 2000, assets of which are planned to reach 1% of GDP by 2004. This target could be more ambitious given that the current social security surpluses are not fully allocated to the fund. Overall, a more comprehensive and ambitious approach is required to place public finances on a sustainable footing.

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Finally, the Council welcomes the important role to be played by other structural policies, particularly in the market for goods and services, in ensuring non-inflationary employment-oriented growth. These measures are consistent with the Broad Economic Policy Guidelines. Those implemented so far should be closely monitored and if necessary strengthened.

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