



STABILITY PROGRAMME UPDATE

SPAIN

2008 - 2011

CONTENTS

1. SUMMARY.....	4
2. INTRODUCTION	5
3. GENERAL FRAMEWORK AND OBJECTIVES OF SPAIN'S ECONOMIC POLICY	6
4. CURRENT ECONOMIC SITUATION AND OUTLOOK.....	12
4.1 External assumptions	12
4.2 Cyclical developments and outlook.....	13
4.3 Prospects for 2008–2011: baseline scenario	16
4.4 Sectoral balances	19
5. BUDGETARY OUTCOMES AND PROJECTIONS.....	21
5.1 Fiscal policy strategy.....	21
5.2 Medium-term budgetary objective.....	23
5.3 Actual budgetary balances and implications for next year.....	25
5.4 Structural balance and fiscal stance	29
5.5 Public debt developments	30
6. SENSITIVITY ANALYSIS AND COMPARISON WITH THE PREVIOUS UPDATE.....	31
6.1 Sensitivity analysis: alternative growth scenarios.....	31
6.2 Sensitivity analysis: interest rates.....	32
6.3 Comparison with the Previous Stability Programme Update	33
7. QUALITY OF PUBLIC FINANCES	34
7.1 Strategy.....	34
7.2 Developments on the expenditure side.....	35
7.3 Developments on the revenue side	36
8. SUSTAINABILITY OF PUBLIC FINANCES.....	38
8.1 Long-term budgetary projections.....	38
8.2 Strategy.....	40
9. INSTITUTIONAL FEATURES OF PUBLIC FINANCES.....	42
9.1 Implementation of national fiscal rules.....	42
9.2 Reform of Territorial Financing System.....	42
9.3 Other reforms with an impact on the budget scenario: Care for Dependent Persons.....	43

TABLES

1. Structural reforms
2. External assumptions
3. Macroeconomic prospects
4. Labour market developments
5. Price developments
6. Sectoral balances
7. Short-term fiscal measures with a direct budgetary impact
8. Budgetary prospects
9. Cyclical developments

10. General government debt developments
11. Sensitivity analysis: alternative growth scenarios
12. Sensitivity analysis: interest rates
13. Divergence from previous Stability Programme Update
14. Medium-term measures to improve the quality and sustainability of public finances
15. Projections of expenditure associated with ageing

FIGURES

1. Real growth and convergence of the Spanish economy
2. Composition of GDP growth
3. Headline inflation and core inflation and differential with EMU

BOXES

Macroeconomic impact of the Services Directive

1. SUMMARY

- *This Update is presented in a radically different context from its predecessors. The intensification of the international financial crisis since September 2008 has required a coordinated, rapid and global response from all economies. In Spain, the impact of the housing sector adjustment is taking its toll, exacerbated by the global financial crisis itself.*
- *Spain initially confronted the crisis from a relatively comfortable position, the result of fiscal consolidation in previous years and the sizeable reduction in government debt.*
- *This budgetary margin has enabled the Spanish economy to contribute decidedly to the European Economic Recovery Plan adopted by the European Council in December 2008, through the Spanish Economy and Employment Stimulation Plan. Specifically, the set of temporary measures with a direct fiscal impact in 2009 are expected to amount to 1% of GDP. Coupled with permanent measures, involving lower tax rates and changes in the tax prepayment system to enhance the liquidity of companies and households, the fiscal stimulus estimated for 2009 amounts to 2.3% of GDP.*
- *This stimulus is fully consistent with EU criteria:*
 - *The temporary nature of many of the measures ensures that the fiscal deterioration will be transitory.*
 - *Moreover, the Update envisages an ambitious fiscal adjustment from 2010 onwards, including improvements in the structural balance that clearly go beyond Stability and Growth Pact requirements. This consolidation effort will be based in large part on containment of public expenditure.*
 - *Among short-term fiscal measures, priority is being given to those aimed at expanding productive investment, which will not only benefit recovery and employment in the short term, but will also encourage faster growth in the long term, and, therefore, provide for greater sustainability of Spain's public finances.*
 - *The government remains firmly committed to the sustainability of public finances. Although the new projections of age-related expenditure indicate that the onset of the problem will be later than expected, the renewal of the Toledo Pact is currently under discussion. The goal is to ensure the long-term strength of Spain's pension system.*
 - *The Spanish Economy and Employment Stimulation Plan envisages an acceleration of structural reforms. The fundamental goal is to increase*

productivity, and, therefore, the Spanish economy's growth potential. Structural reforms will help to ensure that the necessary increase in the Spanish economy's price-competitiveness takes place at the minimum possible cost in terms of production and employment.

- *The quality of public finances remains a priority, through reforms to the tax system which aim to enhance efficiency and equity and through the reorientation of expenditure towards those items that contribute to improving the Spanish economy's capacity for growth.*

2. INTRODUCTION

The tenth Update to Spain's Stability Programme refers to 2008-2011; with the National Reform Programme (NRP), it is one of the most important instruments for Community-wide multilateral surveillance.

In light of the special financial and economic situation worldwide, this Update is fully consistent with the decisions adopted by the European Union. These decisions aim to provide a response to the international crisis that is appropriate, coordinated, comprehensive and coherent with the long-term strategy. In particular, this Update takes into account the European Economic Recovery Plan, presented by the Commission on 26 November, and the resolutions adopted by the Economic and Financial Affairs Council (ECOFIN) on 2 December and by the European Council on 11 and 12 December 2008, which in Spain have been implemented through the Economy and Employment Stimulation Plan.

The following were also taken into consideration: the Opinion of the Council of the European Union as regards the previous Update, the 2008-2011 Integrated Guidelines and the informal horizontal and specific Orientations drafted by the Eurogroup in June. The Update is also consonant with the NRP, the most recent version of which was presented to EU authorities in October 2008. The direct participation by the Ministry of Economy and Finance in drafting both documents (Stability Programme and NRP) ensures coherence and mutual reinforcement between the structural reforms and fiscal policy.

This Update also conforms to the Code of Conduct, which specifies the information to be included in Stability Programmes and their structure. Furthermore, in line with the ECOFIN resolutions of 2 December, it includes additional information proposed by the Commission on short-term fiscal measures (new Table 7), medium-term measures that enhance the quality and sustainability of public finances (Table 14), and structural reforms that support demand and promote resilience (new Table 1).

The remittal of this Update to the EU authorities was approved by the Cabinet on 16 January 2009.

3. GENERAL FRAMEWORK AND OBJECTIVES OF SPAIN'S ECONOMIC POLICY

This Update is presented in a radically different context from its predecessors. The international financial crisis, which has been exacerbated since September 2008, generated major tensions in the financial markets that called for coordinated action at an international level. The difficulties in credit markets and the deteriorating economic prospects have had a strong impact on the real economy, negatively affecting medium-term prospects for the world economy as well as Spain.

In this context, the Government's economic policy continues to pursue the fundamental goal of enhancing citizens' welfare. In particular, it seeks to increase material prosperity and improve employment opportunities. Nevertheless, the new situation has made it necessary to incorporate new elements in order to provide an appropriate response to the most immediate challenges that have arisen.

Accordingly, in line with the fundamental axes of the Spanish Economy and Employment Stimulation Plan, this Update is structured around three basic lines: strengthening confidence in the financial system and favouring appropriate finance for companies and households; adopting measures to promote activity and mitigate the negative consequences of the economic situation on households and companies; and accelerating structural reforms that contribute to improving our economy's capacity for recovery and long-term growth. All the foregoing is, of course, in the context of a firm commitment to the long-term sustainability of public finances.

Strengthening confidence in the financial system and favouring appropriate finance for economic activity

In coherence with the ECOFIN decisions of 7 October, the Spanish Economy and Employment Stimulation Plan includes temporary measures coordinated with the other Member States whose essential goal is to preserve the financial system's stability and facilitate the flow of funding to households and companies:

- Increase¹ the amount covered by the Deposit and Investment Guarantee Fund from 20,000 to 100,000 euro per account-holder and bank.
- Authorisation² to the Ministry of Economy and Finance, on an exceptional basis and until 31 December 2009, to acquire securities issued by Spanish-resident banks where necessary to strengthen their own funds. This authorization has not been used to date.
- Authorization³ to grant State guarantees for new funding transactions by Spanish-resident banks up to 31 December 2009, maturing between three months and three years, although transactions maturing in up to five

¹ Royal Decree 1642/2008, of 10 October.

² Royal Decree-Act 7/2008, of 10 October.

³ Royal Decree-Act 7/2008, of 13 October.

years may exceptionally be guaranteed. To this end, the limit on guarantees for 2008 was increased by 100 billion euro, and 89.794 billion euro in guarantees have been granted to date. Issues covered by these guarantees must be made before 15 December 2009. The guarantees accrue an annual fee which must be paid in advance for the entire lifetime of the issue.

- Creation⁴ of the Financial Asset Acquisition Fund (*Fondo para la Adquisición de Activos Financieros*) in order to promote lending to companies and individuals. To that end, priority will be given to the acquisition of assets backed by new loans, i.e. granted after 7 October 2008. The Fund is temporary and will be phased out as the markets return to normal; it may not hold auctions after 31 December 2009. It has been attached to the Ministry of Economy and Finance and has been endowed with 30 billion euro (which may be expanded to 50 billion euro), financed with public debt. The Fund invests in maximum quality assets that offer a return in excess of the central government's borrowing costs, thus generating net revenue. Two auctions were held in 2008 in which 9.339 billion euro were acquired, 2.115 billion euro of which consisted of repo operations with a term of two years and the other 7.224 billion euro were outright acquisitions of newly-issued mortgage covered bonds and bonds backed by mortgage covered bonds with an estimated average life of three years. Another two auctions for a total of 10 billion euro are planned for January 2009.

Additionally, the activity of the Official Credit Institute (ICO) was stepped up in 2008 and, very particularly, in 2009 to facilitate credit to businesses. In 2008, the State guarantees for securitizing loans to SMEs were increased from 1 to 3 billion euro. The ICO guarantee lines for securitisation of mortgage loans to buy social dwelling were increased from 3 to 5 billion euro. In 2009, allocations to existing ICO funding lines have been increased and two new funding lines were created:

- The four lines of funding for business were allocated a total of 10.8 billion euro in 2009, i.e. nearly 50% more than in 2008. Specifically, the ICO-SME line was expanded to 10 billion euro and its conditions were made more flexible so that it can now finance 100% of an investment project as well as financing up to 40% of associated ancillary expenses. Following its success in 2008, the ICO-Business Growth line has been allocated 600 million euro for 2009 and it may now finance up to 80% of an investment project (previously capped at 70%). The line to fund internationalization of the economy has been increased by 50 million euro in 2009 to 200 million euro. And the ICO-Entrepreneur line maintains the same allocation of 100 million euro for 2009.
- A working capital finance line has been created with an allocation of 10 billion euro, 50% of which will be funded by banks. This line is aimed at solvent, viable companies affected by the situation of credit markets. This line has been kick-started with a loan of 5 billion euro from the ICO, funded by government debt out of the 2008 Budget.

⁴ Royal Decree-Act 6/2008, of 10 October, and Order EHA/3118/2008, of 31 October.

- Finally, the ICO has been instructed to grant a one-year moratorium on repayments by companies which benefited from ICO-SME loans arranged since January 2006. It is estimated that this moratorium may release approximately 5 billion euro in 2009.

Also, to support households, the ICO guarantees the payments associated with the temporary partial moratorium on mortgage repayments that was approved in November.⁵ The deferral of mortgage instalments runs from January 2009 to December 2010. Unemployed, self-employed workers who have ceased activity and earn less than three times the multi-purpose public income indicator (IPREM), and widows' pensioners are entitled to apply for the moratorium. To qualify, the mortgage must be on the habitual dwelling, must have been arranged before 1 September 2008, and may not exceed 170,000 euro; at most 500 euro of the monthly instalment may be deferred. The amount deferred must be repaid after two years of deferral, prorated over a maximum period of 10 years. The measure is estimated to benefit 500,000 families, with 3 billion euro being deferred per year (i.e. 6 billion euro in 2009-2010).

In order to enable the ICO to handle the additional financial burden, its indebtedness cap for 2009 was increased to 27.5 billion euro, from 12.5 billion euro initially.

Mitigate the effects of the crisis and stimulate the economy, particularly through fiscal policy, while preserving the sustainability of public finances and improving their quality

The Spanish Economy and Employment Stimulation Plan also includes measures to palliate the effects of the international crisis on the most vulnerable sectors and improve economic activity. These measures were strengthened following the approval of the European Economic Recovery Plan in December 2008.

In line with the conclusions of the European Council in December 2008, this Update makes use of the available margin in fiscal policy to boost economic activity through short-term measures, thus contributing notably to the recovery of the European economy. These short-term fiscal measures, which are detailed in Table 7 of Section 5.1, focusing on fiscal policy strategy, conform to the EU criteria since they are temporary and targeted. Taken together, these strictly temporary fiscal measures with a direct budgetary impact amount to an additional fiscal stimulus of 11.2 billion euro in 2009, i.e. one point of GDP.

The tax system has also been further reformed to improve its efficiency and simplify processes. These measures are particularly appropriate at the present time because of their positive impact on income and liquidity for households and companies. These permanent measures are detailed in Section 7.3, which

⁵ Royal Decree 1975/2008, 28 November.

deals with the quality of public finances, and in Table 14. They include notably: a reduction in the tax burden on earned income through a new personal income tax credit; the elimination of wealth tax; a second reduction in the general corporate income tax rate to align it with other countries; measures aimed at improving the efficiency of the tax settlement system such as the possibility of obtaining VAT refunds on a monthly basis; and a mechanism for advancing the tax credit for home purchase in the form of a reduction in the applicable withholding rates for taxpayers entitled to that tax credit who obtained a loan to purchase or refurbish their home. As for public expenditure, priority is being given to items that improve the Spanish economy's capacity for growth. At the same time, emphasis on productive expenditure is being accompanied by efforts at austerity in expenditure on the operation of the Public Administrations, as detailed in Section 7.2 and Table 14.

The permanent measures that represent a reduction in taxes amount to 6.8 billion euro in 2009, i.e. 0.7 points of GDP. The measures to improve the system of prepayments and, therefore, enhance liquidity for households and companies represent a similar amount in 2009 (7.7 billion euro). The total volume of all these permanent measures plus the temporary measures increase the 2009 fiscal stimulus to approximately 25.7 billion euro, i.e. 2.3% of GDP.

As discussed later, budgetary actions are accompanied by additional structural reforms within the framework of a firm commitment to the long-term sustainability of the public finances, having regard to the Spanish economy's starting position. The budgetary scenario envisages major efforts to consolidate the budget from 2010 onwards, including annual improvements in the structural balance that clearly exceed the 0.5% rule contained in the Stability and Growth Pact. Moreover, this consolidation effort will be based essentially on measures to control public expenditure.

Accelerating structural reforms

The government is aware that the Spanish economy must undertake an ambitious process of recovering price-competitiveness and, to achieve this, it is essential to have product and factor markets that work efficiently and provide suitable flexibility of prices and wages. Efficient and competitive market functioning is also a determinant for improving productivity and sustaining the economy's potential growth. More competitive and flexible markets facilitate innovation and its dissemination and, therefore, are an essential complement to the policy of strengthening infrastructure and promoting R&D and innovation and human capital that the Government has been implementing for some time.

For these reasons, fiscal measures to boost the economy will be accompanied by major efforts at structural reforms, in line with the conclusions of the December European Council and in the framework of the Lisbon Strategy. Spain's NRP presented in October 2008 evidenced not only the progress made

with the calendar of reforms laid out in 2005 but also Spain's ambition to accelerate the reform process. Although the detail of ongoing reforms may be viewed in the NRP, Table 1 shows some of the reforms with the greatest impact on the economy.

Table 1 - Structural Reforms

MEASURES AND CURRENT SITUATION	DATE OF ADOPTION	DESCRIPTION
Transposition of the Services Directive.	In process	This measure will provide a far-reaching reform of this sector. Reducing red tape and eliminating obstacles that unjustifiably limit activity, simplifying processes and procedures for access and provision of services and expediting them via a computerised one-stop shop will stimulate competition and incentivate productivity. Box 1 shows the estimated effect on potential GDP. Additionally, this measure is expected to provide a positive contribution towards reducing Spain's inflation differential, and it will also sustain economic activity in the short term by improving citizens' purchasing power.
Reform of professional services.	In process	The goal is to strengthen the principle of free access and ensure that restrictions on the provision of services are confined to the situations that are justified strictly by reasons of general interest. The new Act will review existing restrictions on the practice of certain activities and other constraints to competition (obligatory affiliation, operation as a company, joint exercise of various activities, etc.) in activities such as legal, health, economic and engineering services.
Reform of the Retail Act	In process	The goal of this act is to reduce the red tape involved in opening businesses and minimise distortions in business.
Accelerating structural reforms in strategic sectors.	In process	Reforms will be promoted in certain strategic sectors such as transport, telecommunications or energy.
Reform of industry regulators.	In process	In the area of network industries, reform of industry regulators is planned with a view to strengthening their independence, improving their governance and reviewing their functions. The final goal is to encourage the effective application of good regulation principles.
Increase capitalisation to 60%. Adopted	Royal Decree 1975/2008, 28 Nov.	Increase the percentage of lump sum unemployment benefit granted to an unemployed worker who becomes self-employed. Annual cost of 81.2 million euro.
Plan of Action to Reduce Administrative Burdens.	In process	The Plan of Action to Reduce Administrative Burdens is being implemented; it is more ambitious than the EU targets in its goal of reducing red tape by 30% by 2012. In accordance with a study by the Bank of Spain ⁶ , this measure could increase GDP by 0.2% by increasing productivity. Between June and August 2008, the Cabinet approved 81 measures.
Other horizontal reforms	In process	Other relevant actions will be the reform of the system of pre-emptive legal certainty, Bankruptcy Law, the application of evaluation tools that prevent charging avoidable costs to companies under new regulations and the implementation of the Citizens' Electronic Access to Public Services Act.
Social Dialogue	In process	As regards the labour market, social dialogue has proven to be a useful tool for ensuring the correct application of reforms once they are approved and creating a climate of peaceful industrial relations. In the short term, objectives should include first wage moderation so as to prevent the adjustment to the new economic situation from taking place entirely through lay-offs, and, second, promoting the relocation of workers that lose their jobs by improving labour intermediation processes.

The importance of advancing in the field of structural reforms is evident in the following box, which estimates the beneficial effects for the Spanish economy of an effective and ambitious transposition of the Services Directive.

⁶ Paloma López, Ángel Estrada and Carlos Thomas “Una primera estimación del impacto económico de una reducción de las cargas administrativas en España” (An initial estimate of the economic impact of a reduction in red tape in Spain)”, Bank of Spain Economic Bulletin, July-August 2008.

Box 1 - Macroeconomic impact of the Services Directive

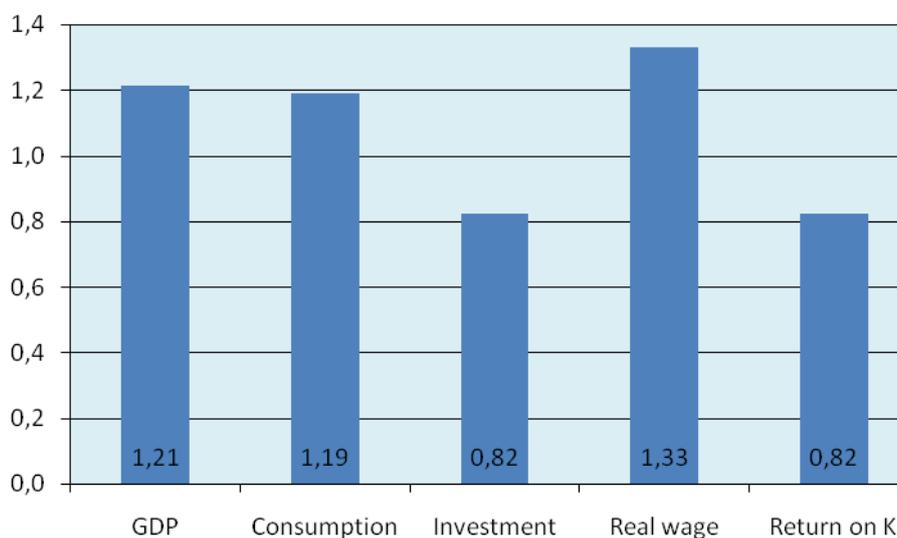
In December 2006, the Services Directive was approved with a view to ending the de facto fragmentation in the internal services market via two main pillars: freedom to provide services and freedom of establishment. In October 2008, the Spanish Cabinet approved the Draft Act on Free Access to and Performance of Services Activities, an ambitious transposition of the European Directive which includes in-depth treatment of such issues as administrative simplification and institutional responsibility.

The creation of an internal services market without the existing impediments should lead to a significant increase in intracommunity trade. The resulting increase in competition will reduce service prices while increasing quality and differentiation. From a business standpoint, access to more wide-ranging markets will allow for better usage of economies of scale and scope and the incorporation of know-how resulting from a more rapid dissemination of knowledge. This should enhance competition, both short-term through prices and long-term through productivity.

It's no simple task to measure a priori the macroeconomic effects of this structural reform, although attempts have been made internationally. As a first step, some studies try to estimate the increase in international trade in services. Using empirical studies by the OECD, Kox et al (2004) calculated an increase in intracommunity trade in services of between 30 and 60%. In a second step, Breuss and Badinger (2005) sought to measure the effects of the Directive through an increase in competition in the affected markets. They explained competition based on a model that takes into account the size of the domestic market and the importance of trade (imports as a percentage of GDP). The more trade there is, the greater the competition in the services sector; the greater the competition, the smaller the margins for providers and the lower the prices for consumers. Considering the increase in trade resulting from the Services Directive, Breuss and Badinger estimate the decrease in margins for each country based on figures from Kox et al. In the case of Spain, margins are estimated to decline by 3.8%.

Using this margins estimate together with the estimated size of sectors affected in the Spanish economy, a simulation exercise has been conducted for Spain as to the predicted impact of the transposition on the principal macroeconomic variables. This exercise was conducted using a REMS model¹, which is particularly appropriate as it reflects the rigidities of the Spanish economy and allows for the analysis of dynamic evolution with or without a structural change of this type. The graph below reflects the long-term impact on the principal macroeconomic variables. The results are quantitatively very significant and underline the importance of accelerating the structural reform process to which the Government is committed. The most significant result is that potential GDP would increase 1.2% once the Directive has been fully transposed. Qualitatively similar effects can be expected from the other measures in the Government's calendar of structural reforms, such as reform of professional services and the increase in competition in vital sectors such as transport and energy.

Macroeconomic effects of the transposition of the Directive.
Percentage deviations with respect to the baseline scenario.



¹ A general equilibrium model for the Spanish economy, with a system of microeconomic-based equations, which is particularly suited to evaluating and simulating the impact of shocks and economic policy actions that affect an open economy. The model details the decisions of households, companies and the public sector. It allows for the simulation of the performance of a wide range of macroeconomic variables as a result of exogenous perturbations

4. CURRENT ECONOMIC SITUATION AND OUTLOOK

4.1 External assumptions

Growth in the advanced economies remained relatively strong in the first quarter of 2008 despite rising commodities prices, the continuing financial turbulence that had begun in summer 2007 and the real estate crisis in various countries. In the second quarter, however, activity became practically stagnant, and in the third quarter it contracted slightly, while the financial crisis was exacerbated from September onwards.

Most of the advanced economies are currently in recession. US GDP fell in the third quarter, with declines in consumer expenditure, investment in machinery and construction; the latter industry has been shrinking for over eleven months. In the euro area, the moderate growth in domestic demand, with declining investment, was not enough to offset the 0.6 point decline in foreign demand, and GDP shrank 0.2% in the third quarter (the same as in the previous quarter).

In a context of exceptionally high uncertainty, growth projections for the developed world have deteriorated significantly. At the same time, the notable reduction in inflationary pressures has considerably increased the scope to implement expansionary monetary policies.

Emerging economies, which had withstood the crisis satisfactorily, have begun to show signs of slowed activity, affected by the decline in foreign demand, falling commodities prices and the funding difficulties inherent in the global financial crisis.

According to the European Commission, global trade of goods and services will bottom out in the fourth quarter of 2008, after which it will slowly accelerate, provided that the duration and intensity of the global financial crisis are not aggravated.

In its Prospects for the Global Economy report, the World Bank does not rule out a contraction in trade in 2009 (which would be the first since 1982) given that demand for imports by the developed economies is falling sharply, and liquidity restrictions have begun to affect developing countries' export activity, limiting commercial credit and hampering export insurance.

Table 2				
EXTERNAL ASSUMPTIONS				
	2008	2009	2010	2011
	(F)	(F)	(F)	(F)
<u>Interest rates</u>				
Short-term interest rates	4.5	2.1	2.8	3.3
Long-term interest rates	4.0	3.1	3.3	3.6
<u>Exchange rates</u>				
Dollars per euro	1.47	1.38	1.38	1.38
Nominal effective exchange rate in the euro area (% change)	4.4	-3.2	0.0	0.0
Nominal effective exchange rate in the EU-25 (% change)	2.6	-5.4	0.0	0.0
<u>GDP and world trade</u>				
World excluding EU-25, GDP growth (*)	3.9	1.2	2.9	3.8
EU-25 GDP growth (*)	1.0	-1.9	0.9	2.1
Export market growth, EU-25 (**)	3.3	-1.7	3.0	4.4
World imports, excluding the EU-25	4.1	-1.3	3.9	5.2
<u>Commodity prices</u>				
Oil prices (Brent, USD/barrel)	98.5	52.1	61.7	61.7
(*) Real percentage change.				
(**) Intra- and extra-EU trade.				
(F) Forecast				
Source: European Commission (October 2008) and Ministry of Economy and Finance.				

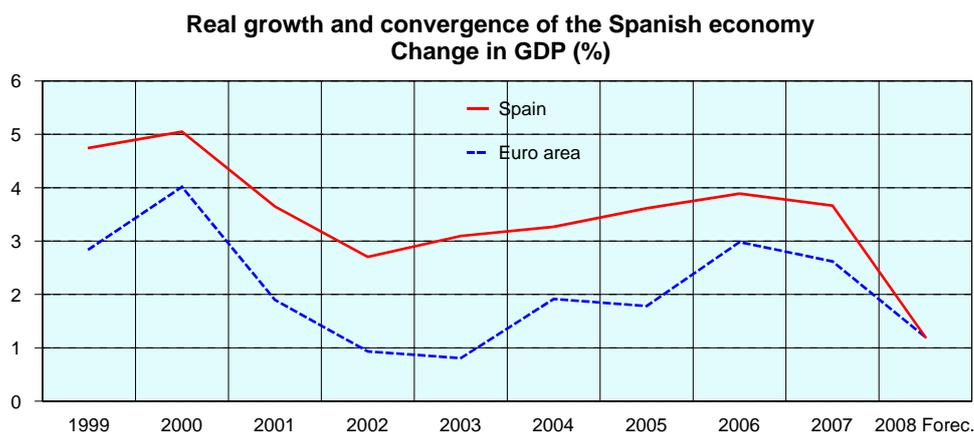
Table 2 reflects the main external assumptions upon which this Update is based. They differ from the last ones published by the Commission because the fast pace economic events have made the latter outdated. The Commission plans to update its economic projections in the near future.

4.2 Cyclical developments and outlook

In 2007, the Spanish economy maintained the strong growth trend of previous years, with GDP expanding 3.7% in the year, just 0.2 points less than in 2006. However, signs of a slowdown were already discernible.

In 2008, adjustment of the Spanish economy intensified, broadly reflecting the deepening turmoil in global financial markets.

Figure 1



Source: INE, European Commission and Ministry of Economy and Finance.

Waning economic activity since the middle of last year is due to weakening domestic demand, a reflection of the change of trend in employment, deteriorating economic projections and tighter lending conditions. At the same time, the slowdown in domestic expenditure was partially offset by greater net foreign demand.

Domestic demand weakened in almost all of its components, particularly consumer spending and fixed capital formation; specifically, investment in construction experienced the greatest decline. The initially gradual correction in Spain's real estate sector has been exacerbated by the global financial crisis, visible in the sharp contraction in residential investment which could not be offset by growth in the non-residential segment.

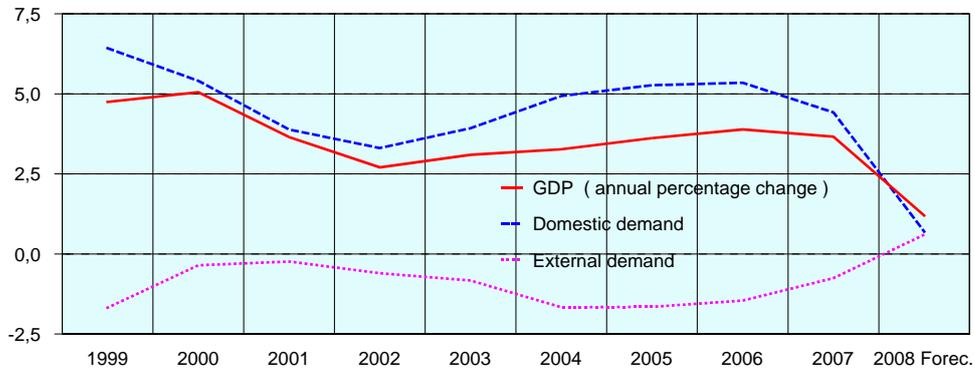
Net external demand contributed 0.8 points to GDP growth in the third quarter of 2008 as a result of a moderate increase in goods and services exports and a decline in imports.

After sustained growth of 4% in the previous three quarters, exports of goods and services expanded 1.5% year-on-year in the third quarter of 2008 due to the impact of the global financial crisis on world trade. The slowdown in trade flows affected the export of services in particular, with tourism declining and other services stagnant. Goods exports performed relatively well, with growth similar to that of worldwide trade in goods.

Goods and services imports shrank 1.1% in the third quarter of 2008. Due to the high sensitivity to financial conditions, the declines in automobile and capital goods imports intensified, in line with lethargic consumer spending and investment in capital goods. Services imports fell (both final consumption abroad by Spanish residents, and imports of other services), after remarkable growth in the last two years.

Figure 2

**Composition of GDP growth
Contribution in percentage points**

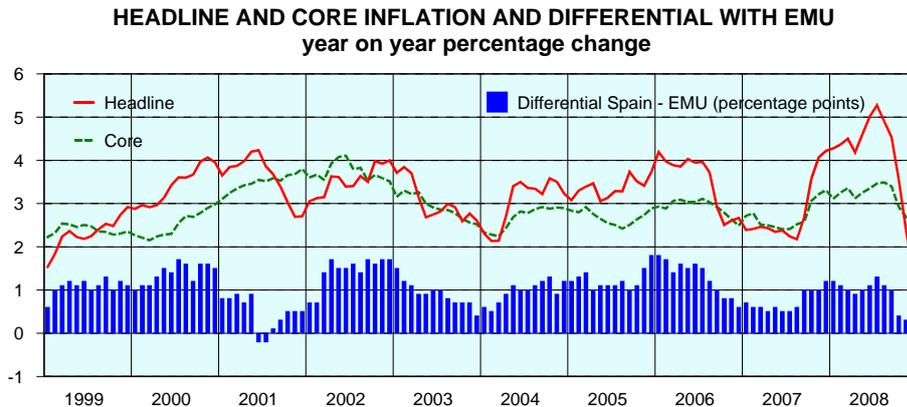


Source: INE and Ministry of Economy and Finance.

Deterioration of the labour market escalated in 2008; the construction sector was the main determinant of the change in cycle. Employment exhibited a year-on-year decline in the third quarter of last year (-0.8%) and growth of the labour force began to lose steam in the second half of 2008. The performance of labour supply and demand has resulted in rising unemployment, which reached 11.3% in the third quarter of 2008. Accelerating labour costs in 2008 were not completely offset by improved productivity.

Prices continued to rise in the first seven months of 2008 due to the steady escalation of oil and food prices. However, once oil prices began to recede as from July and food prices halted their upward trend, inflation abated considerably to reach 1.4% in December. This moderation affected not only headline inflation but also core inflation, which fell from 3.5% in August to 2.4% in December. This slowdown is projected to continue throughout most of 2009, sustained by weak demand and the foreseeable easing of unit labour costs (ULC). Inflation has eased more sharply in Spain than in the euro area, significantly reducing Spain's differential with respect to the euro area, from 1.2 percentage points in December 2007 to -0.1 percentage points in December 2008 (-0.7 pp against the EU27).

Figure 3



There is a breakdown in the Spanish differential in 2001 due to a methodological change.
Source: INE and Eurostat.

4.3 Prospects for 2008–2011: baseline scenario

Following a 3.7% growth rate in 2007, the baseline scenario (Table 3) predicts a significant decline in growth of the Spanish economy in 2008 down to 1.2%. Activity is expected to adjust more intensely in 2009, with GDP expected to decline by 1.6%. Economic recovery will begin in the second half of 2009, Spain's GDP will increase by 1.2% in 2010 and economic growth will accelerate by nearly 1.5 percentage points to 2.6% in 2011.

The slowdown in GDP growth is attributable to the significant reduction in growth of domestic demand, whose contribution to GDP growth in 2008 is estimated at 0.7 percentage points in 2008 and -3.2 percentage points in 2009. This downturn in domestic demand will be partially offset by improved net external demand, which will contribute positively to GDP growth in 2008 (0.6 percentage points) and in 2009 (1.6 percentage points). In 2010 and 2011, domestic demand will recover part of its lost share of GDP, while the foreign sector's positive contribution to growth will ease.

The deceleration projected for domestic demand in 2008 and 2009 is fundamentally due to the sharp contraction in investment. In a context of significant recovery of savings and a correction of indebtedness, household consumption expenditure will show negative growth in 2009.

Table 3							
MACROECONOMIC PROSPECTS							
Chained volume indices: 2000=100, unless otherwise indicated							
	ESA Code	2007 (A)	2008 (F)	2009 (F)	2010 (F)	2011 (F)	
		Level	Rate of change (%)				
1. Real GDP	B1*g	126.5	3.7	1.2	-1.6	1.2	2.6
2. Nominal GDP. Billion euro	B1*g	1050.6	7.0	4.7	0.0	3.3	5.0
Components of real GDP							
3. Domestic private final consumption expenditure (*)	P.3	127.8	3.5	0.5	-1.5	0.7	1.3
4. Public administrations final consumption expenditure	P.3	139.9	4.9	5.1	2.1	1.5	1.7
5. Gross fixed capital formation	P.51	145.6	5.3	-1.8	-9.3	-1.2	4.4
6. Changes in inventories (% of GDP)	P.52+P.53	49.2	0.2	0.2	0.2	0.2	0.2
7. Exports of goods and services	P.6	131.7	4.9	2.9	0.3	3.6	4.6
8. Imports of goods and services	P.7	159.3	6.2	0.6	-4.6	0.4	3.0
Contribution to growth in real GDP							
9. Final domestic demand		134.4	4.5	0.7	-3.2	0.4	2.2
10. Changes in inventories	P.52+P.53	49.2	-0.1	0.0	0.0	0.0	0.0
11. External balance	B.11	615.7	-0.8	0.6	1.6	0.9	0.4

(*) Includes households and NPISH (non-profit institutions serving households)
(A) Advance. (F) Forecast
Source: INE and Ministry of Economy and Finance.

Investment in construction is expected to continue to shrink, due primarily to the residential sector. Although the sharpest phase of the industry correction will take place up to mid-2009, residential investment will continue to register negative growth until 2011 included.

Investment in capital goods will be weak in 2008 and 2009. Stricter lending conditions, the climate of uncertainty and the slowdown in economic activity will negatively affect business investment, particularly in capital goods.

Consumer expenditure is expected to slow to 0.5% year-on-year in 2008 and -1.5% in 2009. The expected performance of household consumption is the result of the negative evolution of employment, stricter lending conditions and the effects of declining home prices on household wealth. Aggregate spending is expected to recover in 2010 and 2011, with projected growth of 0.7% and 1.3%, respectively.

According to the external assumptions, goods and services exports are expected to decelerate in 2009, and then recover in the rest of the projection period, once the global financial crisis has been resolved. In contrast, imports of goods and services will not revive until 2010, when domestic demand is

expected to improve. The foreign sector's contribution to GDP growth will remain positive throughout the entire period, peaking in 2009 at 1.6 percentage points, then easing as Spain's economy nears its potential.

The adjustment by the Spanish economy will also be evident in labour market performance, with a downswing in employment and an upswing in unemployment. Employment is expected to decline by 0.4% in 2008 (measured in FTEQ terms). Expectations are that this deterioration will continue in 2009 and that employment in Spain will fall at an average annual rate of -3.6%. Nevertheless, performance will begin to improve in the second half of the year in line with the aforementioned GDP performance, with the result that the decline in employment will begin to revert in 2010. In 2011, the economy will be slightly above its potential, setting the stage for a growth in job creation at an annual average rate of 1.4%.

Table 4							
LABOUR MARKET DEVELOPMENTS (*)							
	ESA Code	2007 (A)		2008 (F)	2009 (F)	2010 (F)	2011 (F)
		Level	Rate of change (%)				
1. Employment, persons (million)		20.6	3.0	-0.5	-3.7	0.1	1.3
2. Employment, FTEQ (million people)		19.1	2.9	-0.4	-3.6	0.2	1.4
3. Labour productivity, persons (GDP/1) (thousand euro)		38.6	0.6	1.7	2.1	1.2	1.2
4. Labour productivity, FTEQ (GDP/2) (thousand euro)		41.8	0.8	1.6	2.0	1.1	1.1
5. Compensation of employees (**) (thousand euro)	D1	30.1	3.7	5.2	2.9	3.1	3.5
6. Unemployment (% of labour force)		8.3		11.1	15.9	15.7	14.9

(*) National Accounts definition, except the unemployment rate.
(**) Compensation of employees, FTEQ.
(A) Advance
(F) Forecast.
Source: INE and Ministry of Economy and Finance.

Slower growth in the work force will limit the effect of job losses on the unemployment rate. The average unemployment rate will be 11.1% in 2008, 15.9% in 2009 and will start declining in 2010 (15.7%) to stand below 15% in 2011.

Relatively robust productivity performance is expected in the coming years. Productivity is expected to increase by 1.6% in 2008 and 2.0% in 2009, and then ease to 1.1% in the following years. Stronger productivity growth will be partly the result of a relative decline in sectors whose productivity is lower than the economy's average (e.g. construction). It will also be attributable to the ongoing improvement in trend productivity growth that was already evident in the final phase of the period of cyclical expansion.

As a result of the upswing in inflation in late 2007 and much of 2008, employee compensation growth will average 5.2% in 2008. Unit labour costs will have accelerated somewhat in 2008 also. However, the expected containment of employee compensation in the following years, together with productivity growth, will enable ULCs to ease so that they will register annual average growth of 0.9% in 2009, 2.0% in 2010 and 2.4% in 2011. After diminishing 0.7% in 2009, real ULCs will remain stable in the following years.

Table 5							
PRICE DEVELOPMENTS							
Chained volume indices: 2000=100							
	ESA Code	2007 (A)		2008 (F)	2009 (F)	2010 (F)	2011 (F)
		Index	Rate of change (%)				
1. GDP deflator		131,8	3,2	3,4	1,6	2,0	2,3
2. Private consumption deflator (*)		125.4	3.2	4.1	1.0	2.2	2.3
3. Public consumption deflator		126.7	3.2	3.8	2.3	2.5	2.5
4. Gross fixed-capital formation deflator		137.5	2.7	2.1	-0.6	0.9	2.0
5. Export deflator (goods and services)		115.5	2.4	3.0	1.7	2.1	2.5
6. Import deflator (goods and services)		108.2	2.1	3.2	-0.8	1.7	2.2
(*) Includes households and NPISH (non-profit institutions serving households)							
(A) Advance							
(F) Forecast							
Source: INE and Ministry of Economy and Finance.							

After accelerating at the end of 2007 and during most of 2008, the GDP deflator is expected to expand 3.4% in 2008, in annual average terms, i.e. 0.2 points higher than the previous year (Table 5). However, a significant slowdown, to 1.6%, is forecasted for 2009. For 2010 and 2011, the GDP deflator is expected to expand at a rate close to price stability (2%).

The private consumption expenditure deflator growth rate will almost halve between 2008 and 2011, reaching 2.3% in 2011, on par with the GDP deflator. Export and import prices are also expected to decelerate from 2009 onwards. The slowdown in imports may be sizeable, in line with the projected trend in commodity prices.

4.4 Sectoral balances

The Spanish economy's external borrowing will recede significantly in the next few years after peaking in 2007 at almost 10% of GDP. It is expected to reach 5.4% at the end of the projection period. The correction in the external imbalance in 2009 will be primarily attributable to the decline in imports of goods and services, while Spanish exports will slow in parallel with global

trade. However, from 2010 onwards, goods and services exports will recover and contribute to the aforementioned correction.

Among the balance of payments components, the goods and services deficit will undergo the greatest correction as a result of weak domestic demand and the downturn in oil and commodities prices; it will decline to 2.3% of GDP in 2011 (6.8% of GDP in 2007). The net primary income and current transfer deficits will also shrink to 3.3% of GDP in 2009. The slow pace of reduction in this deficit will be attributable to the effect on net interest of the debt accumulated in previous years, while remittances will continue to decline until 2010, reversing the rising trend that began with the immigration shock.

After the surpluses in 2005-2007, the Public Administrations' borrowing will amount to 3.4% of GDP in 2008. Borrowing requirements will be attributable to three factors: the stimulus measures adopted, automatic stabilisers, and the change towards an economic pattern less rich in taxes. The Public Administrations' borrowing requirement will reach 5.8% of GDP in 2009 and then gradually decline as economic activity recovers and the effects of budget consolidation starting in 2010 become evident. The private sector saving rate will rise, reversing the downward trend of the last few years; this will enable households to expand their borrowing capacity and business to substantially reduce borrowing needs.

Table 6						
SECTORAL BALANCES						
(National Accounts)						
	2007 (A)	2008 (F)	2009 (F)	2010 (F)	2011 (F)	
	Level (*)	% of GDP				
1. Net lending (+)/borrowing (-) vis-à-vis the rest of the world	-101.4	-9.7	-9.2	-6.6	-5.8	-5.4
- Balance of goods and services	-71.2	-6.8	-6.2	-3.9	-2.8	-2.3
- Balance of primary incomes and current transfers	-34.9	-3.3	-3.6	-3.3	-3.4	-3.5
- Capital account	4.7	0.5	0.5	0.6	0.4	0.4
2. Net lending (+)/borrowing (-) of the private sector	-124.7	-11.9	-5.8	-0.8	-1.0	-1.5
3. Net lending (+)/borrowing (-) of general government	23.3	2.2	-3.4	-5.8	-4.8	-3.9
4. Statistical discrepancy						

(*) Billion euro.
(A) Advance.
(F) Forecast.

Source: INE and Ministry of Economy and Finance.

5. BUDGETARY OUTCOMES AND PROJECTIONS

5.1 Fiscal policy strategy

In line with the expected economic situation and the general framework of economic policy defined in the Spanish Economy and Employment Stimulation Plan and described in the preceding sections, the fiscal policy strategy contained in this Update adopts a dual focus: short term on the one hand, and medium and long term on the other.

Contribution by fiscal policy to overcoming the crisis and its adverse social consequences through temporary measures

Following the sound budgetary position attained in previous years, fiscal policy is focused on letting automatic stabilizers play freely as well as adding discretionary measures which, in line with the EU decisions, are temporary and targeted in nature. Table 7 details these temporary measures, which amount to approximately 11.2 billion euro in 2009, equivalent to 1% of GDP.

Spain's short term stimulus measures are being implemented fundamentally by channelling public funds to foster jobs and public investment. Noteworthy here is the Central Government Fund for Local Public Investment, which has been endowed with 8 billion euro and is for productive investment. Significant funding will also be allocated to vitalizing strategic sectors through the 3 billion euro Special Central Government Fund. Additionally, in order to promote job creation, Social Security rebates have been introduced for employers hiring unemployed workers and in April 2008 the extraordinary plan for orientation, professional training and labour insertion was approved with a budget of 201.32 million euro for 2008-09 with the goal of increasing job opportunities particularly for unemployed workers from the construction industry.

Also, in view of the specific difficulties faced by Spain's real estate industry, a number of extraordinary measures have been adopted to modify the application on the fiscal benefits associated with finance for home purchase. Additionally, although it has no direct budgetary impact, the temporary partial moratorium on mortgage instalments discussed in Section 3 merits mention here.

Finally, though not shown in the Table because of the difficulties of quantifying them, other measures have also been taken to support economic and financial activity that will have a direct budgetary impact. Firstly, businesses are free to take accelerated depreciation⁷ on investments made in 2009 and 2010 in new property, plant and equipment for use in economic activities, subject to the condition that, in the following two years, the company's headcount remains in line with the average headcount of the previous 12 months. Secondly, two of the extraordinary temporary measures to boost confidence in the financial system will have a positive direct budgetary effect. On the one hand, the fee

⁷ Act 4/2008 of 23 December.

revenues earned on government guarantees. And, on the other hand, the positive net return on the financial assets acquired by the Financial Asset Acquisition Fund, since they will provide a return in excess of the cost of the government bonds issued to finance their acquisition.

Table 7- Short-Term Fiscal Measures with a Direct Budgetary Impact

MEASURES AND CURRENT SITUATION	DATE OF ADOPTION	DESCRIPTION	2008	2009	2010
				11,228	227.5
Job Creation				11,083	82.5
Central Government Fund for Local Public Investment. Adopted	Royal Decree-Act 9/2008, 28 November	Assigned to the Ministry of Public Administrations. Funded through an extraordinary 8 billion euro allocation as part of the Ministry's 2008 budget. Unused amounts may be carried forward. Its goal is to fund urgent municipal projects in the area of investment with a strong impact on job creation. It may only fund newly-planned projects (i.e. not envisaged in the 2009 budgets) for immediate execution, giving priority to job-creating investments and the requirement that unemployed workers be hired. City governments must present funding requests between 10-12-08 and 24-01-09; funding allocations will be granted based on the municipal population. The projects must be completed in the first quarter of 2010, as a general rule. City governments must undertake to pay contractors within 30 calendar days after certifications are issued. The extraordinary allocation will be financed with public debt.		8,000	
The Central Government's special fund to vitalise the economy and employment. Adopted	Royal Decree-Act 9/2008, 28 November	Funded with a 3 billion euro extraordinary allocation to the contingency fund. This fund is earmarked for projects that are to be executed immediately over a broad geographical area to enhance the situation of certain strategic economic sectors and undertake projects with a major impact on job creation. Unused amounts may be carried forward. The extraordinary allocation will be financed with public debt. The Cabinet approved the following allocation on 5 December: 490 million euro for R&D&i projects in health, energy and international excellence; 800 million euro to maintain and enhance competition in the automobile industry; 575 million euro for environmental projects aimed at strengthening water programmes and coastal, rural and forest policy projects; 380 million euro for the construction, overhaul and refurbishment of police barracks and penitentiaries; 110 million euro for the refurbishment of homes and urban areas; 140 million euro for small transport infrastructure; 430 million for projects linked to the provision of social services, social tourism and long-term care assistance; and 75 million euro to improve military facilities.		3,000	
Social security rebates Adopted	Royal Decree 1975/2008, 28 Nov.	Employers that provide indefinite contracts to unemployed workers with dependent children will benefit from a social security rebate of up to 1,500 euro per year for two years. This applies to all new hires through December 2010.		82.5	82.5
Extraordinary plan for orientation, professional training and labour insertion. Adopted	Royal Decree-Act 2/2008 21 April	Reinforces labour insertion and training actions by hiring 1,500 professional counsellors at employment offices. Unemployed workers targeted in the plan are eligible for an extraordinary subsidy of 350 euro per month for a maximum of three months in addition to mobility subsidies. This is overseen by the Public Employment Service and those Autonomous Communities with devolved powers in this area.	201		
Housing				145	145
Extension of the deadline for using the savings in home purchase savings accounts. Adopted	Royal Decree 1975/2008, 28 November	Account holders whose deadline for home acquisition is between 1.1.08 and 31.12.10 will have an extension to 31.12.10. Additional contributions are not eligible for tax credit. Total negative revenue impact in 2009-10 is 64.2 million euro.		32	32
Extension of the 2-year deadline for tax exemption on the sale of the habitual dwelling. Adopted	Royal Decree 1975/2008, 28 November	People who acquired their habitual home in 2006, 2007 or 2008 have until 31.12.10 to sell their previous home exempt from taxes. Total estimated 09-10 cost is 226 million euro.		113	113

All of these measures are reversible. Consequently, they ensure that the deterioration in the public accounts which is presented in this Update will be

temporary and they preserve the sustainability of Spain's finances. They are consistent with the flexibility provided by the Stability and Growth Pact for exceptional moments of negative growth. They emphasize productive expenditure and are accompanied by structural reforms which, insofar as they improve the economy's growth capacity, contribute to the long-term sustainability of the public finances.

In order to determine the total fiscal boost to the economy in 2009, in addition to these temporary measures, it is also necessary to consider the permanent measures adopted in 2008. Although the ultimate goal of the permanent measures is to improve the structure and quality of public revenues, they also represent a discretionary fiscal stimulus by increasing disposable income or improving liquidity for businesses and households in 2009. As shown in Section 7.1, these additional permanent measures amount to a total of 14.500 billion euro in 2009. They include notably the new personal income tax credit for earned income, which has increased households' disposable income since June 2008.

Maintain budgetary stability by ensuring adjustment to the medium-term budgetary objective and the long-term sustainability of public finances

Apart from the fact that the stimulus measures that have been adopted are essentially reversible, the Update envisages (see next section) an ambitious adjustment to regain the Medium-Term Budgetary Objective defined in previous updates, even exceeding the requirements of the Stability and Growth Pact.

The strategy also perseveres to address the expected increase in age-related expenditure. The Social Security Reserve Fund now amounts to 5.4% of GDP. Act 40/2007, of 4 December, on Social Security Measures strengthens the contributory nature of the system and encourages delaying retirement beyond the age of 65. Additionally, the current renewal of the Toledo Pact seeks to enhance these measures in order to guarantee the long-term sustainability of Spain's public pension system, even though the new projections indicate a delay, not a reduction, in the challenge posed by ageing for Spain's public accounts.

5.2 Medium-term budgetary objective

The reform of the Budgetary Stability Acts introduced the principle of budgetary stability over the cycle, enabling budgetary objectives to be established on the basis of the cyclical situation at any given time. This optimizes the contribution of fiscal policy to economic activity, thus always guaranteeing consistency with the Stability and Growth Pact.

In this second year of application of the new budgetary framework, the evident economic deterioration and the EU's decisions to boost the economy have led to the use of the margin of flexibility provided by the legislation, enabling the administrations bound by the principle of stability over the cycle to present budget deficits in 2009. Although the report on the cyclical position on the Spanish economy, drafted⁸ in April by the Ministry of Economy and Finance, and the macroeconomic projections in July 2008 envisaged a less favourable macroeconomic scenario than in the December 2007 update, subsequent information and the decisions adopted at EU level made it necessary to substantially modify the macroeconomic and budgetary projections. In particular, the exceptional situation in 2009 leads to an estimated deficit for all levels of government amounting to 5.8% of GDP (see Table 8):

- In the case of the Autonomous Communities, in view of the downward revision of projections, the Fiscal and Financial Policy Council decided that, by virtue of the provisions of article 8 of Organic Act 5/2001, the Autonomous Communities that approved a deficit budget in 2009, subject to the deficit not exceeding 0.75% of regional GDP, were exempted from the obligation to present a rebalancing plan that included revenue and expenditure policies to correct the deviation from the stability target within at most the following three budget years. They were also allowed to incur an additional deficit for productive investment amounting to at most 0.25% of regional GDP. Accordingly, debt may be increased by the amount needed to finance both deficits.
- Local governments are expected to incur a deficit amounting to 0.4% of GDP in 2009. They have been exempted from the requirement to draw up rebalancing plans provided that the deficit does not exceed the overall limit of 0.2% of GDP.
- Regarding the central government, the change in projections led the budget stability target to be revised to a deficit of 4.7% of GDP. This figure is a breach of the maximum deficit established for the Central Government (0.4%) in the case of growth projections below 2%. Consequently, by virtue of article 14.1 of the General Budgetary Stability Act (Act 18/2001, of 12 December), the government will send to Parliament a rebalancing plan detailing the revenue and expenditure policies required to correct this situation.
- The Social Security surplus is reduced to 0.2% of GDP.

The fiscal strategy envisages a reduction in the deficit from 2010 onwards, to 3.9% of GDP in 2011. All administrations subject to the principle of budgetary stability, particularly the Central Government, will contribute to correcting the deficit. As shown in section 5.4, reducing the deficit requires a very ambitious fiscal adjustment from 2010 onwards, including annual improvements in the structural balance amounting to over 1% of GDP (the improvement in the

⁸ Following consultations with the National Statistics Institute and the Bank of Spain, and taking account of the projections by the European Central Bank and European Commission. The Commission's interim projections of February 2008 were used.

primary structural balance will be 1.7% of GDP in 2010 and 1% in the following year). The efforts to consolidate the public accounts will focus primarily on expenditure restriction.

In short, the exceptional economic circumstances and the measures adopted to combat it explain the temporary deviation of Spain's structural balance from the medium-term objective, "a cycle-adjusted budgetary balance", defined in the 2005 Update, which is more demanding than would derive from strict application of the Pact (which allows a cycle-adjusted deficit of up to 1% of GDP).

5.3 Actual budgetary balances and implications for next year

In line with the current situation of the Spanish economy and the stimulus measures that have been adopted, Spain's public administrations registered a negative budget balance amounting to 3.4% of GDP in 2008, following a surplus of 2.2% in 2007. This deterioration in the public accounts can be attributed, on the revenue side, to the negative impact of the economic cycle on employment and the tax base (particularly corporate earnings, nominal aggregate expenditure and capital gains) and the measures and regulatory changes with an impact on the main tax revenues. Moreover, the sharp increase in unemployment benefit expenditure and the steady improvement in certain basic public services are the main reasons for the increase in public spending in 2008.

Public revenues will have declined notably as a percentage of GDP in 2008, by an estimated four percentage points to around 37% of GDP. Direct and indirect taxes will have contributed approximately equally to that decline. The reduction in direct tax revenues as a percentage of GDP is due primarily to the discretionary measures that have been adopted. The reduction in indirect tax revenues is due principally to the effect of the economic cycle.

The reform of direct taxes, which came into force in January 2007, and the measures to palliate the adverse impact of the economic deceleration on companies' and households' disposable income, could have reduced revenues in 2008 by an estimated 1.5% of GDP.⁹ The considerable deceleration in consumer spending and the setback in the real estate and housing sector, which had been one of the main drivers in the Spanish economy's growth phase and a major source of public revenues in previous years, led to an equally significant decline in indirect tax revenues in that year¹⁰.

⁹ The impact of the reform of personal income tax and corporate income tax on pre-payments and net tax balances payable in 2008 is approximately 0.7% of GDP; the advance of the tax credit of up to €400 in personal income tax withholdings and prepayments amounts to 0.5%; and the option for companies to choose between two different methods of calculating corporate income tax prepayments, regardless of their previous election, and the elimination of the tax effects of the new accounting regulations on the calculation of tax prepayments, will amount to approximately 0.3% of GDP.

¹⁰ Moreover, the new special VAT return system for consolidated groups, in force since January 2008 under Act 36/2006, of 29 November, enables companies within a consolidated group to offset VAT amounts of opposite signs. This regulatory change is estimated to have modified VAT revenues by an amount equivalent

Public expenditure accelerated in 2008, mainly as a result of the rapid growth in social transfers derived from the sharp increase in unemployment and other benefits¹¹, and, to a lesser extent, of the expenditure related to improving basic public services, most of which are classified as public consumption expenditure. Spending is estimated to be growing faster than estimated GDP; it may have increased by around 1.5 percentage points in 2008 to 40.4% of GDP¹².

Assuming that the current economic conditions persist into the early quarters of 2009, the economic stimulus measures and the regulatory changes with an impact in 2009 will raise the budget deficit in that year to 5.8% of GDP, 2.4 percentage points more than in 2008. This increase in the public deficit will result from the fact that, though expenditure will decelerate with respect to 2008, it will increase by approximately 2.9 percentage points of GDP to around 43.3%, whereas revenues will increase by about 0.5 points of GDP to 37.5%.

to 0.3% of GDP.

¹¹ These include notably the impact of the new 2,500 euro benefit for the birth or adoption of a child (which did not exist the previous year), whose impact is estimated at 0.1% of GDP.

¹² The budget projections for 2008, drawn up months before the sudden sharp deterioration in economic activity in Spain and internationally, envisaged 6.7% nominal GDP growth; the current estimate for 2008 is around 4.8%.

Table 8
BUDGETARY PROSPECTS
(Excessive Deficit Procedure)

	SEC Code	2007	2007	2008	2009	2010	2011
		Level (million euro)	% of GDP				
Net lending (+)/borrowing (-) (EDP. B9)							
1. General government	S. 13	23,259	2.2	-3.4	-5.8	-4.8	-3.9
2. Central government	S. 1311	13,675	1.3	-2.7	-4.7	-4.1	-3.7
3. Autonomous Communities	S. 1312	-1,695	-0.2	-1.0	-0.9	-0.8	-0.5
4. Local government	S. 1313	-2,438	-0.2	-0.5	-0.4	-0.3	-0.2
5. Social security Administrations	S. 1314	13,717	1.3	0.8	0.2	0.4	0.5
General government (S. 13)							
6. Total revenue	TR	431,121	41.0	37.0	37.5	38.3	38.7
7. Total expenditure	TE	407,862	38.8	40.4	43.3	43.1	42.6
8. Lending/borrowing	EDP. B9	23,259	2.2	-3.4	-5.8	-4.8	-3.9
9. Interest expenditure	EDP. D41	16,862	1.6	1.5	1.7	1.9	2.0
10. Primary balance		40,121	3.8	-1.9	-4.1	-2.9	-1.9
Selected components of revenue							
11. Total taxes		263,373	25.1	21.1	21.1	21.6	21.9
11a. Indirect taxes	D.2	122,779	11.7	9.8	10.0	10.3	10.3
11b. Direct taxes	D.5	135,773	12.9	10.8	10.6	10.9	11.1
11c. Capital taxes	D.91	4,821	0.5	0.5	0.5	0.5	0.5
12. Social contributions	D.61	136,640	13.0	13.1	13.3	13.5	13.6
13. Property income	D.4	10,715	1.0	1.0	1.0	1.0	1.0
14. Other		20,393	1.9	1.8	2.1	2.1	2.2
15. Total revenue	TR	431,121	41.0	37.0	37.5	38.3	38.7
p.m.: Tax burden		389,711	37.1	33.2	33.2	34.0	34.5
Selected components of expenditure							
16. Compensation of employees + intermediate consumption (16a+16b)	D.1+P.2	161,058	15.3	15.8	16.4	16.4	16.2
16a. Compensation of employees	D.1	107,093	10.2	10.5	10.9	10.9	10.8
16b. Intermediate consumption	P.2	53,965	5.1	5.3	5.5	5.5	5.4
17. Social transfers (17a+17b)		148,272	14.1	15.2	16.6	16.7	16.5
17a. Social transfers in kind via market	D.63 (1)	26,146	2.5	2.6	2.8	2.9	2.9
17b. Social transfers other than in kind	D.62	122,126	11.6	12.5	13.8	13.9	13.6
18. Interest expenditure	EDP D.41	16,862	1.6	1.5	1.7	1.9	2.0
19. Subsidies	D.3	11,099	1.1	1.1	1.1	1.1	1.0
20. Gross fixed capital formation	P.51	40,362	3.8	3.9	4.4	4.0	4.0
21. Other		30,209	2.9	2.9	3.0	2.9	2.8
22. Total expenditure	TE	407,862	38.8	40.4	43.3	43.1	42.6
p.m.: Public consumption expenditure	P.3	192,025	18.3	19.0	19.9	20.0	19.9
(1) D.63 = D.6311 + D.63121 + D.63131							
Source: Ministry of Economy and Finance.							

The acceleration by public revenues in 2009, in the context of a sharply weakening economy, is partly due to the fact that the regulatory measures which had an impact on revenues in 2008 are being maintained and, therefore, will not have a negative effect on growth rates in 2009. Additionally, capital revenues will rise substantially because of the expected increase in transfers from the EU through the ERDF and Cohesion Fund. However, those increases will be offset by the negative impact of the cycle downturn on tax bases, the impact of the new measures, and the prolongation of the effects of the 2007 fiscal reform on 2009 revenues¹³.

The stagnation of nominal GDP expected in 2009 means that most components of public expenditure will increase as a percentage of GDP, particularly social benefits and gross fixed capital formation. The former will be boosted mainly by the still rapid (though decelerating) increase in the average number of unemployed expected for 2009. Moreover, in line with the guidelines of the European Union's Economic Recovery Plan approved in December, the measures in the government's plan to stimulate the economy and employment will lead to a sizable increase in public investment¹⁴.

A more favourable economic environment and fiscal policy oriented toward consolidating public finances will provide a steady improvement in budgetary balances. The current Update envisages a reduction of the public deficit in 2010-2011 of 1.9 percentage points to 3.9% of GDP in 2011. Although that reduction may appear modest in principle, it will be due entirely to the discretionary action of fiscal policy since the economic cycle and interest expenditure will both make a negative contribution to the budgetary balance.

The planned budgetary consolidation will be based to a great extent on controlling public expenditure. This restrictive tone, coupled with the improvement in the economic situation, will lead to a decline in public expenditure as a percentage of GDP in 2010 and, in particular, in 2011.

Expenditure containment will be concentrated in the Public Administrations' operating and other current spending. Conversely, interest expenditure will contribute significantly to the increase in public expenditure due to the increase in public debt as a result of the deficits and the plans to strengthen the financial system's liquidity and solvency in the preceding years.

Public investment will remain dynamic, as required to continue the process of accumulating and modernizing the Spanish economy's stock of public capital; therefore, following the extraordinary increase in public investment in 2009 as

¹³ As regards direct taxes, the elimination of wealth tax from 1 January 2008 will have an impact amounting to 0.2% of GDP; the advance of part of the personal income tax credit for home mortgages will amount to 0.2%, and the impact of the reduction in the corporate income tax rate on the net tax payable in 2009 will amount to 0.2%. Regarding indirect taxes, the monthly VAT refund is expected to have an impact amounting to 0.5% of GDP. The total impact on tax revenue in 2009 will, therefore, be approximately 1.1% of GDP.

¹⁴ The Central Government Fund for Local Public Investment (8 billion euro) and the Central Government Special Fund (3 billion euro) together amount to 1% of GDP in 2009 (Table 7).

a result of the government's stimulus measures, this variable will remain high in comparison with past trends in Spain and Europe.

More rapid growth of direct tax revenues and social contributions will also contribute to improving the budget balance in the period 2010-2011, as the economy recovers and the regulatory changes cease to have an impact on the rate of change of public revenues.

A somewhat slower recovery by private and public final consumption expenditure and residential investment will lead to a more subdued increase in indirect taxes, although the reversal of the effects of certain regulatory changes with an impact in 2009 (monthly VAT refunds) will increase the inter-year change in VAT revenues in 2010. In short, since public revenues will grow slightly faster than GDP, they will gain as a percentage of GDP while nevertheless remaining well below their 2007 level.

5.4 Structural balance and fiscal stance

In order to analyze the orientation of fiscal policy, this Update, like its predecessor, estimates the Spanish economy's potential GDP in accordance with the production function methodology used by the European Commission and agreed upon by the Output Gap Working Group¹⁵.

In view of the sharp deceleration by the Spanish economy in 2008-2009, in the context of a deep international financial crisis, fiscal policy turned expansionary in 2008 and 2009 after being practically neutral in previous years (Table 9). Spain is thus making a determined contribution to the European Economic Recovery Plan adopted by the December European Council.

In any event, this expansionary fiscal policy has been adopted in the conviction that the economic situation is exceptional and that, once normality is regained, the temporary nature of many of the measures in place coupled with the expected fiscal adjustment will enable the medium-term objectives to be attained without impairing the long-term sustainability of the public finances.

Accordingly, fiscal policy will turn restrictive from 2010 onwards, with the structural balance improving by 1.4 percentage points in 2010 and close to 1 point in 2011, i.e. clearly above the 0.5 point reference envisaged in the Stability and Growth Pact.

¹⁵ Using Potential GDP in accordance with the EU's production function methodology and filtering population series. As agreed at the last meeting of the EC's Output Gap Working Group in Brussels on 17 November 2008, Spain made use of the possibility of estimating the output gap by controlling for population (with a standard lambda of 100) on the grounds that the interpretation of the resulting potential growth series is more coherent with the economic concept of potential growth.

Moreover, the fiscal policy strategy is being accompanied by determined acceleration of the agenda of structural reforms. This provides support to the Spanish economy's potential growth and thus contributes to enhancing the country's budgetary strength.

Table 9					
CYCLICAL DEVELOPMENTS ⁽¹⁾					
% of GDP, unless otherwise stated					
	2007	2008	2009	2010	2011
1. Real GDP growth (% change)	3.7	1.2	-1.6	1.2	2.6
2. Net lending(+)/borrowing(-)	2.2	-3.4	-5.8	-4.8	-3.9
3. Interest expenditure	1.6	1.5	1.7	1.9	2.0
4. Potential GDP growth (% change)	3.2	2.4	1.4	2.3	2.4
Contributions:					
- labour	1.1	0.5	-0.1	0.8	0.7
- capital	1.7	1.5	1.1	1.0	1.0
- total factor productivity	0.3	0.4	0.5	0.5	0.6
5. Output gap	1.4	0.3	-2.7	-3.7	-3.6
6. Cyclical budgetary component	0.7	0.1	-1.2	-1.6	-1.6
7. Cyclically-adjusted balance (2-6)	1.6	-3.5	-4.6	-3.2	-2.3
8. Cyclically-adjusted primary balance (7-3)	3.2	-2.0	-3.0	-1.3	-0.3
<small>(1) Using Potential GDP (production function). Source: Ministry of Economy and Finance.</small>					

5.5 Public debt developments

Estimating debt developments for this Update is more complex than on previous occasions because of the uncertainties of estimating how the deficit will evolve in a complex international situation, and of the impact of the measures to strengthen the financial system's liquidity and solvency in increasing the debt (through financial transactions included in the stock-flow adjustment of the determinants of the variation in debt, as detailed in Section 3).

In 2008, debt is estimated to have increased by about 3.3 points to 39.5% of GDP. As shown in Table 10, that increase is driven principally by the primary deficit, which would have contributed an estimated 2 points, and also by interest and the stock-flow adjustment, each contributing approximately 1.5 points.¹⁶ Finally, the variation in nominal GDP, which is the denominator of the debt ratio, would have reduced that ratio by 1.6 points, i.e. much less than it has contributed for many years, due to the sharp deceleration in nominal GDP in 2008.

¹⁶ The increase in the stock-flow adjustment in 2008 is due to 9.339 billion euro of transactions by the Financial Asset Acquisition Fund, as detailed in Section 3.

Table 10						
GENERAL GOVERNMENT DEBT DEVELOPMENTS						
% of GDP						
	2007	2008	2009	2010	2011	Change 2009-2011
1. Gross debt	36.2	39.5	47.3	51.6	53.7	14.2
2. Change in gross debt	-3.5	3.3	7.8	4.3	2.1	14.2
Contributions to change in gross debt						
3. Primary budget balance	-3.8	1.9	4.1	2.9	1.9	8.9
4. Interest expenditure	1.6	1.5	1.7	1.9	2.0	5.5
5. Effect of nominal GDP growth	-2.6	-1.6	0.0	-1.5	-2.4	-3.9
6. Other factors (debt-deficit adjustment)	1.3	1.5	2.0	1.0	0.7	3.7
p.m.: implicit interest rate on debt	4.33	4.49	4.25	4.10	4.00	
Source. Ministry of Economy and Finance.						

In 2009-2011, the debt ratio is expected to increase by approximately 14.2 points, to 53.7% of GDP at the end of the projection period. The main factor driving this performance will, logically, be the accumulation of primary deficits during the period, estimated at approximately 8.9 points. Interest expenditure will increase the debt ratio by 5.5 points as a result of the increasing debt (since implicit interest rates are expected to decline). The effect of nominal GDP growth will reduce the ratio by about 4 points. Finally, the combination of factors in the stock-flow adjustment (of which net acquisition of financial assets has recently been the largest item) will contribute 3.7 points to increasing public debt during the period.¹⁷

6 SENSITIVITY ANALYSIS AND COMPARISON WITH THE PREVIOUS UPDATE

6.1 Sensitivity analysis: alternative growth scenarios

With a view to analysing deficit and public debt sensitivity to changes in economic growth, an exercise has been carried out to estimate those fiscal variables under the assumption that economic growth in each year of the

¹⁷ In 2009, the stock-flow adjustment is expected to be at its highest in this projection period since, in that year, the Financial Asset Acquisition Fund is expected to allocate the bulk of the 20 billion euro (which may be expanded to 40 billion euro) with which it is endowed for that year. As indicated in section 3, the two auctions scheduled for January 2009 already amount to 10 billion euro.

projection was one half a percentage point less than the figures used in the baseline growth scenario. It is also assumed that the only variable that changes is real GDP growth.

Table 11					
SENSITIVITY ANALYSIS					
Alternative economic growth scenarios					
	2007	2008	2009	2010	2011
Baseline scenario					
Real GDP growth (%)	3.7	1.2	-1.6	1.2	2.6
Budget balance (% of GDP)	2.2	-3.4	-5.8	-4.8	-3.9
Gross debt (% of GDP)	36.2	39.5	47.3	51.6	53.7
Alternative scenario: GDP growth is half a percentage point lower					
Real GDP growth (%)	3.7	1.2	-2.1	0.7	2.1
Budget balance (% of GDP)	2.2	-3.4	-6.0	-5.2	-4.5
Gross debt (% of GDP)	36.2	39.5	47.7	52.6	55.6
Source: Ministry of Economy and Finance.					

Table 11 reflects the results of the exercise, showing that a half-point reduction in annual GDP growth during the projection period, i.e. 2009-2011, would increase the public deficit (with respect to the baseline scenario) by 0.2, 0.4 and 0.6 percentage points of GDP, respectively, to 4.5% at the end of the period, vs. the 3.9% estimated in the baseline scenario of this Update.

Assuming lower economic growth increases the debt ratio in 2009-2011 with respect to the baseline scenario by 0.4, 1.1 and 1.9 percentage points, respectively, to 55.61% of GDP at the end of the period, vs. 53.7% in the baseline scenario.

6.2 Sensitivity analysis: interest rates

The sensitivity of fiscal variables to changes in interest rates is analysed by estimating the effect on those variables of a 1 percentage point shift (upwards and downwards) in the yield curve implicit in calculating these variables in this Update (baseline scenario). As usual, it is assumed that these shifts only affect fiscal variables (without affecting macroeconomic variables) and the authorities do not react to the change in interest rates by changing other public expenditure or revenue items. Additionally, the new rates are assumed to apply only to new debt issued to cover borrowing needs and maturities in the period.

Table 12					
SENSITIVITY ANALYSIS: Interest rates (% of GDP)					
	2007	2008	2009	2010	2011
Alternative scenario: +1 percentage point					
Budget balance	2.2	-3.4	-5.9	-4.9	-4.1
Gross debt	36.2	39.5	47.3	51.8	54.1
Baseline scenario					
Budget balance	2.2	-3.4	-5.8	-4.8	-3.9
Gross debt	36.2	39.5	47.3	51.6	53.7
Alternative scenario: -1 percentage point					
Budget balance	2.2	-3.4	-5.7	-4.7	-3.6
Gross debt	36.2	39.5	47.2	51.3	53.3
Source: Ministry of Economy and Finance.					

The results of the interest rate sensitivity analysis under the foregoing assumptions are shown in Table 12. The fiscal variables' response to the change in interest rates is relatively slow because the current average term of Spain's public debt is around 7 years. After 3 years, the 1-point variation in interest rates produces a change (with respect to the baseline scenario) between 0.2 and 0.3 percentage points of GDP in the budget balance and 0.4 percentage points of GDP in the debt ratio.

6.3 Comparison with the Previous Stability Programme Update

The large differences between the current and last year's projections, in terms of both budget balance and public debt, are due primarily to the great differences in profile and magnitude between the economic cycles considered in each of the two projections. In the case of public debt, measures that have had to be adopted to support the financial system as a result of the global economic crisis must also be considered.

Table 13					
DIVERGENCE FROM PREVIOUS STABILITY PROGRAMME UPDATE					
	2007	2008	2009	2010	2011
GDP growth (%)					
Previous update	3.8	3.1	3.0	3.2	
Current update	3.7	1.2	-1.6	1.2	2.6
Difference	-0.1	-1.9	-4.6	-2.0	
Budget balance (% of GDP)					
Previous update	1.8	1.2	1.2	1.2	
Current update	2.2	-3.4	-5.8	-4.8	-3.9
Difference	0.4	-4.6	-7.0	-6.0	
Gross debt (% of GDP)					
Previous update	36.2	34.0	32.0	30.0	
Current update	36.2	39.5	47.3	51.6	53.7
Difference	0.0	5.5	15.3	21.6	
Source: Ministry of Economy and Finance.					

7 QUALITY OF PUBLIC FINANCES

7.1 Strategy

The quality of public finances is one of the key elements of the fiscal strategy established in the 2005 Budget; it is addressed from a broad perspective, focusing not only on the structure and efficiency of public expenditure and revenue but also on the development of an appropriate institutional framework. This is fully consistent with the priority given to the quality of public finances in the Integrated Guidelines, the Stability and Growth Pact and in various Conclusions adopted by ECOFIN.

As noted in section 3, the significant deterioration of the economic situation and future projections does not diminish the importance of the quality of public finances, as recognised by the Government. As a result, spending on those items with the greatest capacity to stimulate potential growth of the economy, i.e. technological, human and physical capital, are still priorities. In terms of revenues, new measures were adopted which, in addition to reducing the fiscal burden on companies and households and thus stimulating demand, afford continuity to the regulatory reforms from previous years and contribute to the ongoing modernisation of the tax system. These measures not only impact efficiency and fairness, but they also address prepayment and withholding systems in particular with a view to improving taxpayers' liquidity. In this new scenario, the prevention of and fight against tax fraud continue to be a priority with a view to enhancing the fairness of the tax system in the

long term and avoiding an unfair distribution of the tax burden during times of economic difficulty.

7.2 Developments on the expenditure side

In addition to helping consolidate the recovery in productivity that is already visible, which is an explicit objective of the NRP, strengthening productive spending will directly stimulate economic activity, which is vital for overcoming the economic crisis. These are policies which boost the economy's resilience and, as they affect productivity, they also improve long-term sustainability of public finances.

The Government's Commission for Economic Affairs is playing an important role as coordinator, providing coherence between the NRP and this Update. The NRP was drafted by the President's Office of Economic Affairs, although it is subject to review by the Government Commission for Economic Affairs before its remittal to the Cabinet. The Commission, which is chaired by the Minister of Economy and Finance and includes the Ministries with economic powers, is also responsible for coordinating the Stability Programme's successive updates.

The prioritisation of public expenditure on those items with the greatest impact on productivity and economic growth, R&D&i, education and infrastructure, has increased accumulated expenditure on these three areas in 2004-2008 by 168%, 92% and 33%, respectively. As a result, productive expenditure on these areas in the Central Government budget increased by 1 percentage point of GDP since 2004 reaching 8.2% in 2008. This, together with the planned acceleration of market reforms, is providing the economy with the foundation to transition towards a more balanced growth model that is more capable of addressing adverse situations.

The 2009 Central Government Budget continues to focus on these policies, giving priority to expenditure on productive investment, especially R&D&i, and infrastructure, while simultaneously maintaining the necessary allocations to implement educational reform. For details, see Table 14.

Considering the narrow room for manoeuvre in the budget and the priority given the aforementioned items, this strategy also envisages greater austerity and efficiency in public expenditure. To this end, it is essential to rationalise human resources policy and review management policies under criteria of efficiency.

The quality of these public policies is also supported through institutional and regulatory improvements:

- In 2008, the State Agency for the Assessment of Public Policy and Service Quality continued evaluating the public administration's actions. An amount of 5.47 million euro was earmarked for the Agency in the 2009 Budget, i.e. 6.2% more than in 2008.
- The State Agencies Act provides the administration with an organisational

model that facilitates more flexible, autonomous management, reinforces effectiveness control mechanisms and promotes accountability.

7.3 Developments on the revenue side

After the major reform of direct taxation (approved in 2006 and effective since 2007), and the measures adopted in the 2007 and 2008 Budgets (both described in previous updates), additional tax measures that complement and enhance this reform were adopted during 2008. See Table 14 for details on these measures:

- As regards the Personal Income Tax, the tax burden on wage-earners has been further eased via a new tax credit.
- As regards Corporate Income Tax, the reduction in the general rate was completed in 2008 and the scope of R&D&i credits was expanded.
- The Wealth Tax was eliminated.

The measures were not confined to direct taxation. In August 2008, a new reform was implemented to enhance the use of taxation to achieve environmental objectives. The VAT treatment of building refurbishment has been improved.

With a view to achieving more efficient taxation, prepayment, settlement and withholding systems have been modified; the changes are particularly opportune in the current situation, when stimulating business and household liquidity is vital:

- All companies will be able to request a monthly refund of VAT starting in 2009.
- Advance of the tax credit¹⁸ for mortgages on the habitual dwelling.

The fight against tax fraud was strengthened in 2008 with the presentation of the second Plan to Prevent Tax Fraud, for 2008-2012. The update centres on the search for new sources of information and on focusing efforts on researching the most complex fraud. Additionally, it places a special emphasis on improving voluntary compliance and on strengthening national and international cooperation. The outcome of the four years of the first plan (2005-2008) is clearly positive. More than 27 billion euro were collected through actions related to fraud control. Close to 8 billion euro are expected to be collected in 2008 alone, twice the 2004 figure.

Furthermore, three Royal Decrees were approved which implement the Act on Measures to Prevent Tax Fraud (approved in 2006), modify the Corporate Income Tax Regulation and approve the Regulation on Friendly Procedures in Direct Taxation. They will improve mechanisms in the fight against fraud and will reinforce legal certainty in relations between taxpayers and the Administration with a view to facilitating tax compliance and preventing fraud.

¹⁸ Royal Decree 1975/2008 of 28 November.

Table 14- Medium-Term Measures to Improve the Quality and Sustainability of Public Finances

MEASURES AND CURRENT SITUATION	DATE OF ADOPTION	DESCRIPTION
IMPROVEMENT IN THE QUALITY OF PUBLIC FINANCES		
Personal Income Tax: Credit of up to 400 euro. Adopted	Royal Decree-Act 2/2008, 21 April Royal Decree 861/2008, 23 May	Reduction of up to 400 euro in the gross tax payable by wage-earners. Additionally, the system for calculating withholdings was modified to apply this reduction from June 2008, with an estimated impact in 2008 and 2009 of around 5 billion euro in each year.
Personal Income Tax: 2007 reform. Adopted	Act 35/2006, 28 November.	Entry into force in January 2007 and with effects continuing in 2008 for an estimated total of 2.4 billion euro.
Personal Income Tax: Tariff deflation and update of minimums in 2008. Adopted	2008 Budget	Estimated effect of 940 million euro in 2008.
Wealth Tax: elimination. Adopted	Act 4/2008, 23 Dec.	Its elimination, which will reduce the savings distortions generated by the tax system, will be effective in 2008, and will therefore reduce 2009 revenue by an estimated 1.8 billion euro.
Corporate Income Tax. Rate reduction. Adopted	Act 35/2006 of 28 Nov. and Royal Decree-Act 2/2008	The second reduction in the general tax rate from 32.5% to 30% was implemented in January 2008.
Corporate Income Tax. Expansion of the R&D tax credit. Adopted	Act 4/2008, 23 Dec.	From 2008, the credit may be applied to companies with more than 25% of their research activity in another EU or European Economic Area country.
VAT and Personal Income Tax. Improved tax treatment of building refurbishment. Adopted	Royal Decree 861/2008, 23 May	Refurbishment whose cost is over 25% more than the acquisition price (not including the land). Effective January 2008. The goal is for more projects to be eligible for a more neutral beneficial tax scheme, improving input VAT recovery and stimulating the construction industry. The same applies to the rehabilitation credit allowed for the habitual dwelling under Personal Income Tax.
Motorcycle Registration Tax. Adopted	Act 4/2008, 23 Dec.	The vehicle tax rates for motorcycles were redefined on the basis of their CO2 emissions; a similar change was approved for automobiles in 2007. This change will be revenue-neutral but will favour less-polluting vehicles.
Payment system improvements with positive effects on liquidity in 2009: Personal Income Tax: Advance of the tax credit for habitual dwelling mortgages. Adopted VAT. Monthly repayment. . Adopted	Royal Decree 1975/2008, 28 November Act 4/2008, 23 Dec.	Possibility of receiving the Personal Income Tax credit for mortgage payments on a monthly basis. Applicable for salaried and self-employed workers with annual earnings of less than 33,000 euro. Implemented via a 2% reduction in Personal Income Tax withholdings (salaried employees) or prepayments (self-employed). The advance is voluntary. The estimated effect in 2009 is 1,7 million euro, which will be offset in 2010 by the annual income tax returns, benefiting 3.5 million people. Possibility as of January 2009 of requesting VAT refunds on a monthly basis. Six billion euro are expected to be advanced in 2009. . This will benefit entrepreneurs and investing companies in particular.
Prioritisation of R&D expenditure	2009 Budget	New stimulus for R&D&i policy in 2008 with the creation of the Ministry of Science and Innovation and the approval of the statute converting the Higher Council for Scientific Research into a state agency. In 2009, regulations will be enhanced through a new Science and Technology Act. The 2009 Budget calls for a 6.9% increase in expenditure, i.e. greater than the increase in the overall budget and projected nominal GDP growth. This will build on results of the Ingenio 2010 programme, which allowed for the ongoing expansion of research and development expenditure to 1.22% of GDP in 2007. Also of special note are the additional R&D&i investments in the Special Central Government Fund for the vitalisation of the economy and employment (Table 7).
Prioritisation of infrastructure expenditure	2009 Budget	Expenditure focuses on infrastructure in the areas of transport (2005-2020 Strategic Infrastructure and Transport Plan, PEIT), water (AGUA Programme) and other infrastructure (e.g. environment). These investments are financed through both the budget and government agencies and public limited companies under the Infrastructure Ministry (Sociedad Estatal de Infraestructuras de Transporte Terrestre SA — SEITT; ADIF, AENA, State-owned Ports) and the Environment Ministry (State-owned Water Companies). The creation of the Environment, Rural and Marine Affairs Ministry, to replace the Agriculture, Fisheries and Food Ministry and the Environment Ministry, will facilitate more comprehensive management of water and environmental investments. The decline in infrastructure expenditure envisaged in the 2009 Budget is due broadly to a change

		in funding of infrastructure managed by central-government-owned companies. Therefore, investment in infrastructure by the Central Government, its institutions and central-government-owned companies will expand 4.4%. Additionally, other investments will be financed through the Special Central Government Fund to vitalise the economy and employment.
Prioritisation of education and training expenditure	2009 Budget	The 2009 Budget increases allocations by 1.9%. A large portion of this expenditure is earmarked for student grants and aid and for applying the new Education Organic Act (LOE). The grant and aid programme will be enhanced with a view to increasing the number of beneficiaries and the amount of individual grants in order to ensure equal opportunities. Funding for Erasmus grants will increase 10% in 2009. Funding for training unemployed and employed workers will increase in 2009 by 7.5% and 7.4%, respectively.
Improvement to the institutional and regulatory environment		Four state-owned companies will be converted into agencies: the Higher Council for Scientific Research, the State Agency for Air Safety, the State Antidoping Agency and the State Agency for Meteorology. The National Agency for the Evaluation of Public Policies and Quality of Services is operational.
LONG-TERM SUSTAINABILITY		
Social Security Reserve Fund		The Social Security surplus has expanded the fund to 5.4% of GDP (i.e. 9 months of pension payments) to be able to meet the future needs in the area of contributory benefits.
Implementation of the Social Security Reform Act	Act 40/2007 of 4 December	Enhances the contributory nature of the system and incentivates delaying retirement beyond the age of 65. Within the framework of expenditure projections linked to ageing carried out by the Economic Policy Committee, the estimated impact of the 2002 and 2007 reforms on increased the activity of senior citizens raised the average age for leaving the labour market by 1.3 years between 2006 and 2025.
Renewal of the Toledo Pact	In process	The goal is to strengthen the long-term sustainability of the public pension system

8 SUSTAINABILITY OF PUBLIC FINANCES

8.1 Long-term budgetary projections

In accordance with the "Guidelines on the format and content of Stability and Convergence Programmes", this Update includes the projections of public expenditure related to population ageing in Spain drawn up for all the EU countries every three years by the Working Group on Population Ageing attached to the Economic Policy Committee (EPC) and the European Commission and backed by the European Union's Council of Ministers for Economic and Financial Affairs (ECOFIN). The projections address five categories of public spending: pensions, healthcare, long-term care, education and unemployment. They use demographic and macroeconomic assumptions agreed upon by the Member States and the Commission, and they assume no changes in economic policy.

Table 15 reflects the 2006 projections for pensions and other items under uniform assumptions. This table also shows that total expenditure will reach 28.6% of GDP in 2050, compared with a projected expenditure of 20% of GDP in 2005. The main source of increased expenditure will be pensions (expanding 7 percentage points in 2005-2050), followed by healthcare (expanding 2.2 percentage points).

Based on these 2006 projections and the budget position, in its annual evaluation of sustainability using the Stability and Convergence Programmes,

in 2008 the ECOFIN Council ranked Spain among the countries with a medium sustainability risk. Due to the higher impact of ageing on public finances, primarily due to pension payments, the Council recommended maintaining large primary surpluses in the medium term and implementing more measures to slow growth in expenditure.

Table 15							
PROJECTIONS OF EXPENDITURE ASSOCIATED WITH AGEING							
FROM THE EUROPEAN UNION ECONOMIC POLICY COMMITTEE (2006)							
(% of GDP)							
	2005	2007	2010	2020	2030	2040	2050
Total contributory pension expenditure (1+2)	8.7	8.8	8.9	9.3	11.8	15.2	15,7
Contributory social security pension expenditure* (1)	7.8	8.0	8.1	8.5	11.0	14.4	15,2
Old-age and early retirement pensions	5.2	5.2	5.2	5.5	7.7	10.9	11,8
Disability	0.9	1.0	1.0	1.1	1.2	1.2	1,1
Survivors' pensions	1.7	1.8	1.8	1.9	2.1	2.3	2,3
Non social security benefits (2)	0.8	0.8	0.8	0.8	0.8	0.7	0,5
Healthcare expenditure	6.1	6.1	6.3	6.7	7.3	7.9	8,3
Long-term care expenditure	0.5	0.5	0.5	0.5	0.5	0.6	0,8
Education expenditure	3.6	3.6	3.2	3.2	3.0	2.9	3,1
Unemployment expenditure	1.1	1.1	0.9	0.7	0.7	0.7	0,7
Total expenditure on ageing	20.0	19.9	19.7	20.4	23.4	27.3	28,6
ASSUMPTIONS							
Real potential GDP growth	3.1	3.5	2.8	2.0	1.0	0.4	1.0
Labour productivity growth	0.8	0.9	1.6	2.0	1.7	1.7	1.7
Participation rate males (aged 15-64)	80.8	81.5	82.4	82.9	82.0	81.8	82.9
Participation rate females (aged 15-64)	58.0	60.1	62.9	67.9	69.0	69.4	70.4
Total participation rate (aged 15-64)	69.5	70.9	72.7	75.5	75.6	75.7	76.8
Employment rate in ages 15-64	10.4	9.4	8.7	7.0	7.0	7.0	7.0
Population aged 65+ as % of total population of working age (15-64)	24.5	24.4	25.3	29.8	38.2	52.5	65.6

* Includes minimum pensions.

Source: 2004-2050 Baseline Scenario of the Report on Projected Public Expenditure associated with Population Ageing. EPC and Commission, 2006.

A new set of projections is being finalised for publication in 2009 (2007-2060); it will serve as the basis for this year's sustainability evaluation. Demographic and macroeconomic assumptions have already been agreed, and projected pension expenditure has been presented by each country and studied by the aforementioned working group, pending approval by the EPC. Projections for other expenditure items have not been finalised¹⁹.

Although new expenditure projections for pensions are based on a slightly more positive demographic scenario than the 2006 report, the significant impact of ageing on potential GDP and public finances is unavoidable. The annual growth rate of potential GDP halved over the projection period, from 3.7% in 2007 to 1.6% in 2060, in line with most other European countries. Pension expenditure will rise by 6.7 percentage points of GDP between 2007 and 2060; however, peak expenditure will come a few years later than in previous projections (2053 rather than 2046). This is due to the fact that the negative impact of the decline in the active population on employment takes place from 2030 onwards, i.e. 8 years later than indicated in the previous projection, as a result of greater immigration. Nevertheless, higher projected immigration in the short term, especially young people, will expand the elderly population and the number of pensions in the long term. The new projection also includes an increase in life expectancy, thereby raising expenditure.

8.2 Strategy

The strategy to address the increase in expenditure is based on three cornerstones:

- Budget stability during the cycle and allocations to the Social Security Reserve Fund.
- Greater employment, a longer working life and higher productivity.
- A review of the pension, healthcare and long-term care systems.

Social Security Reserve Fund

The Social Security surplus has allowed for continuous allocations to the Social Security Reserve Fund (FRSS), which was created in 2000 to meet future needs in the area of contributory benefits. In December 2008, the Reserve Fund totalled 57.221 billion euro, equivalent to 9 months' pension expenditure and 5.4% of GDP. The breakdown of assets in portfolio by issuing country, on the basis of acquisition price, is as follows: 56.04% in Spanish government bonds, and the remainder in German (26.83% of total foreign bonds), French (41.22%) and Dutch (31.95%) government bonds. In 2008, the Fund's investment policy respected the principles of security, profitability, risk diversification and duration matching.

¹⁹ The EPC's new Report on Population Ageing will be published in early 2009 in two parts: assumptions and projections.

If the additional contribution of 8.023 billion euro scheduled for 2009 materialises, the total Reserve Fund could reach 65 billion euro.

Pension reform

In the area of Social Security, significant reforms were introduced through Act 40/2007 of 4 December, entering into force on 1 January 2008. The main objectives of the Act (described in the 2007 Update) are to strengthen the contributory nature of the system, including pensions for permanent disability; encourage voluntary deferral of retirement beyond 65; rationalise partial retirement; and reform survivors' pensions to include cohabitation and economic dependence criteria. Other measures have been adopted to enhance the lowest pensions, increase control of expenditure on disabilities and strengthen the contributory nature of the special regimes.

Within the framework of the EPC's projections, the Commission estimated the impact of the 2002 and 2007 pension reforms on the increase in activity by older workers; this impact has been included in the 2008 projection of potential GDP. The result is that the average age of retirement will increase by 1.3 years between 2006 and 2025.

Renewal of the Toledo Pact is envisaged, with a view to achieving a new political agreement on the measures required to guarantee long-term sustainability of Social Security accounts.

Control of healthcare expenditure

The measures to control pharmaceutical expenditure have had a positive moderating effect in the last few years; average annual growth has decreased from 12% before 2004 and close to 6% this year. During 2008, the various Administrations continued to implement measures to rationalise pharmaceutical expenditure contained in Act 29/2006 on Guarantees and Rational Use of Medicines and Health Products and the Strategic Plan for Pharmaceutical Policy, including the Reference Price System, regional plans for the use of generic medicines and programmes to encourage the rational use of medicines. Progress has been made on the modernisation measures included in the Quality Plan and the Electronic Health Plans within the AVANZA Plan (Royal Decree envisaged for 2009 to regulate electronic prescriptions and implement digital clinical histories with territorial interoperability).

The National Agency for the Evaluation of Public Policies and Quality of Services issued a positive evaluation of the implementation of the Strategic Plan for Pharmaceutical Policy, in particular regarding the effectiveness of the temporary measures to reduce prices. Recommendations to overcome some of the Plan's deficiencies include: a greater focus on supply and prescription, the inclusion of hospital medicines, evaluations of the plan and a greater commitment from the Autonomous Communities. Many of the recommendations are included as measures in the new Strategic Plan for Pharmaceutical Policy, which is currently being drafted.

As regards the application of medicine reference prices, the Ministerial Order that will enter into force in 2009 (which will determine new groups of medicines, both generic and patented, and their reference prices, and review the reference prices from the previous two years) is expected to save 343 million euro in public expenditure in 2009, compared with 109 million euro in 2007.

The degree of execution of the 2004-2008 Strategic Plan of Pharmaceutical Policy is 80%. The new 2008-2011 Strategic Plan, which is being drafted, aims to deepen selective financing with transparency criteria and ensure that public funding is earmarked for therapeutic breakthroughs.

Finally, given the decentralised nature of health expenditure, the Ministry of Health and Consumer Affairs has offered the Autonomous Communities a Health Pact which aims to guarantee the equity, quality, innovation, cohesion and sustainability of Spain's health system. This pact includes the implementation of strategies to rationalise healthcare expenditure.

9. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

9.1 Implementation of national fiscal rules

In coherence with ECOFIN conclusions²⁰ on information about national fiscal rules contained in Stability Programmes, the eighth Update (issued in 2006) provided a very detailed description of the reform²¹ of the budgetary stability rules, in force since January 2007, which were fully implemented for the first time in the 2008 Budget. The Update also explained the rules limiting territorial administrations' indebtedness. Both regulatory frameworks remain unchanged and fully in force.

9.2 Reform of Territorial Financing System

Reform of the Autonomous Communities' Financing System, in force since 2001, is close to completion. Following intense negotiations with the Autonomous Communities at the end of the year, on 30 December 2008 the Government made a proposal which is expected to receive widespread support, facilitating its entry into force in the near future. The new proposal respects the basic principles of the July proposal: fiscal co-responsibility; financial autonomy; an increase in regulatory capacity; sufficient funding for all devolved powers; guaranteed funding for basic public services regardless of place of residence; reduction in per capita funding gaps between Autonomous Communities; and improved funding of welfare state services for citizens.

²⁰ ECOFIN Council of 10 October 2006 conclusions on the quality of public finances and ECOFIN Council of 9 October 2007 on Improving the effectiveness of the preventive arm of the Stability and Growth Pact.

²¹ The regulatory framework was formally completed with the approval on 2 November 2007 of the Regulation implementing the General Budgetary Stability Act for Local Governments; it was first applied in the 2008 Budget. Its main characteristics were discussed in the previous Update.

As a result of this new proposal, the percentage of Autonomous Community funds derived from partly or wholly devolved taxes will be increased from 70% to 90%. Autonomous Communities will receive 50% of personal income tax and value added tax (VAT) revenues and 58% of excise tax revenues. Moreover, Autonomous Communities' regulatory capacity will increase, expanding their personal income tax competencies (modification of individual and household tax-free allowances; approval of regional tax scales; tax credits, e.g. for home acquisition or rental); Autonomous Communities will have VAT and excise tax powers in line with EU regulation; and the reciprocal participation and cooperation between tax administrations will be expanded.

There will be other funding sources. A Basic Public Services Guarantee Fund, which guarantees equal funding for basic public services, corrected for population²², and will be reviewed annually. An Overall Sufficiency Fund that finances the remaining devolved powers, ensuring that the status quo is maintained and incorporating additional funds provided by the Central Government. And the Convergence Funds, one of which aims to reduce per capita funding gaps (Competitiveness Fund for Autonomous Communities with per capita funding that is below either the average or its fiscal capacity), and the other seeks to strengthen the welfare state and the convergence of living standards (Cooperation Fund for Autonomous Communities with lower relative wealth).

The system will be reviewed every 5 years.

9.3 Other reforms with an impact on the budget scenario: Care for Dependent Persons

Since its approval²³ in December 2006, the new system for caring for dependent persons is being implemented gradually. The process, which is expected to be completed in 2015, requires the collaboration of all Autonomous Communities to guarantee care and protection throughout Spain. According to July 2008 figures, the system already provides services for 387 thousand people.

Progressive application represents an increase in the annual allocation projected in the 2009 Budget to 1,175.69 million euro, 35% more than the previous year and six times more than the 2006 figure. This allocation is in line with the minimum funding guaranteed by the Central Government to cover certain expenses within the system and the social security contributions of non-professional caregivers. The Special Central Government Fund to vitalise the economy envisages an additional 400 million euro allocation for care for dependent persons.

²² Population adjustment criteria are: territory, dispersion, islands, population over 65, equivalent population entitled to healthcare, population under 18.

²³ Act 39/2006, of 14 December, on Personal Autonomy and Care for Dependent Persons