STABILITY PROGRAMME

UPDATE

KINGDOM OF SPAIN

2001 – 2005

STABILITY PROGRAMME

UPDATE

KINGDOM OF SPAIN

2001 – 2005

CONTENTS

Page

TABLES AND FIGURES

Page

I. TABLES

II. FIGURES

I. INTRODUCTION: ECONOMIC POLICY OBJECTIVES AND INSTRUMENTS

This Stability Programme Update sets forth the information needed for the multilateral supervision conducted annually in the European Union (EU). Its pages provide an updated vision of the recent performance of the Spanish economy alongside medium- and long-term forecasts. It also discusses the main features of economic policy design, with particular regard to fiscal policy matters.

Over **2000-2001**, the Spanish economy has kept up the robust, employment-generative growth, free of major imbalances, which has characterised these past few years. GDP growth averaged 3.5% approximately in the two-year period, almost one point ahead of the Eurozone rate, while employment growth was more than one point higher, at 2.7%. However, both output growth and job creation, as elsewhere in the EU, have entered a deceleration phase.

Spain’s inflation differential with the Eurozone narrowed from 1.1 points in 1999 to eight decimal points in October 2001. The economy, as such, maintained its steady advance in real convergence with the European Union.

In the **budgetary** sphere, more headway was made in both fiscal consolidation and the credibility of fiscal policy. The objectives of the previous Stability Programme Update were again complied with. In 2000, the general government deficit reduced by eight decimal points with respect to the previous year, to just three decimal points off a balanced budget, and 2001 is expected to close in balance despite the growth shortfall to initial forecasts.

The **economic outlook** is presently clouded with uncertainties and conditioned by an adverse international setting. This Programme makes use of Commission projections for the international economy, as approved on 21 November 2001, which serve it as a frame of reference for 2002-2005 budgetary projections.

Economic policy will again seek to positively influence potential output growth. Fiscal consolidation efforts will be kept up, in order to secure and maintain balanced budgets or small surpluses throughout the projection period, pursuant to the new General Law of Budgetary Stability. Balanced budgets will be achieved by means of current expenditure contention. Conversely, spending on those items with most power to leverage the economy’s potential growth, primarily human, physical and technological capital, will increase ahead of nominal GDP growth. Progress in fiscal retrenchment will pave the way for supply-side-oriented tax reductions within the comprehensive reform of personal income tax scheduled for the year 2003.

Reform measures will increasingly address the issue of **population ageing** to guarantee an adequate level of social protection sustainable over time.

Economic reforms will receive renewed attention through liberalisation and pro competitive measures in product and factor markets. The focus in product markets is on boosting competition in network industries, the fostering of entrepreneurship, and support to Research, Development and Innovation. Labour market modernisation will be pursued by enlarging the incentives to labour supply.

This Update incorporates the Code of Conduct on Stability and Convergence Programme **content and format** approved by the ECOFIN Council in July 2001. It starts with a description of main economic policy objectives, the economy's recent performance and budgetary outcomes, and medium-term budgetary objectives. It then goes on to a detailed discussion of the long-term quality and sustainability of public finances, and closes with a sensitivity analysis of budget projections under differing economic assumptions. Finally, the annexes to this document set out the main structural reforms underway in view of their importance in the economic policy agenda.

The Stability Programme Update stands alongside the Progress Report on the Reform of Goods, Services and Capital Markets and the National Action Plan on Employment as the cornerstones of the Spanish Government's economic policy design.

II. RECENT PERFORMANCE OF THE SPANISH ECONOMY

1. Economic policy

The main **objective** of Spanish economic policy is to maintain the conditions for Spain's real convergence in income and employment with the most developed EU nations.

This requires the upkeep of a stable macroeconomic framework and priority attention to raising the potential growth of the Spanish economy. As a member of Economic and Monetary Union (EMU), Spain has basically two **instruments** available towards this end: fiscal policy and structural reform policy.

Economic policy in 2000 and 2001

From a **fiscal policy** standpoint, 2001 will mark a milestone in the ambitious budgetary consolidation process dating back to 1996, and pursued with special intensity in the past few years. The general government deficit has narrowed from 1.1% of GDP in 1999 to 0.3% in 2000, and this year will close with a balanced budget despite the more adverse economic context.

Fiscal consolidation has been kept compatible in recent years with a series of broad-ranging tax reforms. Following on from the personal income tax reform whose first year in force was 1999, corporate income tax rules were modified in 2000 to foster new enterprise creation, stimulate Research, Development and Innovation investment and support companies engaging in ICT activities.

Work has also progressed on **structural reforms** in goods and services markets. All measures seek a greater degree of market openness and competition, particularly in those sectors which as providers of basic inputs to the rest of the economy or as key development drivers for the knowledge-based society have most power to leverage the economy's potential growth. These were the goals addressed by the ambitious liberalising package of June 2000, with measures bearing on a wide range of sectors like energy, telecommunications, retail distribution and pharmaceuticals.

Competition policy was strengthened in recognition of its key role in guaranteeing the efficient allocation of resources in fully competitive markets. Concentration rules have been modified and a shorter time limit imposed for resolving case files. Caps have been placed on equity interests in more than one operator in liberalised sectors. Finally, competition policy has been assigned more material resources.

A new **labour market reform** was enacted in the opening months of 2001 (see Annexe II). It aims, basically, to support the job creation process and maintain incentives to indefinite hirings, while favouring a better supply-demand match by means of more flexible formulae for employment contracts.

The package includes measures to enlarge the take-up of incentivised permanent employment contracts, and changes to the legal conditions governing part-time contracts, to endow them with more flexibility and bring them closer to labour-market needs.

Future economic policy guidelines

Spanish economic policy is guided by medium-and long-term considerations. And fiscal and structural reform policies are designed, ultimately, to raise the potential growth of the economy.

In **fiscal policy**, the goals are to ensure a stable macroeconomic framework and help expand the economy’s mid-term growth potential. This, in essence, means deploying the right revenue and expenditure mix to remove obstacles to growth, reducing the public sector’s weight in the economy as a whole, and aiding private initiative in its wealth and employment creating functions. Short-term adjustments to demand deviations from the economy’s potential growth will accordingly be left to the play of automatic stabilisers.

This theoretical stance has practical applications on both the revenues and expenditure sides. Starting with revenues, the Government’s main objective is to maximise tax efficiency. In the case of direct taxes this has meant, for instance, new corporate income tax rules in support of SMEs, R&D and Innovation investment and private retirement saving via occupational pension schemes, which are called on to play a relevant role as the second pillar of the pensions system. Also, the personal income tax cuts planned for next year will act to stimulate saving, investment and labour supply.

On the expenditure side, the Government will continue the strategy which has yielded such good results in the past few years, namely, the prioritisation of those spending items conducive to supply-side growth and to priming the Spanish economy for the future challenges of a fast-moving global economy. This translates as priority attention to enlarging physical, technological, organisational and human capital. Budgetary support will therefore be kept up for infrastructure construction and upgrade, the spread of new technologies and the knowledge-based society, the perfecting of education and training programmes and the development of the SME sector.

The **structural reform** of product and factor markets to boost the openness and competitiveness of Spain’s economy, aids towards the goal of raising potential growth by favouring the correct allocation of productive resources and opening up new investment and business opportunities.

More specifically, upcoming liberalisation measures in **goods and services markets** seek to enlarge competition in network industries by completing the milestones set in the reform package of June 2000, supplemented as and when needed. Work will also continue towards fuller economic integration and the completion of the single market.

Labour market modernisation is the remaining economic policy priority. This means, first and foremost, procuring wage evolution in tune with the competitiveness needs of the Spanish economy. Measures will also be taken to raise the participation rate, including a broad review of the unemployment benefits system. Human capital improvement, finally, will be addressed by new laws on professional training and the universities, the second of which is now before Parliament.

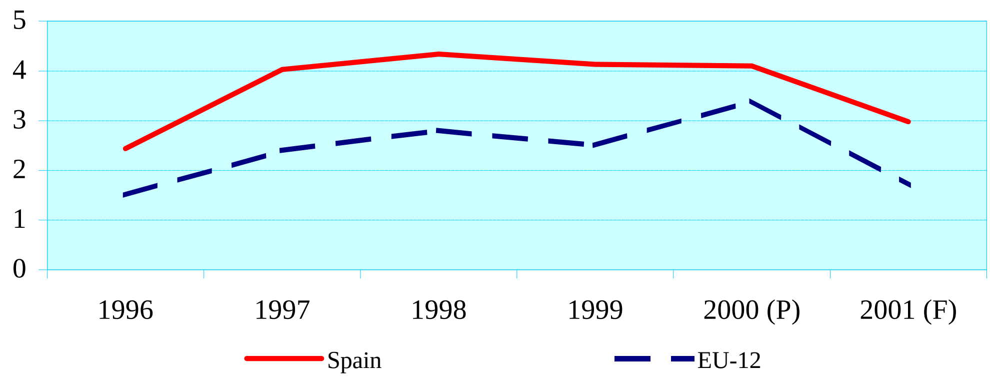
2. The Spanish economy 2000–2001

In 2000, the Spanish economy recorded real **growth of 4.1%,** closing its fourth consecutive year above the 4% mark. The pace of growth is expected to slow to around 3% in 2001 as a consequence of the worsening external context and, above all, the weakening of domestic demand. Spain, even so, will advance further in real convergence with Eurozone partners, thanks to a growth differential slightly upwards of one percentage point.

FIGURE 1

REAL CONVERGENCE OF THE SPANISH ECONOMY

Real annual growth of GDP



SOURCE: National Statistics Office and European Commission
(P) Provisional (F) Forecast

Domestic demand has been gradually slowing over 2000 and 2001, while net exports have made a slightly negative contribution to growth.

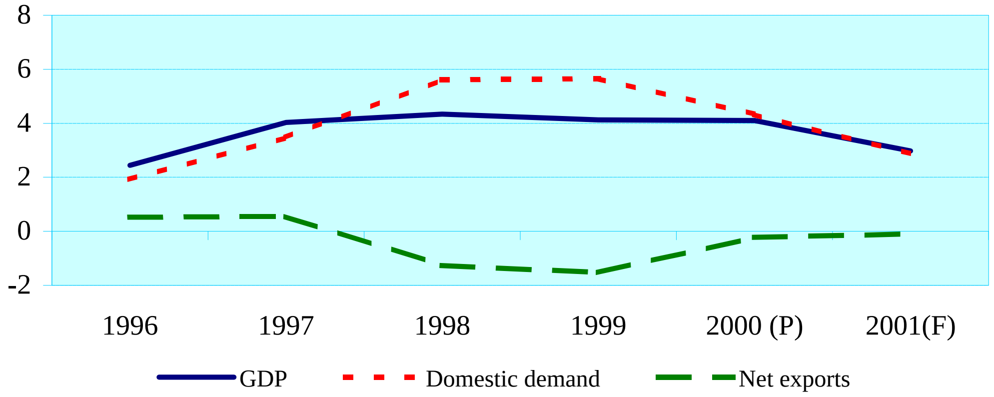
The 2000 pattern was of mildly decelerating **domestic demand**, while the net exports growth contribution narrowed to –0.2 points from the -1.5 points of the previous year. The factors behind this improvement were a quickening of export growth accompanied by a slowdown in imports. Domestic demand expanded 4.2% in the same year with all components losing momentum.

Domestic consumption expenditure slowed slightly in the year 2000 due to rising oil prices and interest rates, and the slacker pace of job creation. These same pressures, with the exception of interest rates, have made further inroads into private consumption in the year 2001. **Government consumption**, meantime, recorded only moderate growth in keeping with the fiscal consolidation drive.

Gross fixed capital formation also decelerated over 2000–2001, but with a divergent performance by component. The slower advance of construction investment owed to a slight stall in housing construction, now apparently losing steam after the strong expansion of past years, while civil works investment held up. Equipment investment has been decelerating fast since mid-2000, due possibly to the heavy spending of previous years, the conjunctural upturn in interest rates, higher crude prices and the steady decline in business expectations.

FIGURE 2

COMPOSITION OF GROWTH
Contribution to GDP growth



SOURCE: National Statics Office and Ministry of Economy
(P) Provisional (F) Forecast

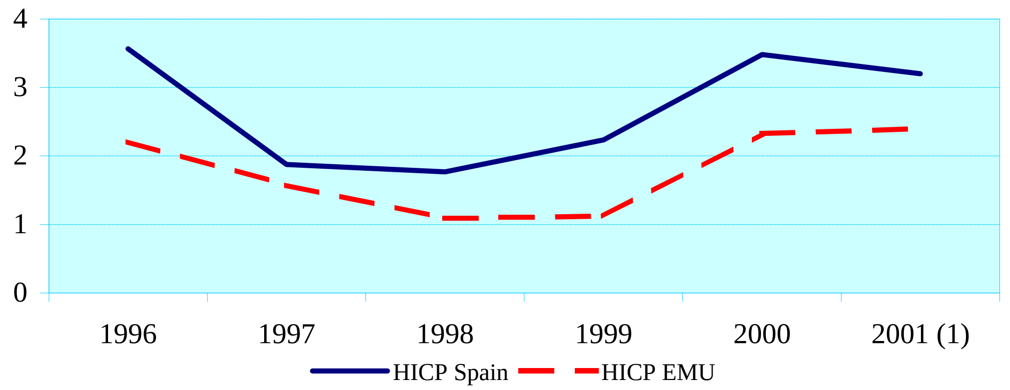
The slower advance of domestic demand was offset in part by **net exports**, which are projected to drain just one decimal point from 2001 growth against two decimal points in the year 2000. The improved international setting in 2000 spurred recovery of Spanish exports, while domestic demand moderation reined back imports. The result was a positive external contribution to GDP growth from third-quarter 2000 until second-quarter 2001. As the year progressed, so too did the downwards trend in domestic demand and its restraining effect on imports growth. However, the economic slowdown of Spain's main trading partners also reduced the growth of Spanish goods and services exports, so eroding the growth contribution of external demand.

Inflation conduct in 2000-2001 has been largely dictated by oil and fresh food prices. Oil prices, it is worth remembering, stood upwards of $30/barrel in December 2000, an increase of 60% versus the prior-year close, while the euro had depreciated 20% versus the previous year to an October 2000 rate of $0.85. The result was to drive up crude oil and oil product prices and, with them, inflation rates across all of Europe. Inflationary pressures were also stoked by the outbreak of the livestock crisis in November 2000 and the poor harvests of the same year, which raised meat and other food prices respectively.

As such, 2000 and first-half 2001 saw an inflation run-up which reached its peak around mid-year. Rates have since eased significantly, however, on the back of crude price softening in euros and a return to normality in agricultural product markets. These factors plus the moderation of domestic demand should steer headline inflation to well under 3% at the end of 2001.

FIGURE 3

PRICE DIFFERENTIAL SPAIN - EMU
Annual % change



SOURCE: National Statics Office and European Commission
(1) October

Wages have priced in the inflation upturn of 1999 and 2000. The rises agreed in collective wage bargaining were 3.1% in 2000, climbing to 3.5% in 2001 due to the triggering of safeguard clauses.

However, the lower inflation projected for this and next year should herald a return to the path of wage moderation. Main trade unions and employers' organisations are also discussing new wage moderation elements in response to the international slowdown which will foreseeably exert an additional restraining influence in 2002.

Employment has kept up a sturdy advance over these two years despite the slower pace of GDP growth. The number of persons in employment has risen by some 750,000 while jobless numbers have dropped 350,000. But the pace of job creation and unemployment reduction has been tapering off, due perhaps to the adverse impact of the last two years' wage rises and to worsening business expectations as the world economy cools.

Finally, **the net borrowing requirement of the Spanish economy** was 2.6% of GDP in the year 2000 and will likely close 2001 around 2.4%.

3. Short- and medium-term forecasts 2002–2005: baseline scenario

Common international assumptions

Table 1
BASELINE ASSUMPTIONS

	2001	2002	2003
World GDP growth (real % change):	2.1	2.2	3.7
- U.S.	0.9	0.5	3.4
- Japan	-0.6	-0.9	0.5
- EU 15	1.7	1.4	2.9
World import volumes, excluding the EU	0.3	1.4	5.9
Annual average interest rates: (1)			
- Short-term	4.3	3.3	3.3
- Long-term	5.0	5.0	5.0
$US/€ exchange rate (annual average) (1)	0.91	0.91	0.91
Nominal effective exchange rate (Eurozone)	1.6	0.7	-0.1
Nominal effective exchange rate (EU)	-0.1	0.3	-0.6
Crude prices (Brent $US/barrel) (annual average)	24.9	22.3	24.8
Change in commodity prices ex. crude oil ($US)	-3.6	-1.4	3.8

(1) 2002 and 2003 data are purely technical assumptions

SOURCE: European Commission

The international outlook is one of heightened uncertainty as leading economies slip into synchronised slowdown. The original cause, back in the second half of 2000, was a sharp cutback in business investment, especially in new technologies, which then made growing inroads into international trade. Private consumption, meantime, has been acting as a backstop to the slowdown.

The terrorist attacks of 11 September 2001, on top of this already vulnerable situation, have caused rising uncertainty which will push back investment and consumption decisions and so provoke a deeper and more lasting slowdown than first envisaged. What this means is that activity will continue losing impetus over the opening months of **2002**.

There are signs, however, that the economy may come back strongly in the second half of 2002, once present uncertainties have been removed. The rapid, decisive response of economic policy, allied with lower commodity costs, lower inflation and healthier public accounts will be the main forces driving the recovery. Even so, next year's average growth rates are unlikely to better those of 2001.

The world economy, according to the recently approved forecasts of the European Commission, will grow by 2.2% in 2002 and world trade by 1.8%. On a breakdown by region, the rates projected are 0.5% in the United States, -0.9% in Japan and 1.3% in the Eurozone.

The slower advance of world activity will depress demand for oil, with the likely result that crude prices/barrel will hover near the lower limit of the US$ 22-28 target range set by the OPEC.

Low-key activity and cooler commodity prices will have a beneficial influence on US and Eurozone inflation, while deflationary pressures seem set to persist in Japan.

Central banks will presumably respond by keeping monetary conditions loose, which in the Eurozone translates as a technical assumption of 3.3% for short-term rates. It is also supposed that bond yields will hold near 5% on both sides of the Atlantic.

A technical exchange rate assumption is also set, whereby rates hold constant at the levels of the last three weeks of October 2001.

The prospect for **2003** is of firming recovery and a substantial advance in world output and trade, which are projected to grow by 3.7% and upwards of 6% respectively.

This upswing promises to be strongest in the United States, which will recoup growth rates of 3.4%. Eurozone forecasts are for 2.9%, while Japan will grow an estimated 0.5%.

One result of this brisker activity is that crude oil prices will remount to around $25/barrel in average terms.

Finally, world output and trade are expected to repeat the growth rates of 2003 in the **2004-2005** period.

Macroeconomic forecasts: baseline scenario

The Government's macroeconomic forecasts envisage **2002 growth of 2.4%**, assuming a net export contribution of –0.1 points and a prolongation of the domestic demand slowdown.

Table 2
MACROECONOMIC SCENARIO

	2000	2001	2002	2003	2004	2005
GDP by demand components (real % change)						
Final domestic consumption expenditure	4.0	2.6	2.2	2.6	2.6	2.6
- households (a)	4.0	2.8	2.2	2.8	2.8	2.8
- general government	4.0	1.9	2.0	2.0	2.0	2.0
Gross capital formation	5.0	4.4	3.3	4.6	4.6	4.6
- Gross fixed capital formation	5.7	4.0	3.4	4.7	4.7	4.7
- Equipment	5.1	1.0	2.2	5.4	5.4	5.4
- Construction	6.2	5.8	4.3	4.1	4.1	4.1
- Change in stocks (contribution to GDP growth)	-0.1	0.1	0.0	0.0	0.0	0.0
Domestic demand	**4.2**	**3.0**	**2.4**	**3.1**	**3.1**	**3.1**
Internal demand (contribution to GDP growth)	4.3	3.1	2.5	3.2	3.2	3.2
Exports of goods and services	9.6	5.3	4.5	7.6	7.6	7.6
Imports of goods and services	9.8	5.1	4.6	7.7	7.7	7.7
Net exports (contribution to GDP growth)	-0.2	-0.1	-0.1	-0.2	-0.2	-0.2
GDP	**4.1**	**3.0**	**2.4**	**3.0**	**3.0**	**3.0**
- GDP at constant prices (€ bn)	608.8	651.4	685.8	723.4	763.1	804.8
- GDP at current prices (% change)	7.7	7.0	5.3	5.5	5.5	5.5
PRICES AND COSTS (% change)						
GDP deflator	3.4	3.8	2.8	2.4	2.4	2.4
Final household consumption deflator	3.2	3.6	2.6	2.0	2.0	2.0
Payments (labour cost) per employee in terms of FTEJ (b)	3.4	3.7	3.0	2.5	2.5	2.5
Unit labour costs (in FTEJ) (b)	2.4	2.8	1.7	1.3	1.3	1.3
LABOUR MARKET (FTEJ) (b)						
Employment: change in %	3.1	2.1	1.1	1.8	1.8	1.8
Employment: change in thousands	452.3	324.2	169.5	276.3	281.2	286.2
OTHER VARIABLES						
Net lending (+) or borrowing (-) vs rest of world	-2,6	-2,4	-2,4	-2,5	-2,6	-2,8
Unemployment as % of labour force (LFS)	14,1	12,7	12,4	11,7	11,0	10,3

(a) Includes Non Profit Institutions Serving Households
(b) Full-time equivalent jobs

SOURCE: Ministry of Economy

In this scenario, **private consumption** decelerates with respect to 2001. Lower employment growth, the recovery of household savings and greater economic uncertainty will presumably act as a brake on this variable. In the case of gross fixed capital formation, a mild slowdown in construction investment will be partly offset from the equipment side.

The latest international events and the slowdown of partner countries will constrain export growth to lower rates than in 2001. However, imports too will reduce their rate of advance as domestic demand decelerates further. The result will be a mildly negative **external contribution** in 2002; around –0.1% of GDP, in line with 2000 and 2001 outcomes.

Employment growth may recede due to economic slowdown, while worsening labour-market conditions will curtail labour force growth. On these two factors combined, job creation will stand at 1.1% in terms of full-time equivalent jobs, while the unemployment rate will fall to 12.4%.

The tamer **inflation** emerging in second-half 2001 will continue through 2002. After an initial downturn led by cheaper energy products and the better conduct of fresh food prices, remaining components will join the moderation trend in the second half of 2001. In symmetry with the acceleration of these CPI items through 2000 and the opening months of 2001, this year's closing months should bring a gradual downturn, which will continue into 2002 supported by the year-long slowdown in domestic demand.

Wages should trend the same way as inflation, in the absence of the upside price expectations and retrospective reviews which quickened their increase over 2000 and 2001.

Projections for current and capital accounts prefigure a **net borrowing requirement** unchanged at 2.4% of GDP.

Growth in leading industrial countries should start to pick up as next year progresses, and accelerate further over **2003-2005**. The Spanish economy will grow around 3% in 2002 as domestic demand revives on the back of a moderate advance in government and private consumption and the acceleration of investment spending.

Private consumption demand, in this scenario, will rise by a fairly modest 2.8%, bettering the 2002 rate but far from the growth vigour of the late nineties. Despite improved inflation expectations, historically high household borrowings and the likely recovery of the savings rate will combine to keep a lid on consumption growth. By the same token, the General Law of Budgetary Stability will oblige all government branches to tighten their spending controls from 2003 on.

Investment demand should begin to accelerate, but with equipment investment as the main driver in place of construction. International economic recovery should exert a boost effect on capital spending and ramp up growth of this variable to close-on 5% in 2003-2005. Equipment investment vigour will contrast with some tailing-off in construction investment as the housing sub-segment decelerates, though civil works investment will continue buttressed through the period by large infrastructure programmes.

The **net exports contribution** will reflect the dual recovery of foreign and domestic demand. Demand for Spanish goods and services exports will presumably augment as the international economy works back to strength, while domestic demand recovery, most notably in equipment investment, should act as a spur to imports growth. The outcome predicted is a slightly more negative contribution from the net exports side in comparison to 2002, as far as two decimal points of GDP.

Inflation should hold to its moderation course over 2003-2005. The gentle upturn in consumption, the more flexible functioning of productive sectors and the greater openness of the Spanish economy, such that imports keep a lid on domestic prices, will lead the private consumption deflator to stabilise at 2%, below the level recorded in 2002.

Cooler price growth in 2002 should alleviate **wage** pressures in 2003-05. The inflation downturn, specifically, should cause a downward adjustment in price expectations which will work through as more moderate wage claims. Also, the capital spending of previous years should have delivered some gains in labour productivity. On these assumptions, annual employment growth in terms of full-time equivalent jobs will stand at 1.8% in the three-year period.

Finally, a slight deterioration in the current account balance will lift the Spanish economy's **net borrowing requirement** to 2.6% in the period 2003-2005.

III. BUDGETARY PERFORMANCE AND PROJECTIONS

1. Fiscal policy guidelines

The primary goal of Spanish economic policy, as stated, is to progress in real convergence with the most developed economies of the EU. Fiscal policy is seen as an essential means to this end, in tandem with a comprehensive programme of structural reforms. Its implementation is guided by medium-and long-term propositions and milestones with the final goal of raising the economy's potential growth.

Both the academic literature and direct experience tell us that fiscal policy cannot serve as a fine-tuning instrument of demand-side adjustment when used by the authorities in a discretionary manner, divorced from the perceptions and expectations of economic agents. Not only is it inefficient in such cases, it can actually disturb economic activity and harm the processes of wealth and employment creation.

Experience teaches that, contrary to traditional Keynesian precepts, fiscal policy can in certain circumstances shows signs of "non linearity". This widely observed phenomenon enshrines the apparent contradiction that fiscal consolidation can power the economy by way of agent expectations. This potential, added to the dividends from establishing a known, predictable, stable and credible economic framework, incline the Government to prolong and intensify the fiscal retrenchment central to its policymaking in these past five years.

Moreover, in a medium-size economy like Spain's – open and forming part of an integrated economic and monetary space – the impulse that springs from a proactive fiscal policy stance has little power to affect domestic demand, since much of the thrust filters out of the economy.

The simple putting into practice of discretionary and, therefore, unpredictable measures sows confusion among economic agents, and engenders distrust of market signs and signals. Discretionary fiscal policy focused on short-term objectives accordingly becomes a disturbing force.

There is also general agreement that exogenous supply shocks like the current one should not be addressed through too compensating a fiscal policy. This is not just because of the lags any fiscal policy implies, but because it can also postpone the adjustments needed to absorb the shock.

In such cases, fiscal policy has very little room for short-term manoeuvre. All it can or should do is design efficient automatic stabilisers with no disturbing effect on economic agent decision-making. This will ensure that transition from the theoretical pre-shock equilibrium to the theoretical post-shock equilibrium is as rapid and least costly as possible.

Fiscal policy must be credible if it is to be effective. And credibility is an asymmetric intangible, hard to achieve and easy to lose. This is especially true in the case of Spain, which has undergone a sea change in attitude towards the exercise of fiscal policy. The situation before this change was one of a steadily rising public debt, and widespread fiscal imbalances, frequently of a marked pro-cyclical nature. Hence the importance of holding to the fiscal adjustment path mapped out, in order to consolidate this hard-won credibility and provide a dose of certainty and stability in a situation which, for conjunctural reasons beyond the control of the economic authorities, is already unsettling enough for economic agents.

Fiscal policy, for all these reasons, is not geared to smoothing out demand fluctuations beyond the play of automatic stabilisers, but to improving medium- and long-term supply conditions. It also seeks to be credible and predictable and keep discretionary tinkering to a bare minimum.

This goes to say that, however uncertain the international environment, the means and the end remain the same; namely fiscal consolidation and austerity at the service of a balanced budget. The Government is aware that this is an ambitious goal in today’s circumstances, but also a necessary and a right one if the credibility gained is to be conserved and consolidated.

The headway already made in fiscal retrenchment gives the Government a margin of freedom to allow automatic stabilisers to do their work.

Just as important as the amount of the fiscal impulse is the assignation made to each budget head. This is what determines the balanced growth of the economy and the decision-making framework for economic agents.

On the expenditure side, adjustment measures must ring-fence investment, given their vital role as a stimulus to growth and real convergence. One of the Government’s priorities is to enlarge and improve physical, human, organisational and technological capital. And promotion of the information and knowledge society has become a touchstone for all future progress plans.

On the revenues side, the Government regards tax cuts as a powerful fiscal policy tool, when devised to act positively on the economy from the supply side. This is the guiding principle behind this year's changes to corporate income tax rules and the personal income tax reform due to come into force in 2003.

Corporate income tax changes pursue a better tax treatment for business in general and small and medium-size enterprises in particular. The definition of SMEs is also broadened to bring more companies within their advantaged regime. New benefits include a lengthening of goodwill amortisation periods; a longer offset period for tax loss carryforwards; clarification and improvements in the tax treatment of R&D and Innovation investments; a reduction of the tax rate on reinvested capital gains; a raising of the maximum threshold for access to the special Small-Sized Company Tax Regime to five million euros turnover and, finally, a more advantageous treatment of employer contributions to Occupational Pension Schemes.

But such actions must also consider the medium- and long-term sustainability of public sector finances. This is not just about coping with the budgetary demands of an ageing population, an issue which must be dealt with as part of a secular, timetabled global strategy, consistently applied. It is about getting the public-sector balance right. The composition of expenditure and revenues must be such that the savings and growth generated by public action engender a downwards trend in public debt and an easing of the tax pressure, as excessively heavy taxation can set back the potential growth of the economy. The aim can be summed up as a balanced budgetary position throughout the cycle, compatible with a sustained and dynamic reduction in the public sector's weight within the economy.

This is the rationale behind the **General Law of Budgetary Stability** now before Parliament; one of the major structural changes of recent times and a major change in the understanding of fiscal policy.

The Law makes it incumbent on central government, territorial governments and the Social Security system to return balanced or surplus budgets, and lays down four principles as the cornerstones of fiscal policy design:

- Transparency: full and timely information on the financial position of all government branches, with records of the financial flows between each.

- Fiscal coresponsibility: each branch of government must close the year in balance or surplus. In the event of deficit, an action plan will be presented setting out remedial measures. The distribution of powers between national and subnational authorities is thus brought within a structure perfectly compatible with the requirements of the Stability and Growth Pact.

- Limits on the growth of central government spending: the Law stipulates the preparation of multi-annual budget projections, so manager efforts are focused on mid-term efficiency. This implies the setting of an annual ceiling on spending growth, so public investment is kept compatible with tax reductions. The establishment of a "contingency fund", which can only be drawn on in specified cases, will ensure that unforeseen needs can be met without altering budgetary structure or orientation.

- Fiscal discipline: the Law is, above all else, a token of the authorities' commitment to fiscal discipline. The Government is conscious of the major advances made in this respect, but also of the need to give institutional weight to the budgetary contention that has yielded such good results for the Spanish economy in the recent past.

Among the advantages offered by this type of strategy are:

a) It reinforces the credibility of the Government's commitment to budgetary rigour.

b) It facilitates agents' economic decisions by providing a long-term stable framework for the public sector's intervention.

c) It minimises the disturbances issuing from discretionary adjustments.

d) It sets an agenda for the public sector, and obliges managers to plan ahead against the risk of non compliance. This means in practice that each spending unit has to weigh up alternative plans for different cycle stages.

e) It fosters a culture of budgetary rigour and cost control at all levels of government.

f) It promotes the use of structural measures with permanent effects on revenues and expenditures.

g) It allows tax reforms or early public debt redemptions to be planned and implemented without jeopardising commitments under the Stability and Growth Pact.

h) It lays the groundwork for the medium- and long-term financial sustainability of general government accounts, and thus favours inter-generational equity.

Finally, Spain is a decentralised country engaged in an open-ended process of revenue and expenditure transfers to the Autonomous Communities. The ultimate aim of the recent **Autonomous Community Financing Agreement** is to lay down a stable, consensuated financing model conducive to expenditure consolidation and revenue sufficiency, without imposing too heavy a burden on the economy.

This model, described in detail in Annexe I, takes fiscal coresponsibility as its central tenet, so favouring the cause of austerity while dividing ownership of Spain's international commitments between the two layers of government accounting for the bulk of expenditures. By enlarging fiscal coresponsibility in a regulatory framework, it creates a more direct link between spending decisions and their political cost, and therefore more incentive to budgetary discipline. It is, in this respect, a necessary supplement to the General Law of Budgetary Stability.

2. Budgetary performance

The years 2000-2001 saw the upkeep of the fiscal consolidation process initiated in the middle of the last decade. Public accounts are expected to close 2001 in balance, as projected in the previous Stability Programme Update, despite a lower-than-envisaged rate of economic growth. This means, in effect, that a goal which seemed easily in reach at the year's outset, the more so with a start-out deficit of 0.3%, has required a supplementary effort.

This year's presumed zero deficit has been arrived at slightly differently than envisioned in the abovementioned Update, which posited an 0.3-point central government deficit and an 0.3-point surplus in the Social Security system, which added with the zero deficit of territorial governments would give the balanced budget sought. It now appears that the first two of these three outcomes will be –0.5 points and 0.5 points respectively. The good recent-year results of the Social Security system, consistently beating initial forecasts, have allowed larger inflows to the Reserve Fund. These additional provisions, and agreements between the social agents on pension matters will favour the medium- and long-term sustainability of the Spanish pension system.

The reduction of the general government deficit between 1999 and 2001, amounting to 1.1 percentage points of GDP, has been entirely sourced from the expenditure side. In the past year, specifically, the GDP weight of government expenditures has receded 1.5 points to 39.3%, while revenues dropped by 0.4 percentage points to 39.3%.

The brunt of the adjustment has again fallen on current expenditures, which dropped one percentage point of GDP weight between 1999 and 2001. The reduction in capital expenses (0.4 points) owes entirely to transfers, as the weight of general government gross fixed capital formation remained unaltered. In any case, government saving, positive since 1997, has overtaken public investment in the period, and stands around 3.9% of GDP in 2001 against the 3.4% of gross fixed capital formation.

Improvement in budgetary balances over 2001 and 2001 translated as a primary surplus of 0.7 points, since interest payments also dropped back 0.4 points. This wider surplus in tandem with economic expansion and falling effective interest rates on public debt, brought public debt/GDP down by almost 5 points to under 60% (57.5%) in 2001; another imprint of fiscal consolidation on Spanish public finances.

Spain also ranks among the EU members which have progressed most in fiscal retrenchment. Whereas the Eurozone public deficit has narrowed just three decimal points approximately in the last two years, Spain has not only reined back its deficit by 1.1 points but is set to close 2001 with a balanced budget against the roughly one point deficit of the Eurozone. Spanish public finances have thus renewed their positive input to the macroeconomic stability of the Eurozone as a whole.

3. Budgetary projections

The international economic climate has worsened substantially since the last Stability Programme Update was published. However, the authorities' decision not to use budgetary policy as a short-term demand regulator beyond the limited action of automatic stabilisers, makes it reasonable to project general government accounts in balance or surplus over the 2002-2005 period.

Government revenues will increase an average 5.3% annually in 2002-2005, close in line with the nominal rate of GDP growth, such that their weight in the aggregate will reduce very slightly (from 39.3% in 2001 to 39.2% in 2005). These projections factor in new reforms in direct taxation (personal income tax in 2003 following on from the 1999 reform) to facilitate corporate and household saving, investment and employment decisions. Their cost is currently estimated at around 3 decimal points of GDP.

Table 3 GOVERNMENT REVENUES AND EXPENDITURES (National Accounts basis, ESA-95. Annual % change)							
Item	2000 (P)	2001 (F)	2002 (F)	2003 (F)	2004 (F)	2005 (F)	Avge 03-05
Total revenues	7.1	6.5	5.4	5.0	5.3	5.5	5.3
- Tax receipts	9.4	6.2	5.3	4.8	5.3	5.9	5.3
Total expenditures	5.2	5.6	5.5	4.9	5.2	5.0	5.0
- Current	6.1	5.2	5.1	4.5	4.7	4.7	4.6
- Capital	-1.1	9.0	7.8	7.3	8.6	7.2	7.7
Gross capital formation	1.8	10.0	9.0	8.2	10.0	8.0	8.7

(P) Provisional.
(F) Forecast

SOURCE: IGAE and Ministry of Economy

Tight limits will be kept on **expenditures** in line with the budgetary implementation of the past six years. Support in this quarter will come from the General Law of Budgetary Stability , which binds all government branches to plan and execute their economic activities within a framework of budgetary equilibrium or surplus.

Table 4 GENERAL GOVERNMENT ACCOUNTS (National Accounts basis, ESA-95. As % of GDP)						
Item	2000 (P)	2001 (F)	2002 (F)	2003 (F)	2004 (F)	2005 (F)
Total revenues	39.5	39.3	39.4	39.2	39.1	39.2
- Tax receipts	35.5	35.3	35.2	35.0	34.9	35.1
Total expenditures	39.8	39.3	39.4	39.2	39.1	38.9
- Current expenditures	34.9	34.3	34.3	33.9	33.7	33.4
Financial charges	3.3	3.1	3.0	2.9	2.8	2.7
- Capital expenditures	4.9	5.0	5.2	5.2	5.4	5.5
Gross capital formation	3.3	3.4	3.5	3.6	3.7	3.8
General government surplus (+) or deficit (-)	-0.3	0.0	0.0	0.0	0.1	0.2
Central government	-0.1	0.0	0.0	0.0	0.1	0.2
State and Autonomous Agencies	-0.6	-0.5	-0.5	-0.5	-0.4	-0.3
Social Security	0.5	0.5	0.5	0.5	0.5	0.5
Territorial governments	-0.3	0.0	0.0	0.0	0.0	0.0
Autonomous Communities	-0.3	0.0	0.0	0.0	0.0	0.0
Local governments	0.0	0.0	0.0	0.0	0.0	0.0
Gross debt	60.4	57.5	55.7	53.8	51.9	50.0
Primary surplus	2.9	3.1	2.9	2.9	2.8	2.9
Gross saving	3.5	3.9	3.9	4.0	4.3	4.6

(P) Provisional
(F) Forecast

SOURCE: IGAE and Ministry of Economy

Nonetheless, the expected slowdown of nominal GDP growth in comparison with recent years will narrow the difference between the aggregate growth rate and the expenditure growth rate. The result is that the GDP weight of government expenditures will settle around 39%, with a slight downward bias, in the 2002-2005 period. This is still a long way down on the 45% of halfway through the past decade.

The GDP weight projected will arise from a reduction in current spending practically made up from capital spending:

- Current expenditures will grow a few decimal points short of GDP in 2002-2005, so reducing their weight to around 33.4% in 2005. This outcome owes much to reduction of financial charges on the public debt; an expected –0.4 percentage points of GDP in 2002-2005. Reasons for this decrease include: likely interest rate reductions; the progression from a public deficit to a balanced or surplus budget; and, finally, the public debt restructuring conducted in recent years by Tesoro Público, which has cut the effective average interest rate on the public debt.

- Budgetary policy will prize the expansion of the nation’s stock of productive capital, in which public investment has a pivotal role. General government gross fixed capital formation will accordingly grow in the projection period above the nominal rate of output growth (around 9%), as far as a GDP weight in the terminal year (2005) around 3.8%. This is sizeably higher than the Eurozone average (2.5%) and reflects the efforts made by the Spanish economy to hasten real convergence with partner countries.

The above expenditure and revenues projections would set gross government saving gradually rising as far as 4.6% approximately in the year 2005, that is, seven decimal points more than the 2001 estimate, and comfortably upwards of the investment rate referred to above. The balanced or surplus budgets featuring would be compatible with increased government investment, since outlays would be wholly financed from government saving. This, in turn, will avoid the pernicious effects of crowding out private investment.

On the assumptions managed, general government accounts will close in balance in 2002 and 2003 (the latter, the year of a new personal income tax reform whose revenue impact, as stated, should be just under 2 decimal points of 2003 GDP and one decimal point in 2004), giving way to surpluses in 2004 and 2005 of around 0.1% and 0.2% of GDP respectively. These budgetary developments will further the public debt/GDP reduction begun in 1997 as far as 50% approximately in 2005, that is, 7.5 percentage points down on the ratio for 2001.

Changes in the public debt stock over the Update period are projected as follows.

Table 5
CHANGES IN THE PUBLIC DEBT STOCK

	2000 (P)	2001 (F)	2002 (F)	2003 (F)	2004 (F)	2005 (F)
Public debt stock (% of GDP)	60.4	57.5	55.7	53.8	51.9	50.0
Change in debt stock	-2.7	-2.9	-1.8	-1.9	-1.9	-1.9
Contributions to changes in the debt stock						
Primary balance	2.9	3.1	2.9	2.9	2.8	2.9
Interest payments	3.3	3.1	3.0	2.9	2.8	2.7
Nominal GDP growth	7.7	7.0	5.3	5.5	5.5	5.5

(P) Provisional
(F) Forecast
SOURCE: IGAE and Ministry of Economy

The reduction in public debt/GDP between 2001 and 2005 owes to the moderate conduct of interest rates, the upkeep of a primary balance around 3% and the nominal GDP growth recorded in the period.

IV. THE QUALITY AND SUSTAINABILITY OF PUBLIC FINANCES

The quality and sustainability of public finances have become mainstays of fiscal policy design and implementation. The Government understands that these are priority objectives for the economy's healthy development in time and, also, that both properties are inextricably linked.

Starting with the **quality of public finances**, the Government has sought a well-balanced revenues and expenditures mix conducive to its two central mid-term goals: the upkeep of a balanced budgetary position over the cycle and the raising of the economy's potential growth as a means to hasten real convergence with the most developed economies of the EU.

On the expenditure side, this has meant a strict control of current spending to make room for capital outlays on investment and the promotion of research, development and innovation. The Spanish economy can thus be assured a sufficient stock of human, physical, technological and organisational capital to address the challenges it faces both within and outside the European Union.

A case in point is the priority resourcing of education (up by 9%) and central government investment (up by 9.6%) in the 2002 National Budget. Rises in both cases are substantially ahead of the nominal GDP growth rate, projected at 5.9%. Under the investments head, also worth of note are the additional 10.4% assigned to infrastructures, where Spain remains somewhat deficitary, and the 7.6% increase for Research, Development and Innovation. Spending on this last item will be guided by the National Plan for Scientific Research & Development and Technological Innovation 2000-2003, which sets priorities and has the prize objective of drawing 60% of Research, Development and Innovation funding from private-sector companies.

On the revenues side, this year's reform of corporate taxation, to apply as of 2002, will be followed by a personal income tax reform scheduled to come into force in 2003. This, as is natural, will demand further spending contention efforts on the part of government authorities.

On the question of **public finance sustainability**, perhaps the first step is to warn against establishing too close a tie between fiscal policy strategy and the solving of the long-term financial problems attendant on population ageing. Fiscal adjustments and planning obviously have an important role, but a lasting response to the challenges of the ageing population requires a multi-way strategy taking in a wide range of measures. These include: establishing a

Social Security Reserve Fund to be appropriated to from current surpluses; moves to raise the participation rate of Spanish society and push back the real retirement age; agreements with the social agents on pension system reforms; establishing a stable framework of budgetary discipline and austerity under the General Law of Budgetary Stability and, finally, progressively reducing the public debt stock as fiscal consolidation permits.

The strategy adopted in this socially sensitive area targets a level of pensions adequate for the country's needs, and the financial sustainability of the pensions system, backed by the broadest possible social consensus. The Government is convinced that the growth potential of the Spanish economy, and timely reform measures as warranted by the dynamic approach this kind of issue requires, can ensure the financial sustainability of the public pensions system and related social benefits.

1. Pensions

Listed below are some of the principal measures adopted or planned which will act directly or indirectly on the Spanish social protection system:

- Employment measures aimed at raising the participation rate.

- Passage of the General Law of Budgetary Stability which underwrites future budgetary rigour.

- A gradual reduction in public debt facilitated by the upkeep of budgetary rigour.

- Measures to promote later retirement, on a voluntary basis, like exempting workers over 65 from paying social contributions and allowing retired persons to combine paid work with receipt of a pension.

- Establishing a more proportional relationship between contributions and benefits by lengthening the pay-in period that counts towards the reference wage for pension entitlement. This period is being phased up, year by year, as far as 15 years in 2003. The next point to study and decide the optimal way to calculate pension benefits. In any event, these measures improve the fairness of the system and reinforce its contributory nature.

- The establishment and funding of a Reserve Fund for the public pensions system, whose content should equate to at least 1% of GDP by 2004.

- Support to the second pillar of the pension system. This basically means developing occupational pension schemes, i.e. those to which employers pay in on behalf of their workers, by improving their regulatory and tax treatment. Specifically, SMEs are given wider possibilities to establish occupational schemes, and the option is extended to sole proprietors. Occupational plans are also given a better tax treatment and a broader investment repertoire, while changes have been made in the composition of their supervisory committees.

- Specific actions to combat benefit fraud and so assure a fairer pensions system.

Many of these measures are contained in an Agreement concluded between the Government and social agents in April 2001. This accord gives proof of the maturity of Spanish society in addressing future challenges, and of the Government's determination to facilitate consensus and only intervene directly in this type of matter when the social agents have failed to reach agreement or when an agreement contravenes the basic principle of promoting the well-being of society as a whole.

2. Health spending

The policy of generic medicines and reference prices now in force is a structural instrument devised to rationalise pharmaceutical spending. It is expected to raise over Ptas 100 billion savings in the next three years in terms of manufacturer's sale price.

Pursuant to a parliamentary resolution, an agreement was concluded with all the parties involved in pharmaceutical spending (laboratories, pharmacists, warehousers, doctors and consumers), known as the Integrated Plan for Pharmaceutical Spending Control and the Rational Use of Medicines. This plan, which runs from 2002 to 2004, will establish timetabled actions for each collective to ensure a working system is put in place.

The agreement also sets out to limit the growth of public pharmaceutical spending. If drug company sales to the National Health Service increase more than the revised growth rate of nominal GDP plus 3 percentage points, the agreement will be overturned and the government can apply cost-control measures beyond those deriving from the reference price and generics system. This same cap (revised GDP+3) will be applied to the sales of pharmacies and pharmaceutical warehousers and, again, any overshoot will immediately trigger additional contention measures.

3. Dependents

Dependence becomes a growing concern as the population ages, and one with broad social, economic and financial implications which must be addressed within the sustainability strategy.

The balance between public finance stability and guaranteeing a decent standard of living to dependent citizens is being pursued through concerted action at all levels of government in partnership with the private sector.

The Agreement on Social Security System Development of April 2001 sets up a Working Commission of representatives from all the relevant authorities (central, regional and local government), which will put forward regulatory changes to tackle this problem before July 2002.

The Government has also sent a report to Parliament on private dependency insurance, proposing the creation and promotion of private saving instruments providing this type of coverage.

4. Other targeted areas

The Government has recently approved an Integrated Plan of Support Measures for the Family to encourage greater labour-market participation, particularly among the female population. It attempts to tackle the key issue of reconciling working life with family responsibilities through a broad array of measures:

- Tax support measures for unemployed parents entering work.

- Tax deductibility of expenses on nursery schools, childminders and care assistants for dependent relatives.

- Regulatory development of new legislation on reconciling work and family responsibilities.

- Larger rebates on employers’ social security contributions for hiring women returning to work after having children or lone parents on the unemployed register, and for reemploying women who are mothers in their former post.

5. Long-term public finance projections

The policies discussed in this section seek to strike a balance between the higher demands on government spending of an ageing population and the long-term upkeep of budgetary equilibrium. Table 6 below offers a synthetic projection of the financial variables with most bearing on pensions; the area where the inverting age pyramid has its most serious implications. The period is set at fifteen years, as anything longer would be too unreliable.

The projections shown rest on conservative assumptions for main macroeconomic variables, and are solely for the purpose of analysing the actuarial/financial impact on the public pensions system. In no event should they be read as estimates of the likely long-term performance of the said variables. Assumptions are: real GDP growth averaging 2.9% in the 2001-2015 period; average employment growth of 1% measured by the number of Social Security enrolments, and a constant inflation rate of 2%.

The findings, as shown, are that the pensions system will suffer relatively little financial alternation in the next fifteen years. This signifies, in short, that there is time enough for the necessary reforms to be implemented and to do their work.

Table 6
LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES

	2000	2005	2010	2015
Pension expenditure (1) (2)	8.43	7.98	8.03	8.25
Revenues from social contributions (2)	10.02	9.66	9.40	8.50
Activity rate (%) (3)	63.6	67.3	70.0	70.0

(1) Includes retirement, disability, orphan’s, widow’s and family support pensions.
(2) As % of GDP.
(3) The rates stated for 2005 and 2010 are the averages for 2005-2009 and 2010-2014 respectively.

SOURCE: Economic actuarial projection of Social Security spending on contributory pensions and projected evolution of social contribution receipts. Ministry of Employment and Social Affairs. September 2001.

V. SENSITIVITY ANALYSES

This Stability Programme Update sets out a scenario of general government accounts in balance in 2002 and 2003 and slightly in surplus over the remaining years of the projection period. In order to check how these outcomes would stand up to changes in the economic juncture, two alternative scenarios have been modelled based on higher and lower than baseline growth.

The table below reproduces the projected performance over the cycle of the budget balance and interest payments to aid comparison between alternative and baseline assumptions.

Table 7
CYCLICAL PERFORMANCE
(% change or % of GDP)

	2000 (P)	2001 (F)	2002 (F)	2003 (F)	2004 (F)	2005 (F)
Real GDP growth	4.1	3.0	2.4	3.0	3.0	3.0
Budget balance (% GDP)	-0.3	0.0	0.0	0.0	0.1	0.2
Interest payments (% GDP)	3.3	3.1	3.0	2.9	2.8	2.7

(P) Provisional
(F) Forecast
SOURCE: Ministry of Economy

1. Alternative growth scenarios

The **higher growth scenario** assumes a rapid and confident recovery of the world economy starting in the first quarter of 2002, and the upkeep of sturdy growth rates in successive years. In this framework, the Spanish economy would grow 2.9% in 2002, rising to 3.2% in 2003 and holding at this level over 2004 and 2005. Domestic demand and employment perform rather better than in the baseline scenario, while the net external contribution remains virtually unchanged. This is because the recovery-implied boost to goods and services exports would offset greater domestic demand pressures on imports.

The **lower growth scenario** posits a later and less vigorous world recovery than baseline assumptions. For the Spanish economy, this translates as 2002 growth of 1.8% then a flat 2.6% in the next three years. Domestic demand and employment have a less expansive tone than in the baseline scenario while the net external contribution stays roughly the same. A more adverse international climate and lower demand depress trade growth in goods and services but without affecting the growth contribution of net exports.

Table 8
SENSITIVITY ANALYSIS: Macroeconomic variables
(% change unless otherwise stated)

	2001 (P)	2002 (F)	2003 (F)	2004 (F)	2005 (F)
Higher growth scenario					
GDP	3.0	2.9	3.2	3.2	3.2
GDP deflator	3.8	2.9	2.4	2.4	2.4
Employment: change in %	2.1	1.8	2.0	2.0	2.0
Unemployment: % of labour force (LFS)	12.7	11.5	10.8	10.1	9.4
Net lending (+) or borrowing (-) vs rest of world (1)	-2.4	-2.3	-2.5	-2.6	-2.8
Baseline scenario					
GDP	3.0	2.4	3.0	3.0	3.0
GDP deflator	3.8	2.8	2.4	2.4	2.4
Employment: change in %	2.1	1.1	1.8	1.8	1.8
Unemployment: % of labour force (LFS)	12.7	12.4	11.7	11.0	10.3
Net lending (+) or borrowing (-) vs rest of world (1)	-2.4	-2.4	-2.5	-2.6	-2.8
Lower growth scenario					
GDP	3.0	1.8	2.6	2.6	2.6
GDP deflator	3.8	2.7	2.3	2.3	2.3
Employment: change in %	2.1	0.6	1.3	1.3	1.3
Unemployment: % of labour force (LFS)	12.7	12.7	12.0	11.3	10.6
Net lending.(+) or borrowing (-) vs rest of world (1)	-2.4	-2.4	-2.4	-2.4	-2.5

(1) As a % of GDP
(P) Provisional
(F) Forecast

SOURCE: Ministry of Economy

These different scenarios give rise to different budgetary outcomes.

In the higher growth scenario, government accounts would close 2002 in balance, then record an 0.2% surplus in 2003, even allowing for the effects of the direct tax reform. In the following years, the growth envisaged would deliver surpluses bordering on 0.4% of GDP.

In the lower growth scenario, 2002 accounts would close in deficit, but remaining years would close in balance as required by the General Law of Budgetary Stability .

In the case of public debt, all three scenarios would permit some reduction in its GDP weight.

Table 9 SENSITIVITY ANALYSIS: Budgetary outcomes					
	2001 (P)	2002 (F)	2003 (F)	2004 (F)	2005 (F)
Higher growth scenario					
General government surplus or deficit (-)	0.0	0.0	0.2	0.3	0.4
Public debt	57.5	55.3	53.1	50.9	48.8
Baseline growth scenario					
General government surplus or deficit (-)	0.0	0.0	0.0	0.1	0.2
Public debt	57.5	55.7	53.8	51.9	50.0
Lower growth scenario					
General government surplus or deficit (-)	0.0	-0.3	0.0	0.0	0.0
Public debt	57.5	56.3	54.7	53.1	51.5

(P) Provisional
(F) Forecast
SOURCE: IGAE and Ministry of Economy

2. Interest rate sensitivity analysis

Two alternative scenarios have been modelled to gauge the sensitivity of baseline budget objectives to variations in interest rates. Both assume a parallel shift of one percentage point in the interest rate curve factored in the baseline scenario, upwards in one case and downwards in the other.

The following table shows the impact of these differing rate scenarios on public debt and budgetary outcomes, assuming that the effect of higher rates is allowed to pass through in full to the fiscal balance:

Table 10 SENSITIVITY ANALYSIS: Interest rates (National Accounts basis, ESA-95. As % of GDP)						
Scenario	2000 (P)	2001 (F)	2002 (F)	2003 (F)	2004 (F)	2005 (F)
Higher rates						
Budget balance (1)	-0.3	0.0	-0.1	-0.1	-0.1	0.0
Public debt	60.4	57.5	55.7	53.9	52.2	50.5
Baseline rates						
Budget balance	-0.3	0.0	0.0	0.0	0.1	0.2
Public debt	60.4	57.5	55.7	53.8	51.9	50.0
Lower rates						
Budget balance	-0.3	0.0	0.0	0.1	0.2	0.4
Public debt	60.4	57.5	55.6	53.6	51.6	49.5

(1) The deficit balance appearing is for analysis purposes only, and would be corrected in line with the General Law of Stability.
(P) Provisional
(F) Forecast
SOURCE: IGAE and Ministry of Economy

The conclusion of this analysis is that both higher and lower rates would allow a consistently declining public debt ratio. In the higher rate scenario, the negative impact on the budget balance is around one decimal point of GDP in 2002, working outwards to two decimal points in the terminal year (2005). The budgetary impact of lower rates is of a similar magnitude but, logically, works in the opposite direction.

3. Comparison with projections contained in the previous Update

The principal change with respect to the previous Update is the less favourable economic environment and its impact on the growth rates of the Spanish economy in 2001 and the following years.

The exact differences resulting are set out below:

Table 11
DIFFERENCES VS PREVIOUS STABILITY PROGRAMME UPDATE

	2000	2001	2002	2003	2004
GDP growth					
Previous Update	4.0	3.6	3.2	3.2	3.2
Present Update	4.1	3.0	2.4	3.0	3.0
Difference	-0.1	0.6	0.8	0.2	0.2
Budget balance					
Previous Update	-0.3	0.0	0.2	0.3	0.3
Present Update	-0.3	0.0	0.0	0.0	0.1
Difference	0.0	0.0	0.2	0.3	0.2
Gross debt					
Previous	61.1	58.9	56.6	52.8	49.6
Present Update	60.4	57.5	55.7	53.8	51.9
Difference	0.7	1.4	0.9	-1.0	-2.3

SOURCE: Ministry of Economy

The lower growth of 2001, despite a difference of 6 decimal points vs initial forecasts, has no material effect on the budget position and slightly reduces public debt/GDP.

From this point onwards, the biggest difference arises in 2002 growth, 8 decimal points, though the gap shrinks to just two decimal points in projected budget balances. Growth forecasts converge anew as of 2003, although the fiscal impacts of differences are generally more adverse than in the previous Update.

Finally, debt/GDP evolves more favourably in the opening years, despite slower nominal GDP growth and thinner surpluses, because the start-out ratio is lower. As the period progresses, however, the more adverse performance of these same variables causes a reduction in the ratio which is less than that anticipated in the previous Update.

VI. HORIZONTAL ISSUES IN PUBLIC FINANCES

1. Institutional changes

General Law of Budgetary Stability

This text, described in an earlier section of the present Update, is a keynote institutional change giving legal weight to the spirit of discipline which has guided fiscal policy over recent years, and marking a renewed commitment towards the goals set in the Stability and Growth Pact.

It will ensure that all branches of government maintain a financial position in keeping with these international commitments through times of cycle downturn, so precluding debt spirals which might jeopardise the future sustainability of the public sector.

The Government will use the margin won to undertake a direct tax reform, as described elsewhere. This reform will locate Spain among the developed countries which have gone furthest in easing the tax burden and removing tax impediments to employment and wealth creation.

New Autonomous Community Financing System

Spain, as stated, is a highly decentralised country, and subnational authorities have broad expenditure powers which need adequate financing. The new system provides a stable, regulated, consensuated framework for the financial relations between central government and the Autonomous Communities.

Its main principles and innovations are outlined below (for fuller details see Annexe I):

- **Integration:** Financing extends to all Autonomous Community services including healthcare and IMSERSO (social services). All Autonomous Communities within the so-called common regime have the same sources of tax financing which are supplemented through redistributive mechanisms.

- **Coresponsibility:** The Autonomous Communities will take on more responsibility for raising revenues and assigning them to different spending policies. These greater fiscal powers have the corollary of more accountability to citizens.

- **Sufficiency:** The new system, like the one it will replace, provides sufficient funds for all Autonomous Communities to fulfil their competencies.

- **Solidarity:** Like the present model, the new system assures that any one Autonomous Community can deliver its citizens a standard of services commensurate with the rest, regardless of the relative wealth within its bounds.

  This is the purpose of the Sufficiency Fund, designated to make up differences between Autonomous Communities as regards the unit costs and thereby investment incurred in delivering services to citizens.

  The Interterritorial Compensation Fund is retained under the new system, while innovations include the Healthcare Fund and an equalising facility for specific needs.

- **Stability:** Given that the wider array of tax-funding sources permits more stable, less dependent revenues and that greater coresponsibility means more decision-making power plus greater accountability, the new model should refrain from formats like the five-year review.

- **A closer relationship with the tax administration (Agencia Estatal de la Administración Tributaria, AEAT):** The new financing system strengthens Autonomous Communities' co-ordination with AEAT, since their greater tax powers require them to be more involved in tax management.

- **Dialogue:** The new model was developed in consultation and discussion with the Autonomous Communities and parliamentary parties to secure its common ownership by government branches.

VII. CONCLUSIONS

This Stability Programme Update has been drawn up on conservative economic assumptions, in keeping with the greater uncertainty now abroad. It starts from a supply-side-oriented economic policy design to set forth budgetary projections in which fiscal policy neutrality is upheld in the short term.

Further ahead, it projects budgetary surpluses which will allow margin for the partial play of automatic stabilisers should the economy enter slowdown, without giving rise to undue fiscal imbalances. It again targets an optimal mix of government revenues and expenditure conducive to raising the economy's potential growth, as follows:

- Lowering tax revenues as a percentage of GDP through tax cuts designed to stimulate saving, investment and job creation.

- Reducing government spending as a share of GDP by means of current expenditure contention, while social outlays are maintained.

- Public investment growth ahead of GDP as a means to enlarge and improve the country's stock of physical, human and technological capital. Government saving will again exceed investment.

- Accumulating resources in the Reserve Fund from the surpluses generated by the Social Security system.

- A steady fall in public debt/GDP to less than 50% in the year 2005.

The Government is at the same time keenly aware of the long-term financial implications of population ageing. So, although the effects of this phenomenon are not expected to show for at least another fifteen years, it has begun a strategy of consensuated steps in reforming public and private pension systems, to ensure an adequate, sustainable standard of living for Spain's present and future retired population.

Work has also continued on structural reforms in product and factor markets. The focus in product markets has been on building competition in industries like energy and telecommunications which provide basic inputs to other productive sectors. The efficiency gains unlocked will improve the competitiveness of the economy while assuring a better deal for consumers. The other main plank of structural reform is the fostering of the information society and entrepreneurship, further supported through improvement in capital markets.

Improvement in labour-market performance is seen as vital to meet the objectives set by the Lisbon Council. Measures target equally on contract modalities, taxation and benefit systems with the aim of enlarging and improving labour supply.

In conclusion, the combination of a fiscal policy prizing budgetary stability and the quality of public finances; and economic reforms to raise the economy's potential growth, is seen as the right way to advance in real convergence with the European Union, as well as towards full employment and the greater well-being of Spanish society at large.

ANNEXE 1

NEW SYSTEM OF AUTONOMOUS COMMUNITY FINANCING

The present annexe sets out the main features of the new financing system for Autonomous Communities (ACs).

There are three large expenditure blocks to resource: general competencies, Social Security healthcare expenses and Social Security social services (IMSERSO). The system starts from a calculation of outlays under these three heads in 1999 (known as the start-out restriction). Once this is established, each community's expenditure needs are estimated with reference to a series of variables.

a) **General competencies:** three instruments are provided for expenditure needs under this head:

   – The General Fund: distributed on the basis of population, area, dispersion and insularity.

   – The Relative Income Fund: for ACs whose relative population is higher than their relative Gross Value Added. It is used to fund ten ACs: Andalusia, Asturias, the Canary Islands, Cantabria, Castilla-León, Castilla-La Mancha, Extremadura, Galicia, Murcia and Comunidad Valenciana.

   – The Compensation Fund for Low Population: beneficiaries are Aragon and Extremadura, on the grounds that their population density is at odds with their geographical extension.

   If these funds do not suffice for a given AC to cover its general expenses, a supplement will be provided under the so-called minimum level guarantee. This means no AC will have less to cover its general competencies than in 1999, and some ACs will have more. A number of coefficients have also been established which modulate the growth rate.

b) **Healthcare expenses**: distributed on the basis of population covered, population over 65 and insularity, starting from a floor-level spending requirement. Central Government guarantees that the funds assigned to ACs for healthcare will rise by the nominal rate of GDP, at least, in the first three years of the system's application.

c) Social services (IMSERSO competencies): distribution is based on population aged over 65.

The next two tables provide a summary of the new system's financing sources and the funds assigned.

Table 12
FINANCING SOURCES OF THE NEW SYSTEM

Sources	Remarks
System funding	
Basket of assigned taxes plus fees	Unconditional financing (see table 13)
Sufficiency Fund	Unconditional financing to make up the difference between ACs' general spending requirements and fiscal capacity. To be reviewed when new expenditure or tax transfers are decided
Non system funding	
Interterritorial Compensation Fund	Conditional financing to correct interterritorial economic differences on the redistributive principle
Equalising facility	To assure a minimum level of essential public services throughout Spain (as such, to cover special health or education needs – for instance in case of a large influx of immigrants)
SOURCE: Ministry of Economy	

Table 13
FUNDS ASSIGNED UNDER THE NEW SYSTEM

<table>
<tr><th>Funds</th><th>Definition</th><th>Remarks</th></tr>
<tr><td>Fees (1)</td><td>In respect of services transferred</td><td>Same as to date</td></tr>
<tr><td>Taxes assigned (1)</td><td>Wealth, capital transfer, document, inheritance, gift and gaming taxes</td><td>ACs are given enlarged powers in regulating these taxes</td></tr>
<tr><td>Personal income tax (1)</td><td>33%</td><td>Autonomous Community tariff; regulatory competencies are enlarged in respect of the tariff and deductions</td></tr>
<tr><td rowspan="3">Percentage of net receipts from specified taxes</td><td colspan="2">This tax basket is only assigned if the AC has taken on Social Security healthcare competencies.</td></tr>
<tr><td>35% VAT
40% Excise taxes on beer, wine, spirits and derivatives, tobacco and fuels</td><td>ACs have no regulatory powers, as these are harmonised taxes at EU level</td></tr>
<tr><td>100% Taxes on electricity and certain transport means</td><td>ACs could be given regulatory powers, though the matter is still under discussion</td></tr>
<tr><td colspan="3">(1) To finance general expenses
SOURCE: Ministry of Economy</td></tr>
</table>

ANNEXE 2

STRUCTURAL REFORMS

The year 2001 marked a renewed advance in structural reforms in product and factor markets. Work continued on implementing the ambitious liberalising package of June 2000, now showing its first fruits, and the **liberalisation process was deepened** through the design and launch of new market-opening measures.

The Progress Report on the Reform of Goods, Services and Capital Markets gives a detailed description of the past year's developments. Its most relevant aspects are summarised in the following pages.

I. GOODS AND SERVICES MARKETS

Measures in **goods and services markets** pursued greater openness and competition, particularly in those sectors which as providers of basic inputs for the rest of the economy, or as key development drivers for the information and knowledge society, have most power to enhance the potential growth of the Spanish economy.

1. Energy

1.1. Electricity

Market liberalisation was deepened with the regulatory development of measures contained in Royal Decree Law 6/2000, whose aim is to increase operator numbers, assure transparent, non discriminatory network access and enlarge interconnection capacity with neighbour countries.

Incentives were launched to encourage more producers into the special regime market. Liberalised consumers were offered more options in power purchasing and forward supply contracts, and approval was given to the reform and review of transmission and distribution network access tolls.

The most palpable results of measures to date are: in generation, a fall in the market share of the two largest producers and the entry of a fifth operator as of this year. In supply, a rise in the market share of new operators as more consumers get supplier choice. In the retail market, the volumes of power sold off the tariff continue to augment while average final prices have dropped 20% in 2001.

1.2. Natural gas

Gas market liberalisation is at an earlier stage than that of electricity. Nonetheless, important measures have been taken and the first results are now showing through. Attention has centred on separating out ownership and management across industry stages (import, transport and distribution), removing entry barriers and introducing competition in each.

The appointment of ENAGAS (owner of the main natural gas network) as the system's Technical Manager, and the placing of a 35% cap on the equity interests held in the same by any company or corporate group, was followed up in 2001 by approval of ENAGAS's Action Plan for the enlargement of its shareholder base and the divestments required under current legislation.

An integrated economic system has been developed for the natural gas sector, including a calculation mechanism for network access tolls and a remunerative system based on costs. Finally, 25% of the gas covered by the supply contract with Algeria has been auctioned to supplier companies.

A sizeable number of operators have entered the market since the start of liberalisation, consumers are taking up their network access rights, and tariffs fell significantly in the residential (-3.37%) and industrial (-15.3%) segments in the first eight months of 2001. Liquefied petroleum gas prices have also been brought down in both bulk (-20.3%) and bottled (-2.7%) product.

1.3. Liquid hydrocarbons

Added steps were taken in 2001 to guarantee the management neutrality of dominant logistics operator CLH. The Action Plan approved for opening up its shareholder base limits the ownership interest of any one person or company (to 25% of share capital or voting rights), and places a 45% cap on the combined interest of shareholders with refining capacity.

The minimum distance rule has been overturned as applying to highway service stations, in order to foster competition in the retail sector by increasing the number of sales points.

Finally, a website has been launched which posts the prices offered by retail distributors, as a means to favour market transparency.

2. Telecommunications

Liberalisation made further inroads in telecommunications with the effective opening of the local loop. The most appreciable effects of the reform are: in fixed telephony, Telefónica has lost market share and prices have held to their downwards course. By the 2001 close, the tariffs of fixedline services and fixed-mobile calls will have fallen by CPI-9. The launch of the flat-rate Internet tariff has met with considerable success, and over 7 million people were Internet users by mid-2001.

A new Reference Interconnection Offer (RIO) approved in the year modifies the system of network access. The RIO sets the prices and conditions to apply for other operators' access to Telefónica lines. The option of sharing out interconnection resources is provided for, as is the modification of the General Interconnection Agreements when these are affected by regulatory changes or by administrative or judicial decision.

Other measures due for approval before the end of this year are the regulation of Virtual Mobile Operators, the incorporation into Spanish law of European rules on service quality, and elaboration on some aspects of the Universal Service Regulations.

3. Transport

The privatisation of IBERIA culminated on 3 April 2001 with the company's stockmarket flotation. The carrier also engages in complementary activities like baggage handling and aircraft maintenance. At present, all these businesses are conducted under conditions of competition.

Measures now at the preparation stage include: changes to the tariff review system applying to regular road passenger transport services; the drawing-up and implementation of a five-year Strategic Plan for the road haulage sector (Plan PETRA); promotion of short-distance maritime routes as an alternative to road transport (for environmental reasons), and a review of the legal-economic regime governing ports and port services, in order to increase competition and enshrine the freedom of pricing principle.

4. Water

The National Hydrological Plan (NHP) approved in July 2001 takes the Directive on Community water policy as its frame of reference. The NHP is the cornerstone of water management planning in Spain, and sets ground rules for co-ordinating the plans of individual river basins. It contains various measures to rationalise and optimise water use, including the new “transfer levy” and support to desalination and re-utilisation projects and artificial groundwater replenishment. The NHP foresees €18 billion investments (around 3% of GDP) in the next 8 years.

5. Postal Services

A law of end-2000 transformed public corporation Correos y Telégrafos into a state-owned company. The public postal operator is thus equipped with an appropriate legal personality to negotiate deepening sector liberalisation.

Competition Policy

The competition authorities have been active in overseeing concentration processes and in the detection of anti-competitive practices. The case receiving most attention was the failed merger between the two largest electric utilities.

The Tribunal and Service have been assigned greatly increased resources and more autonomy, their organisation has been strengthened and procedures have been simplified, so they can devote more of their attention to potentially conflictive areas. Finally, draft legislation has been presented on the Co-ordination of Powers between Central Government and the Autonomous Communities in competition-related matters.

II. FACTOR MARKETS

1. Capital markets and financial services

The soon-to-be-approved **Finance Law** seeks to assure that legal provisions cause no unnecessary impediment to the activities of financial institutions, to guarantee that increased competition and the use of new technologies do not harm the interests of financial service users, and to promote the channelling of saving to productive investment, with particular regard to the financing conditions available to SMEs.

The Securities Market Law has been amended to allow for stock exchange demutualisation. This removes a major entry barrier, namely the requirement that market members should also participate in the capital of the governing board.

The Royal Decree to govern the legal regime of **investment services companies** has a clearly liberalising intent, in reducing the initial capital required for their incorporation.

More flexible rules are applied to the creation, authorisation and operation of collective investment undertakings, while the monitoring and supervisory powers of the National Securities Markets Commission are strengthened in their respect.

Risk capital companies and funds have been given a more favourable tax treatment, a new investor guarantee fund has been approved, and rules on cross-border money transfers have been tightened up.

2. The labour market

The labour market reform of 2001 marks a milestone in the development of Spanish economic policy. Its aims are: to support the job creation process, provide further incentives to permanent hirings and correct certain imbalances detected in labour market functioning.

Main measures are:

- New impetus behind the incentivised permanent employment contract. This contract format, introduced in 1997, basically sets lower severance payments than in standard permanent employment contracts. The significant increase in permanent hirings that followed its inception has moved the Government to extend its validity and enlarge its scope to other collectives.

- Constraints on the use of fixed-term contracts. Compensation for termination of contract is set at eight days' pay for each year worked, while a maximum term is set for casual work contracts.

- Changes in the legal regime governing part-time contracts, to better adapt them to new market needs. The limit on part-time working hours is abolished (hitherto 77% of full-time hours) and the working of supplementary hours is given a more flexible treatment.

- Repeal of legislation promoting the compulsory retirement of older workers as an instrument of employment policy.

III. OTHER REFORMS AFFECTING PRODUCT AND FACTOR MARKETS

1. Promotion of the Information and Knowledge Society

Measures to develop the Information Society work on four main fronts: the regulatory framework, the e-Administration, the spread of Internet access and Spanish on the Net.

Growth of Information Society services will be fostered by liberalisation measures in telecommunications and by **regulatory** innovations. A keynote legislative text in this respect is the preliminary draft of the Information Society and Electronic Commerce Services Law. Work has also proceeded on legislating electronic signatures and on developing an Internet domain plan under the country code corresponding to Spain (.es).

The second line of action targets the spread of Information Society practices through all government branches and departments and the development of online public services (the e-**Administration**).

The third, as stated, is assuring all citizens have **access** to the Information Society. Actions already programmed aim to provide fuller training to users and professionals by equipping educational centres with broadband Internet connections, to increase the number of users and professionals in Information and Communication Technologies (ICT), to improve disabled people's access to ICT, to establish public Internet access points, etc.

The **Info XXI Initiative Action Plan (2001-2003)** launched in January 2001 seeks to co-ordinate the efforts of all branches of government behind the development of the Information Society. The Plan takes on board the objectives set in the e-Europe initiative and the "e-Europe 2002" Action Plan.

2. Education

The Government assigns priority importance to the ongoing development of human capital, as a means to improve both employability and productivity. This is the principle behind the soon-to-be-adopted **Universities Law** establishing the legal regime and general operational framework to govern both public and private universities, once education powers are transferred in their entirety to the Autonomous Communities.

The **Law of Professional Training and Grading**, now under discussion, pursues an integrated system of professional training, grading and certification, taking in all training modalities, which responds efficiently and transparently to social and economic demands.

3. Scientific Research and Development and Technological Innovation

Recent initiatives have centred on enlarging **tax incentives** for Research, Development and Innovation activity, increasing the availability of seed **capital** for technology companies and reforming **patents** legislation, alongside the provision of support to **networking** practices and **human capital** development.

4. Fostering entrepreneurship

Among the Government's economic policy priorities is to provide a supportive environment for new firm creation. Measures to this end act on the legal, administrative and tax framework in which companies operate, with special regard to SME needs.

Work continued on rolling out the One-Stop Shop for Business programme, which aims to centralise all administrative formalities for new business creation in a single, accessible point.

The goal of simplifying the regulatory framework for SMEs is simultaneously being addressed by the New Enterprise project.