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2002 UPDATE

OF THE STABILITY PROGRAMME OF SPAIN

(2002-2006)

AN ASSESSMENT

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SUMMARY AND CONCLUSIONS

Spain submitted its fourth updated stability programme, covering the period 2002-2006, on 27 December 2002.

The information provided in the updated programme broadly complies with the revised code of conduct on the content and format of stability and convergence programmes[1], and some improvements have been made following remarks in the Council Opinion on the 2001-2005 update. However, the updated programme was presented almost four weeks beyond the 1 December deadline set in the revised code of conduct[2]. In addition, still following the previous pattern, the latest update provides year-by-year macroeconomic projections but identical, and thus less informative, growth rates for the three later programme years (2004-06).

Overall, the economic policies as reflected in the planned measures in the update are consistent in part with the 2002 Broad Economic Policy Guidelines. Specifically, no major measures for reviewing the public pension system in the programme are timetabled.

Implementation in 2002 of the previous update has been broadly successful. Slightly weaker than expected growth (2.2% rather than 2.4%, due to both external and domestic factors) and some primary expenditure overrun resulted in the budget balance being a modest deficit of 0.2% of GDP compared with the original balanced budget target. However, the worse than expected inflation helped contain the share of interest expenditure (GDP deflator is now envisage to grow by 3.5% compared with a previous forecast of 2.8%). By government sector, the outturn was most divergent for the autonomous communities, which recorded a deficit of 0.5% of GDP (compared with balance projected in the previous update), while the social security sector achieved a higher-than-expected surplus of 0.8% (0.5%). The debt ratio fell broadly in line with plans, reaching an estimated 55.2% of GDP at the end of 2002[3]. Structural reform measures were implemented as planned and in accordance with the 2002 Broad Economic Policy Guidelines, notably including passage of legislation (to take effect from 2003) reforming personal income tax to give greater incentives for labour market participation, geographical mobility and long-term saving.

The update's macroeconomic scenario shows GDP growth recovering to 3.0% in 2003 and remaining at that level for the remainder of the programme period. Although this may be somewhat optimistic for 2003 (compared, for example, with the Commission's autumn forecast of 2.6%), the medium-term projection may, prudently, actually be slightly cautious, given available estimates of potential output growth. The downgraded

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1 *Revised Opinion of the Economic and Financial Committee on the content and format of the stability and convergence programmes*, document EFC/ECFIN/404/01-Rev 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

2 According to the Spanish authorities, this delay was due to the ecological disaster caused by the sinking of the oil tanker "Prestige" in November 2002. However, the fiscal projections contained in the programme do not include the budgetary implications of this accident.

3 The fall in the government debt ratio between 2001 and 2002 in the current programme is similar to that considered in the former update (1.9 p.p. and 1.8 p.p. respectively).

inflation projection of 2.8% per annum for the GDP deflator (from 2.4% in the previous update) apparently reflects the expected continuation of recent poor performance.

Despite the slight deficit recorded in 2002, the updated programme retains an objective of balance for 2003, while shaving down previous targets for 2004 and 2005 (to balance and 0.1% of GDP compared with surpluses of 0.1% and 0.2% respectively in the previous update). The projection for 2006 is a marginal surplus (of 0.2% of GDP). Also slightly lower, the projected primary surplus remains almost unchanging at 2.7% of GDP throughout the programme period. In contrast, the debt-to-GDP ratio, is set to decline slightly more quickly than previously foreseen. The faster reduction, to 47% of GDP by 2006, is almost entirely due to a level of inflation almost a half-percentage point higher than projected a year ago.

The update broadly confirms the existing fiscal strategy, though revenue and expenditure shares are higher than in the previous update and the tax ratio now rises slightly during the period. Primary current expenditure is planned to decline by around a half-percentage point relative to GDP between 2002 and 2006 (with some of this reduction front-loaded in 2003); the programme does not detail how this will be achieved. This decline marginally outweighs an increase in the capital expenditure ratio; the total primary expenditure ratio remains roughly constant at just over 37% of GDP. Taking into account an easing burden of interest payments, the total expenditure ratio declines a modest half-percentage point to 39.6% in 2006. The higher ratios compared with the previous update mostly reflect overrun in 2002 not being clawed back, though the decline during the programme period is also rather less ambitious. Total revenues are set to remain stable relative to GDP at just under 40%, while rising corporate tax receipts contribute to the tax ratio increasing slightly, despite the 2003 personal income tax reform. Although reservations over the authorities' macroeconomic outlook for 2003 also apply to that year's budgetary projections, for 2004 and beyond these appear prudent, with some room for manoeuvre.

Based on trend GDP calculated by the Commission services from the programme's projected actual growth[4], the cyclically-adjusted budget balance (which in the case of Spain coincides with the underlying balance, given the absence of transitory factors) rises by over a half-percentage point over the programme period, somewhat front-loaded in 2003. The underlying position thus improves from a slight deficit in 2002 to balance in 2003 and 2004 and to a similarly-sized surplus in 2006. The Commission's autumn forecast, despite a somewhat less buoyant budgetary forecast for 2003, yields similar estimates to 2004. Accordingly, the budgetary targets in the programme, including their evaluation in underlying terms, clearly continue to respect the "close-to-balance" objective of the Stability and Growth Pact throughout the period.

By general government sub-sectors, central government excluding social security (i.e. the State and agencies) is expected progressively to narrow its deficit from an estimated 0.6% of GDP in 2002 to 0.2% in 2006. The surplus on the social security accounts is projected to halve from 0.8% of GDP to 0.4% over the same period. Territorial governments are estimated to have been in deficit by 0.4% of GDP in 2002 but are expected, within the framework of the new General Law of Budgetary Stability (prescribing the objective of a balance or surplus position for each entity in the public sector), to be in balance as from 2003. The divergence from planned outturn for the

4 These calculations are based on the Hodrick-Prescott filter.

territorial governments in 2002 (the nature of which the programme does not specify) points to the need for fiscal discipline to be ensured at different levels of government. This is especially so given the transfer underway of important tax and spending powers to regional authorities. In this respect, the fiscal discipline framework set by the General Law of Budgetary Stability needs to be implemented effectively while preserving adequate margins of manoeuvre for the working of the automatic stabilisers in either direction. This includes setting surplus targets when output is above potential.

The updated programme gives greater weight compared with the previous update to the issue of the long-term sustainability of the public finances. Evidence of an adequate reorientation of policy remains lacking, however. The new programme contains projections to 2050 of public pension expenditure. These are based on significantly revised demographic projections compared with those used for the EPC exercise (pension financing or other ageing-relevant expenditure such as healthcare are not presented). The revised demographics (the uncertain nature of which is rightly emphasised) incorporate new estimates of higher net immigration from 2000 onwards leading to a total population stable through the reference period, with a more moderate ageing effect. Although this would also imply somewhat more moderate public finance pressures than the particularly exposed demographic profile previously presented, on the basis of current policies, the risk of unsustainable public finances in terms of emerging budget imbalances remains serious. The risk essentially stems from the large projected increase in age-related public expenditure, notably on public pensions.

Although recent measures make more flexible the transition to retirement and include incentives for continued employment of older workers there has been no major review of the public pension system called for both in the previous Opinion and the 2002 Broad Economic Policy Guidelines. The calendar for reform of the pension system to align more closely contributions and benefits includes only discussions beginning in 2003 and no timetable is provided for reaching policy conclusions and implementation. Assets of the public pensions reserve fund created in 2000 to finance future liabilities now stand at 1% of GDP, a target reached two years earlier than initially planned.

Finally, annexes to the update summarise recent initiatives for structural reform in the labour, capital and product markets, as well as the structural public finance reforms of personal income tax and local government financing. A focus on network industries stems from implementation of the June 2000 liberalisation package. As regards the labour market, although improvement in recent years has been notable, this was from a base of very low total and female employment and wide regional unemployment disparities. Reforms of benefits and employment regulation announced in May 2002 provide greater incentives for the unemployed to enter employment. The strengthening of the competition authority implemented in the year could be helpful to improving inflation performance.

1. INTRODUCTION

The fourth update of the Spanish stability programme[5], covering the period 2002-2006, was submitted to the European Commission on 27 December 2002.

1.1. Compliance with the revised code of conduct

The programme was submitted four weeks later[6] than according to the deadline indicated in the revised *Code of conduct on the content and format of stability and convergence programmes*[7]. The information provided in the updated programme is broadly in line with information requirements of the code and some improvements have been made following remarks in the Council Opinion of the previous update. Nevertheless, some weaknesses and omissions in the data remain. The latest update presents year-by-year macroeconomic projections for the medium-term period. However, for the latter three years (2004-2006 in this case) these are obtained simply by projecting the same growth rate over the period and, therefore, they do not provide any profile for the medium-term. The information on the optional breakdown of general government revenues and expenditure is only partial, making difficult a fuller understanding of the adjustment path[8]. Unlike the previous programme, in order to assess the long-term sustainability of the public finances, the updated programme contains projections of pension expenditure up to 2050[9]. These projections depart from those released by the EPC working group and show a significantly lower budgetary impact from ageing. Corresponding revenue projections are not provided.

1.2. Council Opinion on the previous programme

The previous update, examined by Ecofin Council on 12 February 2002, covered the years 2001-2005. In its opinion[10] the Council considered the update to be in conformity with the provisions of the Stability and Growth Pact and consistent with the Broad Economic Policy Guidelines. However, the Council recommended ending indexation in wage bargaining so as to dampen down inflationary pressures. In addition, the Council strongly recommended adopting measures to ensure the viability of the public pension system and giving greater attention to long-term sustainability.

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5 *The updated programme is available on the website of the Ministry of Economy: http://www.mineco.es/sgpc/405SGPCM.htm.*

6 Although the Spanish authorities announced that the 2002 USP was released later than expected because of the ecological disaster caused by the sinking of the oil tanker “Prestige” in mid-November 2002, the fiscal projections contained in the programme do not include the budgetary implications of this accident. The programme only provides a first estimate of the budgetary cost to finance the measures adopted so far to tackle its aftermath (€ 250 million or less than 0.1% of GDP).

7 *"Revised Opinion of the Economic and Financial Committee on the content and format of the stability and convergence programmes"*, document EFC/ECFIN/404/01-Rev 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

8 Nonetheless, the information on this optional breakdown has improved significantly compared to the previous programme, in which these data were even more scarce.

9 The previous update only provided a projection on pension expenditure up to 2015.

10 OJ C 51/08, 26.2.2002

1.3. Macroeconomic and budgetary strategy in the latest update

The latest updated programme reaffirms the two-handed economic strategy of the Spanish government: the maintenance of budgetary consolidation and the pursuit of structural reforms. The main objective of this strategy continues to be real convergence in terms of per capita income and employment with the most developed EU economies.

In 2002, the general government balance is foreseen to show a deficit of 0.2% of GDP. The updated programme confirms the balanced budget target for the current year of the 2003 Budget Law (and unchanged from the previous update) and extends it to 2004. The targets for 2005 and 2006 are general government surpluses of 0.1% and 0.2% of GDP, respectively. The debt-to-GDP ratio is set to decline faster than in the previous programme, falling below 47% of GDP by 2006. The fiscal consolidation strategy remains unchanged, relying on a restraint of primary current expenditure while allowing for a strengthening of public investment.

2. Implementation of the previous update

In a context of slightly weaker growth in 2002 than assumed in the previous update (GDP is now expected to post a growth of 2.2% compared to 2.4% envisaged one year ago), the implementation of the 2001 Updated Stability Programme registered only small divergences in relation to last year's fiscal objectives. While the former programme targeted for 2002 a balanced budget, the general government accounts are now expected to register a deficit of 0.2% of GDP. This deficit stems mainly from regional government accounts, which are estimated to have posted a deficit of 0.5% of GDP compared to the balanced envisaged previously. This is the chief explanation for the deviation registered from the expenditure initially planned in the preceding programme (39.4% of GDP compared to 40.1% estimated now), which was only partially offset by higher than expected revenues. Despite this, the cyclically adjusted balance (CAB) only deteriorated slightly compared to the initial objective (see Table 1), with the cyclical effect on the budget balance coming essentially from the cyclical component of expenditure[11]. Finally, the debt ratio objective is likely to have been overachieved falling to 55.2% of GDP against a target of 55.7% in the previous programme[12].

Despite the lower than envisaged real GDP growth, the positive track in relation to fiscal targets was supported by nominal GDP growth in line with expectations[13]. In particular, in last year's programme, the projected GDP deflator for 2002 was set at 2.8% compared to an estimate of 3.5% in the latest update and 3.9% forecast by the Commission

[11] The budget cyclical sensitivity to the output gap is 0.4. Since the ratio of revenue to GDP is almost unaffected by cyclical developments, the cyclical effect on the budget balance stems mainly from the cyclical component of expenditure.

[12] This is due to the initial overestimation of the debt-to-GDP ratio in last year's update for 2001. However, the change in the government debt ratio between 2001 and 2002 in the current programme is similar to that considered in the former update (1.9 p.p. and 1.8 p.p. respectively).

[13] While real GDP growth is expected to be now 0.2 p.p. lower than previously envisaged, nominal GDP in the latest programme is set to be 0.5 p.p. higher than in the previous update. Higher than foreseen inflation can help contain some expenditure items as a percentage of GDP, to the extent that expenditure targets are fixed in nominal terms. In the case of Spain, this effect was apparent for interest payments expenditure.

services. The adverse outturn reflected both temporary factors[14], and the persistence of structural rigidities in some sectors. Additionally, wage indexation remained in operation, contrary to last year's Council Opinion.

The structural reforms implemented through the year aimed essentially at deregulating markets, improving the functioning of labour market and strengthening the competition authority. However, the final effects of these measures remain to be evaluated.

Table 1. Implementation of the previous update in 2002: USP 2001 plans and estimated outcomes

In % of GDP	**2002**
Government plans (USP 2001)	
Government budget balance	0.0
Total revenue	39.4
Total expenditure	39.4
of which: Primary expenditure	36.4
Debt ratio*	55.7 (57.5)
CAB (Hodrick -Prescott filter figures)	-0.2
p.m. real GDP growth	2.4
p.m. inflation of GDP deflator	2.8
*p.m. effect of cyclical position***	0.2
Estimated outcomes (USP 2002)	
Government budget balance	-0.2
Total revenue	39.8
Total expenditure	40.1
of which: Primary expenditure	37.2
Debt ratio*	55.2 (57.1)
CAB (Hodrick -Prescott filter figures)	-0.3
p.m. real GDP growth	2.2
p.m. inflation of GDP deflator	3.5
*p.m. effect of cyclical position***	0.1
Difference: estimated outcomes (USP 2002) - Government plans (USP 2001)	
Government budget balance	-0.2
Total revenue	0.4
Total expenditure	0.7
of which: Primary expenditure	0.8
Debt ratio*	-0.5 (-0.4)
p.m. real GDP growth	-0.2
p.m. inflation of GDP deflator	0.7

Source: USP 2001, USP 2002 and Commission Services calculations
* Estimated debt-to-GDP ratio in 2001 between brackets
** Effects of cyclical position CPE=e_e (*ygap*), where e_e is the sensitivity of the budget to the output gap (*ygap*).

In general, the 2002 results comply in part with the Council Opinion on last year's programme and the Broad Economic Policy Guidelines, since a comprehensive reform of the pension system to tackle the long-term sustainability of public finances was not addressed. The measures adopted in this field in the course of 2002, although positive, do not include the key reforms necessary to ensure the long-term viability of the system.

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[14] These temporary factors refers mainly to the acceleration in food prices due to weather conditions or the introduction of euro notes and coins and the increase in taxes on petrol and alcohol implemented in 2002.

3. MACROECONOMIC ASSESSMENT

3.1. External economic assumptions

The programme's central scenario is based on the external assumptions provided by the Commission earlier this autumn[15]. It assumes that economic weakness in 2002 gives way to a gradual acceleration of global economic activity throughout the programme period accompanied by a pick-up in non-oil commodity prices.

3.2. Domestic macroeconomic developments

In the central macroeconomic scenario GDP growth, after slowing down to 2.2% in 2002 (2.7% in the previous year), resumes at a rate close to potential output growth (3.0%) from 2003 to the end of the projection period. Compared to the previous programme, the deterioration in the world economy is reflected in a slight downward revision in GDP growth by 0.2 p.p. for 2002 while the rest of the projection period is left unchanged.

This macroeconomic scenario looks somewhat upbeat for 2002 and 2003, for example compared to the Commission forecasts of GDP growth of 1.9% and 2.6% respectively (see Table 2). For 2003, this divergence stems mainly from different assumptions on the second-round effects of the personal income tax reform to be implemented, with the Commission being rather more cautious about the positive growth impact. Given the still uncertain economic setting for 2003 and the growing indebtedness registered by the Spanish households in recent years, the Commission services consider that the expected increase in the gross disposable income will imply a rise in the saving ratio to a grater extent than a sharp acceleration in private consumption. For the rest of the projection period, the outlook for growth is plausible, subject to the improvement in the international economic setting materialising and given the ongoing catching-up process of the Spanish economy.

Applying the production function method to the data in the programme, the implicit rate of growth of potential turns out to be 3.2% in each year between 2002-2004, slightly above the corresponding estimates based on the Commission Autumn Forecasts. It appears to decline rather sharply in the last two years of the programme. The decline is attributable to the estimated contribution of labour, whereas the capital accumulation contribution is estimated to be constant through the programme period. This seems broadly consistent with the strong job creation experienced in Spain in recent years[16].

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15 According to the Code of Conduct, Member States should endeavour to use common basic assumptions on the main extra-EU variables. These were provided by the Commission in September 2002 in a note for the attention of the Economic and Financial Committee.

16 The decomposition of potential GDP growth based on the production function (PF) approach indicates poor productivity performance, which might be partially caused by the strong content of employment in output growth. Total factor productivity (TFP) shows a zero contribution (given the estimated PF for Spain which had restricted TFP growth to be non-negative). This is why the application of PF approach raises concerns including its use in assessing the fiscal stance. Accordingly, when the PF methodology was officially adopted for the assessment of the stability and convergence programmes, it was agreed to continue to use the HP filter approach in the case of Spain. In this respect, the sharp fall in potential GDP growth estimated for 2005 and 2006 applying the PF method contrasts noticeably with the more stable estimates of trend GDP growth provided by the HP filter.

TABLE 2. Main macroeconomic scenario: Commission forecasts - Updated Programme 2002-2006

		2002	2003	2004	2005	2006
GDP AND MAIN AGGREGATES (Annual average growth rate at constant prices, in %)						
Private consumption	**C.f.**	**1.7**	**2.3**	**3.1**		
	USP-02	**1.9**	**2.9**	**2.9**	**2.9**	**2.9**
Government consumption expenditure	**C.f.**	**2.2**	**3.0**	**2.5**		
	USP-02	**3.0**	**3.0**	**3.0**	**3.0**	**3.0**
Gross Fixed Capital Formation	**C.f.**	**1.5**	**2.5**	**4.5**		
	USP-02	**1.7**	**3.8**	**3.6**	**3.6**	**3.6**
Domestic Demand	**C.f.**	**1.8**	**2.5**	**3.3**		
	USP-02	**2.1**	**3.1**	**3.1**	**3.1**	**3.1**
Exports of Goods and Services	**C.f.**	**-0.4**	**5.9**	**7.1**		
	USP-02	**1.8**	**4.0**	**7.3**	**7.3**	**7.3**
Imports of Goods and Services	**C.f.**	**-0.5**	**5.6**	**7.1**		
	USP-02	**1.7**	**4.4**	**7.3**	**7.3**	**7.3**
External sector 1)	**C.f.**	**0.0**	**0.0**	**-0.2**		
	USP-02	**0.0**	**-0.2**	**-0.2**	**-0.2**	**-0.2**
Gross Domestic Product	**C.f.**	**1.9**	**2.6**	**3.2**		
	USP-02	**2.2**	**3.0**	**3.0**	**3.0**	**3.0**
PRICES (Annual change, in %)						
GDP deflator	**C.f.**	**3.9**	**3.1**	**2.7**		
	USP-02	**3.5**	**2.8**	**2.8**	**2.8**	**2.8**
Private consumption deflator	**C.f.**	**3.6**	**2.9**	**2.5**		
	USP-02	**3.5**	**3.1**	**2.5**	**2.5**	**2.5**
LABOUR MARKET						
Employment 2):						
Annual change, %	**C.f.**	**1.3**	**1.8**	**2.3**		
	USP-02	**1.1**	**1.8**	**1.8**	**1.8**	**1.8**
Unemployment rate	**C.f.**	**11.3**	**10.7**	**10.1**		
	USP-02	**11.3**	**11.0**	**10.7**	**10.3**	**10.0**
OTHER VARIABLES						
Net lending (+) or net borrowing (-) vis-à-vis ROW 3)	**C.f.**	**-1.4**	**-1.1**	**-1.0**		
	USP-02	**-1.6**	**-1.7**	**-1.7**	**-1.7**	**-1.8**
Trend GDP growth 4)	**C.f.**	**3.0**	**3.0**	**3.0**		
	USP-02	**3.2**	**3.1**	**3.1**	**3.1**	**3.1**
Output gap 4)	**C.f.**	**0.4**	**-0.1**	**0.1**		
	USP-02	**0.3**	**0.1**	**0.0**	**-0.1**	**-0.2**
Potential GDP growth 5)	**C.f.**	**3.2**	**3.2**	**3.2**		
	USP-02	**3.1**	**3.1**	**3.0**	**2.7**	**2.6**
of which: Labour contribution	**C.f.**	**1.9**	**1.9**	**1.9**		
	USP-02	**1.7**	**1.7**	**1.7**	**1.4**	**1.3**
Capital accumulation contribution	**C.f.**	**1.3**	**1.3**	**1.3**		
	USP-02	**1.3**	**1.3**	**1.3**	**1.3**	**1.3**
TFP contribution	**C.f.**	**0.0**	**0.0**	**0.0**		
	USP-02	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Output gap 5)	**C.f.**	**-0.8**	**-1.5**	**-1.5**		
	USP-02	**-0.2**	**-0.3**	**-0.3**	**-0.0**	**0.4**

1) Contribution to GDP growth
2) Full-time equivalent jobs
3) % of GDP
4) Hodrick-Prescott filter
5) Production function method

SOURCE: European Commission and Ministerio de Economía, Updated Stability Programme 2002-2006

For 2003 and 2004 the outlook for inflation in the programme does not depart very much from the Commission forecasts while for the rest of the projection period the envisaged price developments seem attainable. Finally, employment forecasts in the programme are prudent, given the expected GDP growth around its potential. Nevertheless, the prospects of declining inflation and sustained employment growth in the medium-term highly depend on the maintenance of wage moderation.

4. FISCAL TARGETS AND MEDIUM-TERM PATH OF PUBLIC FINANCES

4.1. Programme overview

The new update revises marginally the budgetary objectives contained in the previous programme. Compared to the former update, a balanced budget, previously assumed to have been reached in 2001, is now expected to be achieved in 2003 whereas a budgetary surplus is postponed by one year to 2005 (see Table 3).

Table 3. Composition of the adjustment in public finances in 2002 USP

In % of GDP	2001	2002	2003	2004	2005	2006	2006 -2002
Total revenues	**39.8**	**39.8**	**39.8**	**39.8**	**39.8**	**39.8**	**0.0**
tax receipts	35.4	35.4	35.4	35.5	35.6	35.7	0.3
Direct	10.5	10.7	10.5	10.5	10.7	10.8	0.1
Households	7.4	7.4	7.2	7.1	7.1	7.1	-0.3
Coorporations	3.0	3.3	3.3	3.4	3.6	3.8	0.5
Indirect	11.4	11.2	11.2	11.2	11.2	11.2	0.0
Social contributions	13.6	13.6	13.7	13.7	13.7	13.7	0.1
Total expenditure	**39.9**	**40.1**	**39.8**	**39.7**	**39.7**	**39.6**	**-0.5**
Primary expenditure	36.8	37.2	37.0	37.0	37.1	37.1	-0.1
Primary current expenditure	*31.6*	*31.8*	*31.7*	*31.6*	*31.5*	*31.4*	*-0.4*
Capital expenditure	*5.2*	*5.4*	*5.4*	*5.5*	*5.6*	*5.7*	*0.3*
Gross fixed capital formation	*3.3*	*3.5*	*3.5*	*3.6*	*3.7*	*3.8*	*0.3*
Interest payments	3.1	2.9	2.8	2.7	2.6	2.5	-0.4
Primary balance	3.0	2.7	2.8	2.7	2.7	2.7	0.0
General government budget balance	**-0.1**	**-0.2**	**0.0**	**0.0**	**0.1**	**0.2**	**0.4**
of which							
Central government	**-0.5**	**-0.6**	**-0.5**	**-0.4**	**-0.3**	**-0.2**	**0.4**
Territorial governments	**-0.5**	**-0.4**	**0.0**	**0.0**	**0.0**	**0.0**	**0.4**
of which							
Regional governments	-0.5	-0.5	0.0	0.0	0.0	0.0	**0.5**
Local governments	0.1	0.1	0.0	0.0	0.0	0.0	**-0.1**
Social security	**0.8**	**0.8**	**0.5**	**0.4**	**0.4**	**0.4**	**-0.4**
Memorandum items:							
Gross saving	*3.9*	*3.9*	*4.0*	*4.2*	*4.4*	*4.6*	*0.7*
Government budget balance in 2001USP	*0.0*	*0.0*	*0.0*	*0.1*	*0.2*	-	-
Government budget balance Commission forecast	**-0.1**	**0.0**	**-0.3**	**0.1**	-	-	-
Source: Update Stability Programme 2002-2006 and Commission Autumn Forecasts							

The present update is the first prepared under the General Law of Budgetary Stability approved in December 2001, which aims at ensuring fiscal consolidation for all general government sub-sectors. Accordingly, all public sector entities are obliged to present their accounts in balance or in surplus[17], and any budgetary deficit will have to be corrected based on a three-year plan. This is especially relevant taking into account the new financial system for regional governments, implying a high degree of decentralisation in expenditure decisions along with higher joint fiscal responsibility[18].

The updated programme's balanced budget target for 2003 was previously set in the 2003 Budget Law. This target is extended to 2004 whereas small surpluses of 0.1% and 0.2% of GDP are foreseen for 2005 and 2006. The debt-to-GDP ratio is set to decline more rapidly than in the previous programme, falling below 47 % of GDP at the end of the forecasting period.

The maintenance of a close to balance position in 2001 and 2002 in spite of lower growth than assumed initially suggests that the original fiscal targets had been set prudentially. For 2003, however, taking into account the optimistic GDP growth forecast and the implementation of the personal income tax reform, the official target of a general government balanced budget will be more testing[19]. For comparison, Commission services forecast a general government deficit of 0.3% in 2003. Nevertheless, the targets for the following years appear cautious, giving some margin against less positive developments in the economy. This would be consistent with the prudent fiscal-target setting carried out by the Spanish authorities up to now.

The fiscal consolidation strategy remains expenditure-based as in former programmes. It relies on a restraint of primary current expenditure and lower interest charges while allowing for a strengthening of public investment.

The total expenditure ratio is expected to decrease gradually falling by 0.5 percentage points of GDP: from 40.1% in 2002 to 39.6% in 2006. After the increase recorded in 2002, primary expenditure is projected to decline marginally, from 37.2% to 37.1% of GDP. Primary current expenditure is expected to register a similar path, decreasing by 0.4 p.p. between 2002 and 2006. Nevertheless, detailed information on particular measures envisaged to constrain such expenditure is lacking[20]. This expenditure containment should be underpinned by decreasing interest payments from 2.9% of GDP in 2002 to 2.5% in 2006[21]. In contrast, capital expenditure is projected to increase by 0.3

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17 Central government and social security accounts will continue to consolidate until the complete separation of their financing sources is completed, which is envisaged to occur in 2012.

18 This new financial system for regional governments was partially implemented in 2002 and is expected to be fully operational in 2003. In turn, the central government is currently negotiating a new financial framework for local entities.

19 The personal income tax reform is presented as a reason for the optimism of the official macroeconomic scenario. However, the positive second round effects envisaged by the authorities, implying a moderate final loss of revenues set at 0.3% of GDP, appear on the high side. On the other hand, the behaviour of regional governments under the new financing system adds to the uncertainties of the budgetary outcome.

20 Similarly to the previous programme, the present update only provides some information regarding health care expenditure. In particular, savings on pharmaceutical costs, mainly based on the wider use of generic medicines, could be around 0.1% of GDP for the period 2002-2006.

21 The expected evolution of the implicit interest rates have been set cautiously, giving a margin to realise the fiscal targets envisaged in the programme.

p.p. of GDP during the programme period allowing for a similar increase in gross fixed capital formation.

On the revenue side, the updated projects a steady share of total revenues at 39.8% of GDP. In contrast, tax revenues are foreseen to gain 0.3 p.p. of GDP by the programme horizon (from 35.4% in 2002 to 35.7% in 2006) in spite of the personal income tax reform to be implemented from 2003 on. This is due to an increase in the GDP share of corporate taxes which more than offsets the fall in households' direct taxes, while indirect taxes and social contributions remain stable. Overall, the revenue projection over the programme period seems plausible since total revenues are set to grow in line with nominal GDP in a context of sustained economic growth around potential. Nevertheless, the sharp increase in corporate taxes by 0.5 p.p. in 2003-2006 seems somewhat upbeat and no additional information is provided[22].

By general government sub-sectors, the State deficit is expected to fall gradually to 0.2% of GDP in 2006 from an initial estimate of 0.6% for 2002. The social security sub-sector is projected to register surpluses of 0.8% and 0.5% in 2002 and 2003 respectively, decreasing thereafter to a stable surplus of 0.4%. Finally, territorial governments are expected to comply with the provisions of the General Law of Budgetary Stability, showing balanced budgets between 2003 and 2006.

To sum up, in line with the recent past experience, the envisaged budgetary approach implies that the adjustment relies on restraint of primary current expenditure and on decreasing interest payments. This allows for an increase in public investment while total expenditure relative to GDP is envisaged to fall. However, similarly to the previous programme, the absence of detailed information on measures to constrain current primary expenditure hinders full assessment of the feasibility of and the main risks to this budgetary approach. Given the expenditure-based strategy, a close co-ordination among all general government tiers is needed so as to ensure the achievement of the announced fiscal targets. In this connection, the implementation of the General Law of Budgetary Stability from 2003 on is expected to play a prominent role.

The programme estimates that cyclically-adjusted budget balances[23] will improve by 0.6 p.p. of GDP from 2002 to 2006. This result is in accordance with Commission services' calculations based on GDP growth and general government balances presented in the update (see Table 4), which confirm a close-to-balance or in surplus position. In turn, these results do not depart significantly from those obtained using Autumn Commission Forecasts. The positive output gap in 2001 drops sharply in 2002 and closes in 2004 to turn slightly negative afterwards, with trend GDP growth estimated around 3%. As a consequence, the cyclically adjusted primary balance remains nearly flat at around 2.7% throughout the period.

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[22] In November 2002 corporate tax collection was growing by more than 17% on the year. This is due to the more favourable fiscal treatment to be applied to non-ordinary capital gains devoted to reinvestment. This incentive has significantly stimulated the booking of capital gains and thus corporate income tax receipts, and may justify the increased weight of this tax relative to GDP between 2001 and 2002.

[23] The method applied to assess the fiscal stance in the case of Spain provisionally continues to use a Hodrick-Prescott GDP filter, as agreed in the Ecofin Council on 12 July 2002.

The budgetary projections in the programme comply with the close-to-balance objectives set out in the Stability and Growth Pact, with the fiscal targets and their evaluation in cyclically adjusted terms confirming this conclusion. Finally, the fiscal stance defined as the change in the cyclically-adjusted balances represents a slight tightening.

Table 4.Output gaps and cyclically adjusted budget balances

	Spain's Updated Stability Programme					Commission's Autumn 2002 Forecasts				
	GDP trend growth	Output gap	Budget balance	CAB	CAPB	GDP trend growth	Output gap	Budget balance	CAB	CAPB
2001	3.2	1.2	-0.1	-0.6	2.5	3.1	1.5	-0.1	-0.7	2.4
2002	3.2	0.3	-0.2	-0.3	2.6	3.0	0.4	0.0	-0.1	2.8
2003	3.1	0.1	0.0	-0.1	2.7	3.0	-0.1	-0.3	-0.2	2.6
2004	3.1	0.0	0.0	0.0	2.7	3.0	0.1	0.1	0.0	2.7
2005	3.1	-0.1	0.1	0.1	2.7					
2006	3.1	-0.2	0.2	0.3	2.8					

CAB:Cyclically adjusted balance; CAPB: Cyclically adjusted primary balance. Calculated with the HP filter method.

Source: Commission's Autumn 2002 Forecasts and ECFIN calculations on Spain's updated Stability Programme 2002-2006

4.2. Sensitivity analysis

4.2.1. Sensitivity to economic growth

The programme provides an alternative "moderate-growth" scenario. This assumes that annual GDP growth is lower than the baseline by 0.2 and 1 percentage points in 2002 and 2003 respectively, and by 0.5 percentage points each year for the rest of the period (see Table 5). In the "moderate-growth" scenario, general government balance registers a deficit of 0.4% of GDP in 2003 and gradually reaches a balanced budget at the end of the forecasting period. The CAB, although weaker than in the baseline, maintains the close-to-balance position and records a small surplus in 2006 very close to that of the baseline. Additionally, the debt-to-GDP ratio remains on a downward trend falling below 50% at the end of the period.

A useful exercise to assess the fiscal effort to be made in order to meet the targets in the baseline scenario is the calculation of an hypothetical CAB (HCAB). This would result from adjusting revenue and expenditure to GDP ratios in the baseline scenario by the new potential output in the "moderate-growth" scenario (see Table 5)[24]. Therefore, the difference between this calculation and the CAB (1) of the baseline scenario (fiscal effort indicator 1) would indicate the discretionary fiscal adjustment needed to meet the targets of the baseline subject to the lower GDP growth. This analysis suggests that the CAB may deteriorate significantly in the absence of policy measures if the moderate scenario materialises, failing to keep the close-to-balance position in cyclically adjusted terms.

Nonetheless, in order to avoid the underlying fiscal deterioration mentioned in the previous paragraph and fulfil the requirements set by the General Law of Budgetary

[24] This hypothetical CAB is computed under the assumption of unchanged policies from the baseline expenditure and revenue figures as follows: baseline revenues at potential are adjusted for the estimated difference in potential output by applying the standard semi-elasticity; baseline (primary) expenditure at potential is the same in nominal terms (thereby increasing as a share of GDP for a lower GDP level).

Stability[25], the programme incorporates new fiscal targets for the "moderate-growth" scenario. In this case, the CAB (2) would not depart from the close-to-balance position. The fiscal effort indicator (2) shows that the adjustment needed to meet the new targets under this scenario is considerable, reaching 0.8 p.p. of GDP at the end of the programme period. In other words, this entails a strong commitment of the Spanish authorities to the maintenance of the close-to-balance objective of the SGP.

Table 5. Sensitivity to GDP growth (as % of GDP)

	2002	2003	2004	2005	2006
BASELINE SCENARIO					
Real GDP growth	2.2	3.0	3.0	3.0	3.0
General government balance	-0.2	0.0	0.0	0.1	0.2
Public debt	55.2	53.1	51.0	49.0	46.9
Trend GDP growth	**3.2**	**3.1**	**3.1**	**3.1**	**3.1**
Output gap	**0.3**	**0.1**	**0.0**	**-0.1**	**-0.2**
CAB (1)	**-0.3**	**-0.1**	**0.0**	**0.1**	**0.3**
MODERATE GROWTH SCENARIO					
Real GDP growth	2.0	2.0	2.5	2.5	2.5
General government balance	-0.2	-0.4	-0.3	-0.2	0.0
Public debt	55.2	54.1	52.6	51.1	49.5
Trend GDP growth	**2.9**	**2.8**	**2.7**	**2.7**	**2.6**
Output gap	**0.7**	**-0.0**	**-0.2**	**-0.4**	**-0.5**
CAB (2)	**-0.5**	**-0.4**	**-0.2**	**-0.0**	**0.2**
Hypothetical CAB (HCAB)*	**-0.8**	**-0.5**	**-0.5**	**-0.6**	**-0.6**
Fiscal effort indicator 1: CAB(1) - HCAB**	**0.5**	**0.4**	**0.5**	**0.7**	**0.9**
Fiscal effort indicator 2*: CAB(2) - HCAB**	**0.3**	**0.1**	**0.3**	**0.6**	**0.8**

Source: Commission services calculations based on figures provided in the Spain's updated stability programme. Trend GDP is calculated with the HP filter.
* See footnote 24.
** Fiscal effort to be made to meet budget balances in the baseline scenario with the moderate growth.
*** Implicit fiscal effort to meet budget balances in the moderate growth scenario

4.2.2. Sensitivity to interest rates

The update also provides an interest rate sensitivity analysis. Based on the baseline macroeconomic scenario, an upward/downward shift in the entire yield curve by one percentage point over the period is assumed from 2002 onwards. According to the programme, the average maturity of government debt is set at more than six years. As a result, the impact stemming from interest rate shifts should mainly take place by debt substitution or new issuance.

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25 Provided a deficit is registered, a balanced budget situation must be restored within a three-year period.

Given these considerations, the impact on the budget balance and debt ratio is around 0.2 percentage points in both alternative interest rate scenarios. The relatively long maturity delays the impact of shifts in the yield curve. Accordingly, the close-to-balance and debt reduction objectives are not threatened.

Table 6. Sensitivity to interest rates (as % of GDP)

	2001	2002	2003	2004	2005	2006
HIGH RATES						
General goverment balance	-0.1	-0.2	-0.2	-0.2	-0.2	0.0
Public debt	57.1	55.2	53.2	51.2	49.2	47.2
BASELINE RATES						
General goverment balance	-0.1	-0.2	0.0	0.0	0.1	0.2
Public debt	57.1	55.2	53.1	51.0	49.0	46.9
LOW RATES						
General goverment balance	-0.1	-0.2	0.1	0.2	0.3	0.5
Public debt	57.1	55.2	53.0	50.8	48.7	46.6
Source: Updated Stability Programme 2002-2006						

4.3. Debt ratio

The programme envisages a continuous reduction in the government debt to GDP ratio of almost ten percentage points: from 57.1% of GDP in 2001 to 46.9% in 2006. On average the path reduction entails yearly reductions of 2 p.p. of GDP (see table 7).

Table 7. Decomposition of changes in the government debt ratio (as % of GDP)

		2001	2002	2003	2004	2005	2006
Level of government debt	**USP-02**	**57.1**	**55.2**	**53.1**	**51.0**	**49.0**	**46.9**
	C.f.	**57.1**	**55.0**	**53.2**	**51.1**		
Change in government debt ratio:	**USP-02**	-3.4	-1.9	-2.1	-2.1	-2.0	-2.1
	C.f.	-3.4	-2.1	-1.8	-2.1		
• Contribution of primary balance	**USP-02**	-3.0	-2.7	-2.8	-2.7	-2.7	-2.7
	C.f.	-3.0	-3.0	-2.6	-2.7		
• GDP growth contribution	**USP-02**	-3.9	-3.1	-3.0	-2.9	-2.8	-2.7
	C.f.	-3.9	-3.2	-3.0	-3.0		
• Contribution of interest payments	**USP-02**	3.1	2.9	2.8	2.7	2.6	2.5
	C.f.	3.1	3.0	2.9	2.6		
• Stock-flow adjustment (residual)	**USP-02**	0.4	1.0	0.9	0.8	0.9	0.8
	C.f.	0.4	1.1	0.9	1.0		

Source: Commission estimates based on nominal GDP growth rate and budgetary balance projections given in the updated Stability Programme.

Note:The decomposition of changes in the gross debt ratio is based on the following equation for the budget constraint:

$$\frac{Dt}{Yt} - \frac{Dt-1}{Yt-1} = \frac{PDt}{Yt} + \frac{Dt-1}{Yt-1} \bullet \frac{i-yt}{1+yt} + \frac{SFt}{Yt}$$

with: D_t = government debt; PD_t = primary deficit; Y_t = GDP at current prices; y_t = nominal GDP growth rate; i = implicit interest rate; SF_t = “stock-flow adjustment”.

Source: Commission estimates based on nominal GDP growth rate and budgetary balance projections given in the updated Stability Programme.

The decomposition of contributions to debt reduction shows that primary surpluses and nominal GDP growth are the driving forces behind this downward trend. In contrast, the stock-flow adjustment, calculated as a residual, remains positive and significant throughout the forecasting period. As in the previous update, the lack of information on below-the-line operations does not allow for detailed analysis. However, the sizeable stock flow adjustment considered in the programme may relate to acquisitions of financial assets by the general government sector from general government-owned entities responsible for specific investment projects (mainly infrastructure)[26].

Finally, the programme does not provide information on the portfolio allocation of the social security reserve fund: accumulation of non-general government assets would, ceteris paribus, tend to slow the reduction in gross debt.

5. THE SUSTAINABILITY OF PUBLIC FINANCES

The 2002 updated stability programme contains a section on the sustainability of public finances. It includes national projections for public expenditures on pensions (excluding pensioned staff of the central government administration) which show an increase in public spending of 5.1% of GDP between 2005 and 2050. This is substantially less than the increase of some 8 percentage points of GDP projected by the EPC over the same period. Nevertheless, neither projections on the revenue side nor other age-related expenditure are provided[27].

It is first necessary to consider whether current budget polices can ensure that the SGP will continue to be respected in the future in light of the budgetary implications of ageing populations. The Commission considers that on the basis of current policies, the risk of unsustainable public finances in terms of emerging budget imbalances cannot be excluded. The risk essentially stems from the large projected increase in age-related public expenditures, notably on public pensions. In this respect, it should be borne in mind that these projections are sensitive to underlying assumptions including demographic developments. Nevertheless, the more favourable demographic scenario considered in the programme, which reflects updated population figures for recent years, does not suggest a permanently more ‘favourable’ demographic profile for Spain. This might simply imply a delay in the full demographic impact of ageing populations. In any case, the new scenario does not justify postponing a comprehensive reform of the public pension system. So far, no measures in this direction have been adopted.

A second issue is whether the budgetary strategy outlined in the programme is compatible with improving the sustainability of public finances. The commitment to sustain balanced budget positions will lead to a continuous fall in the reduction of the debt ratio over time and thus help meet the projected increase in spending on pensions and health care.

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[26] These general government-owned entities do not belong to the general government definition according to ESA-95 rules. For instance, in the 2003 Budget Law consolidated capital expenditure, after taking into account the new financial system for regional governments, grows by 6.8%. Nevertheless, when the investment effort from the State-owned entities is taken into account, this figure becomes 12.9%. Despite such operations meet EUROSTAT standards, this issue has already been raised by public and private analysts (see for example the IMF “2002 Article IV Consultation” on Spain).

[27] Due to this lack of other age-related expenditure different from pensions in the programme, Annex 2 on “A quantitative assessment of the sustainability of public finances” combines pension expenditure provided by the Spanish authorities with other age-related expenditure readings prepared by the EPC working group.

Finally, it is necessary to consider the type and scale of the budgetary challenges that will emerge in coming years to ensure sustainable public finances. While the Commission welcomes the measures to achieve debt reduction, increase employment rates and encourage greater recourse to private pensions outlined in the programme, this strategy needs to be complemented with actions to reform the key parameters of the system (such as the number of contributory years, retirement age etc). This would allow for enhancing the financial sustainability of the system and its capacity to deal with uncertain demographic developments. This strategy would be in line with the statement contained in the programme calling for a public pension reform by strengthening the link between contributions and benefits.

6. STRUCTURAL MEASURES AND OTHER REFORMS WITH LIKELY BUDGETARY IMPACT

Structural measures play a key role not only in raising potential growth but also in helping to ease inflationary pressures. The programme includes a description of the main structural measures approved in the recent past so as to increase growth in the medium and long term and improve the institutional functioning of the public sector. Measures can be grouped into five categories: (i) goods and services market reforms, (ii) labour market measures, (iii) the new personal income tax, (iv) the General Law of Budgetary Stability together with the new financial systems for territorial governments and (v) the strengthening of the competition authority.

Among the most significant measures on goods and services markets are those based on the package approved in June 2000, which concerned especially network industries and which speeded up the calendar for full liberalisation. The electricity and gas sectors, for instance, have been completely liberalised from January 2003. Nevertheless, competition in net work industries is still underdeveloped and the incumbent operators retain a clear dominant position. As a result, these reforms should be closely monitored in the coming years to assess correctly their final impact in terms of market efficiency.

Regarding the labour market, the government enacted a reform of social benefits and employment legislation in May 2002. This reform encompassed tougher criteria for unemployment benefit eligibility, lower dismissal costs and the gradual phasing out of the special unemployment benefit scheme for the agricultural sector currently in force in the regions of Andalucía and Extremadura. Additionally, it became legitimated for the formerly unemployed aged over 52 to continue to receive benefits (or a part thereof) after commencing paid employment. However, this reform was partially amended in October 2002, especially in relation to dismissal costs while the removal of the unemployment benefit scheme for agricultural workers is at present under discussion between the government and the social partners. Other measures in this field have aimed at prolonging active working life by allowing workers to continue to work part-time while receiving a pension. Overall, these measures are targeted at increasing the participation rate and improving the functioning of the labour market. In general, these actions go in the right direction so as to improve labour functioning.

The recent reform of the personal income tax incorporates positive elements in relation to work and saving incentives. The fiscal treatment of saving devoted to private pension schemes is now more favourable. In turn, the effect on labour supply could take place through different channels: marginal tax rates are lowered and the fiscal wedge is reduced, especially for the lowest and the highest income brackets, while there are fiscal rebates for workers aged above 65 and tax incentives to promote geographical mobility.

In order to raise the female participation rate, a tax relief for working women with children has been introduced. Most of these objectives are closely linked with issues raised in the previous paragraph. Although the final effects of these measures will not become evident before some time, the reform is supply-side oriented and thus in accordance with the BEPGs for Spain.

With regard to the reforms of the institutional budgetary and fiscal framework, the implementation of the General Law of Budgetary Stability should ensure that the increased fiscal decentralisation following the new financial system for regional and local governments does not come at the expense of budgetary stability.

Finally, the strengthening of the competition authority stems from both a new legal status for the competition court, providing a higher degree of autonomy, and increased resources.

In general, these measures are welcome and respond quite directly to issues that have been raised in the BEPG country-specific recommendations addressed to Spain. Structural measures increasing market competition are of key importance in order to dampen down inflationary pressures. Nevertheless, given that the effects derived from structural measures take some time to be felt, a full evaluation is not yet possible. Moreover, although the overall assessment is positive, further structural measures appear needed in that market rigidities remain in several sectors.

7. Overall assessment of compliance with the SGP

The update broadly fulfils the revised "Code of conduct on the content and format of stability programmes". Nevertheless, the programme was delivered late. A wider breakdown on public expenditure components in line with the optional breakdown proposed in the code of conduct would have been desirable so as to fully assess the adjustment path during the projection period.

The baseline macroeconomic scenario considered in the programme seems realistic, growing around potential, although for 2003 real GDP growth is clearly on the high side compared to both the Commission and consensus forecasts.

Based on this macroeconomic scenario, the authorities target a balanced budget for 2003 and 2004 and small surpluses thereafter. While the objective for 2003 seems ambitious, overall the general government balances considered in the update appear attainable, respecting the close-to-balance or in surplus position. Additionally, the assessment of the fiscal targets envisaged in the "moderate-growth" scenario reveals a strong commitment of the Spanish authorities to the maintenance of fiscal consolidation through a non-negligible fiscal effort. In this respect, the implementation of the General Law of Budgetary Stability should underpin the achievement of these objectives. Finally, the debt-to-GDP ratio is expected to fall below 50% in both macroeconomic scenarios.

As a result, the programme complies with the SGP, maintaining a close-to-balance or in surplus position, with a comfortable margin, throughout the projection period.

Finally, the update complies in part with the country specific recommendations in the BEPG for Spain. The main weakness of the programme refers to the lack of relevant measures to ensure the sustainability of the public finances, given the impact of ageing.

Although the Spanish authorities have announced the intention of pursuing the reform of the public pension system in 2003, no detailed calendar is provided.

ANNEX 1. SUMMARY TABLES FROM THE 2002 UPDATED STABILITY PROGRAMME

Table A 0: Basic assumptions

	2002	2003	2004	2005	2006
Euro area short-term interest rate (annual average)	**3.3**	**2.8**	**3.2**	**-**	**-**
Euro area long-term interest rate (annual average)	**4.8**	**4.4**	**4.7**	**-**	**-**
USA: short-term (3-month money market)	-	-	-	-	-
USA: long term (10-year government bonds)	-	-	-	-	-
US$/€ exchange rate (annual average)	**0.94**	**0.98**	**0.97**	**-**	**-**
World GDP growth rate	-	-	-	-	-
World excluding EU, GDP growth	**3.0**	**3.9**	**4.2**	**-**	**-**
USA GDP growth	2.4	2.4	2.8	-	-
Japan GDP growth	-0.6	1.2	1.5	-	-
EU-15 GDP growth	**1.0**	**2.1**	**2.7**	**-**	**-**
Growth relevant foreign markets	**-**	**-**	**-**	**-**	**-**
World import volumes, excluding EU	**3.2**	**6.8**	**7.4**	**-**	**-**
World import prices (manufactured goods in USD)	-	-	-	-	-
Oil prices (Brent USD/barrel)	**25.5**	**24.1**	**22.5**	**-**	**-**
Non-oil commodities prices (in USD)	0.3	4.3	4.5	-	-

Table A 1. Growth and associated factors

	2001	2002	2003	2004	2005	2006
GDP growth at constant market prices (7+8+9)	**2.7**	**2.2**	**3.0**	**3.0**	**3.0**	**3.0**
GDP *level* at current market prices (€ bn.)	**651.6**	**689.0**	**729.2**	**771.5**	**816.1**	**863.3**
GDP deflator	**4.2**	**3.5**	**2.8**	**2.8**	**2.8**	**2.8**
HICP change	-	-	-	-	-	-
Employment growth [28]	**2.4**	**1.1**	**1.8**	**1.8**	**1.8**	**1.8**
Unemployment rate	10.5	11.3	11.0	10.7	10.3	10.0
Labour productivity growth						
Sources of growth: percentage changes at constant prices						
1. Household and NPISHs consumption expenditure	**2.6**	**2.2**	**2.9**	**2.9**	**2.9**	**2.9**
2. Government consumption expenditure	**3.1**	**3.0**	**3.0**	**3.0**	**3.0**	**3.0**
3. Gross fixed capital formation	**3.2**	**1.7**	**3.8**	**3.6**	**3.6**	**3.6**
4. Changes in inventories and net acquisition of valuables [29]	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
5. Exports of goods and services	**3.4**	**1.8**	**4.0**	**7.3**	**7.3**	**7.3**
6. Imports of goods and services	**3.5**	**1.7**	**4.4**	**7.3**	**7.3**	**7.3**
Contribution to GDP growth						
7. Final domestic demand	**2.8**	**2.1**	**3.2**	**3.1**	**3.1**	**3.1**
8. Change in inventories and net acquisition of valuables	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
9. External balance of G&S	**-0.1**	**0.0**	**-0.2**	**-0.2**	**-0.2**	**-0.2**

[28] Full-time equivalent, national accounts

[29] Contribution to GDP growth

Table A 2. General government budgetary developments

In % of GDP	2001	2002	2003	2004	2005	2006
Net lending by sub-sectors						
General government	**-0.1**	**-0.2**	**0.0**	**0.0**	**0.1**	**0.2**
Central government	**0.4**	**0.2**	**0.0**	**0.0**	**0.1**	**0.2**
State government	**-0.5**	**-0.5**	**0.0**	**0.0**	**0.0**	**0.0**
Local government	**0.0**	**0.1**	**0.0**	**0.0**	**0.0**	**0.0**
Social security funds	**0.8**	**0.8**	**0.5**	**0.4**	**0.4**	**0.4**
General government						
Total receipts	**39.8**	**39.8**	**39.8**	**39.8**	**39.8**	**39.8**
Total expenditures	**39.9**	**40.1**	**39.8**	**39.7**	**39.7**	**39.6**
Budget balance [4]	**-0.1**	**-0.2**	**0.0**	**0.0**	**0.1**	**0.2**
Net interest payments	**3.1**	**2.9**	**2.8**	**2.7**	**2.6**	**2.5**
Primary balance [30]	**3.0**	**2.7**	**2.8**	**2.7**	**2.7**	**2.7**
Components of revenues						
Taxes	21.9	21.9	21.7	21.7	21.9	22.0
Social contributions	13.6	13.6	13.7	13.7	13.7	13.7
Interest income	-	-	-	-	-	-
Other	-	-	-	-	-	-
Total receipts	39.8	39.8	39.8	39.8	39.8	39.8
Components of expenditures						
Collective consumption	-	-	-	-	-	-
Social transfers in kind	-	-	-	-	-	-
Social transfers other than in kind	-	-	-	-	-	-
Interest payments	3.1	2.9	2.8	2.7	2.6	2.5
Subsidies	-	-	-	-	-	-
Gross fixed capital formation	3.3	3.5	3.5	3.6	3.7	3.8
Other	-	-	-	-	-	-
Total expenditures	39.9	40.1	39.8	39.7	39.7	39.6

Table A 3. General government debt developments

In % of GDP	2001	2002	2003	2004	2005	2006
Gross debt level	**57.1**	**55.2**	**53.1**	**51.0**	**49.0**	**46.9**
Change in gross debt	**-3.4**	**-1.9**	**-2.1**	**-2.1**	**-2.1**	**-2.1**
Contributions to change in gross debt						
Primary balance	**-3.0**	**-2.7**	**-2.8**	**-2.7**	**-2.7**	**-2.7**
Interest payments	**3.1**	**2.9**	**2.8**	**2.7**	**2.6**	**2.5**
Nominal GDP growth	**-3.9**	**-3.1**	**-3.0**	**-2.9**	**-2.8**	**-2.7**
Other factors influencing the debt ratio	0.4	1.0	0.9	0.9	0.8	0.8
Of which: Privatisation receipts	-	-	-	-	-	-
p.m. implicit interest rate on debt	-	-	-	-	-	-

[30] Actual balance less net interest payments.

Table A 4. Cyclical developments

In % of GDP	2001	2002	2003	2004	2005	2006
GDP growth at constant prices	**2.7**	**2.2**	**3.0**	**3.0**	**3.0**	**3.0**
Actual balance	**-0.1**	**-0.2**	**0.0**	**0.0**	**0.1**	**0.2**
Interest payments	**3.1**	**2.9**	**2.8**	**2.7**	**2.6**	**2.5**
Potential GDP growth	-	-	-	-	-	-
Output gap	-	-	-	-	-	-
Cyclical budgetary component	-	-	-	-	-	-
Cyclically-adjusted balance	-	-	-	-	-	-
Cyclically-adjusted primary balance	-	-	-	-	-	-

Table A 5. Divergence from previous update

In % of GDP	2001	2002	2003	2004	2005
GDP growth					
Previous update	3.0	2.4	3.0	3.0	3.0
Latest update	2.7	2.2	3.0	3.0	3.0
Difference	-0.3	-0.2	0.0	0.0	0.0
Actual budget balance	-	-	-	-	-
Previous update	0.0	0.0	0.0	0.1	0.2
Latest update	-0.1	-0.2	0.0	0.0	0.1
Difference	-0.1	-0.2	0.0	-0.1	-0.1
Gross debt levels	-	-	-	-	-
Previous update	57.5	55.7	53.8	51.9	50
Latest update	57.1	55.2	53.1	51	49
Difference	0.4	0.5	0.7	0.9	1.0

Table A 6. Long-term sustainability of public finances [31]

In % of GDP	2001	2005	2010	2020	2030	2040	2050
Total expenditure	-	-	-	-	-	-	-
Old age pensions	8.4	7.9	8.0	8.5	9.9	12.0	13.0
Health care (including care for elderly)	-	-	-	-	-	-	-
Interest payments	-	-	-	-	-	-	-
Assumptions							
Labour productivity growth	-	-	-	-	-	-	-
Real GDP growth	-	-	-	-	-	-	-
Participation rates males (aged 20-64)	-	-	-	-	-	-	-
Participation rates females (aged 20-64)	-	-	-	-	-	-	-
Total participation rates (aged 20-64)	-	-	-	-	-	-	-
Unemployment rate	-	-	-	-	-	-	-

[31] Projections carried out by the Spanish authorities are different from those released by the EPC working group on ageing population.

ANNEX 2. A QUANTITATIVE ASSESSMENT OF THE SUSTAINABILITY OF PUBLIC FINANCES

This is the second assessment of the sustainability of Spanish public finances as part of the Stability and Growth Pact. The quantitative indicators are similar to those used last year, but have been adjusted in line with the recommendations of the Ageing Working Group to the EPC.

The stability programme contains a section assessing the sustainability of public finances including only a national budgetary projections for public pension expenditure. This projects a substantially lower increase in public spending on pensions compared with the EPC projections. According to the stability programme, the differences are due to the demographic scenario, which assumes a much higher initial population level and important differences as regards migration flows. This would result in a much more limited impact on the size of the population of working age compared with the projections used by the EPC. However, it is unclear whether the alternative demographic scenarios used in making the national projections would result in a permanently more ‘favourable’ demographic profile for Spain or whether it would simply delay the full demographic impact of ageing populations. While the differences between both exercises suggest that the public pension system in Spain may be very sensitive to population changes, the uncertainty on future demographic developments makes advisable to undertake a comprehensive reform by strengthening the link between contributory effort and benefits, in line with the guidelines on this issue considered in the programme.

In assessing the sustainability of public finances under the SGP, the Commission has to draw a balance between using national projections which may be more comprehensive and up to date, and the need to ensure comparability across countries. The Commission decided to use the national projections on pensions provided by the Spanish authorities in the stability programme, together with existing EPC projections for other age-related expenditures.

The table below presents the debt and budget balance development according to two different scenarios, a “programme scenario” and a “2002 situation scenario”. The ”programme scenario” is calculated on the following basis:

- government revenues are held constant at the ratio projected for 2006;

- the starting point for gross debt and the primary surplus are the 2006 levels reported in the programme.

The “2002 situation scenario” is based on the budgetary data for 2002 in the programme. It is that no budgetary adjustment occurs during the time frame of the stability programme: in other words the primary balance remains unchanged at its 2002 level until 2006. This allow one to gauge the impact on the sustainability of public finances of the proposed change in the underlying budget position during the programme.

According to the quantitative indicators, the risk of budgetary imbalances cannot be ruled out as debt levels would approach and breach the 60% of GDP reference value by the end of the projection period. It should be noted that the sharp increase in projected debt levels would occur between 2040 and 2050, which is consistent with the revised demographic projection whereby the impact of ageing populations is.

Alternative simulations using the EPC projections for pensions project that the debt ratio would increase to levels well above the 60% of GDP reference value.

Quantitative indicators on the sustainability of public finances

Main assumptions - baseline scenario (as % GDP)	2006	2010	2020	2030	2040	2050	changes
Total age-related spending	13.6	13.8	14.6	16.4	19.0	20.2	6.6
Pensions	7.9	8.0	8.5	9.9	12.0	13.0	5.1
Health care	5.6	5.8	6.1	6.5	7.0	7.2	1.6
Other age related expenditures	0.0	0.0	0.0	0.0	0.0	0.0	0.0
*Total non age-related spending**	23.5						
*Total revenues**	39.8						

* constant

Results (as % GDP)	2006	2010	2020	2030	2040	2050	changes
Programme scenario							
Debt	46.9	38.0	20.8	16.6	38.3	88.9	42.0
Net borrowing	0.2	0.2	0.5	-1.0	-4.6	-8.5	-8.7
2002 situation scenario							
Debt	44.6	35.6	18.2	13.6	34.4	83.7	39.1
Net borrowing	0.2	0.4	0.6	-0.9	-4.4	-8.2	-8.4

Tax gaps	T1*	T2**	T3***
Programme scenario	1.1	0.7	2.4
2002 situation scenario	1.0	0.6	2.4

* it expresses the constant difference between projected revenues and the revenues required to reach in 2050 the same debt to GDP ratio as the close to balance position holds for the whole projection period. P.m. debt to GDP at the end of the period: 6.6

** it expresses the constant difference between projected revenues and the revenues required to reach in 2050 a debt to GDP ratio equals to 40%.

*** It indicates the change in tax revenues as a share of GDP that guarantees the respect of the interteporal budget constraint of the government, i.e., that equates the actualized flow of revenues and expenses over an infinite horizon.