COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 18.2.2004
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Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) n°1466/97 of 7 July 1997

On the updated stability programme of Spain, 2003-2007

(presented by the Commission)

EXPLANATORY MEMORANDUM

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

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

Spain submitted its fifth and more recent update of the stability programme, covering the period 2003-2007, on 12 January 2004. The Commission services have carried out a technical evaluation of this updated programme, taking into account the information provided in accordance with the Code of Conduct[3], the Autumn forecasts as well as subsequent evaluations, the commonly agreed methodology for the estimation of cyclically-adjusted balances, the recommendations in the Broad Economic Policy Guidelines and the principles laid down in the Communication of the Commission to the Council of 27 November 2002 on strengthening the co-ordination of budgetary policies[4]. This evaluation warrants the following assessment:

> The information provided in the updated programme largely complies with the data requirements of the revised code of conduct on the content and format of stability and convergence programmes. However, the updated programme was presented six weeks beyond the 1 December deadline set in the revised code of conduct without any apparent justification.
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> The update confirms the budgetary strategy aiming at maintaining sound public finances defined by a budgetary position of close to balance or in surplus. Apart from incorporating the results of 2003, it does not present significant changes compared to the previous programme concerning both macroeconomic projections and fiscal targets.
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> Growth in 2003 is now estimated to have been lower than projected in the last year's programme (2.3% against 3%) mainly reflecting a more negative contribution of the external sector. For 2004 onwards, the programme envisages a return to sustained economic growth at around its trend rate (3%), which can be considered realistic and is broadly consistent with the Commission's autumn 2003 forecast. In line with the growth projections, employment creation is expected to strengthen from 1.8% in

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1 OJ L209, 2.8.1997. The documents referred to in this text can be found at the following web site http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm.

2 OJ C 124, 5.5.1999.

3 Revised Opinion of the Economic and Financial Committee on the content and format of stability and converge programmes, document EFC/ECFIN/404/01 – REV 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

4 COM(2002) 668 final, 27.11.2002.

2003 to slightly above 2% on average over the programme period. Inflation eased significantly throughout 2003, although by less than projected in the previous year's programme. Taking also into account the closing of the output gap over the programme period, the new inflation projections of 2.9% in 2004, down from an estimated 4% in 2003, and 2.6% in 2005-2007 for the GDP deflator appear on the low side.

Despite slower than expected growth and the effects of the reform of the personal income tax, the budgetary targets of the previous update were overachieved. The initial balanced budget target for 2003 now turns out to be an estimated surplus of 0.5%. This surplus is, however, based on the assumption of a balanced budget for territorial governments, for which very little information is currently available. The better than foreseen result can be explained by several factors, including the support of domestic demand to growth and the resilience of job creation, which helped sustain the GDP share of indirect taxes and social security contributions, respectively. In particular, the social security sub-sector is estimated to record a surplus of 0.9% of GDP compared to a projection of 0.5% in last year's programme. Lower than projected interest payments helped contain overall expenditure as a share of GDP.

The update retains a prudent balanced budget target for 2004 and small, though increasing, surpluses for the rest of the years in line with previous projections (0.1%, 0.2% and 0.3% of GDP for 2005, 2006 and 2007, respectively). By general government sub-sectors, central government excluding social security (i.e. the State and agencies such as the National Institute of Employment) is expected progressively to narrow its deficit from an estimated 0.4% of GDP in 2004 to 0.1% in 2007. The surplus in the social security accounts is projected to halve in 2004 to 0.4% of GDP, remaining unchanged thereafter. Territorial governments, within the framework of the General Law of Budgetary Stability, are expected to record balanced budgets throughout the programme period.

The programme envisages keeping the ratio of revenues and non-interest expenditure-to-GDP constant throughout the programme period at 40% and 37.4% respectively, while allowing for an increase in the capital expenditure share and a corresponding decrease in the share of primary current expenditure. The resulting primary surpluses, virtually unchanged at 2.6% of GDP during the programme period, are consistent with a steady decline in the debt-to-GDP ratio, from 51.8% in 2003 to slightly less than 44% in 2007. Given the rather conservative balanced budget objective for 2004, the targets for the subsequent years appear cautious, providing margin against less positive developments in the economy. Since budget targets have been set prudently and the path for the GDP deflator can be considered optimistic, a faster debt reduction cannot be excluded.

Based on trend GDP calculated by the Commission services[5] from the programme's projected actual growth, the cyclically-adjusted budget balance deteriorates by a half-percentage point to 0.1% of GDP in 2004. This reflects the better than expected result estimated for 2003 and the maintenance of the previous year's balanced-budget

[5] The commonly agreed methodology based on the production function approach is not yet applied to Spain, pending the resolution of estimation problems. Therefore, cyclically adjusted balances are calculated based on the Hodrick-Prescott filter methodology.

target for 2004. For the remaining programme period, the cyclically-adjusted budget balance improves by 0.2 percentage points to a surplus of 0.3% of GDP in 2007. The Commission's autumn forecast yields slightly more favourable estimates for 2004 and 2005. In the light of the result for 2003, an overachievement of the budgetary target for 2004 seems likely. Accordingly, the budgetary stance, including its evaluation in underlying terms, appears sufficient to ensure the maintenance of the "close-to-balance" objective of the Stability and Growth Pact throughout the period with a comfortable safety margin.

The programme highlights measures recently adopted to increase the quality of public finances, in particular on the expenditure side. The General Budgetary Law, approved in November 2003, reforms the budgetary procedure with the aim of enhancing the transparency and efficiency of public expenditure including the introduction of a system of budgeting by objectives and monitoring of the results. The General Subsidies Law seeks to improve the use of subsidies by providing for systematic cost/benefit reviews. Finally, the General Taxation Law simplifies and reforms the legal framework of tax management including the relationship between taxpayers and tax administration.

On the basis of current policies, as reflected in the situation of public finances and its medium-term evolution showed in the programme as well as the long-term projections for age-related expenditure provided in the programme, Spain seems relatively well placed to cope with the budgetary costs of ageing populations. However, such long-term projections of expenditure are very sensitive to the underlying assumptions, in particular on demography, where the impact of immigration is especially difficult to assess, and on the link between the average pension benefit and average productivity per worker, where a steady reduction of the former relative to the latter may be difficult to achieve. Moreover, even under relatively favourable assumptions on these two critical issues, the increase of pension expenditure in the long-term remains very large. Therefore, current policies need to be supplemented by measures to prevent the emergence of unsustainable trends, in particular a comprehensive reform of the pension system.

While a number of positive measures were recently adopted, including incentives for continued employment of female and older workers, the creation of a supplementary pension fund for civil servants and tax incentives for private pension provision, the economic policies as reflected in the updated programme are partly consistent with the recommendations of the Broad Economic Policy Guidelines, in that steps to implement a major pension reform are not taken. Notwithstanding these measures and the renewal of the multi-partisan agreement "Pacto de Toledo", aiming at ensuring the future financial viability of the public pension system, the calendar for the reform, specifically by aligning more closely contributions and benefits, is not yet defined.

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) n°1466/97 of 7 July 1997

On the updated stability programme of Spain, 2003-2007

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[6], and in particular Article 5 (3) thereof,

Having regard to the recommendation of the Commission, after consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [9 March 2004] the Council examined Spain's updated stability programme, which covers the period 2003-2007. The updated programme largely complies with the data requirements of the revised “code of conduct on the content and format of stability and convergence programmes”. However, the update was submitted six weeks after the deadline set in the code of conduct without any apparent justification.

The budgetary strategy underlying the update, essentially unchanged from the previous programme, aims at maintaining sound public finances defined by a budgetary position of close-to-balance or in surplus. To this end, the programme envisages keeping the ratios of revenue and non-interest expenditure-to-GDP constant throughout the programme period, at 40% and 37.4% respectively, while allowing for an increase in the GDP share of capital expenditure and a corresponding decrease in the current expenditure share. The resulting primary surpluses are consistent with a balance or surplus on the overall balance and a steady decline in the debt ratio over the programme period.

The update projects real GDP growth to recover from an estimated 2.3% in 2003 to 3% for 2004 onwards. Employment is expected to strengthen from 1.8% in 2003 to slightly above 2% on average over the programme period. Inflation measured by the GDP deflator is projected to decline rapidly from 4% in 2003 to 2.9% in 2004 and to stabilise at 2.6% thereafter. On the basis of currently available information, the macroeconomic scenario underlying the update seems realistic. In particular, the rate of growth of the economy in the medium term is broadly in line with the prevailing

[6] OJ L 209 of 2.8.1997.

estimate of potential growth. By contrast, the projections for inflation, particularly the sharp fall foreseen for 2004, seem to be on the optimistic side.

Notwithstanding the surplus estimated for 2003, the update retains an objective of balance for 2004 and small, though increasing, surpluses (0.1%, 0.2% and 0.3% of GDP for 2005, 2006 and 2007, respectively) for the rest of the years in line with previous projections. In cyclically-adjusted terms, based on Commission services' calculations, the balance deteriorates by half a percentage point to 0.1% of GDP in 2004. This reflects the better than expected result estimated for 2003 and the maintenance of the previous year's balanced-budget target. For the remaining programme period, the cyclically-adjusted budget balance improves by 0.2 percentage points to a surplus of 0.3% of GDP in 2007.

The budgetary targets presented in the programme are consistent with a position of close-to-balance or in surplus in each year of the projection. The risks can be considered broadly balanced: in fact, the targets, especially the balanced budget for 2004, appear cautious and may be overachieved giving margin against less positive developments in the economy. Therefore, the budgetary stance can be considered sufficient to ensure the maintenance of the SGP's close-to-balance or in surplus objective throughout the programme period. For the same reasons, it also provides a sufficient safety margin against breaching the 3% of GDP deficit threshold.

On the basis of current policies, as reflected in the situation of public finances and its medium-term evolution showed in the programme as well as the long-term projections for age-related expenditure provided in the programme, Spain seems relatively well placed to cope with the budgetary costs of ageing populations. However, given the risks surrounding such long-term projections of expenditure and the large increase of pension expenditure projected in the very long term, current policies need to be supplemented by measures to prevent the emergence of unsustainable trends, in particular a comprehensive reform of the pension system.

The economic policies as reflected in the updated programme are partly consistent with the recommendations of the Broad Economic Policy Guidelines, specifically those with budgetary implications. In particular, concerning the recommendations to address the challenge of ensuring the long-term sustainability of public finances in the face of population ageing, although a number of positive measures have recently been adopted, no steps to implement a major pension reform have been taken.