STABILITY PROGRAMME UPDATE

SPAIN

2004 - 2008

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1. INTRODUCTION. ECONOMIC POLICY OBJECTIVES

This is the **sixth Update to Spain's Stability Programme**, drafted annually in the framework of Community supervision and coordination of economic policies. This Update describes the general lines of fiscal and budgetary policy which the Spanish government plans to implement in the coming years.

The content of the Update conforms to the provisions of the Code of Conduct on the content and format of stability and convergence programmes approved by the ECOFIN Council in July 2001 and responds to the specific recommendations for Spain contained in the Broad Economic Policy Guidelines for the 2003-2005 period. The budgetary projections in the Update are fully compatible with the Stability and Growth Pact and with the budgetary objectives approved by Parliament.

Objectives of Spain's economic policy

The chief goal of Spain's economic policy is to increase citizens' well-being. This requires an economic environment of sustained growth in which it is possible to attend to collective needs and foster greater social cohesion, while responding to the challenges of increasing economic integration, within a framework of social and environmental sustainability.

This goal can only be attained through a pattern of balanced, lasting growth which is underpinned by progress in productivity and employment so as to improve the Spanish economy's competitiveness. To reach this goal, Spain's economic policy is structured around three basic axes: budgetary stability, a boost to productivity and the transparency and quality of the regulatory framework.

Budgetary stability is a key factor for a sustained growth situation that fosters investment and innovation while contributing to an increase in the growth potential. Moreover, in the short term, budgetary stability strengthens the stabilising role of the budget throughout the economic cycle by generating surpluses in "good times" with which to deal with adverse cyclical developments.

In the medium term, budgetary stability contributes to improving the quality and sustainability of public finances. It stimulates rational expenditure and efficient resource assignment, thus releasing resources for use where they can have the greatest impact on productivity and social cohesion, while also enhancing the ability to respond to the budgetary consequences of demographic changes.

Budgetary stability is also a key factor in intergenerational equity, since it means that the burden of current policies will not fall on future generations, thus preserving the ability to provide public services and implement income redistribution policies in the future.

The effort to increase **productivity** will be implemented via a multi-dimensional strategy on the supply side in order to take advantage of the dynamic, technical and assignment gains deriving from more competitive product markets and more efficient factor markets. Innovation, improvements in education and infrastructures, and a climate that is favourable to business and entrepreneurship will be the fundamental elements in the new orientation of the economic growth model. The battery of measures in place or being implemented seeks to invert the sharp deceleration in Spain's productivity in the second half of the 1990s that has slowed the Spanish economy's progress towards real convergence.

Finally, greater **transparency** improves the performance of the economy and its competitiveness, and it contributes to efficiency in the public sector. This principle is applied firstly to the budget itself, thus creating a predictable framework for private-sector players, and involves providing extensive information about public accounts, above and beyond the items that directly affect the budget balance in national accounting terms. This practice will be maintained in the future under the new Budget Stability and Transparency Law.

Initiatives are also being taken to enhance the dissemination and quality of the large volume of economic information produced by the public sector. Transparency also applies to regulatory procedures, which will include an economic justification of the measures to be adopted in addition to an assessment of their budgetary impact. Application of the transparency principle will also mean that the public sector will apply private sector good governance principles in decision-making, as reflected in the recently-presented Code of Good Governance.

2. CURRENT ECONOMIC SITUATION AND OUTLOOK

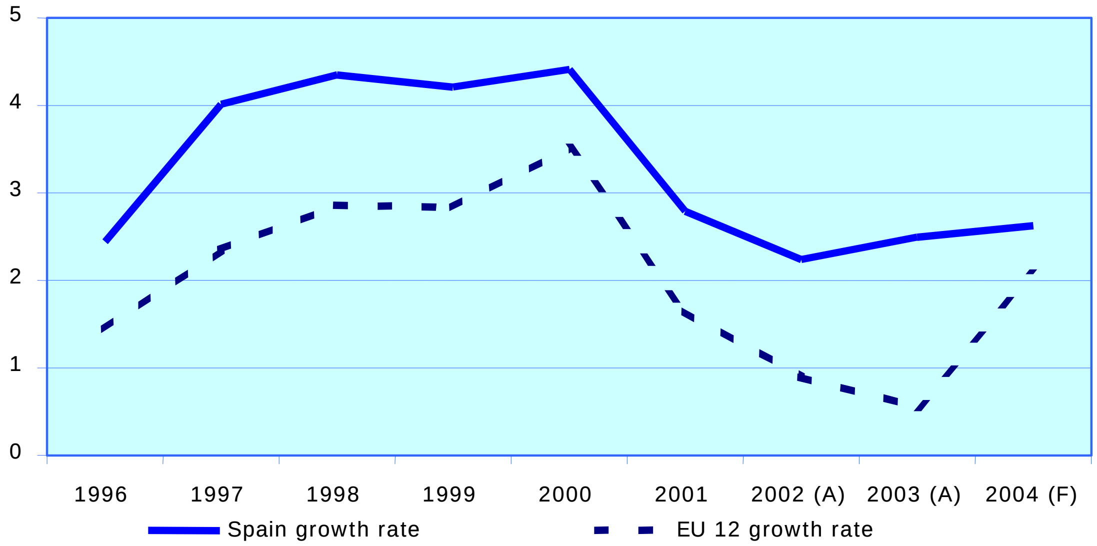
2.1. The Spanish economy in 2003-2004

The Spanish economy attained **2.5% growth in 2003**, three-tenths of a point more than in 2002, thus marking an end to the downswing that had commenced in 2000. The acceleration was due to improved performance by domestic demand, which offset the net negative contribution by the external sector.

The pace of GDP growth has accelerated moderately and is expected to be **2.6%**; this is slightly lower than the projections released in the first half of the year, due to the sudden increase in oil prices and the deterioration of the external sector.

Domestic demand (basically household spending and investment in homes) was the growth engine in 2003 and maintained this role in 2004. Good labour market performance, with job creation accelerating strongly, and low interest rates due to the single monetary policy are key factors behind this performance.

Figure 1
Real convergence of the Spanish economy
Real annual GDP growth rates



Source: INE, European Comission and Ministry of Economy and Finance

(A) Advance (F) Forecast

The main new development in 2004 was the sharp acceleration in investment in equipment to close to 10% in the third quarter. The recovery in corporate finances, optimistic expectations about economic developments and favourable lending conditions, plus the need to improve competitiveness, explain the acceleration in demand for equipment by Spanish companies and the fact that the trend is expected to continue.

Construction, the other major component of gross fixed-capital formation, has been growing at a very rapid rate, due mainly to strong demand for housing. This pace of growth may ease somewhat in the future, which will lead to a better balance in the Spanish economy's growth pattern.

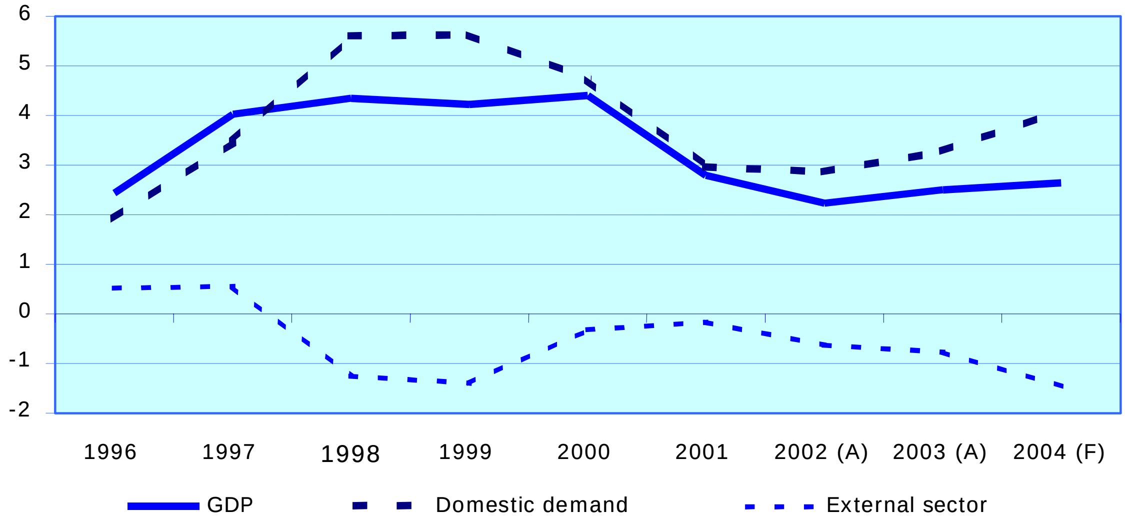
Domestic demand is expected to account for over four percentage points of GDP growth, while the external sector's net negative contribution will be nearly 1.5 points.

The external sector's net contribution declined slightly in 2003 and 2004; this can be attributed, on the one hand, to vigorous imports, partly reflecting strong domestic demand, and, on the other hand, to the slow recovery in our main foreign markets, primarily the euro zone, which represents 60% of our exports of goods. Moreover, the inflation differential with this area might be affecting the Spanish economy's competitiveness. More recently, exports outside the Monetary Union have performed well as a result of dynamic growth in some of those markets, which offset the effect of appreciation in the real effective exchange rate vis-à-vis those markets. Nevertheless, this recovery was not sufficient to offset the effect of domestic demand on imports.

Figure 2

Composition of growth

Contribution to GDP growth



Source: INE and Ministry of Economy and Finance

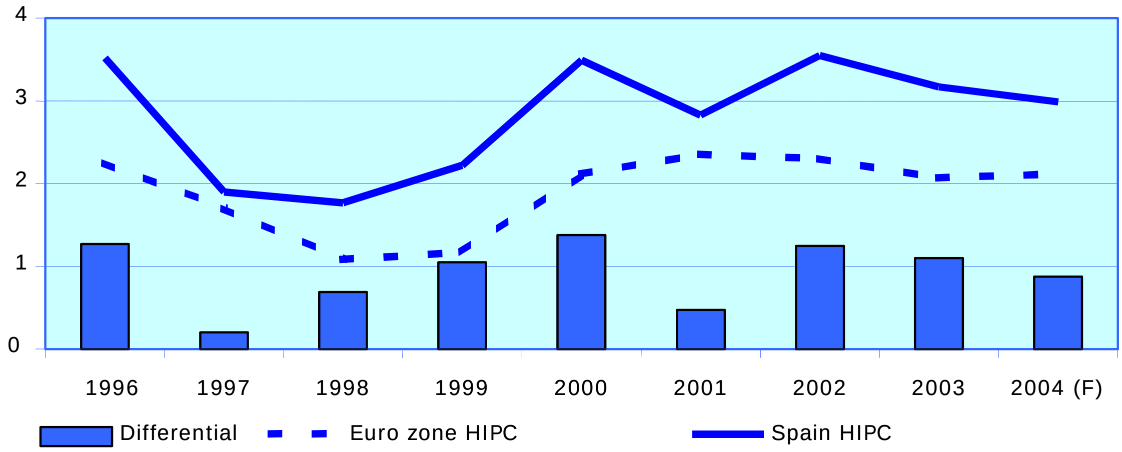
(A) Advance (F) Forecast

With regard to **price performance**, the inflation rate has been declining since 2002 in annual average terms, but this has been limited by certain adverse circumstances, most notably the surge in oil prices in 2004; however, the inflation rate (in terms of harmonised ICP) and the core inflation rate are expected to be lower than in 2003 in average terms. The inflation differential with respect to the euro zone was around one percentage point in 2003 and 2004, but has been narrowing in annual average terms. The GDP deflator has also decelerated, due partly to the trend in external sector deflators.

Figure3

Spain-EMU price differential

% annual change and percentage points



Source: INE and Eurostat

(F) Forecast

The **labour market** performed well in 2003 in terms of job creation, which amounted to 1.7% in terms of full-time equivalent posts according to the national accounts. This rate is expected to accelerate to 2.1% in 2004. The unemployment rate fell slightly in 2003, to 11.3% of the working population, according to the Labour Force Survey (LFS), and is falling faster in 2004; it is expected to be under 11% by year-end. In this context it should be emphasised that the unemployment rate was 10.5% in the third quarter, the lowest level since the first quarter of 2002.

The Spanish economy's **borrowing requirement** increased in terms of GDP in 2003 and is expected to do so again in 2004 as a result, amongst other factors, of the increase in crude oil prices.

2.2. Forecasts for 2005-2008: baseline scenario

International assumptions

In accordance with the Code of Conduct for drafting Stability Programmes, the basic international assumptions drafted by the European Commission must be used to ensure comparability.

Table 1 BASIC ASSUMPTIONS			
	2004	2005	2006
Growth			
World GDP excluding EU (a)	5.7	4.8	4.6
- USA	4.4	3.0	2.9
- Japan	4.2	2.1	2.3
- EU	2.5	2.3	2.4
World imports, excluding EU (a)	11.6	8.8	8.3
Change in euro effective nominal exchange rate (%)	2.8	0.6	0.3
Year average $/€ exchange rate	1.23	1.24	1.24
Euro zone interest rates (annual average)			
Short-term rates	2.1	2.6	3.5
Long-term rates	4.2	4.6	4.8
Commodity prices			
Crude oil ($US/barrel)	39.3	45.1	40.1
Non-oil commodity prices in $US (% change)	12.9	-2.9	-0.5

(a) Real percentage change.
SOURCE: European Commission.

A key point of the Commission's forecasts is that it expects worldwide growth (excluding the EU) to decelerate in 2005 and 2006, and more intensely in the US and Japan. In the case of the EU, the slow-down expected for 2005 will be temporary and small. This lower growth will also be reflected in world trade, which will decelerate in 2005 and 2006.

Crude oil prices are an important factor in these projections. The European Commission projects an average price of $US 39.3/barrel in 2004, rising to over $US 45 in 2005 and falling to an average of $US 40 in 2006. In view of the recent decline in the oil price and its strong volatility, this variable might perform better than initially expected, which would have a positive impact on the macroeconomic scenario on which this update is based.

As for exchange rates, following the euro's effective appreciation in 2004, the Commission expects it to stabilise in 2005 and 2006. Regarding interest rates, the Commission projects that both short- and long-term rates will begin to rise in 2005.

Macroeconomic forecasts: baseline scenario

Forecasts for 2005

The baseline scenario in Table 2 is based on the Commission's assumptions in Table 1 and assumes 2.6% growth in 2004. This scenario gives **2.9% growth in 2005**, which is 0.1 points lower than envisaged in the macroeconomic projections for the 2005 Budget and in the previous Stability Programme Update but 0.3 points higher than the growth projected for 2004. It is also 0.9 points higher than projected euro zone growth in 2004 and over 0.5 points higher than the expected growth in the EU overall. Moreover, if oil prices perform better than the Commission expects, the Spanish economy could attain over 3% growth in 2005.

Table 2
MACROECONOMIC SCENARIO

	2003	2004	2005	2006	2007	2008
GDP by demand component (% real change)						
Final domestic consumption expenditure	3.1	3.5	3.2	3.1	3.0	3.0
- Households (a)	2.9	3.3	3.1	3.0	2.9	2.9
- General government	3.9	4.2	3.5	3.3	3.3	3.3
Gross capital formation	3.4	5.3	5.5	4.7	4.2	4.0
- Gross fixed capital formation	3.2	4.5	5.7	4.8	4.3	4.1
- Equipment and other products	1.7	4.6	8.0	6.7	6.2	6.0
- Construction	4.3	4.3	3.9	3.3	2.7	2.4
- Change in stocks (contribution to GDP growth)	0.1	0.2	0.0	0.0	0.0	0.0
Domestic demand	**3.2**	**4.0**	**3.8**	**3.5**	**3.3**	**3.3**
GDP growth contribution of domestic demand	3.3	4.1	4.0	3.7	3.5	3.5
Exports of goods and services	2.6	5.1	6.4	6.8	6.9	6.9
Imports of goods and services	4.8	8.9	8.5	7.5	7.0	6.9
Net foreign balance (contribution to GDP growth)	-0.8	-1.5	-1.0	-0.7	-0.5	-0.4
GDP	**2.5**	**2.6**	**2.9**	**3.0**	**3.0**	**3.0**
- GDP at current prices (€ billion)	744.8	793.2	846.3	902.5	959.3	1,016.1
- GDP at current prices (% change)	6.6	6.5	6.7	6.6	6.3	5.9
Output gap	0.2	-0.2	-0.2	-0.2	-0.1	0.0
PRICES (% change)						
GDP deflator	4.0	3.8	3.7	3.5	3.2	2.8
Final household consumption expenditure deflator	3.1	3.0	3.1	2.9	2.7	2.4
LABOUR COSTS AND FULL-TIME EQUIVALENT EMPLOYMENT (% change)						
Remuneration (labour cost) per employee	4.2	3.8	4.1	3.7	3.4	3.1
Total employment	1.7	2.1	2.1	2.2	2.1	2.0
Salaried employment	2.3	2.1	2.2	2.5	2.3	2.2
Employment: change in '000	274.5	342.3	342.9	368.8	367.9	353.9
Productivity per occupied worker	0.7	0.5	0.8	0.8	0.9	1.0
Unit labour cost	3.5	3.3	3.2	2.9	2.5	2.1
Real unit labour cost	-0.5	-0.5	-0.4	-0.6	-0.6	-0.7
Pro memoria						
Unemployment (% of labour force)	11.3	10.9	10.4	10.1	9.8	9.6
Unemployed ('000)	2,127.4	2,085.8	2,040.6	2,012.7	1,990.0	1,984.2
OTHER VARIABLES						
Saving by households and NPISH (%GDI)	10.6	10.4	10.3	10.3	10.2	10.1
FOREIGN BALANCE (% GDP)						
Trade balance (fob -fob)	-5.2	-6.3	-6.9	-7.1	-7.3	-7.4
Current account balance	-3.3	-4.8	-5.3	-5.5	-5.6	-5.7
Net lending (+) or borrowing (-) vs. rest of world	-2.1	-3.6	-4.3	-4.5	-4.6	-4.8
PUBLIC SECTOR						
Financing capacity or need	0.4	-0.8	0.1	0.2	0.4	0.4
Public debt (% GDP)	50.7	49.1	46.7	44.3	42.0	40.0

(a) Includes NPISH (Non-Profit Institutions Serving Households)

Source: Ministry of Economy and Finance

Domestic demand is expected to ease slightly, to 3.8% growth, and the external sector's negative contribution is projected to decline to -1.0 percentage point. The slight deceleration in domestic demand from the 4%

projected for 2004 is the result of lower growth in private and public spending and in investment in construction, which will be partly offset by an acceleration in investment in equipment and other products.

Private consumption will continue to outgrow GDP due, among other factors, to continuing good employment performance. However, this variable is expected to decelerate slightly due to a slower rate of decline in Spanish households' saving rate. Final consumption by government will maintain a decelerating trend from the high rates attained in recent years.

Investment in fixed capital is expected to accelerate as a result of more buoyant investment in equipment and other items, offset partly by a slow-down in construction growth. The positive performance by equipment will be due to continuing strong growth in domestic demand, accelerating exports in line with the Commission's projections for the European Union overall, sound corporate finances, the still-favourable orientation of single monetary policy, and the need to make technological changes and improve productivity in an increasingly competitive international environment. The deceleration in construction is due to lower growth in housing demand following the boom of recent years. Rising interest rates plus growing house price inertia will tend to dampen demand growth. However, civil engineering is expected to expand more steadily due to the priority given to infrastructure in government budgets and the availability of Community funds to co-finance projects; accordingly, the sector's deceleration should be moderate.

Spain's **exports of goods and services** will continue to accelerate due to relatively high growth in imports inthe euro zone in 2005 and a degree of containment in the euro's appreciation, which has been impairing price competitiveness of Spanish products. The external sector's lower negative contribution to growth will be due to an improvement in exports plus a slow-down in imports (which will nevertheless continue to grow much faster than exports); tourism is also expected to perform more favourably, in line with the recovery observed in the final months of 2004.

As for **prices**, the projection that crude oil prices will rise to $US 45.1 per barrel in 2005 makes it likely that the decline in the private spending deflator will halt temporarily (it is expected to rise by around 3% in 2004 and 2005). The projection for the GDP deflator in 2005 is that the deceleration observed in 2003 and 2004 will continue if, as expected, the increase in crude oil prices is not passed on in full to domestic prices and incomes. Logically, if oil prices perform better than the Commission expects, this will have a favourable impact on price performance in 2005.

The **labour market** is expected to maintain the high pace of job creation (2.1% year-on-year), while productivity per occupied worker is expected to accelerate, thus partly reflecting higher investment in equipment and civil engineering, a subsector in which apparent labour factor productivity is greater than in home-building. The continuing growth in employment plus a deceleration in working population growth due to internal demographic factors and lower immigration pressure will make it possible to continue reducing the unemployment rate.

The Spanish economy's **current account balance** has deteriorated steadily in recent years, from a surplus amounting to 0.4% of GDP in 1997 to a deficit of over 4% in 2004. The current account deficit is expected to continue to widen in 2005, basically as a result of strong domestic demand.

Forecasts for the rest of the period (2006-2008)

In the years after 2005, economic growth is expected to be **3%** in real terms, while the GDP deflator will decelerate and the composition of growth will become more balanced as a result of a lower contribution from domestic demand and a smaller negative contribution from the external sector. In this scenario, the Spanish economy will return to its GDP trend by 2008.

During this period, household and government consumption **spending** will decelerate, while the public sector saving rate will rise due to the budgetary stability objective. Household savings will increase in absolute terms, although more slowly than disposable income, leading to a gradual decline in their saving rate. This performance reflects the trend to keep a relatively high rate of consumption spending growth, nuanced by the advisability of improving household finances, in a scenario in which interest rates will probably be slightly higher than at present.

In the next few years, **investment in equipment** and other items is also expected to maintain a relatively rapid pace of growth, while **investment in construction** will slow. Regarding the former, the trend should contribute to enhancing the Spanish economy's productivity as more advanced technological equipment is brought into operation. Concerning construction, its rapid pace of growth observed in recent years can be expected to ease. The net effect of these trends is expected to be an increase in investment's weight within GDP.

As a result of the trend in its components, **domestic demand** will slow, but will continue to grow at slightly over 3% in 2008. The growth rates of imports and exports are also expected to converge in this period, thus steadily reducing the external sector's negative contribution to growth.

Since GDP is growing relatively fast, a strong pace of **job** creation is expected (around 2% per year) while productivity per occupied worker will continue to accelerate. Expected growth rates in employment and the increase in the working population will lead to a reduction in unemployment, which will be close to 9.5% in 2008.

The GDP **deflator** is expected to continue decelerating and to be growing by slightly under 3% in 2008. The private consumption spending deflator is expected to follow a similar course, with its growth rate below 2.5% by 2008. This trend in the two deflators will be accompanied by a sharper slow-down in unit labour costs due to the combination of an expected moderation in wages with higher growth in productivity per worker.

The Spanish economy's **financing needs** will continue on a path that reflects buoyant domestic demand and the expected steady recovery in the terms of trade. The overall outcome will be a slight increase in the country's borrowing requirement to 4.8% of GDP by the end of the period.

3. BUDGETARY PROJECTIONS

3.1. Fiscal policy guidelines

The general principle guiding fiscal policy is that of budgetary stability over the full economic cycle. In compliance with the requirements of the Budget Stability Laws, on 4 June 2004 the Spanish Cabinet established the budget objectives for 2005-2007, and they were approved by the Spanish Parliament later that month[1]. These objectives mean that the Public Administrations will generate growing budget surpluses, rising from 0.1% of GDP in 2005 to 0.4% in 2007, distributed among the various administrations as shown in the table below, with which this Stability Programme Update is consistent.

Table 3
BUDGETARY OBJECTIVES
APPROVED BY THE SPANISH PARLIAMENT
(% of GDP) 2005-2007

	2005	2006	2007
CENTRAL GOVERNMENT	0.2	0.3	0.4
State	-0.5	-0.4	-0.3
Social security	0.7	0.7	0.7
AUTONOMOUS COMMUNITIES	-0.1	-0.1	0.0
LOCAL GOVERNMENTS	0.0	0.0	0.0
GOVERNMENT TOTAL	0.1	0.2	0.4

Secondly, fiscal policy contributes to restoring a balance in **Spain's growth pattern** through a budget composition that gives priority to those items with the greatest impact on productivity, by stepping up public investment in infrastructure, human capital and knowledge. This public sector investment effort follows a medium-term approach, and it will be implemented gradually in the next few years.

Finally, fiscal policy has a strong social orientation which enhances this dimension of general economic policy and is based on strengthening the budgetary allowances for protection against the contingencies of old age, disability, unemployment, etc., as well as support for families and housing policy.

[1] Plenary session of the Congress on 17 June and of the Senate on 22 June 2004.

3.2. Budgetary projections (2004-2008)

Following the surplus of 0.4% of GDP that was attained in 2003, the Spanish Public Administrations are expected to end 2004 with a deficit equivalent to approximately 0.8% of GDP. However, this deficit is not due to a change in the government's fiscal policy stance but, rather, to the government's decision to take on certain payment commitments not initially included in the 2004 Budget, such as RENFE's debt, and the need to make accounting adjustments that were not envisaged in the 2004 Budget, such as that relating to RTVE's deficit. Excluding these one-off expenditure items, the budget would be practically balanced.

Table 4
CHANGE IN PUBLIC REVENUES AND EXPENDITURE
(National Accounting, ESA-95. year-on-year change)

	2003 (A)	2004 (F)	2005 (F)	2006 (F)	2007 (F)	2008 (F)	Average 06-08
Total revenues	7.1	6.2	6.9	6.8	6.6	6.2	6.5
- Tax revenues	7.2	6.8	7.0	6.7	6.5	6.1	6.5
Total expenditure	5.7	9.3(*)	4.5(*)	6.5	6.3	6.0	6.3
- Current	6.1	7.4	5.7	6.3	6.1	5.8	6.1
- Capital	3.2	23.0(*)	-3.2(*)	8.0	7.8	7.2	7.7
Gross capital formation	6.0	14.5(*)	2.5(*)	8.1	7.7	7.5	7.8

(A) Advance
(F) Forecast
(*) Affected by one-off measures in 2004
Source: Ministry of Economy and Finance

Projected revenue and expenditure growth in the period is shown in Table 4, which reveals that the rate of growth in total expenditure is similar to that of nominal GDP, except in 2004 and 2005. Those two years are affected by the non-recurring items in 2004 (mentioned above), which are mostly classified by National Accounting as capital expenditure (either gross capital formation or transfers). Capital spending growth is expected to outstrip total Public Administration spending during the period, with the exception of 2005 (for the aforementioned reasons). This trend will enable the public sector to contribute higher productivity to the economy, thus increasing the stock of public capital.

Revenues are expected to fall gradually as a result of the expected lower nominal GDP growth in the coming years due to slower price inflation.

Comparing these projections with GDP growth leads to Table 5, which shows that **public spending** will stay approximately constant at 39.8% of GDP during the period. In contrast, because of growth in economic activity and the real progressive nature of the tax system, **revenues** will increase slightly, from 39.9% of GDP in 2005 to 40.2% in 2008.

The assumptions about interest rates plus the reduction in public debt as a percentage of GDP suggest that **interest payments** will continue to decline as a percentage of GDP in 2005-2008, although not as quickly as in the past. Interest payments will decline from 2.3% of GDP in 2004 to 1.9% in 2008. In line with government strategy, the resources that are released as a result will be allocated to budgetary items with a greater impact on potential growth or with greater social returns, while adhering to the target of keeping public spending stable in terms of GDP. In this connection, **gross fixed capital formation** will rise from 3.5% of GDP in 2004 (excluding the State's assumption of RENFE's infrastructure debt) to 3.8% in 2008.

Table 5
PUBLIC ADMINISTRATIONS
(National Accounting, ESA-95. % of GDP)

	2003 (A)	2004 (F)	2005 (F)	2006 (F)	2007 (F)	2008 (F)
Total revenues	40.0	39.9	39.9	40.0	40.1	40.2
- Tax revenues	36.2	36.3	36.4	36.4	36.5	36.6
Direct	10.6	10.5	10.6	10.6	10.6	10.6
- Households	7.2	7.1	7.1	7.1	7.1	7.1
- Companies	3.4	3.4	3.5	3.5	3.5	3.5
Indirect	12.0	12.0	12.1	12.1	12.2	12.2
Social contributions	13.7	13.7	13.7	13.7	13.8	13.8
Total expenditure	39.6	40.6	39.8	39.8	39.8	39.8
- Current	34.8	35.1	34.8	34.7	34.6	34.6
Interest charges	2.5	2.3	2.1	2.0	1.9	1.9
- Capital	4.8	5.5	5.0	5.1	5.2	5.2
Gross capital formation	3.5	3.7	3.6	3.6	3.7	3.8
General govt. surplus (+) or deficit (-)	0.4	-0.8	0.1	0.2	0.4	0.4
Central government	0.7	-1.0	0.2	0.3	0.4	0.4
State and autonomous agencies	-0.3	-1.8	-0.5	-0.4	-0.3	-0.3
Social Security	1.0	0.8	0.7	0.7	0.7	0.7
Territorial government	-0.3	0.2	-0.1	-0.1	0.0	0.0
Autonomous Communities	-0.2	0.2	-0.1	-0.1	0.0	0.0
Local government	-0.1	0.0	0.0	0.0	0.0	0.0
Gross debt	50.7	49.1	46.7	44.3	42.0	40.0
Primary surplus	2.9	1.5	2.2	2.2	2.3	2.3
Gross saving	4.4	4.1	4.4	4.6	4.8	4.9

(A) Advance
(F) Forecast
Source: Ministry of Economy and Finance

As a result of the aforementioned performance by public revenues and expenditure, the Spanish Public Administrations will go **from a deficit of 0.8% of GDP in 2004 to a surplus of 0.4% in 2008**, in keeping with their objective of budgetary stability. The overall surplus of the Public Administrations will be due to the Social Security, which is expected to attain a surplus of 0.8% in 2004 and 0.7% in the rest of the period. This situation is the result of high revenues due to growth in employment and moderate growth in the number of pensioners and welfare beneficiaries, due to the relatively small number of people aged close to 65 in Spain's population structure.

Following the deficit incurred in 2004 by the **State and its agencies** as a result of one-off measures, that deficit will narrow steadily to reach 0.3% in 2008. At the same time, the **Autonomous Communities**' surplus due to transfers to Andalusia will be followed by deficits of 0.1% in 2005 and 2006 and a balanced budget in 2007 and 2008. Finally, **local governments** will attain a balance overall during the projection period.

Based on projected budgetary performance and the nominal GDP growth projections in this Update, the **public debt** is expected to continue declining **as a percentage of GDP** to reach 40% in 2008, from 49.1% expected in 2004. Table 6 shows the contribution by the various factors to the reduction in the public debt/GDP ratio.

Table 6
CHANGES IN PUBLIC DEBT LEVEL

	2003 (A)	2004 (F)	2005 (F)	2006 (F)	2007 (F)	2008 (F)
Debt	50.7	49.1	46.7	44.3	42.0	40.0
Change in debt	-3.7	-1.6	-2.5	-2.4	-2.2	-2.1
Contributions to change in debt						
Primary balance	-2.9	-1.5	-2.2	-2.2	-2.3	-2.3
Interest payments	2.5	2.3	2.1	2.0	1.9	1.9
Nominal GDP growth	-3.4	-3.1	-3.1	-2.9	-2.6	-2.4
Other factors	0.1	0.8	0.7	0.7	0.7	0.7
Pro memoria nominal GDP growth	6.6	6.5	6.7	6.6	6.3	5.9

(A) Advance
(F) Forecast
Source: Ministry of Economy and Finance

This information is complemented by an analysis of cyclically-adjusted balances, as shown in Table 7, which may be indicative of the fiscal policy approach in the projection period.

The cyclically-adjusted primary balances[2] show sizeable fluctuations in 2004 and 2005 because of one-off expenditures. The cyclically-adjusted primary balance will stabilise in 2006-2008, pointing to neutral fiscal policy. Excluding the impact of one-off measures in 2004, the result would be a **practically neutral fiscal policy** over the period, as shown by the figures in parentheses in Table 7

[2] To calculate trend GDP, a Hodrick Prescott filter was applied with a value of $\lambda = 100$ and the budgetary elasticities estimated by the OECD were used.

Table 7 CYCLICAL DEVELOPMENTS (% of GDP or % year-on-year change)						
	2003 (A)	**2004 (*) (F)**	**2005 (*) (F)**	**2006 (F)**	**2007 (F)**	**2008 (F)**
1. Real GDP growth (%)	2.5	2.6	2.9	3.0	3.0	3.0
2. Budget balance	0.4	-0.8 (-0.1)	0.1	0.2	0.4	0.4
3. Interest payments	2.5	2.3	2.1	2.0	1.9	1.9
4. Trend GDP growth	3.0	3.0	3.0	3.0	2.9	2.9
5. Output gap	0.2	-0.2	-0.2	-0.2	-0.1	0.0
6. Cyclical budgetary component	0.1	-0.1	-0.1	-0.1	0.0	0.0
7. Cyclically-adjusted balance (2-7)	0.3	-0.7 (0.0)	0.3	0.3	0.4	0.4
8. Cyclically-adjusted primary balance (7+3)	2.8	1.6 (2.3)	2.4	2.3	2.3	2.3
9. Change in cyclically-adjusted primary balance	0.5	-1.2 (-0.5)	0.7 (0.1)	0.0	0.0	0.0

(A) Advance
(F) Forecast
(*) Figures in parentheses exclude the one-off items in 2004
Source: Ministry of Economy and Finance

4. SENSITIVITY ANALYSIS AND COMPARISON WITH THE PREVIOUS UPDATE

Based on the macroeconomic scenario in Table 2, this Update shows the public accounts attaining a surplus that is 0.1% of GDP in 2005 and rises to 0.4% in 2008. The impact on those budget balances of two alternative scenarios is presented below: one scenario uses different economic growth assumptions, and the other uses different assumptions about interest rates.

4.1. Alternative growth scenario

To analyse sensitivity to economic growth, real GDP growth was assumed to be 2.5% from 2005 onwards, with a GDP deflator slightly lower than in the baseline scenario. The differences between the forecasts for the main variables in the baseline and lower growth scenarios are shown in Table 8. The lower growth scenario includes a slower pace of growth in domestic demand and exports, and a slightly sharper slow-down in import growth. The net outcome is a slight improvement in the external sector's contribution to growth and lower current account deficits, thus lowering the financing needs from the rest of the world.

Table 8 SENSITIVITY ANALYSIS: Macroeconomic variables (% change unless otherwise stated)					
	2004 (F)	2005 (F)	2006 (F)	2007 (F)	2008 (F)
Baseline scenario					
GDP	2.6	2.9	3.0	3.0	3.0
GDP deflator	3.8	3.7	3.5	3.2	2.8
Employment (% change)	2.1	2.1	2.2	2.1	2.0
Unemployment: % working population (LFS)	10.9	10.4	10.1	9.8	9.6
Net lending(+)/ borrowing (-) vs. rest of world[1]	-3.6	-4.3	-4.5	-4.6	-4.8
Lower growth scenario					
GDP	2.6	2.4	2.5	2.5	2.5
GDP deflator	3.8	3.5	3.4	3.0	2.7
Employment (% change)	2.1	1.6	1.7	1.6	1.5
Unemployment: % working population (LFS)	10.9	10.8	10.9	11.0	11.2
Net lending(+)/ borrowing (-) vs. rest of world [1]	-3.6	-4.0	-4.1	-4.2	-4.4

[1] Percentage of GDP

(F) Forecast

Source: Ministry of Economy and Finance

Contrasting with the baseline scenario, the lower growth scenario gives a slight deficit in 2005 due to the interplay of the automatic stabilisers and which will be maintained until the end of the programme period, assuming no change in fiscal policy. The reduction in the public debt ratio comes later than in the baseline scenario.

Table 9 SENSITIVITY ANALYSIS: Budgetary developments					
	2004 (F)	2005 (F)	2006 (F)	2007 (F)	2008 (F)
Baseline growth scenario					
General government surplus (+) /deficit (-)	-0.8	0.1	0.2	0.4	0.4
Public debt	49.1	46.7	44.3	42.0	40.0
Lower growth scenario					
General government surplus (+) /deficit (-)	-0.8	-0.2	-0.2	-0.2	-0.2
Public debt	49.1	47.2	45.5	43.9	42.6

(A) Advance

(F) Forecast

Source: Ministry of Economy and Finance

4.2. Analysis of interest rate sensitivity

This section analyses the effects on the public accounts of variations in interest rates with respect to the baseline scenario. The interest rate curve is assumed to shift 100 basis points up (high interest rate scenario) or down (low rate scenario) from the baseline scenario assumptions.

The analysis considers only the effects of the change in debt interest payments, ignoring any impact on other macroeconomic variables. It is also assumed that the other government expenditure and revenue items remain unchanged and that the new interest rates apply only to debt that is newly issued either to replace maturing debt or as a result of a higher borrowing requirement. Within these constraints, the budget balance and the debt/GDP ratios in the baseline and alternative scenarios are shown in Table 10.

Table 10
SENSITIVITY ANALYSIS: Interest rates
(National Accounting, ESA-95. Percentage of GDP)

Scenarios	2004 (F)	2005 (F)	2006 (F)	2007 (F)	2008 (F)
Higher rates					
Budget balance	-0.8	0.1	0.1	0.2	0.2
Public debt	49.1	46.8	44.5	42.4	40.5
Baseline					
Budget balance	-0.8	0.1	0.2	0.4	0.4
Public debt	49.1	46.7	44.3	42.0	40.0
Lower rates					
Budget balance	-0.8	0.2	0.4	0.5	0.6
Public debt	49.1	46.5	44.0	41.6	39.4

(A) Advance
(F) Forecast
Source: Ministry of Economy and Finance

The deviations from the baseline scenario take place relatively slowly since the average lifetime of Spain's public debt is around six years. Moreover, the effects of a change in interest rates would persist beyond 2008 (the end of this projection period) since the process of debt refinancing would not have been completed. In any event, the differences in the general government budget balance in 2008 are of the order of 0.2 percentage points of GDP, and the differences in the public debt/GDP ratio are around half a point.

4.3. Comparison with projections of the previous Stability Programme Update

Table 11 DIFFERENCES WITH RESPECT TO PREVIOUS STABILITY PROGRAMME UPDATE					
	2003	2004	2005	2006	2007
GDP growth					
Previous update	2.3	3.0	3.0	3.0	3.0
Update 2004-2008	2.5	2.6	2.9	3.0	3.0
Difference	0.2	-0.4	-0.1	0.0	0.0
Budget balance					
Previous update	0.5	0.0	0.1	0.2	0.3
Update 2004-2008	0.4	-0.8	0.1	0.2	0.4
Difference	-0.1	-0.8	0.0	0.0	0.1
Gross debt					
Previous update	51.8	49.6	47.7	45.7	43.8
Update 2004-2008	50.7	49.1	46.7	44.3	42.0
Difference	-1.1	-0.5	-1.0	-1.4	-1.8
Source: Ministry of Economy and Finance					

Economic growth in 2003 was slightly higher than envisaged in the previous Update (Table 11) as a result of higher-than-expected growth in domestic demand and exports. The budget balance was slightly less positive due to minor deviations from the projections for revenues and expenditure. Also, the debt/GDP ratio was lower than expected as a result of a lower net acquisition of financial assets and a greater increase in nominal GDP.

Oil price trends and a more negative contribution from the external sector than initially expected will lead to lower GDP growth in 2004. The difference in the budget balance is due mainly to the one-off measures (discussed earlier) which were not envisaged in the previous update. Their one-off nature is confirmed by the fact that the budget balance projected for 2005 and 2006 is the same as in the previous update. The difference in the debt/GDP ratio in 2003 is carried forward into subsequent years, adjusted for the difference in budget balances.

5. QUALITY AND SUSTAINABILITY OF PUBLIC FINANCES

5.1. Quality in the 2005 Budget

The composition of the 2005 budget reflects the priorities of Spain's economic policy. In particular, public resource assignment is set out in expenditure policies that pursue two basic objectives: increase productivity and growth in the Spanish economy, and strengthen social cohesion. The quality of public finances improves through more neutral taxation and through the budget's contribution to raising potential growth through expenditure that increases productivity (spending on R&D+i, human capital and infrastructure).

In the coming years, Spain's fiscal policy will advance in this direction. This qualitative change in the budget composition has begun with the 2005 Budget, in which public spending is reoriented towards items with a greater impact on productivity and growth, including most notably: active policies in the labour market; education; investment in infrastructure; and investment in knowledge and technology. Moreover, progress is being made towards the second stated objective – social cohesion – through support for actions of a social nature, all in a general framework of improvements to basic public services (justice, public security, etc.).

Figure 4 shows the projected change in the 2005 Budget in spending that affects productivity and that reinforces social cohesion; both items increase more than overall expenditure.

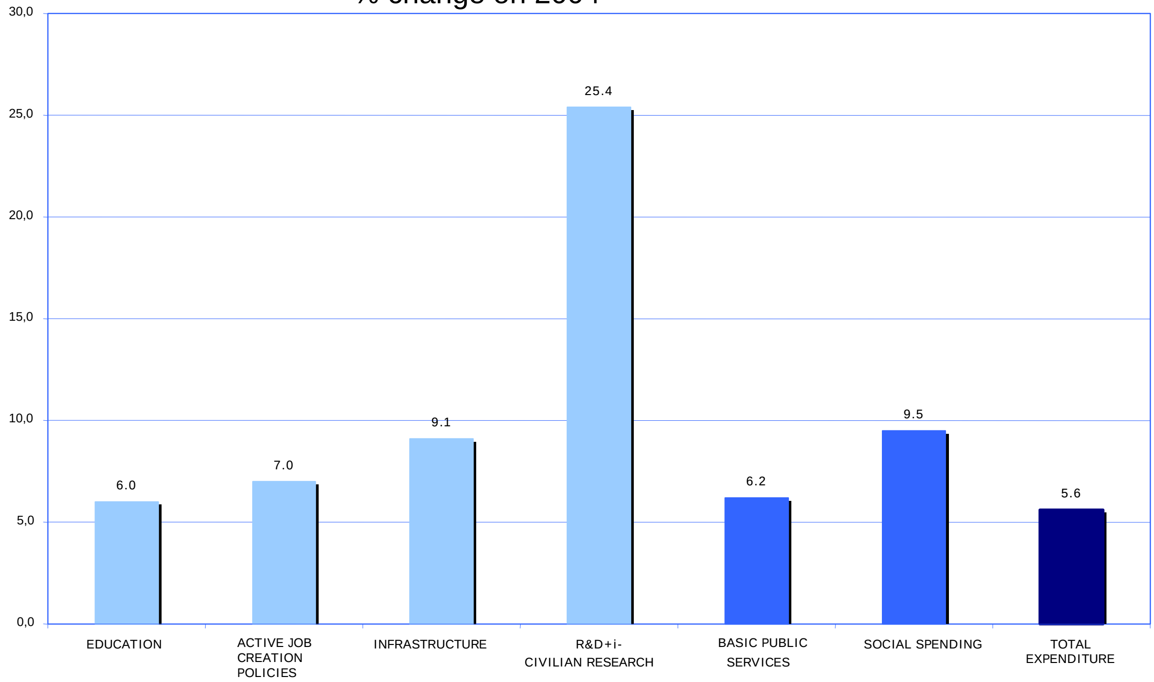
Job creation is a basic objective of the government's economic policy; accordingly, the budget allocation for active policies in the labour market has increased 7% on 2004. Three objectives are being pursued:

- Contribute to reducing the extent of temporary employment;
- Facilitate the search for employment with more effective public employment services;
- Improve employee training, while promoting investment in training and ongoing education.

The state budget allocation for **education policy,** the other axis of qualitative change in public spending, is 6% higher than in 2004. The Autonomous Communities have the bulk of the power in this area, and they directly manage education spending in their territories. Action by the central administration includes most notably an increase in the funds for grants and allowances within the Educational Promotion Programmes, which represent 56% of the total and have increased by 10.5% with respect to 2004.

The allocation for **investment in infrastructure** is 9.1% higher than in 2004. The goal is to increase factor mobility and productivity, stimulate private investment and foster social and regional cohesion, while maintaining infrastructure safety, upkeep and quality. Priority is being given to terrestrial transport: investments will be made in high-capacity road networks in the framework of the future Strategic Plan for Infrastructure and Transport. The budget allocation for road infrastructure is 7.5% higher. In the area of rail infrastructure, particular attention will be given to high-speed rail and efforts will be made to foster freight transport.

Figure 4
SPENDING POLICY - GENERAL STATE BUDGET 2005
% change on 2004



The **Research, Development and Innovation (R&D+i) policy** is a budget priority. Spain must reduce its deficit in the area of investment in technological capital, which limits the scope for growth potential in the medium term. The objective of research policy is to double spending on **research** within four years in order to bring R&D+i spending into line with the Community average in the medium term. The 2005 General State Budget increases the allocation for research policy by 16.3% (25.4% if defence programmes are excluded). Additionally, the number of researcher positions will be increased and their working conditions will be improved, and the links between business and universities will be strengthened. The strategic objectives that are being pursued in this area are as follows:

- Reinforce the role of the public sector in generating fundamental knowledge and strengthen the process of internationalisation of the Spanish science.
- Improve the standards of the system by increasing human resource numbers and quality in the public and private sector.

To achieve these objectives, the greatest increases in budget allocation are concentrated in scientific coordination, health, telecommunications, industry, energy and environment, fisheries and oceanography, and astrophysics. Moreover, the programmes for technological and industrial development include sizeable allocations of interest-free refundable advances. The focus is therefore on refundable funding, in the segments where this is justified, as a means of ensuring the efficient use of public funds.

In connection with **social spending**, the 9.5% increase envisaged for 2004 includes the provision to the Social Security Reserve Fund.

On the revenue side, there are plans to reform direct taxation, which will affect the main taxes on income: personal income tax and corporate income tax. The process, which will commence in 2005, has the goal of improving taxation efficiency by increasing neutrality vis-à-vis taxpayers' saving and investment decisions and will simplify the tax tables so as to reduce overtaxation. The reform will also focus fundamentally on fairness in taxation.

5.2. Long-term sustainability

The strategy to ensure the long-term sustainability of public finances is structured around **three fundamental axes:** budgetary discipline; sustained growth in GDP and employment; and structural actions on pensions, in line with the Toledo Pact recommendations, and on other areas closely linked to demographic changes.

The combination of **budgetary discipline** with high economic growth, among other factors, will enable public debt to continue declining as a percentage of GDP; this reduction will be slightly more than 9 percentage points of GDP in the projection period to which this Update refers.

The commitments contained in the "Declaration in Favour of Social Dialogue 2004: Competitiveness, Stable Employment and Social Cohesion" will have a major impact on the sustainability of public finances through their effect on employment and social security. This agreement, which was signed in July 2004 by the government and the leading employers' organisations and trade unions, defines the subjects, targets and general guidelines of social dialogue.

Regarding the **labour market**, the priorities of the "Declaration in Favour of Social Dialogue" are: higher labour participation and job stability; ongoing training; enhancing active job-creation policies; and adapting collective bargaining to the needs of employers and workers.

With respect to **social security**, the content of the Toledo Pact recommendations will be fleshed out, based on the consensus in the framework of the "Declaration in Favour of Social Dialogue", thus reinforcing the system's current favourable situation, in the following spheres:

- Make the system more contributory through a better match between contributions and benefits.

- Complete the process of separating funding sources, with the State funding all the non-contributory pensions, making it possible to improve the lowest pensions.
- Guarantee a steady increase in the Reserve Fund.
- Social security contributions must make a balanced system compatible with the creation of an appropriate environment for creating employment and wealth.
- Foster supplementary providential systems and analyse problems hampering the development of systems resulting from collective bargaining.
- Adapt social security systems to new needs, with priority being given to dependency and to improving protection for families

For the sixth consecutive year, the Social Security Administrations attained a surplus, estimated at 0.8% of GDP in 2004. This is due in part to the increase in the number of contributors as a result of growth in employment and to the higher bases of contribution. Meanwhile, the volume of current transfers from the State to finance non-contributory pensions continues to rise.

The Social Security surplus plus budget stability have made it possible to continue raising the **allocations to the Social Security Reserve Fund (SSRF)** to meet future needs in the area of contributory benefits that arise from a mismatch between social security revenues and expenditure. In accordance with the regulations governing the SSRF[3], these funds may be used only to finance contributory pensions and the other necessary management expenses, and only in the event of a structural deficit due to non-financial operations in the Social Security System. Under the Budget Law, 5.351 billion euro will be provisioned to the Reserve Fund in 2005, so that the Fund balance will reach 25 billion euro, i.e. 3% of GDP. At the end of November 2004, the SSRF, valued at market prices, **amounted to approximately 19.7 billion euro**. The breakdown of the fund by asset class valued at market prices is shown in the table below:

Table 12
SOCIAL SECURITY RESERVE FUND

	%
Bank of Spain current account balance	0.5
Spanish short-term government bonds	5.9
Spanish long-term government bonds	89.1
Foreign government bonds	4.5

In the area of **healthcare**, which has been devolved to the Autonomous Communities, the State is focusing in the short and medium term primarily on pharmaceutical spending and on the system of healthcare funding. The first step in this rationalisation process is the recently-unveiled Strategic Plan for Pharmaceutical Policy, whose goal is to improve the quality of

[3] Law 28/2003, dated 29 September, regulating the Social Security Reserve Fund, and Royal Decree 337/2004, dated 27 February, which implements Law 28/2003

pharmaceutical benefits and foster rational use of medicines; make more efficient use of the public funds used to finance pharmaceutical spending; and ensure the financial sustainability of the National Health System. The various aspects of the healthcare funding system are being examined, with particular emphasis on reinforcing the fiscal co-responsibility of Autonomous Communities (*corresponsabilidad fiscal*).

Regarding the **long-term public finance projections**, and since, by Ecofin mandate, the Economic Policy Committee is working on the new projections of expenditure related to population ageing until 2050, which will not be available until mid-2005, it does not appear to be advisable for this Programme Update to include the latest available projections, which are those included in the previous Update and which may be considered to be obsolete as a result of changes in demographic scenarios.

6. HORIZONTAL ISSUES IN PUBLIC FINANCES

6.1. Reform of the Budgetary Stability Law

The new government has just commenced an in-depth reform of the Budgetary Stability Laws, which came into force in the previous legislature; the process is expected to be completed in 2005. The reform seeks to improve certain aspects of current legislation, such as the guarantee of compliance with the stability objective by all levels of government, and procedural and competency-related issues. The reform has the following fundamental objectives

- Reinforce the commitment to fiscal discipline by all levels of government and make it more effective;
- Redefine "budgetary stability" to mean a situation of equilibrium or surplus throughout the cycle, i.e. attaining a budget surplus in the upswing so as to be able to incur a deficit in the downswing. The reform will specify what circumstances constitute a breach of the stability principle. These measures will strengthen the stabilising role of fiscal policy.
- Improve the transparency of public accounts, specifically the budgetary information of Autonomous Communities and local governments, and adapt them to Community regulations on national accounting and the requirement that all levels of government disclose their future borrowing requirements and payment commitments.

6.2. Other measures:

Creation of a State Agency for the Evaluation of the Quality of Public Services and Policies

Improving the efficiency of the public sector is an essential function of government. In the framework of the Stability and Growth Pact, it is all the more important to assess public policies. For this reason, the government's project to set up a State Agency for the Evaluation of the Quality of Public Services and Policies has aroused considerable interest.

The first step in this direction was the creation of an interdisciplinary Committee of Experts in evaluation, which drafted a report analysing domestic and international experience in the field of evaluation and making methodological and institutional proposals for the implementation of the State Agency. That report was presented to the Minister of Public Administrations in October and is available at the Ministry's web site[4].

As the Commission of Experts stated in their report, the creation of the State Evaluation Agency should "contribute to improving the actions and results of the public sector and its institutions by establishing a Public System for the Evaluation of public policies and the improvement of service quality in a framework of transparency and institutional ethics".

Underlying this overall objective are important questions such as rationalisation and the search for efficiency in the management of public affairs, accountability, transparency, citizen participation, and the improvement of normative and regulatory procedures. In the latter area, the Agency can play a major role to reinforce the evaluation of economic and social impacts while legislation is being drafted; this should include not only the budgetary cost but also an *ex-ante* evaluation of the need for the regulation that clearly defines the goals that are pursued and which compares the efficacy of the measure against other possible alternatives. The Agency can also assist in evaluating and contributing to the goals of quality in government services, with particular reference to administrative simplification and the elimination of redundant and unnecessary burdens, with the consequent beneficial effect on Spain's productive sector and on citizens in general.

Tax Fraud Prevention Plan

This Plan is currently in the public consultation phase[5]. It has an eminently operational focus and will lead to the appropriate regulatory changes. The goal is to combat tax fraud by strengthening the measures for prevention and control, paying special attention to those activities where most fraud is detected, particularly in connection with indirect taxation, such as excise taxes and VAT (e.g. real estate, intra-Community transactions, objective assessment systems). The plan will strengthen the investigation, prevention and control activities and enhance cooperation with the State Security Forces.

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[4] http://www.igsap.map.es/ticker/agencia_evaluacion_calidad.pdf

[5] http://www.aeat.es/campanyas/fraude/home.html

7. CONCLUSION

This Update is fully consistent with the budget targets approved by Spanish Parliament in June and with the Stability and Growth Pact in its current wording.

This Update also reflects the new Government's strategy to advance towards an economic growth model that focuses more on factors that contribute to increasing the economy's potential growth, and it highlights that budgetary stability creates more room to increase productive expenditure in the public sector, particularly spending on the knowledge society and infrastructure. This strategy also has a positive effect on the long-term sustainability of public finances, which should be supported by structural actions.