



**ECONOMIC PARTNERSHIP
PROGRAMME**

**KINGDOM OF
SPAIN**

2013

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1. MACROECONOMIC SITUATION

1.1. The backdrop to the correction of the macroeconomic imbalances

Current indicators of economic activity in Spain reveal numerous signs of stabilisation. These suggest that GDP bottomed out in the second quarter of 2013, followed by the start of a gradual recovery. This would be a turning point for the country's economy following 9 consecutive quarters of contraction. This increase in economic activity is not just a "rebound" following a deep recession; rather, it is a new phase of growth built on solid, sustainable and balanced foundations.

The rate of decline in real GDP slowed by 3 tenths in the second quarter of 2013, to -0.1% quarter-on-quarter. This is almost stability, at a time of a relaxation in funding pressures, a strengthening in net foreign demand and reduced weakness in domestic demand. However, a degree of uncertainty remains, with credit available to households and companies being uneven and a number of constraining factors affecting both supply and demand.

The positive signals are largely related to the external sector. Exports of goods are growing strongly in real terms (9% in the first half of this year), helped by competitiveness gains by Spanish companies resulting from a moderation of costs, prices and margins, together with structural improvements in the export sector and repositioning in international markets. Exports have also been helped by improved performance in our main international markets. In addition, tourism exports performed more strongly in the second quarter (4.2% quarter-on-quarter) due, in part, to increases in both the number of tourists and average spending per tourist.

Spain's strong export performance is explained by a number of factors common to all sectors: sustained improvement in competitiveness indicators, such as the real effective exchange rate and, in particular, unit labour costs (ULCs), together with structural "non-price" competitiveness gains resulting from an increase in the number of exporting companies and increasing geographic diversification. The number of exporting companies has increased continuously over recent years, accelerating since 2010. This increasing focus of companies on export markets seems to be becoming well established, according to figures for January-June 2013 (compared to the same period in 2012). With regard to geographic diversification, Spain's exports to emerging markets have continued to expand rapidly in 2013, despite these countries growing less strongly than expected this year.

Table 1. Number of exporting companies

2004	2005	2006	2007	2008	2009	2010	2011	2012	2012 (Jan-Jun)	2013 (Jan-Jun)
96,401	99,232	100,177	97,418	101,395	107,579	109,363	123,128	136,973	93,311	102,101

Source: Datacomex.

Domestic demand continues to make a negative contribution to growth. However, two factors should be noted. Firstly, the pace of contraction is slowing considerably, and heading towards stability in aggregate terms. Secondly, and more importantly, certain qualitative aspects relating to the composition of domestic demand give cause for optimism about the strength of the recovery. From a qualitative point of view, it should be noted that private sector confidence indicators (for the consumer and for various productive sectors, excluding construction) are improving considerably.

Accumulated capital investment has grown for two consecutive quarters (2.9% quarter-on-quarter in the second quarter of 2013), indicating a sustained recovery in activity from the coming year. Construction investment is continuing to adjust, although some signs of stabilisation are starting to appear, particularly with regard to lower unemployment rates in the sector.

Private consumption was flat in the second quarter of 2013, following seven quarters dominated by contraction. This was driven by improving confidence, labour market conditions and a gradual reduction in household debt levels. The contraction in private consumption in Spain has been so prolonged as a result, mainly, of adverse labour market conditions. The labour market has affected household consumption through two channels: job losses and moderation of income per employee (and through the indirect channel of uncertainty). Reversal of this pattern has an important role in explaining the change in the cycle, and the 2012 labour market reform made a significant contribution.

The labour market is also approaching stability. In calendar and seasonally-adjusted terms, registered unemployment has been practically constant since the end of 2012, behaviour similar to that pointed by Social Security (SS) covered workers and Labour Force Survey (LFS). The month-on-month change in the number of Social Security covered workers has been slightly positive over recent months (-0.4% in September, on a seasonally adjusted basis), whilst the decline in employment measured by the LFS slowed over the first two quarters of the year, particularly in the second quarter, when it fell to a quarter-on-quarter rate of -0.3%, compared to -0.9% in the previous quarter.

Labour market reform has also opened up an alternative route for reducing unit labour costs per employee: pay flexibility. Since the reform came into effect, the increase in the remuneration of employees has slowed from nearly 2% year-on-year in the previous quarters to negative territory in the last three quarters (-0.1% in the second quarter of 2013), but it is expected that compensation per employee for the whole economy will grow by 0.5% in 2013. Such positive trend has enabled a faster drop in unit labour costs, from an annual rate of -1% for 2011 as a whole to -3% in 2012 and -2.6% in the first half of 2013. This increasing reduction of unit labour costs has established the foundations for a more durable expansionary phase, enabling many companies -and their capacity for investment and growth- to remain viable.

Inflation is another factor favouring a recovery in domestic demand and increased exports. The annual inflation rate stood at 0.3% in September 2013, 1.2 percentage points below the one registered in August. The sharp moderation in annual inflation registered in September was due to the phasing out of the effects on prices in September 2012, when of the increase in Value Added Tax (VAT) rates and also of the effects of excluding various medicines from the funding of the National Health System. 2013 could end with an inflation rate below 1%. The Consumer Price Index (CPI) and core CPI at constant taxes have been negative or practically zero from April to August, but in September the annual rates of these indexes increased eight tenths and 1.1 percentage points respectively standing at 0.3% and 0.7%. This lack of inflationary pressure is favouring the consolidation of salary restraint, helping to keep exports competitive. This also enables economic agents to make consumption and investment decisions with less uncertainty.

One aspect common to both consumers and companies is a prolonged fall in expenditure; this has resulted in both sector becoming net lenders (0.9% and 3.5% of GDP on average respectively in 2012). This is of fundamental importance for the correction of other macroeconomic imbalances, such as the current account and private sector indebtedness. The existence of financing capacity for agents makes increasing expenditure more compatible with private-sector deleveraging. The correction in the current account of the balance of payments is particularly noteworthy, having improved from a deficit of -10% of GDP in 2007 and 2008 to virtual balance in 2012 (with surpluses recorded in the latter months of the year); a surplus of 1.6% of GDP is forecast for 2013. The main factor behind the improvement in the current account is the balance on goods and services, which is running a surplus of around 1% of GDP. The trade balance is particularly significant here, as it will end the year nearly in balance, despite rising energy costs.

The public sector will also make a negative contribution to GDP growth in the short term, due to the need for fiscal consolidation. However, following significant progress in 2012, the consolidation is becoming more gradual, making this more compatible with economic recovery. As the reduction in the public sector deficit increases, this will start to have a positive impact on the risk premium, reinforcing the confidence of economic agents and reducing the need for the public sector to call on bank lending. This will attenuate the crowding out of the private sector, impacting positively on private-sector financing conditions.

In summary, the Spanish economy is currently stabilising, and now has the foundations in place for recovery. This will initially be based on exports and capital investment. The improvement will subsequently be felt more sharply in job creation and private consumption.

This involves the correction of significant imbalances, both external -the current account of the balance of payments and net foreign borrowing- and internal -significant productivity improvements, costs and prices-, together with progress on fiscal consolidation. These are the foundations needed for robust economic growth over the medium term. The robustness of this growth pattern is in turn corroborated by the correction of accumulated macroeconomic imbalances. This correction goes beyond factors relating solely to the macroeconomic environment, and is also explained by structural factors deriving from the reforms implemented.

1.2. Structural adjustment of macroeconomic imbalances

The Spanish economy has corrected significant external and internal imbalances, establishing the basis for sustained recovery. The correction of these imbalances is due to the structural policies pursued, both in terms of the General Government and the functioning of the markets for goods and services, labour and capital.

The adjustments achieved in the foreign trade accounts point to a correction in domestic imbalances. The correction to the current account of the balance of payments, which is partly explained by strong export performance, is a reflection of competitiveness gains, as shown by unit labour costs.

Such improvements in the foreign trade accounts are more lasting than those achieved by devaluation, which only had a short-term impact, as the weak currency stoked inflation. Competitiveness gains due to structural reform of the markets for labour, products and capital are more lasting, and are consistent with moderate inflation and costs.

Spain's economy racked up significant macroeconomic imbalances during the bonanza period prior to 2008. These were interrelated, announcing the exhaustion of a growth model that proved to be unsustainable.

The most telling variable for the limitations of this growth model of the Spanish economy is the current account deficit, which reached 10% of GDP in 2007 and 2008. The causes of this imbalance include both cyclical factors, such as the growth differential with our trading partners and high oil prices, and structural factors such as erosion of price competitiveness and the weight of the construction sector (not tradable and with low productivity).

The consequence of this deficit was the accumulation of a highly negative Net International Investment Position (NIIP), at around -90% of GDP. Such an NIIP led to increased interest payments in the balance of payments income account, further increasing the current account deficit.

In terms of domestic imbalances, growth was dominated by the construction sector, both in terms of prices and volumes. As this sector is very sensitive to credit, the debt levels of both companies and households increased enormously at a time of historically low real and nominal interest rates.

This accumulation of macroeconomic imbalances led to the Spanish economy going into deep recession in 2008, initiating the most severe and prolonged economic crisis of recent decades. The recession was also accompanied by two serious imbalances. Firstly, economic contraction led to a significant increase in unemployment, particularly in the construction sector, which generates a lot of employment, but employment tends to be temporary and of low productivity. The overall unemployment rate increased from 8% to over 26%. At the same time, the public finances, which started from a healthy position, deteriorated significantly. The expansionary push to fiscal policy, together with the drying up of government revenues considered to be structural, took the public deficit to levels in excess of 11% of GDP in 2009, putting public debt on a path of rapid growth.

In summary, Spain faced a return to growth whilst struggling with major economic imbalances, both internal and external. A recovery seemed to be underway in 2010, but this proved to be ephemeral, with the economy returning to negative growth in the second quarter of 2011. One of the reasons for this fragility was that the correction of the economy's macroeconomic imbalances was not yet complete, and had not even started in some cases.

Although the current account deficit recovered from a deficit of 10% of GDP in 2008, it still stood at over 4% of GDP in 2011. This was particularly important at a time of volatile financial markets that were particularly sensitive to certain fundamental variables, as Spain still needed to call on external financing to fund its current needs.

Moreover, the recovery in price competitiveness was insufficient. Whilst the appreciation in the euro and the inflation differential with our European partners had been reversed, progress still needed to be made on pay restraint; in fact, the improvements in unit labour costs in essence were due to apparent productivity increases resulting from job losses.

Likewise, little progress had been made on private debt. The construction sector started on an adjustment of volumes, but prices still did not fully reflect the fundamentals, and the weight of the sector in GDP, employment and credit remained excessive.

With regard to the public sector, the deficit of the General Government stood at 9.4% of GDP in 2011, when the target was 6%, with public debt increasing sharply in the year to around 70% of GDP; this raised serious doubts about the capacity for budget consolidation. For these and other reasons, Spain's economy fell back into recession in 2011, with significant macroeconomic imbalances still pending a solution.

The recession generated significant doubts about the ability to tackle these imbalances. Together with doubts about the irreversibility of the euro, this generated significant tension in the capital markets, increasing the costs of public and private funding out of all proportion, and in some cases closing off access to wholesale finance all together.

However, the new phase of stabilisation and resulting growth that began in 2013 is based on more solid foundations.

The correction of foreign trade imbalances is the most noteworthy indicator of the improvements to the Spanish economy. The current account of the balance of payments was close to equilibrium at the start of 2013¹, with a surplus forecast for year end of 1.6% of GDP.

¹ In fact, Spain recorded current account surpluses in the third and fourth quarters of 2012. Nevertheless, given the marked seasonality of Spain's accounts with the rest of the world, these figures should be assessed considering the accumulated balance over the last four quarters. Under this approach, Spain ended 2012 with a current account deficit of 1.2% of GDP, and 0% of GDP in the first quarter of 2013.

To evaluate this adjustment, we need to take into account that the private sector undertook it quickly and flexibly. The companies have gone from a net borrowing position of 10.8% of GDP in 2007 to a net lending one of 3.8% of GDP in the second quarter of 2013. Meanwhile, in the same period households have gone from a net borrowing of 2.7% of GDP to a net lending close to 6% of GDP. This is a quick and flexible adjustment compared to other countries (especially in the Eurozone) which began with a similar situation at the start of this global crisis. It is also a notable adjustment in historic terms (both for the Spanish economy and for other reference cases), considering that the traditional resort of nominal devaluation was not available.

The growth pattern of the Spanish economy over the last 50 years has been unstable, as growth phases led to the deterioration of external accounts, with a knock-on effect on the growth of activity, which would need a nominal devaluation to overcome. For example, after the successive devaluations of the early and mid-80s, competitiveness clearly began to deteriorate again some 5 or 6 quarters after the positive nominal shock. The last episode of devaluation before entering the euro, in the early 1990s, took longer to generate a worsening of the real effective exchange rate (which reached its lowest level in 1995), due among other factors to exceptionally high unemployment and the effects of the monetary authority becoming independent in 1994. However, in 1999 there was already a real appreciation of around 10%, a trend which would deteriorate throughout the expansion phase which continued until 2007.

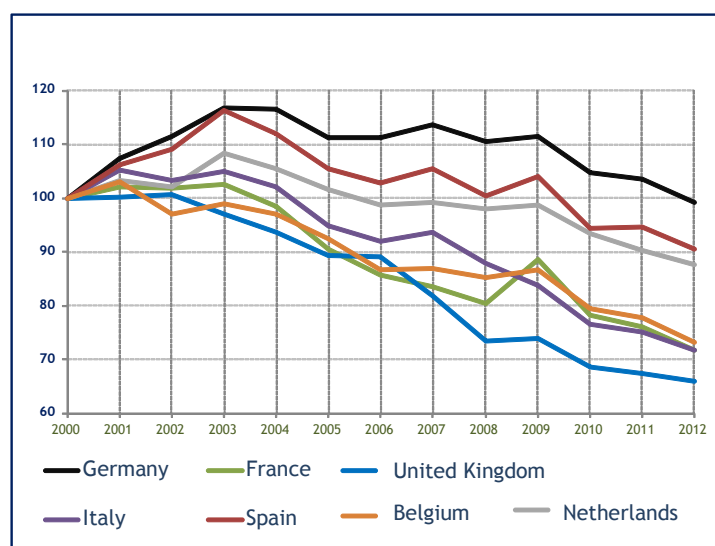
In this new scenario, external adjustment was an unprecedented milestone for the Spanish economy, given the impossibility of resorting to nominal depreciation. Instead, an internal devaluation is now in progress which is enabling the recovery of competitiveness. This internal devaluation, in the form of an improvement in unit labour costs and inflation containment, is slower than the traditional nominal devaluation, but more effective in the medium to long term. Currency depreciation used to produce short term gains in competitiveness, but in the medium term had second-round inflationary effects which dissipated the gains in competitiveness in real terms. In contrast, internal devaluation through price and wage moderation allows the real effective exchange rate to be improved in a lasting way.

Given this situation, the main question is in what proportion does this result from structural or temporary factors connected to the compression of economic activity. According to calculations based on the methodology currently used by the European Commission to calculate the cyclical and structural components of

the current account balance, the value estimated in 2012 for the cyclically adjusted component of the current account in Spain is -2.1% of GDP², compared to the balance of -1.2% observed that year.

The strong performance of exports of goods and services is a symptom indicating that the improvement is largely structural, as in principle sales abroad are conditioned by external rather than internal demand. Attesting to this, the best indicator of competitiveness is the share export in world markets, and this shows better development in Spain than in the other major European countries, except Germany. In fact, the Spanish export share was 14.2% lower in 2012 than in 2007, a rate similar to that of the Netherlands, while in countries such as Italy or the United Kingdom the reduction of this period was significantly higher.

Graph 1: Export quota (index 2000=100 of the EU countries with the highest quota (>2% in the last five years))



The data available for 2013 show a favourable trend, and Spain may be able to increase its quota in real terms. According to figures published by the World Trade Organisation, growth in world imports of goods and services could be close to 1.6% in the first half of the year, while Spanish exports grew in the same period by 6.4% in year on year terms. The performance of Spanish exports of goods was even more expansive, which increased by 9% year on year, compared to the increase of around 2% of world goods imports, according to CPB data³.

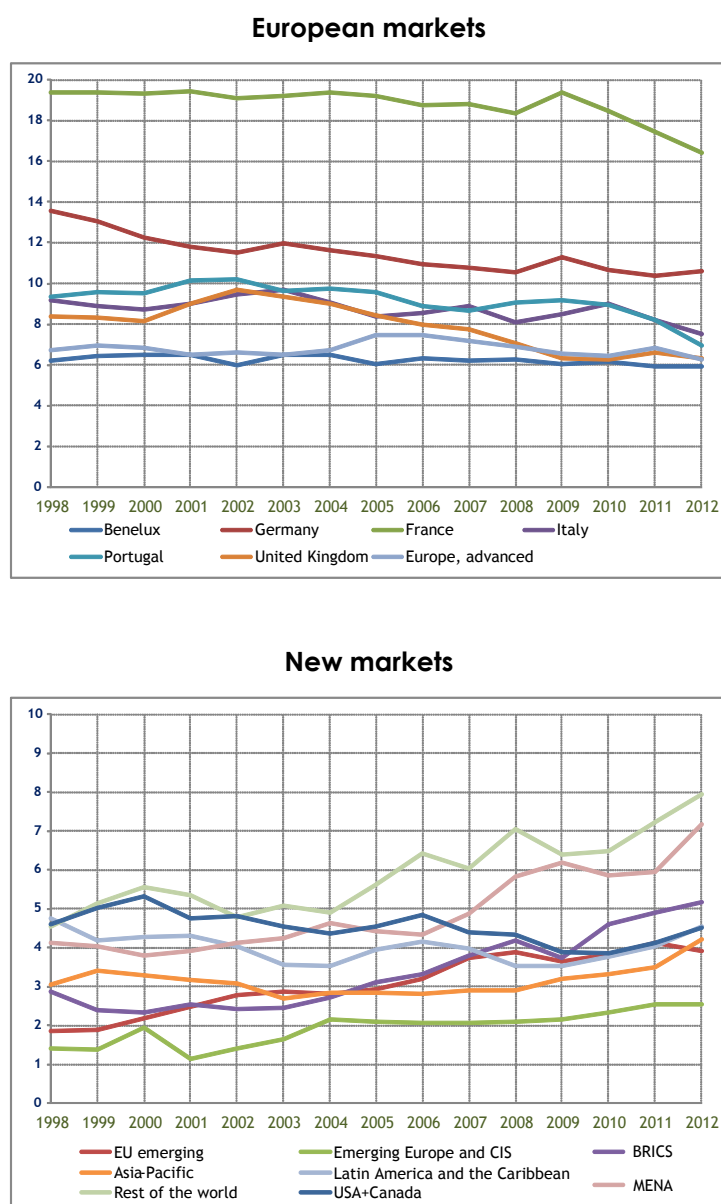
The recent trajectory of Spanish exports has particular merit, as it is their traditional and natural markets in the European Union which have been the weakest, leading

² Cyclical adjustment of Current Account Balances. LIME, September 2013.

³ CPB Netherlands Bureau for Economic Policy Analysis.

Spanish companies to make an effort to diversify geographically. In the mid-2000s, the Spanish foreign trade sector began to diversify towards new markets. This trend has been accentuated with the crisis, and the most dynamic regions are increasing their weight in exports, particularly the BRICS (Brazil, Russia, India, China and South Africa), MENA (Middle East and North Africa), Latin America and the Caribbean (without Brazil) and Asia-Pacific (without China).

Graph 2: Weight of the markets in Spanish good exports



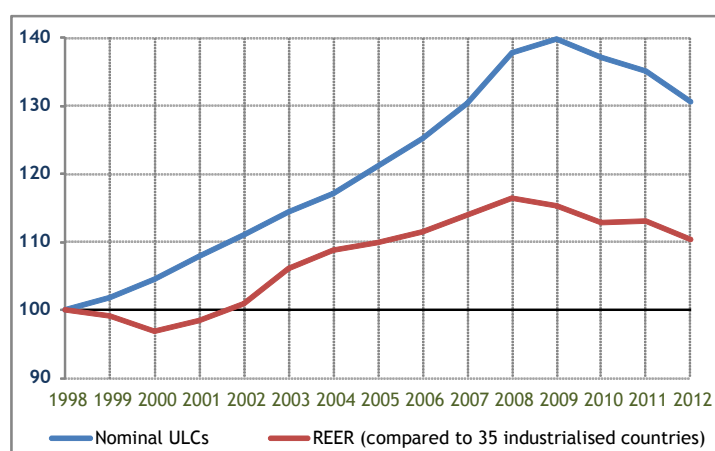
Another factor demonstrating the clear structural component of the correction of the external deficit is the recovery of price competitiveness. In terms of the real effective exchange rate, Spain lost approximately 16% of its price competitiveness⁴

⁴ Using an HICP deflated scoreboard against 35 industrialised countries.

after entering the Eurozone, but had already recovered half of this reduction from 2008 to 2013, and this recovery is expected to accelerate after discounting the knock-on effect of Value Added Tax (VAT) in September-October 2013.

In terms of unit labour costs, the gain is appreciably greater, influenced both by the increased productivity of work and by wage moderation after the labour reform in 2012. As commented above, ULCs have been falling more sharply since the labour reform came into force, with annual rates of -3% in 2012 and -2.6% in the first half of 2013, compared to the 1% decrease seen in 2011.

Graph 3: Competitiveness indexes (1998=100)



Using a relative indicator of ULCs against euro-zone countries, the gain in competitiveness is even greater, almost fully reversing the loss of competitiveness since EU entry.

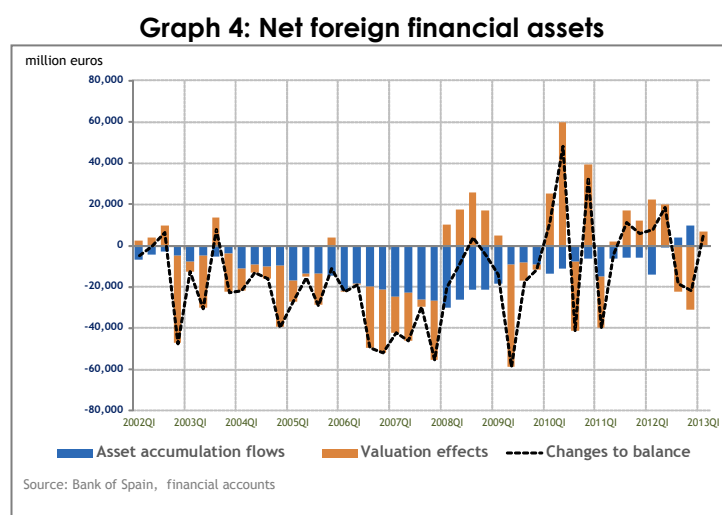
In summary, the majority of the current account improvement can be attributed to structural factors. The weight of sectors such as construction and real-estate services (non exportable and with low productivity) has been reduced -from 19% of GDP in 2008 to 15.4% in 2012- with the weight of other, more export-focused sectors, having increased, due in part to a lessening of credit restrictions. This is demonstrated by the sustained increase in the number of exporting companies, which empirical evidence suggests is likely to be largely maintained even when domestic demand starts to grow more rapidly.

In fact, the improvement in the current account would be even greater if it were not for two factors subject to great inertia: firstly, energy-related imports at a time of high international commodity prices and with demand that is not very sensitive to

price movements; and the deficit balance in revenues, although this has fallen somewhat as a result of lower interest rates - this is closely linked to Spain's debtor NIIP position.

The NIIP is one imbalance where continued progress is needed. Although it has stabilised, it remains around 90%, standing at 92.4% in the first quarter of 2013. Whilst the current account is a flow variable, the international investment position is a stock variable. This explains why a sharp correction of this variable is neither feasible nor desirable. Nevertheless, the upward trend has been detained, and is expected to reverse given the positive signs for the economy net lending position.

In some quarters, the NIIP correction has also been slowed by what are known as valuation effects, understood as those changes in the NIIP not due to flows in the financing account⁵. Although valuation effects technically include several factors, the main determinants are changes in the prices of assets and liabilities and the exchange rate. An improvement in Spain's financial markets increases the value of our foreign liabilities (even if it does not cause an effective increase in indebtedness), and an appreciation of the euro reduces the value of foreign investments denominated in other currencies, when they are translated into that currency⁶.



As shown in graph 4, recent quarters provide a clear example of the influence of valuation effects on the net stock of financial assets with the external sector.

⁵ Non-performance, restructuring, reclassifications due to change of ownership and measurement errors.

⁶ These factors may become relevant for Spain's NIIP over the coming months. Spain has direct investments in a number of emerging economies, such as Brazil, which are currently subject to downward pressure on their exchange rates. If this occurs, this will reduce the value of Spain's stock of foreign assets, and this will be reflected from an accounting perspective by a worsening of the NIIP.

Despite a net accumulation of financial assets in the second half of 2012, the debit balance on the net stock of financial assets with the external sector increased. Analysis of the instruments involved reveals that this was caused by the revaluation of Spanish liabilities in the form of shares and other participations and fixed income instruments (money market instruments, notes and bonds).

Nevertheless, the trade surpluses forecast for the coming years will enable Spain to reduce our debtor position against the rest of the world sustainably. Therefore, in the absence of adverse valuation effects, we do not expect any additional deterioration in external debt. Moreover, Spain's expected net lending to the rest of the world and the growth expected over the coming years will make it possible to reduce this external imbalance.

The correction of macroeconomic imbalances also has an internal dimension that is in fact connected to the improvement in the external position.

The problem that perhaps most needed addressing was the excessive weight of the construction sector and the bubble of prices and volumes. The excessive growth of this sector has had pernicious consequences and it is connected to other macroeconomic imbalances, such as the vulnerabilities of the financial sector, excessive lending density, indebtedness, the creation of temporary jobs with low productivity and the drainage of resources (credit, jobs, etc.) that could have been better invested in more productive, export-oriented, activities.

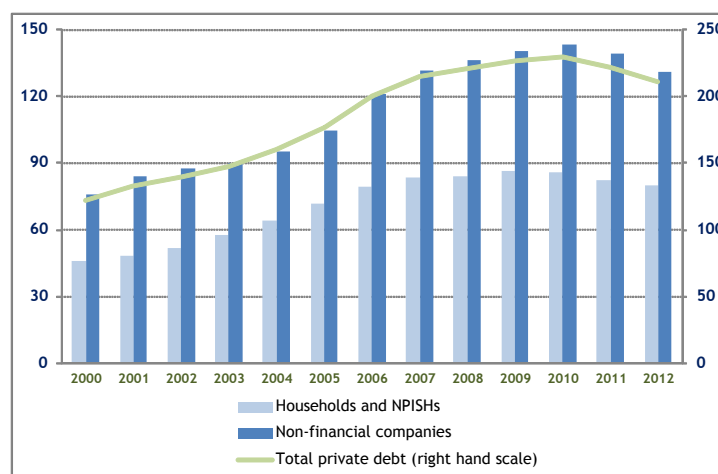
Following the bursting of the real-estate bubble in 2008, much of this adjustment has now occurred. In terms of prices, the rate of decline has accelerated to over 10% year-on-year, with an accumulated fall of over 30% in real terms from the peak, and 38% in the case of new housing, according to the National Statistical Institute's figures. In terms of volume, the weight of the construction sector in GDP, investment, employment and credit has fallen sharply. This is currently the most depressed area of activity, and it will therefore continue to lose weight relatively over the short and medium term.

A number of measures have helped to accelerate the process recently, particularly the creation of the Sociedad de Gestión de Activos Procedentes de la Reestructuración Bancaria (SAREB - the Asset Management Company for Bank Restructuring) and the general strategy for restructuring and recapitalising the financial system. SAREB's mandate to dispose of its portfolio has contributed to the acceleration in the pace of price corrections, and the transfer of certain troubled assets from credit entities to SAREB has enabled the former to reduce their exposure

to the sector and to limit their refinancing of unviable projects, focusing instead on more profitable companies and sectors.

The creation of SAREB and the financial reform has also contributed to accelerating the correction of another imbalance, swollen private debt.

Graph 5: Private debt as a % of GDP



The stock of private debt reached an all-time high in mid-2010, at 230% of GDP, with 144 points of this total owed by non-financial corporations and 87 points by households⁷. There has been a process of continuous deleveraging since this peak, with a reduction of over 25 percentage points of GDP, to around 206% of GDP: over 8 points of this reduction was by households, and 16 points by non-financial corporations.

There has been more progress over recent quarters than in the five previous years. For example, company debt fell by 10 points of GDP between the third quarter of 2012 and the first quarter of 2013.

The creation of SAREB has contributed to this in a number of ways. Firstly, it has led to a correction of the value of certain assets that could not recover their face values. In accounting terms, this correction has led to a reduction of the stock of private debt held by non-financial companies. Financial entities have taken these losses onto their balance sheets by establishing provisions. In the medium term it is a necessary condition for a recovery in financing of the private sector and a refocusing on new sectors of growth.

⁷ The calculation of the stock of private debt compared to GDP is based on nominal GDP figures prior to the review of the National Accounts at the end of August. For the sake of consistency, the ratios have been maintained as we await the publication of revised figures for private debt, which might affect the numerator in these ratios.

The second advantage is that, following the haircut mentioned in the previous paragraph, the assets have been transferred from private credit entities to SAREB. Banking entities can now channel the freed up financial resources to new projects, as the demand for credit rebounds in parallel with the economic recovery.

This will further boost the reassignment of credit between productive sectors that had begun before SAREB came into existence.

Wide-ranging reforms have been implemented in capital markets and the markets for goods and services to complete this reassignment of resources between productive sectors. The enormous transparency, restructuring and recapitalisation effort for the financial sector has restored confidence in these institutions, opening up access to the markets and gradually improving financing conditions for Spanish entities and companies. In parallel, reforms in product markets to improve regulation, reduce administrative burdens and promote competition have improved both competitiveness and prices.

Furthermore, labour-market reform has been a key factor in the reallocation of resources between productive sectors. The unemployment rate remains above 26%, and this is the most worrying imbalance. In addition to the social, economic and budgetary implications of high unemployment, it is also a signal of inefficient resource allocation.

Given this difficult situation, Spain is facing twin problems. Firstly, it must achieve a reduction in unemployment as rapidly as possible. Secondly, the reduction in unemployment must be robust to any small changes in economic conditions; it is therefore essential that workers are assigned to the most productive vacancies, companies and activities.

Labour reform has included many elements to achieve these ends. In addition to the increased flexibility for wage adjustments as discussed above, labour reform has introduced other promising aspects, such as greater internal flexibility in companies. Royal Decree-Law 4/2013, of 22 February, complements the labour reform with additional measures to promote enterprise, self-employment and the contracting of young people. In particular, it establishes a more favourable tax structure for the self-employed embarking on a business activity and introduces incentives for the hiring of jobless young people.

These measures have helped the labour market to stabilise earlier than expected, and will help it to bolster rather than hamper the recovery. We can expect

unemployment to start to fall as the economic recovery takes hold, with no need for growth rates as high as in the past for net job creation.

At a time like the present, when compliance with European commitments on fiscal consolidation is the highest priority, the current structural reforms have an essential part to play in promoting the competitiveness and flexibility of the Spanish economy -through the adjustment of our prices relative to other euro-zone countries- and in establishing the foundations for sustained and balanced economic recovery.

Finally, public debt is a stock imbalance and will therefore take time to correct, particularly with a horizon of gradual reduction of budget deficits. This gradual approach may be more efficient than a more abrupt approach, as the scale of the deficit to be reduced and the circumstances in which Spain finds itself present the possibility of high fiscal multipliers, given the negative output gap and financial restrictions.

The imbalances where correction is progressing more slowly (such as public and private debt and the NIIP) are stock variables and should therefore present less of a problem as the economy recovers. The essential aspect is that the correction of other macroeconomic imbalances must ensure that this growth starts soon, and is based on solid and robust foundations.

2. MEASURES TO IMPLEMENT THE SPECIFIC RECOMMENDATIONS OF THE COUNCIL OF THE EUROPEAN UNION (CEU)

The Government's structural reform programme, as set out in the 2013 National Reform Programme, was validated following the European Semester, with its fundamental approach being established in Specific Recommendations for Spain in June this year. We will now discuss compliance with each of these Recommendations.

2.1. Differentiated fiscal efforts favouring growth (Recommendations 1 and 2)

Section 3 provides a more detailed appraisal of action in this area. However, it is worth offering an initial general overview of the main progress to date. This involves a range of actions to guarantee the solvency of the public administration in the short, medium and longer term, whilst ensuring the public sector also contributes - like the private sector- to economic recovery, without generating additional distortions.

A number of actions have already been undertaken to ensure the continuity of fiscal consolidation; these will enable a reduction in the structural deficit of around 1.1 p.p. (according to the latest EC estimates), in line with the Excessive Deficit Procedure.

Specifically, to meet the 2013 budget stability objective, the National Reform Programme (NRP) and the Stability Programme envisage approval of additional consolidation measures with an impact of around 3 billion euros. These measures involve three areas:

- Increasing duties on consumption of alcohol, tobacco and fluorinated gasses and extension of the tax bases for Corporate Income Tax, increasing revenues by 1 billion euros. This measure is being introduced through two instruments.
 - The Royal Decree-Law on urgent measures of a tax and budgetary nature and to promote research approved on 28 June by the Council of Ministers. This increased duties on consumption of products with negative externalities, such as tobacco and medium and high-strength alcohol. In terms of alcoholic drinks, it increased duties on intermediary products and on alcoholic products and derived beverages by 10%. In terms of tobacco, the tax structure was modified to increase the emphasis on specific as opposed to "ad valorem" rates, bringing the structure more into line with that in most European Union countries.

- The Draft Bill establishing certain measures relating to environmental taxation and other tax and financial measures. From 1 January 2014, a new tax will be imposed on Fluorinated Gasses with greenhouse effects, as an instrument to reduce emissions of halogenated hydrocarbons, in accordance with European Union recommendations to increase environmental pressure through taxation.

This Draft Bill, which has nearly completed its parliamentary stages, also introduces modifications to Corporate Income Tax (removal of certain deductions and reductions⁸) which also imply modifications to Personal Income Tax (IRPF)⁹. These aim to reinforce fiscal consolidation by increasing the tax base of current taxes; this will also serve to remove certain adverse incentives for the behaviour of economic agents.

This Draft Bill also extends to 2014 and 2015 the increase in the Real Estate Tax (IBI) rate for urban properties.

- Coordination of active and passive employment policies. Under development, with a saving of around 1 billion euros.

A new system is being designed for administering unemployment benefits, using new IT tools and methodologies for the sharing of databases. This will improve control of whether recipients of unemployment benefits are complying with their obligations. This will ensure the coordination of active and passive policies in the monitoring of active job seeking by benefit claimants and actions to improve their employability.

These measures are in addition to others contained in the 2013-2016 Employment and Enterprise Strategy, which addresses active employment policies, and which has been implemented through Royal Decree-Law 4/2013, on support measures for entrepreneurs and stimulating growth and job creation. The first title of this Royal Decree-Law proposes measures to reduce youth unemployment through access to the labour market either as employees or through enterprise and self-employment.

⁸ In the case of Corporate Income Tax, this establishes the non-deductibility of portfolio impairment, together with losses incurred abroad through a permanent establishment or as part of a Joint Venture. It also extends into 2014 a number of measures that would otherwise have expired in December 2013, principally: the limit of 50% or 25% on the offsetting of negative tax bases for entities with turnover in excess of certain thresholds; limits on the deductibility of goodwill and intangible assets with indefinite useful lives at 1% and 2% respectively; a minimum payment in instalments of 12% for entities with turnover in excess of €20 M, with rates increasing for payment in instalments for entities with turnover in excess of certain thresholds; the inclusion until 2015 in the base for payment in instalments of dividends and gains from the transmission of shares with exemption rights; and, finally, a limit of 25% or 50% on deductions to promote certain activities.

⁹ Consistently with Corporate Income Tax, the non-deductibility of negative income from Joint Ventures has also been established for Personal Income Tax.

As a complement to this regulation, on 19 September the Congress of Deputies approved the Law to Support Entrepreneurs and their Internationalisation (published in the Official State Gazette on 28 September), a comprehensive law seeking to facilitate enterprise and business activity through aspects as wide ranging as the formation of businesses, tax regimes, financial support and relationships between companies and the public administration.

- Adjustment of the collaboration agreements with the Autonomous Regions (AR) regarding Active Employment Policies, which are currently being drawn up, with a financing system linked to meeting the targets set in the Annual Active Employment Policy Plan.

Also in this framework of collaboration with the ARs, development has begun of a Single Employment Portal which will have a single database for the whole of Spain with all the training and job offers as well as data on the unemployed. This measure will be accompanied by the design of a Framework Agreement, which the ARs will sign, to channel the collaboration of the State Public Employment Service and Public Employment Services with private employment agencies, in order to improve labour intermediation and favour matching supply to demand. On 2 August the Council of Ministers approved the framework agreement and the bidding procedure is already under way to select placement agencies to work with the Public Employment Services in integrating the unemployed into the labour market.

Fiscal consolidation is being reinforced by the exhaustive monitoring undertaken by the Ministry of Finance and Public Administration (MINHAP) to ensure compliance with stability targets at the regional and local level, based on:

a) Improving statistical information on budget execution, for which monthly information is available for 2013 in the National Accounts on the Central Administration, Autonomous Regions and Social Security, and quarterly data on Local Corporations. This statistical base improves the early detection of any deviations, and the consequent application of mechanisms to ensure compliance with the budget targets set in the Budget Stability Law.

b) At the regional level, the measures applied by all the ARs are being closely monitored, whether financial plans (Planes Económico Financieros, PEF) for a failure to meet their targets (at present, five ARs) or adjustment plans after adopting the mechanism of the Fund for Financing Payments to Suppliers (fourteen ARs) or the Regional Liquidity Fund (at present, nine ARs). These adjustment plans are monitored on a monthly basis. In the sphere of the PEFs, in accordance with the

Organic Law on Budget Stability, quarterly reports are drawn up, evaluating deviations in the fulfilment of measures and targets. These reports have led to the Ministry of Finance requiring the ARs to adopt measures, which they have done.

In turn, 2.500 local corporations have Adjustment plans under the supplier payment Plan.

As well as these monitoring mechanisms established by Organic Law 2/2012, supervision will be provided by the Independent Fiscal Responsibility Authority (Autoridad Independiente de Responsabilidad Fiscal, AIRF), a commitment undertaken in the PNR for execution before the end of 2013.

The Draft Organic Law was approved by the Council of Ministers on 28 June 2013 and remitted to the Cortes Generales. The amendment period in Congress ended on 12 September 2013 and it is expected to be approved by Parliament in mid-November. Meanwhile, the Organic Statute of this institution is being drafted and will be approved after the approval of the law, by 31 December 2013 at the latest.

As shown in these legislative documents, this new independent institution, with functional autonomy, will undertake the overall supervision of all Public Administrations and will ensure the effective fulfilment of the principles of budget stability and financial sustainability. Its creation complies with various European commitments, concretely the EU Directive of 2011 and the European Union Regulation on common provisions for supervising and evaluating the draft budget plans in force since May 2013. Thanks to its constitutional basis, it can provide overall supervision of the entire public sector, including the Central Government (Administración General del Estado, AGE), Autonomous Regions, Local Corporations, Social Security and other bodies.

The AIRF will have the three functions included in the EU Country-Specific Recommendations for Spain (analysis, advice and monitoring in relation to budget policy), and by exercising them will ensure effective compliance by Public Administrations (PAs) with the principles of budget stability and financial sustainability.

The mandatory reports to be drawn up by the AIRF will deal with the following matters, among others:

- The macroeconomic forecasts included in draft budgets by all public administrations and in the Stability Programme.
- The draft Stability Programme.

- Analysis of budget performance, public debt and the expenditure rule, and expected target compliance.
- The establishment of individual stability targets for the Autonomous Regions.
- The economic-financial plans and rebalancing plans of Central Government and the Autonomous Regions.
- The draft budgets and main parameters of budgets of the public administrations.
- The convenience to activate preventive, corrective and coercive measures as set out in the Organic Law on Budget Stability and Financial Sustainability, and the occurrence of the exceptional circumstances provided for in that Law.

The mandatory reports prepared by the AIRF will not be binding, but the Government must give reasons if it chooses not to adopt the measures it recommends. In particular, the macroeconomic forecasts used in draft budgets and the stability programme must have AIRF report, indicating whether it endorses the figures used.

It may also formulate its own opinions relating to issues set out in the Law, and may carry out studies at the behest of the Government, the Fiscal and Financial Policy Council, the National Local Administration Commission and the Social Security Financial Commission.

The independence of this new body is fully guaranteed by a number of provisions in the Organic Law creating it. The AIRF has full functional autonomy and independence. In addition, its Chairman will be appointed by the Council of Ministers, but the appointment must be approved by absolute majority of the competent Congress Committee. Neither the Chairman of the AIRF nor any of its staff may apply for or accept instructions from any public or private body. Lastly, the main source of financing for the AIRF will be a supervision levy paid by the public administrations it monitors, further reinforcing its economic independence.

With the goal of improving the efficiency of spending, the rationalisation of spending on health care is particularly important. Here some measures have

already been adopted, such as managing purchasing through centralised platforms, and other far-reaching measures are now being drafted:

- Organisation of the basic portfolio of shared care services approved by the Interterritorial Health Council for screened groups, and for the optimisation of 13 specialist medical services. In 2013 this organisation is continuing, and a new catalogue of surgical implants will also be drawn up.
- Regulation of the common supplementary portfolio of the National Health Service (Servicio Nacional de Salud, SNS). The Ministry of Health, Social Services and Equality (Ministerio de Sanidad, Servicios Sociales e Igualdad, MSSI) is currently drafting various Royal Decrees:
 - Royal Decree establishing the contribution of users to the common supplementary portfolio of dietetic products, expected to be approved by the Council of Ministers in September.
 - Royal Decree on ortho-prosthetic products: pending a Report by the Council of State (expected in December).
 - Royal Decree defining the common supplementary portfolio of non-urgent healthcare transport of the SNS: pending a Report by the Council of State.
- Approval of a new Order on Reference Prices, in order to contain spending on pharmaceuticals, in line with other European Union countries. Before this Order is approved a Royal Decree must be adopted (currently in the discussion stage) developing certain aspects of the reference price system arising from the new wording of the Law on Medications, in accordance with Royal Decree-Law 16/2012, of 20 April.
- Centralised purchasing platform. Already in use from 13 September, when the Council of Ministers approved a new bidding process for the centralised purchase of medications with 10 ARs and the National Institute of Healthcare Management (Instituto Nacional de Gestión Sanitaria) which forms part of the Ministry and is responsible for healthcare management in Ceuta and Melilla.. Two more centralised purchasing processes are expected to be open to tenders by the end of the year.
- Rollout of e-health. Development of digital medical history at the national level. On 20 September a Royal Decree was approved which modified Royal Decree 183/2004, of 30 January, regulating the individual healthcare card.

- New legal framework for the clinical management model. Law 10/2013, of 24 July, incorporates changes to the Law for the Organisation of Healthcare Professions and the Framework Statute on statutory healthcare personnel.
- New social and healthcare model for the overall optimisation of healthcare and social resources. For this purpose the Social and Healthcare services Strategy is being drafted to integrate services and guarantee the continuity of care, offering complete patient care by coordinating health and social services.
- Reform of the Dependency Care system through three Royal Decrees now being drafted (once the General Technical Secretariat of the MSSSI has issued a report, the mandatory report of the Council of State will be requested). These are already substantially developed and their goals defined, as follows:
 - Royal Decree on the economic capacity and participation of the beneficiary in the provisions of the system.
 - Royal Decree to fit care provision to the real needs of dependent people and prioritise professional services.
 - Royal Decree establishing the minimum level of protection for beneficiaries of the Dependency System, guaranteed by the General State Administration.
- New regulation of Mutual Funds for Accidents at Work and Occupational Illness, to modernise their functions and management. This regulation, now being drafted, will design a new management system, ensuring transparency and control, so that these bodies contribute to combating absenteeism and to the sustainability of the Social Security system by generating greater surpluses.

In order to ensure financial sustainability and control the commercial debt of the PAs, the following measures have been adopted:

- Plan to eradicate debt arrears among Public Administrations (PAs), approved by the Council of Ministers on 28 June. This plan, which is intended to make the procedures for paying suppliers more flexible and to contribute to the monitoring and eradication of arrears, consists of the following measures, which will ensure effectiveness when applied together:
 - Draft Organic Law on the Control of Commercial Debt in the Public Sector. Its approval is expected in November 2013. This Law centres the control of commercial debt on the concept of the average period for paying suppliers, which PAs are obliged to publish. It also establishes that the monthly treasury plans

of PAs, which they are already obliged to produce under the Stability Law, must include information on forecast payments to suppliers and ensure fulfilment in the maximum period set by regulations on paying suppliers (currently 30 days). MINHAP will monitor the fulfilment of these average payment periods by ARs in order to detect failures to comply, which will involve a system of sequentially applying preventive, corrective, and finally, coercive measures, to the point of withholding resources in order to pay the supplier.

- Draft Law for electronic invoicing and the creation of an accounting invoice register in the Public Sector. This is now in the last stages of the parliamentary process. It is intended to give suppliers security in their relations with the PAs. With this regulation they will present their invoices in an administrative register where the date will be recorded for the purposes of accrual of interest when payments are delayed. Consequently, Administrations will have greater accounting control of invoices, enabling them to better meet payment deadlines, with positive effects in combating fraud, the deficit and control of public spending.

- Supplier Payment Plan, intended to eliminate the unpaid bills of territorial bodies, as the starting point of the law to control commercial debt mentioned above. The Plan came into force through Royal Decree-Law 8/2013, of 28 June, on urgent measures against the arrears of Public Administrations and to support Local Entities with financial problems. Title I of the Royal Decree-Law regulates a third and final phase of the funding mechanism for payments to suppliers which helps regional and local administrations to meet their commercial debts, in the form of matured, liquid and enforceable invoices due before 31 May 2013. Also, Title II regulates a set of extraordinary and urgent measures to support liquidity, in order to help municipalities in especially difficult situations. Coercive measures are established to increase income and reduce spending for town councils and other local entities with liquidity problems, while also ensuring their solvency.

In order to reduce the level of price inertia in public spending and income, these measures have been agreed:

- Law on the Deindexation of the Spanish Economy. On 27 September 2013 the Council of Ministers approved a report on the Draft Law. The elimination in the public sector of the practice of indexing prices and public tariffs to past price indices takes a large step towards the culture of price stability. This initiative was requested by social agents and is intended to bring practices closer to those of the private sector, with the corresponding change towards a culture of price stability.

This regulation will decouple prices, tariffs, levies and rates of the PAs from the evolution of the CPI, in such a way that they will only be linked to the costs of the services rendered. This will avoid the so-called "second-round effect" in the price formation process, will limit the influence of exogenous price shocks on the Spanish economy, and will give continuity to the process of improving the inflation differential compared to our main European trade partners, favouring competitiveness and encouraging growth and employment.

The scope of application of this Law will be the state, regional and local public sector, explicitly excluding collective wage bargaining, pensions and financial instruments. For private contracts with update clauses but without reference to a specific index, it is planned to apply an index guaranteeing competitiveness, which would accentuate the Law's intended effects on economic activity.

In order to ensure the sustainability of the pension system, the following measures will be adopted:

- Regulation governing the sustainability factor. After its discussion in the Toledo Pact, on 27 September 2013 the Council of Ministers approved sending to the Cortes Generales the draft law, beginning its parliamentary procedure. Section 3 describes the basic content of the Draft Law.

In order to combat tax and employment fraud:

- In the fiscal sphere, information sharing on subsidies between the State Tax Agency and the General Comptroller of the State Administration has been strengthened.
- In the sphere of employment and Social Security, the Plan to Combat Irregular Employment and Social Security Fraud, approved in April 2012, will continue to be active until the end of 2013, without prejudice to the regulatory reform continuing to be in force. Also, during 2013 organisational measures and collaboration between institutions to combat fraud are being strengthened.

In order to systematically review the tax system and comply with other fiscal recommendations, an Agreement of the Council of Ministers on 5 July constituted an expert committee to reform the Spanish tax system. This committee will draw up a report of conclusions before the end of February 2014 in order to formulate a proposal for a simpler, more neutral and efficient Spanish tax system, ensuring sufficient income in relation to the constitutional principles of economic capacity,

universality, equality and progress, and the undertaken commitment to fiscal consolidation.

Part three of this report lists all the tax measures.

2.2. Re-establishment of conditions for lending to the economy: (Recommendation 3)

We can emphasise the following actions:

- Law on Savings Banks and Bank Foundations. In the parliamentary process.
- Draft Law on the Solvency of Credit Entities. This regulation is being drafted which will add to Spanish law the new European regulations on capital (in turn, arising from Basel III) and which must be in force on 1 January 2014. This regulation will also include adjustments to the regulations on the supervision of financial conglomerates. Before the end of the year a Royal Decree-law will be approved, given the short time available for its transposition, and the corresponding drafting of new regulations.
- Reform of Corporate Governance. In May the Council of Ministers approved the creation of an Expert Committee which has delivered a report with proposals for improving the current framework of Corporate Governance in October.

Within two months from the reception of the report, the Government will make the changes to the regulations and draw up a code of best practice for unlisted companies.

- Creation of the Alternative Fixed Income Market (Mercado Alternativo de Renta Fija, MARF). The regulations of the MARF were approved in May. Now it remains for AIAF, and then the National Securities Market Commission (Comisión Nacional del Mercado de Valores, CNMV) to approve the minutes of the MARF. The first issuances of the MARF are scheduled to begin in October.
- The Business Finance Development Law. A more wide-ranging structural law is being prepared on business financing to promote access to credit through non-banking channels. This is based on a number of legal reforms and other measures, including:
 - Improving the efficiency of investment vehicles, through in-depth revision of Spain's venture capital regime (repeal of the current Law 25/2005), making progress in two directions: a) reducing regulatory burdens on the authorisation of venture

capital vehicles and adjusting equity requirements to bring them into line with those of our European partners; and in particular, b) the creation of a new investment vehicle, an SME-venture capital entity, with a flexible financing structure for investing in company loans and debt (rather than just in capital). This change will allow funds to invest exclusively in debt for the first time in Spain, thus opening up a direct non-banking channel for SMEs to access finance; this has excellent growth potential.

- To improve traditional banking finance channels, legal reform is being pursued to: a) oblige credit entities to give advance notification to companies whose credit facilities are to be terminated or reduced, helping such companies to make the adjustments needed to maintain their working capital; b) improve the quality and efficiency of underwriting by CERSA of mutual guarantee institutions, to improve their recognition and valuation among credit entities lending to SMEs; c) reduce the consumption of bank capital resulting from financing SMEs. This is being achieved in Spain by anticipating the regulations on calculating capital consumed by exposure to SMEs set out in EU Regulation 575/2013 (through the Bill 14/2013, of 27 September, on Support for Entrepreneurs and their Internationalisation and related reforms to the Bank of Spain Circular).

- To make the regime for Collective Investment Institutions (CII) more flexible, facilitating the creation of exclusively institutional funds with a small number of professional participants, and encouraging the creation of compartments within the funds so that various investment strategies can be pursued, thus exploiting economies of scale.

- To improve the functioning of the Alternative Stock Market (ASM), facilitating the migration of stock-market-listed companies with little activity to this alternative trading system.

- Creation of a new financial instrument, SME bonds, in order to extend the benefits of covered bonds with the best portfolio of eligible credits to the bank financing of SMEs.

2.3. The fight against unemployment and the social consequences of the crisis: (Recommendations 4, 5 and 6)

A number of measures have been implemented to assess and improve the functioning of the labour market, particularly with regard to the effectiveness of active policies:

- The assessment report on the effects of labour market reform. The Ministry of Employment and Social Security submitted a report on 2 August on this issue and an assessment by the OECD is expected to be ready in December.
- The 2013 Annual Employment Policy Plan. This was approved by the Council of Ministers on 2 August 2013. This involves reform of active employment policies including, for the first time, a number of indicators to assess the effectiveness of such policies, and to link the distribution of funds among the Autonomous Regions to achieving certain targets. Secondary legislation will be approved in the coming months to complete implementation of this new model.
- Development of public-private cooperation in employment brokerage services. The legislative reforms have been approved that were needed to implement this, together with the framework agreement for public employment services to award contracts to private agencies. A tender process is currently underway to select these agencies. The model will be in operation before the end of 2013.

The following measures are being introduced with the specific objective of tackling youth unemployment, reducing the abandonment of education and improving the employability of young people:

- The 2013-2016 Youth Employment and Enterprise Strategy. This was approved in February 2013. The measures with the greatest impact are already in place. The remainder will be implemented over the lifetime of the Strategy.

An annual assessment of the implementation of the Strategy will be carried out.

- The Organic Law on Improving Educational Quality. This Law seeks to reduce the abandonment of education and to promote Vocational Training (VT). The draft Organic Law was approved by the Council of Ministers on 17 May and is currently working its way through Parliament. It is expected to come into effect for the academic year 2014-2015.
- The 2013-2015 Dual Vocational Development Strategy. This Strategy will cover the full development of Dual Vocational Training in Spain and its assessment. Currently being prepared.

The following measures are being implemented to promote social inclusion through integration into society and the provision of basic social services to the public:

- The 2013-2016 National Social Inclusion Plan. Currently being prepared. This is expected to be approved by the Council of Ministers in November.

- The Comprehensive Family Support Plan. Currently being prepared. An Inter-ministerial Technical Committee has been set up with representatives of various ministerial departments to establish working groups to prepare this Plan.

2.4. Promoting growth and competitiveness: (Recommendations 7 and 8)

It is essential to remove the barriers and restrictions that hamper companies in order to promote growth and improve business competitiveness (recommendation 7).

- The Draft Law on the Unity of the Market (PLGUM, for its Spanish acronym) was approved by the Council of Ministers on 5 July, and is currently working its way through Parliament. It is expected to receive final Parliamentary approval in early 2014.
- In parallel to the preparation and processing of the PLGUM, at the end of 2012 a Regulatory Rationalisation Plan was launched to analyse the regulatory framework for economic activity and identify barriers to market unity, duplication, discrepancies and inconsistencies, and to propose appropriate regulatory changes. The final assessment report containing the regulatory changes planned at the state level and actions to be undertaken by regional coordination mechanisms (basically sector conferences) will be approved in October 2013.
- Launch of the Comisión Nacional de los Mercados y la Competencia (CNMC - the National Markets and Competition Commission), as established by Law 3/2013, of 4 June.

The Bylaws of the CNMC were approved on 30 August, with the members of its Board being appointed by Royal Decree on 6 September. The CNMC is expected to come into operation in early October.

- The Law on Professional Services and Colleges. As it is one of the commitments under the 2013 National Reform Plan, on 2 August the Council of Ministers decided to commence work on the Draft Bill. Public consultation ended on 23 September 2013, with later mandatory consultation then commencing.
- The Law to Support Entrepreneurs and their Internationalisation. The Draft Law was approved by the Council of Ministers on 28 June. A vote was taken in Congress on 19 September on the Draft and amendments from the Senate. The Law was published in the Official State Gazette (BOE, for the Spanish acronym) on 28 September.

- Law 4/2013, of 4 June, on Measures to Promote and Increase the Flexibility of the Rented Accommodation Market. The measures required to implement this are expected to be developed in regulations over the coming months.
- Law 8/2013, of 2 June, on Urban Rehabilitation, Regeneration and Renovation.

Action is required in sectors such as electricity and transport to ensure that markets function competitively (recommendation 8).

- To this end, Royal Decree-Law 9/2013, of 12 July, was approved introducing certain measures to ensure the financial stability of the electricity system.
- The Electricity Sector Law has also been revised. On 20 September 2013, the Council of Ministers approved the submitting of the Draft Electricity Sector Law to Parliament. Regulatory development of this measure -involving seven Royal Decrees and five ministerial orders- will take place in parallel.
- "Information Memorandum". This Memorandum detailing the requirements and procedures for joint assignment of natural gas interconnection capacity between Spain and Portugal has been approved (BOE 28 May 2013).
- Measures to liberalise passenger rail transport. A number of measures have been adopted to promote competition and maximise use of this infrastructure (Royal Decree-Law 22/2012, of 20 July, Royal Decree-Law 4/2013, of 22 February, and Law 11/2013, of 26 July).

In relation to commercial services, an Order from the Development Ministry to determine the requirements for winning concessions, and for the Council of Ministers to determine the number of concessions to grant for each line or group of lines, and the tender procedure for these.

- Public Service Obligations (PSO) for middle-distance services. On 28 December 2012 the Council of Ministers agreed the definition and rationalisation of the PSO for conventional middle-distance services; on 5 July it agreed the definition and rationalisation of the PSO for services operated by FEVE and Avant high-speed services. The recommendation has therefore been complied with on this point.
- Adapting the Renfe Operadora to act in a liberalised environment. Royal Decree-Law 22/2012, of 20 July, set out the restructuring of the Renfe Operadora into four commercial companies to improve efficiency in a liberalised system. The steps to comply with the mandate set out in Royal Decree-Law 22/2012 are being concluded.

At the end of September, the Council of Ministers approved the split and merger of Renfe, which will make the costs of its various activities more transparent and easier to control.

- Review of the system of rail charges to ensure the sustainability of ADIF (the Railway Infrastructure Administrator) and to establish a system to promote rail traffic. This issue was also complied with through Royal Decree-Law 11/2013, of 2 August, on the protection of part-time workers and other urgent social and economic measures.
- The Draft Royal Decree on the assignment of time slots for an independent entity. Regulations for this are being drawn up.
- The Law on the Organisation of Land Transport. Awaiting development of regulations for the modifications introduced through Law 9/2013, of 4 July.

In addition, the following laws have also been approved or are being processed to improve competitiveness:

- The Basic Law on Official Chambers of Commerce, Industry and Navigation. The Draft Law was approved on 26 July and has been submitted to Parliament. Currently going through Congress.
- The General Telecommunications Law. This Draft Law was approved on 13 September, and has been submitted to the Cortes Generales to begin the parliamentary procedure.
- The Law on State Coverage of the Risks of Internationalisation of the Spanish Economy. The Council of Ministers agreed to send the Draft Law to Parliament on 20 September.
- The Environmental Assessment Law. This Law brings together the legal regime for assessment of plans, programmes and projects which previously had been divided between two laws. The Draft Law was approved on 30 August and is now going through Parliament.
- The Law on Measures to Improve the Functioning of the Food Chain: Law 12/2013, of 2 August.
- The Intellectual Property Law. This Draft Bill was submitted to the Council of Ministers on 22 March. Public consultation started on that date and ended on 17 April 2013.

A new text for the Draft Bill is being prepared based on the observations and reports received. This has been submitted to the Council of Ministers, with a ruling expected before November 2013.

2.5. Modernisation of the Public Administration: (Recommendation 9)

The political economy and structural reform measures for modernisation of the public administration have two main objectives: to guarantee and increase the efficiency of the public administration; and to increase the efficiency of the legal system.

- The first of these measures seeking to guarantee and increase the efficiency of the public administration is the Law on the Rationalisation and Sustainability of Local Government, which is currently being processed. The Draft Law was approved by Agreement of the Council of Ministers on 26 July, and was then sent to Parliament. It is expected to be approved in December 2013.
- This Draft Law clarifies and simplifies municipal competencies to avoid duplication with other branches of government, and rationalises organisational structures to achieve greater efficiency and a balanced budget. The Law suppresses the competencies unduly performed by Councils, by regulating and setting out their competencies precisely. The Law also empowers Provincial Councils (Diputaciones Provinciales) to coordinate the provision of minimum compulsory services in municipalities of fewer than twenty thousand inhabitants; incentivises voluntary mergers; increases requirements for separation and the creation of new municipalities; and brings to an end agreements between administrative bodies with no funding. It also establishes that councils must publish the cost effectiveness of their services, and limits and structures their salaries and their temporary staff. This important initiative will be further developed in the future. The report of the Commission for the Reform of the Public Sector (CORA for the Spanish acronym), approved by the Council of Ministers on 21 June, has a central role to play in the reform of the public sector launched by the Council of Ministers in late 2011, given the scope and nature of the measures it contains.

The report includes general measures together with more concrete proposals relating to four sub-commissions: Administrative Duplication, Administrative Simplification, Management of Common Services and Resources and Institutional Administration. Further details on the content of this report are given below.

- With the same objective, the Senate has begun considering the Draft Law on Transparency, Access to Public Information and Good Governance, after the Draft

Bill was approved by the Council of Ministers on 27 July 2013 and its subsequent passage through Congress. This Draft Law contains a new legal framework with three objectives: to increase and strengthen transparency in public-sector activity (through the obligation on all government bodies and public-sector entities to actively publicize their activities); to recognise and guarantee access to information (as it is regulated as a right with a wide ranging objective and subjective scope); and to establish the good governance obligations to be complied with by those in positions of responsibility, and the sanctions for failure to comply with these. Therefore, it is expected that this Law will have economic effects through the generation of confidence and increasing the responsibility of public-sector managers, who may be penalised by prison sentences or being ruled ineligible for office, as a reform to electoral regulations has been introduced that provides for this.

The public administrations must make available to the public information considered to be of interest (institutional, organisational, planning and of legal, economic or statistical relevance, etc.) relating to contracts, subsidies, agreements and remuneration for senior officers without the need to for this to be requested. A "Transparency Portal" has been created to meet these obligations, giving the public easy access to information. With regard to good governance, a disciplinary regime has been established for all public officers, irrespective of the branch of government in which they serve.

One significant aspect in relation to containing and controlling public spending is the establishment in the General State Budget Law (LPGE for the Spanish acronym) of an annual scale for remuneration of members of local government bodies based on the type of body and a range of objective criteria (population, socio-economic status of the location, etc.).

- Among the measures for reducing administrative burdens, on 21 June the Council of Ministers approved the Seventh Council of Ministers Agreement on reducing administrative burdens. This promotes filing of documents electronically, removing the obligation to file them in person; thus avoiding unnecessary journeys and simplifying administrative procedures. The Agreement is in accordance with the procedural simplification criteria of the Commission for the Reform of the Public Administration, simplifying sixty three bureaucratic tasks with the Administration.
- This last measure to speed up administrative procedures has already been submitted to the Council of State (2 July) and is awaiting the ruling of the Royal Decree to develop a simplified procedure for mediation via electronic means for

claims for payment of less than €600. The procedure will take a maximum of one month and will take place telematically.

- Similarly, the AGE e-Government Action Plan has already been drawn up. The plan is awaiting approval pending the definition by CORA of the "Chief Information Officer", a figure recommended in the CORA report.

To increase efficiency in the judicial system, measures have been implemented to establish a new organisation of the judicial system, reform the court fee system and promote the extrajudicial resolution of disputes.

- Regarding the first type of measure, at the end of 2013 administrative procedures will begin for two draft projects (the Draft Organic Law on Judicial Power and the Draft Law on Criminal Trials) in order to introduce a new organisation of the judicial system and the distribution of judicial matters.

Among other measures, the former of these laws will create a new top level judicial body at the provincial level (Trial Courts) to improve flexibility and efficiency, and courts will not adjourn their activities in August. The Law on Criminal Trials will assign the arraignment of criminal cases to the State Prosecutor and enhance the use of mechanisms to terminate the criminal justice process, avoiding holding trials.

- To rationalise the use of jurisdictional power and ensure the free justice system is sustained for members of the public lacking resources, the judicial fee system has been reformed in Royal Decree-Law 3/2013, of 22 February, modifying the fee regime in the sphere of the Administration of Justice and the free legal aid system.

This Law links the destination of the fees to funding the free justice system and introduces different improvements for fee management, both to facilitate fee payment through the lawyer and legal representative (especially useful for non-residents), and to allow for changes to fees during the process and the refund of a large part of the fee (60%) when a dispute is settled outside the courts. The use of telematic means also incurs a discount, in order to encourage their use in the Administration of Justice.

- Finally, in order to encourage the extrajudicial resolution of disputes, Law 5/2012 of 6 June, on mediation in civil and mercantile cases, was approved. The implementing regulations of the Law were submitted to the Council of State on 2 July and are awaiting a report. These regulations are intended to lessen the workload of the courts and allow the transposition to internal law of the European Parliament and Council Directive 2008/52 of 21 May 2008. It is also designed to

drive a culture of change which offers the public and companies alternative mechanisms for resolving disputes.

3. MEDIUM TERM FISCAL STRATEGY AND STRUCTURAL FISCAL MEASURES

3.1. Medium term fiscal strategy

The medium term fiscal strategy designed by Spain to correct the excessive deficit was presented during the updating of the Stability Programme for 2013-2016. The starting point for this strategy was the significant reduction of public deficit achieved in 2012, a year when economic activity shrank by 1.6% in real terms. In this context, the deficit of all public administrations, without including the effect of financial aid for banks, fell by more than two percentage points from 9.1% of GDP in 2011 to 6.8 in 2012, while the effective structural effort evaluated by the Council of the European Union was 2.9 percentage points of GDP, with total measures equivalent to 4.3 points of GDP in 2012 (60% of that amount is from spending). This volume of measures is the second biggest primary structural adjustment among developed countries in 2012.

These results notably strengthened the credibility of Spanish public finances by demonstrating that even in the toughest economic conditions the excessive deficit could be reduced, fulfilling our commitments to the European Union.

However, it was still necessary to maintain fiscal consolidation in order to continue on the path to reducing the public deficit. Nevertheless, the design of the fiscal strategy for the coming years had to take into account the adverse economic situation and uncertainty about the recovery of the European economy, which impacted the growth of the Spanish economy.

In this context, the Stability Programme included a path to fiscal consolidation extended over a further two years, which would end the excessive deficit in 2016. However, it should be taken into account that in no case would this lengthening of the path mean a relaxation of consolidation efforts, given that the structural effort to be done is not less than that presented in the previous Stability Programme, and is even more for 2013.

The suitability of this new path to reducing the public deficit was confirmed by the Council of the European Union in its meeting on 21 June 2013. The Council of Ministers approved the new targets, and in accordance with the Recommendations of the Council of the EU in relation to the Excessive Deficit Procedure, established a slight upwards modification from the targets set in the Stability Programme (2 tenths in 2013, 3 tenths in 2014, 1 tenth in 2015 and 1 tenth in 2016).

Table 2. 2013-2016 deficit targets
(% GDP)

	2012 (P)	2013	2014	2015	2016
Central Government	-4.2	-3.8	-3.7	-2.9	-2.1
Social Security	-1.0	-1.4	-1.1	-0.6	-0.5
Regions	-1.8	-1.3	-1.0	-0.7	-0.2
Local Government	0.2	0.0	0.0	0.0	0.0
Total Government Sector	-6.8	-6.5	-5.8	-4.2	-2.8
Nominal adjustment		0.3	0.7	1.6	1.4
Effective adjustment (impact of measures)	4.3	3.7	1.6	1.3	1.2

The updated Stability Programme for 2013-2016 contains measures designed to increase revenue and reduce spending in order to fulfil the commitment to reduce the public deficit, and the structural reforms which complement and reinforce the fiscal consolidation strategy. These measures are grouped in the Stability Programme in three categories: tax policies, spending policies and employment policies. These measures and their updates are analysed below.

Tax policies

-

In line with the recommendations made for Spain regarding the Stability Programme and the 2012 National Reform Programme, which signalled a shift away from labour towards consumption and environmental taxation, the Government approved Royal Decree-Law 20/2012, of 13 July, on measures to ensure budgetary stability and to boost competitiveness. This modified the following taxes:

- Value Added Tax (VAT). The tax base has been widened by reclassifying the goods and services subject to reduced and highly-reduced rates. Furthermore,

the standard rate of VAT was raised from 18% to 21%, and the reduced rate from 8% to 10%.

- Personal Income Tax: The tax compensation for the acquisition of a primary home has been withdrawn.
- Corporate Income Tax. Limits have been placed on deduction of prior-year losses (negative tax bases) and of financial costs, and payments in instalments have been increased.

These measures were complemented by Law 16/2012, of 27 December, introducing a number of tax measures aimed at the consolidation of public finances and the promotion of economic activity. This Law included:

- With regard to Personal Income Tax: elimination of the deduction for the acquisition of a primary home for new buyers from 1 January 2013 and a special levy on winnings from State, Autonomous Regions, Organización Nacional de Ciegos Españoles (ONCE), Cruz Roja Española and similar European lotteries.
- With regard to Corporate Income Tax, partial limits were placed on deductions for amortisation and depreciation by large corporations.

The reform of environmental taxation was set out in Law 15/2012, of 27 December, on tax measures for energy sustainability. This included:

- The creation of three new taxes.
- An increase in excise duties

In terms of taxation on energy products, Law 2/2012, of 29 June, the 2012 General State Budget Law, the existing zero rate on biofuels was increased.

To ensure compliance with the committed fiscal consolidation path, a number of measures are in process of being adopted in 2013 to raise additional revenues.

- Regarding the Corporate Income Tax, the temporary measures introduced for 2012 and 2013 are being extended: A number of measures that would otherwise have expired in December 2013 have been extended into 2014. These mainly include the 50% or 25% limitation on the deduction of prior-year losses for companies with turnover in excess of certain thresholds; limits on deductions for goodwill and other intangible assets with indefinite useful lives at 1% and 2%, respectively; a minimum for payment in instalments of 12% for companies with turnovers of over €20 M and an increase in rates for payment in instalments by

companies with turnover in excess of certain thresholds; inclusion until 2015 of dividends and income from the transfer of shares with exemption certificates in the base for payment in instalments; and, lastly, a limit of 25% or 50% on deductions to promote certain activities.

- These measures avoid the negative impact that would have occurred if they had expired, maintaining the positive trend in tax revenue collection. They contribute to the widening of tax bases in order to continue improving the effective taxation.
- In terms of Personal Income Tax, the supplementary levy initially established only for 2012 and 2013 is being continued. This measure avoids the negative impact that would have occurred if it had expired in 2014.
- In order to increase local entities revenues, the increase in the real estate tax rate (IBI) established in December 2011 is also being extended. The Wealth Tax is also being extended, increasing the revenues of the Autonomous Regions.

In addition to these measures being prolonged, there are a number of other measures set out in draft acts or already approved ones that are directly related to the recommendations on the 2013-2016 Stability Programme Update:

- In order to limit tax expenditure in direct taxation, a number of changes are being introduced to Corporate Income Tax. The Consolidated Text of the Corporate Income Tax Law will be modified to end deductions for impairment of instruments representing holdings in the capital or equity of companies, and losses abroad from permanent establishments. These measures are set out in the Bill establishing measures relating to environmental taxation, other tax and financial measures, which will be approved shortly.
- Further work is being done to shift taxation from labour to those areas of consumption with more negative externalities. New environmental taxes will be established (for example, taxes on fluorinated gases) and modifications have recently been made to excise duties.
- The Law to Support Entrepreneurs and their Internationalisation (passed in September 2013) contains a number of selective fiscal economic stimulus measures to complement the other measures approved. In summary, these are:

- Application of cash-basis for VAT: A special voluntary VAT system has been created, which allows VAT to be paid when the invoice is collected rather than when it is issued.
- Deduction for reinvesting profits: Small companies may take advantage of this incentive, consisting of a 10% deduction. A number of additional Corporation Tax measures have been introduced to reduce the bias in favour of debt. This Entrepreneurs Law introduces a deduction for companies with turnover of less than 10 million euros allowing them to deduct up to 10% of profits obtained in the tax year that they reinvest in new tangible fixed assets or real estate investments affected to their activity.
- Tax benefits for R&D: Deductions for R&D investment and spending may also optionally be applied, not subject to any limit on the tax payable, and be credited, with a joint discount of 20% of their value, when it is not possible to apply these due to the tax payable being too low.
- "Patent box" (tax reduction on revenue from certain intangible assets): 40% integration in the tax base of income obtained from transferring use or exploitation of these assets.
- "Business angels" and seed capital: A venture capital system where the investor is a private individual, who will enjoy two tax benefits: a) 20% deduction in Central Government personal income tax payable; b) on exiting the investment, full exemption for any capital gains, providing these are reinvested in another new or recently-founded entity.

- Meanwhile, in compliance with one of the specific Recommendations, a Committee of experts on tax reform was created by Council of Ministers Agreement on 5 July 2013. The Committee shall report on tax reform before end February 2014.

a) Expenditure policies

The Stability Programme includes a range of structural measures to be adopted by Central Government:

- Public Administration reform, which has been designed by the Committee for the Reform of the Public Administration (CORA, for the Spanish acronym). This will have an additional estimated impact of €1,987 million to 2016. This net impact

only includes those CORA measures not considered elsewhere in this report, therefore excluding local reform and personnel costs that fall within the scope of CORA.

The report was approved on 21 June and includes 218 measures, some of which are general, and some more specific; these can be divided into four areas: Administrative Duplication, Administrative Simplification, Management of Common Resources and Services and Institutional Administration.

The first report on the implementation of these measures was submitted to the Council of Ministers on 20 September:

- 138 of these measures jointly affect Central Government and the Autonomous Regions, whilst 80 solely concern Central Government.
- 11 of these measures are general and cut across all areas of the public administration; 119 seek to eliminate duplication with the Autonomous Regions and within Central Government; 41 remove bureaucracy, simplify processes and improve citizens access to the administration; 39 improve service and common resource management; and 8 rationalise Institutional Administration.
- The reform of Local Government, which is intended to improve efficiency and sustainability in the provision of services by Local Entities, mainly through the reorganisation of responsibilities among the different levels of the Public Administrations. The reform sets out a scenario of savings of €8,024 million in 2014-2019, with the greatest savings expected in 2015 (€5,127 million).

The Council of Ministers has approved the submission to the Cortes Generales of the Draft Law on the Rationalisation and Sustainability of Local Administration and has submitted it to the Congress of Deputies for parliamentary processing in the Cortes Generales. The Law has the following four goals:

- To clarify and simplify municipal responsibilities in order to avoid overlaps with the responsibilities of other Administrations.
- To rationalise the organisational structure of Local Administration, in accordance with the principles of efficiency and a balanced budget.
- To ensure more rigorous financial and budget control. To favour local economic activity with liberalisation measures.

This Law clarifies and simplifies municipal responsibilities in order to avoid their duplication with other Administrations, and rationalises their organisational structure to achieve efficiency and a balanced budget.

The Law eliminates responsibilities which should be beyond the scope of Town Councils and precisely regulates the appropriate responsibilities. The Law also empowers Diputaciones (Provincial Councils) to coordinate the provision of obligatory minimum services in municipalities with fewer than twenty thousand inhabitants, incentivises voluntary mergers, increases the requirements for splits or the creation of new municipalities, and eliminates unfunded agreements between Administrations.

Meanwhile, it establishes that Town Councils must publish the effective cost of their services, which is considered an improvement in transparency and in the competition between administrations to improve their efficiency in providing services. It also limits and governs salaries and temporary personnel.

The net economic impact is presented in the following table:

Table 3. Economic impact of Local Reform
(million euros unless otherwise indicated)

	2014	2015	2016	2017	2018	2019	TOTAL PERIOD 2013-2019	% of total
UNDUE EXPENDITURE	680.2	2,601.6	453.4				3,735.2	46.5
TRANSFER OF COMPETENCIES HEALTH, EDUCATION AND SOCIAL SERVICES		473.0	91.0	91.0	91.0	91.0	837.0	10.4
INTEGRATED ADMINISTRATION OF BASIC SERVICES AND MERGERS		1,036.8	566.8	302.9	64.0		1,970.5	24.6
MINOR LOCAL GOVERNMENT	13.9						13.9	0.2
RESIZING OF THE LOCAL PUBLIC SECTOR	381.0	1,016.6					1,397.6	17.4
TEMPORARY AND EXCLUSIVE STAFF	70.4						70.4	0.9
TOTAL SAVINGS	1,145.5	5,128.0	1,111.2	393.9	155.0	91.0	8,024.6	100.0
% of total	14.3	63.9	13.8	4.9	1.9	1.1	100.0	

The largest savings arise from the elimination of undue responsibilities (€3,735 million) which will no longer be held by local entities, followed by the integrated management of services and mergers (€1,970.5 million) which will favour scale

economies, and resizing companies owned by local governments (€1,397.6 million), establishing measures to improve efficiency and ensure their budgetary stability.

- On 27 September a report was presented to the Council of Ministers on the Draft Law on the Deindexation of the Spanish Economy. This is discussed in detail above.
- Numerous measures have also been implemented in relation to public-sector employment. It is estimated that together these will have an impact on the public administration as a whole of around €3,500 million in 2013 and €1,650 million in 2014. However, the overall impact of these compared to 2012 is actually negative, due to the suppression of the extra payment for 2012, which is not being applied in 2013.

These employment measures include: increasing working hours for public-sector employees to 37.5 hours per week; reducing credit and leave for trade unions; setting a maximum of 3 freely-disposable days; ending of additional freely-disposable days and holidays for length of service; freezing of public sector recruitment and non-replacement of employees leaving government employment; and changes to the remuneration system for temporary disability.

- Finally, the Government has approved a limit on non-financial expenditure for the 2014 General State Budgets in accordance with the 2014 deficit target for this sub-sector (3.7% of GDP). Therefore, the non-financial expenditure available to ministries, excluding contributions to Social Security, the State Public Employment Service and electricity system costs, is €34,584 million, 4.7% less than in 2013. Furthermore, territorial governments have had to set spending limits following the spending rule established in the Organic Law on Budgetary Stability, and these will affect the preparation of their 2014 budgets.

The Regions have planned significant efforts for 2013 in all areas of their budgets, moreover the health and education reforms initiated by Royal Decree-Laws 14 and 16/ 2012 will continue to have an impact in 2013, as they only had an impact on education for four months in 2012 and health for six months.

This set of measures is expected to have a €7,000 million impact on spending in 2013, discounting the effect of employment measures resulting from measures adopted in 2012, which are considered in this report. This effort on the spending side will continue over subsequent years, with an additional impact of around €1,600 million and almost €1,900 million in 2014 and 2015 respectively.

There is also still scope for the Regions to increase their tax revenues under current legislation in own taxes. It is estimated they could collect an additional €2,000 million a year in 2014 and 2015. This is based on continuing the current trend of increasing the taxation capacity in devolved taxes and in own taxes, particularly with regard to environmental taxes. Increased savings are expected on long-term care as a result of the reforms initiated in 2012; these savings will amount to around €1,200 million in 2013. These is considered incorporated into the activities of the Autonomous Regions in future years.

b) Employment and Social Security policies

Firstly, it must be remembered that numerous labour-market measures introduced in 2012, and those included in the 2013-2014 Budget Plan submitted in August 2012, will have their greatest impact in 2013, due mostly to the time needed for their implementation.

The impact of these labour-market measures was around €1,000 million in 2012 and will be around €2,757 million in 2013. These measures include: Ending credits for recruitment; ending the special subsidy for people aged over 45 who have consumed their contributory benefits; rationalisation of benefits for people aged over 52; a requirement for having worked previously in order to qualify for Active Insertion Income; and ending of payment by Central Government of part of the social security unemployed' contributions during periods of unemployment. They also include changes to unemployment benefit: 70% of the regulatory base (during the first six months), and a reduction from 60% to 50% of this base from the sixth month; and changes to benefits and subsidies related to part-time contracts. It also includes the impact of the PREPARA Plan and the reform of active employment policies described below, some of its impact likely to fall in 2014, although this has not been quantified.

The reform of active labour market policies aims to make them more efficient and placing the unemployed into work, and to improve the fight against fraud. Significant progress has already been made in this area:

- On 2 August 2013 the Council of Ministers approved the 2013 Annual Employment Policy Plan. This reform of active labour market policies for the first time includes a number of indicators to assess the effectiveness of these policies, and it links the distribution of funds among the Autonomous Regions to results achievement.

- The framework agreement for enhancing public-private partnership in employment intermediation services promotes co-ordination of autonomous region and central employment services.
- Progress is being made on better linking active and passive employment policies.
- The 2013-2016 Youth Employment and Entrepreneurship Strategy was approved in February. Its highest impact measures are already in place. The remaining measures will be implemented over the lifetime of the Strategy.
- Training measures to improve the quality of vocational training, focusing more on real needs.

With regard to Social Security, Royal Decree-Law 5/2013, of 15 March, was approved introducing measures to promote the extension of the working life of older workers and promote active ageing. This is expected to have an annual impact of €800 million. Amongst other issues, this Royal Decree-Law regulates the compatibility of receiving a retirement pension with self-employment or paid employment, to promote the extension of active life and strengthen the sustainability of the Social Security system. It also modifies the legal framework for early and partial retirement and established a committee of independent experts to prepare a report on the sustainability of the Social Security system, which was completed on 7 June 2013.

Table 4. Impact of the main legislative changes (*)
(compared to the previous year)
% GDP

	2012	2013	2014	2015
Expenditure	2.54	1.47	0.79	0.97
Public Employment, extra payment 2012	0.49	- 0.49	-	-
Public Employment (personnel measures)	0.02	0.34	0.16	0.10
Labour market policies	0.10	0.27	0.03	-
Long-term care policies	0.02	0.12	-	-
Other Central Budget expenditure (including CORA)	0.85	0.42	0.13	0.09
Autonomous Region measures (excluding public employment)	0.93	0.69	0.16	0.17
Local Government Measures (excluding public employment)	0.15	0.11	0.20	0.48
Social Security expenditure	-	-	0.11	0.12
Revenues	1.75	2.21	0.83	0.32
Total taxes	1.18	1.66	0.45	0.05
<i>Personal income tax (IRPF) and Non-resident income tax</i>	0.35	0.34	0.01	0.01
<i>Corporate income tax</i>	0.45	0.01	0.28	- 0.06
<i>Special Tax Regularisation (DTE) and combating fraud</i>	0.12	0.01	0.10	-
<i>Environmental taxes and water duties</i>	-	0.21	0.01	-
<i>VAT</i>	0.15	0.82	0.01	0.09
<i>Excise duties</i>	0.03	0.24	0.04	-
<i>Other (taxes)</i>	-	0.03	-	-
<i>Real estate tax (IBI)</i>	0.09	-	0.01	0.01
Autonomous Region measures (revenues)	0.37	0.37	0.20	0.22
Local Government Measures (revenues)	-	0.03	0.10	0.02
Social Security contributions	-	0.16	0.07	0.03
Combating Social Security fraud	0.19	-	-	-
Total	4.29	3.67	1.62	1.28
GDP million	1,029,002	1,026,156	1,047,385	1,076,850

(*) See the Effective Action Report for further details about the measures included in this table.

As previously explained, the Draft Law Regulating the Sustainability Factor and the Pension Revaluation Index has now started to work its way through Parliament. The Draft Law proposes a review of calculation and revaluation mechanisms to take into account demographic and economic changes, so as to ensure the economic viability of the public pay-as-you-go pension system.

The justification for this measure is the need to address demographic and economic risks to the viability and financial sustainability of the current pension system, against a background of economic crisis that has resulted in deficits in the Social Security accounts. To this end, the Draft Law provides for the design and implementation of a Pension Revaluation Index, and accelerates the implementation of the Sustainability Factor introduced into Social Security legislation through Law 27/2011, of 1 August, on the updating, adequacy and modernisation of the Social Security system in order to "maintain proportionality between contributions to the system and expected benefits, and to ensure sustainability". The purpose of the sustainability factor established in this legislation

is to adjust pensions to changes in life expectancy at age 67 in the year of the review. It further establishes the frequency for such reviews as being 5 years, as proposed in this Draft Law. Introduction of this factor was postponed until 2027 in the 2011 Law, but Organic Law 2/2012, of 27 April, on Budgetary Stability and Financial Sustainability establishes that if the Government forecasts a long-term deficit in the pension system, it will review the system and automatically apply the stability factor, subject to the terms and conditions established in Law 27/2011.

The final formulation and proposal for these two factors is based on a report by a committee of experts on the Sustainability Factor in the public pension system submitted on 7 June 2013. This report proposes a Sustainability Factor with two components: a fairness factor (FEI after the Spanish acronym) and an annual updating factor for all pensions (FRA after the Spanish acronym).

According to the Draft Law's regulations, the Sustainability Factor will start to be applied from 2019 and will automatically be reviewed every five years, it will be applied exclusively to new pensions, and not to the retirement age. This factor will be linked to changes observed in life expectancy at age 67, taking 2012 as the base year. The mathematical formula for this is:

$$FS_t = FS_{t-1} * e_{67}^*$$

Where FS is the Sustainability Factor (equal to 1 until 2018); t is the year in which the factor is applied; and e_{67}^* is the average annual change in life expectancy at 67 over the previous five year period (according to the Social Security Department's mortality tables). The year-on-year change in life expectancy calculated as an average and fixed for a period of five years introduces lower variability into the system, capturing the trend in life expectancy whilst avoiding annual fluctuations. The first four decimal points will be used in calculating the Sustainability Factor.

The Sustainability Factor will start to affect new pensions from 1 January 2019. The purpose of this lengthy period is to inform future pensioners and give them time to anticipate the measure and take appropriate decisions. It is also worth noting that the factor will be applied without prejudice to the right of pensioners to receive supplements to bring their pensions up to certain minimum levels, as established in the corresponding General State Budget Law.

Unlike the current system of automatic updating in line with inflation, the Pension Revaluation Index introduces a mechanism to protect the current PAYG system, through its ability to incorporate changes in the dependency rate (the number of

pensioners per worker) and the effect of structural economic risks on the Social Security financing system. This formula is explained in the Appendix.

Appendix 1. The Sustainability Factor

Chapter II of the Draft Law Regulating the Sustainability Factor and the Pension Revaluation Index defines the Pension Revaluation Index (IRP after the Spanish acronym) that will be effective from 2014 and will apply to all pensions. Establishing the IRP involves abandoning the traditional system of inflation indexing for a more prudent index that reflects the Social Security accounts. The IRP is defined as:

$$IRP_{t+1} = \bar{g}_{I,t+1} - \bar{g}_{P,t+1} - \bar{g}_{S,t+1} + \alpha * \frac{I^*_{t+1} - G^*_{t+1}}{G^*_{t+1}}$$

Where the nominal growth rate to apply to all pensions (IRP) in the year t+1 is equal to the arithmetic average of growth in revenues ($\bar{g}_{I,t+1}$), minus the average growth rate in the number of pensions ($\bar{g}_{P,t+1}$), minus the average percentage increase in pensions due to the substitution effect ($\bar{g}_{S,t+1}$), plus/minus an adjustment to cover structural imbalances in the system. The system imbalance is calculated as the ratio between the difference in the geometric moving averages of revenues (I^*) and spending (G^*) and that average spending. The parameter α measures the speed of correction of the imbalance, which the draft law sets at between 0.25 and 0.33, reviewable every five years. The forecast growth rate in revenues and spending is calculated using centred moving averages over eleven years (five years before and five years after the reference year) to eliminate cyclical fluctuations. A minimum of 0.25% and a maximum of the CPI growth rate plus 0.25% have been set.

The calculations for each year require six-year forecasts of income and spending in the system and all its components. Also, the components of the formula are not statistically independent variables, but correlated, meaning that the estimates and assessments of each year in turn condition those of the following years.

Appendix 2. Monitoring the measures of PNR 2013 (pending measures)

	Current status	Next steps	Scheduled approval date
1. Fiscal consolidation			
Creation of the Independent Fiscal Responsibility Authority	Draft Law in parliamentary process	Finalise parliamentary process	Q4 2013
	Drafting of Organic Statute	Approval of Organic Statute	
Measures organising the basic shared portfolio of care services	Being drafted		
Regulation of the supplementary shared portfolio of the SNS	Drafting of three Royal Decrees		
New Order on reference prices	Drafting of Royal Decree which must be approved before the Order is approved	Approval of Royal Decree	Q4 2013
Central purchasing platform	In progress		
New social and healthcare model	Drafting the Social and Healthcare Strategy		
Reform of the dependency care system	Pending 3 Royal Decrees		
New regulation on Mutual Funds for accidents at work and occupational illness	Being drafted		

	Current status	Next steps	Scheduled approval date
Organic Law on controlling commercial debt in the public sector	Approval by the Council of Ministers (20.09.13) of the submission of the draft Organic Law to the Cortes Generales.	Finalise parliamentary process	November 2013
Law of e-invoicing	Draft Law in parliamentary process	Finalise parliamentary process	October-November 2013
Law on the deindexation of the Spanish economy	Report on the Preliminary Draft Law in the Council of Ministers of 27 September 2013.	Approval of the submission of the Draft Law to the Cortes Generales and the parliamentary process.	Q4 2013
Regulation on the pension sustainability factor	Approval by the Council of Ministers on 27 September 2013, agreement requesting urgent parliamentary processing of the Draft Law.	Parliamentary process	Second half of 2013
Revision of the tax system	Constitution of the Expert Committee by the Council of Ministers	Drafting report (before end of February 2014)	March 2014
Limiting tax benefits in direct taxation	Extension of previously adopted Corporate Income Tax measures and elimination of the deductibility	Draft Law in parliamentary process	Fourth quarter of 2013

	Current status	Next steps	Scheduled approval date
	of losses in investee companies		
Additional environmental tax measures	New tax on fluorinated gases		To come into force on 1 January 2014
Exploring margins for limiting the application of reduced VAT rates	To be studied by the Expert Committee for Tax Reform		February 2014
Reduction of the incentive to debt in Corporate Income Tax	Deduction of 10% of profits reinvested in small companies	Law on Entrepreneurs	Approved in September 2013
Intensification of measures to combat the black economy and undeclared earnings	Annual tax and customs control plan	Approval of the next annual plan	Beginning of 2014
2. Re-establishment of conditions for lending to the economy			
Law on Savings Banks and Bank Foundations	Draft Law in parliamentary process		Q4 2013
Law, modifying Law 5/2005, of 22 April, on the supervision of financial conglomerates, and modifying other financial sector laws	End of public hearings	Submission of the Draft Law to the Cortes	

	Current status	Next steps	Scheduled approval date
Reform of Corporate Governance	Expert Committee drafting report with proposals for presentation in September	Adopting changes in regulations until November	Q4 2013
Creation of the Alternative Fixed Income Market (MARF)	Regulations of the MARF approved by CNMV	Approval of the minutes	Q4 2013
Reform of the regulatory framework of venture capital companies	End of public hearings	Submission of the Draft Law to the Cortes	Q4 2013
Elevator Law	Being drafted	Presenting and processing the Draft Law	Q4 2013
3. Combating unemployment and the social consequences of the crisis			
Report evaluating the effects of the labour reform	The MEYSS report was presented	Evaluation by an independent body	July 2013
Annual Employment Policy Plan	Approved	Execution of the Plan	
Reinforce and modernise public employment services	Pending	Execution of the 2013 Annual Employment Policy Plan	
Reinforce the effectiveness of the reclassification programmes	Pending	Execution of the 2013 Annual Employment Policy Plan	

	Current status	Next steps	Scheduled approval date
Single employment portal	Regulated by law	Pending launch	
Public-private collaboration	Regulated by law	Framework agreement on collaboration pending approval	
2013-2016 Youth Employment and Enterprise Strategy	Approved in February 2013	Annual evaluation of the execution of the strategy	
Organic Law on improving the quality of education	Draft Organic Law in parliamentary process		
2013-2016 dual vocational training development strategy	Pending draft	Approval of the Strategy	
2013-2016 National Social Inclusion Plan	Pending draft	Approval of the Plan	
Integrated Family Support Plan	An Interministerial Technical Committee has been created	Finalise the development of the Plan and proceed to its approval	
4. Encouraging growth and competitiveness			
Law to Ensure Market Unity	Draft Law in parliamentary process	Finalise parliamentary process	Q4 2013

	Current status	Next steps	Scheduled approval date
Rationalisation Plan Legislation	Being drafted	Submission of the Draft Law to the Cortes	
National Markets and Competition Commission (CNMC)	Law 3/2013, of 4 June, was approved. The Organic Statute of the CNMC was approved. Council members appointed.	Launch.	Q4 2013
Law on Professional Associations and Services	The process has begun to approve the draft law.	Approval of the submission of the Draft Law to the Cortes Generales and the parliamentary process.	
Law to support entrepreneurs and their internationalisation	Approved in the Congreso de los Diputados on 19 September 2013. Published in the BOE on 28 September.		Approved in September 2013
Encouraging the rental market	Law 4/2013, of 4 June, on measures to encourage and increase the flexibility of the home rental market	Finalise the development of the regulations	Q4 2013
Structural reform of the electricity sector	Royal Decree-Law 9/2013, of 12 July, adopting urgent measures to ensure the financial stability of the		

	Current status	Next steps	Scheduled approval date
	electricity system		
	Approval by the Council of Ministers (20.09.13) of the submission of the draft law to the Cortes Generales.	Parliamentary process.	
Reducing the contingent liabilities for the public accounts of unprofitable transport infrastructures			
Independent observatory to analyse major future infrastructure projects			
Measures to liberalise rail passenger transport		FOM Order with requirements for obtaining operating permits and the determination by the Council of Ministers of the number of operating permits to issue, and the bidding procedure	
Adaptation of Renfe Operadora to a liberalised environment	Royal Decree-Law 22/2012: restructuring of Renfe Operadora into four companies	Approval by the Council of Ministers of 27 September 2013 of the new business model of Renfe Operadora.	
Revision of the railway fee system	Approval of Royal Decree-Law 11/2013, of 2 August		

	Current status	Next steps	Scheduled approval date
RD assigning slots through an independent body	Drafting Royal Decree	Processing text	Second half of 2013
General Telecommunications Law	Approval by the Council of Ministers (13.09.13) of the submission of the draft law to the Cortes Generales.	Parliamentary process	Q1 2014
Law on State coverage of the risks of internationalisation	Being drafted		
Basic Law of Official Chambers of Commerce, Industry and Navigation	Approval of draft law by Council of Ministers of 26 July	Draft Law in parliamentary process	
Law of environmental evaluation	Approval of draft law by Council of Ministers of 30 August	Draft Law in parliamentary process	
Creation of the State Investigation Agency		Pending	
Law on intellectual property	Preliminary Draft Law presented in the Council of Ministers on 22 March. The public consultation process was concluded on 17 April. A new text of the Preliminary Draft Law is being drafted	Submission of the Preliminary Draft Law to the Council of State	
5. Modernisation of the Public Administration			
Law on transparency, access to public information and	Draft Law in parliamentary process		

	Current status	Next steps	Scheduled approval date
good governance			
Public Administration reform in the context of CORA	Quarterly monitoring of the execution of measures in the Central Administration.	Promoting application in Autonomous Regions and Local Entities	
Law on the rationalisation and sustainability of local government	Approval of draft law by Council of Ministers of 26 July	Draft Law in parliamentary process	December 2013
RD for the implementation of a simplified mediation procedure by electronic means for financial claims	Drafting Royal Decree	Pending ruling by the Council of State	
e-government Action Plan for the AGE	Drafting the Plan	Approval of the Plan	
New organisation of the judicial system and the distribution of judicial affairs		Drafting the Draft Organic Law on Judicial Power and the Draft Law on Criminal Trials	
Enhancing out-of-court settlements of disputes	Drafting the regulations	Pending ruling by the Council of State	