STABILITY PROGRAMME UPDATE

SPAIN

2006 - 2009

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1. INTRODUCTION

This is the eighth Update to Spain’s Stability Programme, drafted annually in the framework of Community supervision and coordination of economic policies.

This Update is consistent with the new fiscal policy framework adopted by the Member States in the context of the reform of the Stability and Growth Pact adopted in March 2005. It also incorporates the main elements of the reform of Spain's Budgetary Stability laws, as approved in May 2006. That reform will come into force in January 2007 and will have full effect on the budgets drafted thereafter, i.e. commencing with the 2008 budget. The basic principles of the new fiscal policy are aligned with Community regulations and they introduce new mechanisms to make the budgetary stability principle more effective and more in tune with the cyclical and structural requirements of the Spanish economy. The budgetary projections in this Update take account of the economy's cyclical position without diminishing its capacity to contribute to attaining the Lisbon objectives.

The content and format of this Update conform to the new Code of Conduct adopted in 2005. Also, in line with the Code and the fact that the amended Budgetary Stability Laws require budgetary objectives to be set for periods of three years, this Update (like its predecessor) refers to a three-year period, i.e. until 2009.

This Stability Programme Update will be submitted to the Community Institutions with the approval of the Spanish Cabinet, and it may be presented subsequently to the Spanish Parliament. The European Council's opinion on Spain's Update is taken into consideration when setting multi-year objectives for budgetary stability; these are set in the first half of each year and must be approved by the two houses of Parliament. The Budgets drafted subsequently must conform to those multi-year budgetary stability objectives.

2. OVERALL POLICY FRAMEWORK AND OBJECTIVES

The priority goal of Spain's economic policy is to improve citizens' well-being by increasing their material wealth and job opportunities. In particular, the "National Reform Programme: Convergence and Employment" (NRP[1]) presented by Spain in October 2005 establishes the goal for 2010 of attaining full convergence in per capita income with the European Union (EU-25) and an employment rate of 66% of the population of working age. To attain those objectives, the economic policy implemented since 2004 is aimed at favouring a model of sustainable, balanced and productive growth while also providing solidarity, and to this end it is necessary to increase the stock of productive capital and productivity while

[1] www.la-moncloa.es

maintaining high rates of job creation.

This Stability Programme Update is part of that strategy, whose fundamental components are as follows:

- Macroeconomic and budgetary stability: the commitment to budgetary stability enabled Spain to end 2005 with a government surplus for the first time in 25 years, and besides this commitment was strengthened with the approval in 2006 of the Budgetary Stability laws' reform. This strategy has been improved by reorienting public spending towards the areas with the greatest impact on efficiency and productivity. It also equips the public finances to face the challenges of an ageing population by steadily reducing the public debt as a percentage of GDP and making it possible to continue increasing the pension Reserve Fund out of Social Security surpluses. Long-term sustainability of the public accounts and macroeconomic stability will be supported by the July 2006 agreement to reform the Social Security system and the tax reform approved in November of the same year.

- Fostering productivity: to increase productivity, it will be necessary to improve the functioning of the markets and make efforts to increase the economy's capitalisation in terms of infrastructure, human and technological capital. These were the goals underlying the March 2005 Plan to Dynamise[2] the Economy and Boost Productivity, which included measures in the area of competition, goods and services markets, factors markets, research and development, quality and efficiency in public expenditure, and improving the regulatory framework. These measures were reviewed and updated in March 2006, and it was found that they were being fulfilled to a very satisfactory degree. The plan anticipated, to an extent, the review of the Lisbon strategy undertaken in 2005, since it included a predictable and transparent way of articulating economic policy by defining a detailed calendar of measures, assigning specific responsibilities to each department, and establishing a monitoring mechanism. The commitment made by the Member States, in the framework of the review of the Lisbon strategy, to present National Reform Programmes (NRP) in October 2005 that included quantifiable objectives and a calendar for adoption of measures, led to the Dynamisation Plan being incorporated into Spain's NRP, the first report on which was presented to the Community Institutions in October 2006.

  This broad set of measures to enhance productivity should foster a change in the pattern of growth and real convergence, heretofore driven primarily by growth in the employment rate. It should also contribute to reducing macroeconomic imbalances. In fact, the measures implemented in 2005 and 2006 are enabling Spain to move faster than expected towards the NRP's 2010 goals in terms of per capita income and employment rate.

[2] www.meh.es

- Transparent and efficient regulation: the goal is that the government's regulatory action contributes to an efficient functioning of the economy while also offering more and better information about the economic effects of the measures approved. The draft Royal Decree regulating regulatory impacts assessments will make it possible to assess the appropriateness and effects of proposed regulations, and to consider possible alternatives. This ex-ante assessment will be complemented by ex-post assessment conducted by the State Agency for the Evaluation of Public Policies and Service Quality, created in December 2006 in the framework of the Law on State Agencies for the Improvement of Public Services. Transparency is also being enhanced through the publication of more economic information by the various Administrations. In May 2006, a decision was taken to further enhance transparency in economic and statistical information, which expands and improves the 2005 decision.

Accordingly, this Update provides full continuity with the economic policy strategy that commenced in this legislature and is also fully consistent with the commitments made under the Stability and Growth Pact.

3. CURRENT ECONOMIC SITUATION AND OUTLOOK

3.1. External assumptions

Spain's Stability Programme 2006-2009 is based on the external assumptions provided by the European Commission, as recommended in the Code of Conduct; those assumptions are set out in Table 1.

The assumptions are based on projections made on the basis of the good outlook for the world economy in 2006 since, despite high oil prices, it has continued to expand, prolonging the upward trend of recent years; accordingly, world GDP is projected to grow by close to 5% in 2006.

In the first half of 2006, the European Union and the euro area experienced an acceleration of growth more than expected, forcing an upgrade in the Spring projections for both areas. Inflation also increased slightly due to energy prices and improved economic activity. However, oil prices started to significantly recede from mid-August onwards due to a combination of factors (lower geopolitical tension, higher US stocks, and downward adjustments in demand forecasts), and the price of Brent reached 58.7 dollars per barrel in late November, down from 78 in early August.

The US economy started the year growing at a good pace but then decelerated, mainly as a result of cooling in the housing market, which led the Federal Reserve to halt the process of interest rate increases in June. The Japanese economy continued to strengthen its recovery, even though the pace of activity has slowed in recent quarters. Among the emerging countries, China and India continue to grow rapidly, as do the oil- and commodity-exporting countries, favoured by high international prices for their exports.

Table 1
EXTERNAL ASSUMPTIONS

	2005 (A)	2006 (F)	2007 (F)	2008 (F)	2009 (F)
Dollars per euro	1.25	1.25	1.27	1.27	1.27
Nominal effective exchange rate in the euro area (% change)	-1.4	0.8	1.1	0.3	0.0
Nominal effective exchange rate in the EU-25 (% change)	-1.2	1.9	2.1	0.1	0.0
World excluding EU-25, GDP growth (*)	5.6	5.7	5.2	5.2	5.2
EU-25 GDP growth (*)	1.7	2.8	2.4	2.4	2.4
Growth of foreign markets of the EU-25 (**)	9.0	9.6	8.6	7.8	7.9
World import volumes, excluding the EU-25	8.2	9.1	8.3	7.9	8.0
Interest rates in the euro zone (annual average)					
Short- term interest rates	2.2	3.1	3.7	3.6	3.5
Long- term interest rates	3.4	3.8	4.0	4.2	4.2
Oil prices, (Brent, USD/barrel)	54.5	65.6	66.3	68.0	68.0

(*) Real percentage change
(**) Intra- and extra-EU trade
(A) Advance
(F) Forecast
Source: European Commission and Ministry of Economy and Finance.

The world economy, excluding the European Union, is expected to attain 5.7% growth in 2006, and by half a percentage point less in 2007-2009. This will be driven basically by the slowdown in the US, which is expected to grow by 2.3% in 2007. The US growth will subsequently increase by 0.5 points in 2008 and remain stable in 2009. The big Asian emerging markets, China and India, will experience a slight deceleration through the projection period while Japan's growth will slow due to less dynamic performance by its trade partners. In short, world import volumes (excluding the European Union) will decelerate steadily from 9% expected in 2006 to 7.9% in 2009.

The European Union and the euro area will continue to grow at a steady pace, driven basically by domestic demand, which will take over from foreign demand as the growth driver. Better consumer and business confidence and still-loose monetary policy, plus good corporate earnings, will lead to greater consumption expenditure and gross fixed-capital formation. The European Union will attain 2.8% growth in 2006, and decelerate by 0.4 percentage points in 2007 due to the impact of the VAT increase in Germany and the US deceleration.

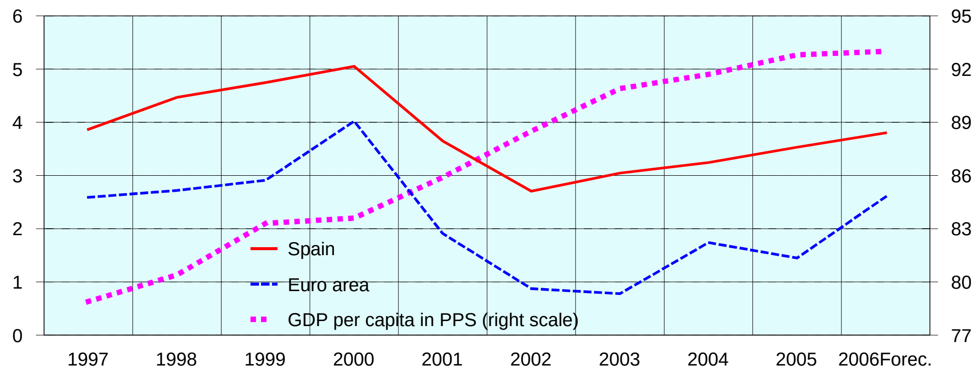
The euro/dollar annual average exchange rate is expected to be stable in 2006, and will appreciate slightly in 2007 and remain stable throughout the rest of the projection period. Rising demand for energy, scant idle capacity and limited scope to increase production in the short term will keep oil prices relatively high, with Brent rising gradually to 68 dollars per barrel in 2009. Nevertheless, euro area inflation will ease, in line with the sharp decline in oil prices since mid-August, together with tighter monetary policy.

3.2. Cyclical developments and outlook

The Spanish economy attained a 3.5% real growth rate in 2005, according to the latest estimates by the National Accounts, which upgraded the growth figures for the last few years. Specifically, growth rates in 2004 and 2005 were revised upwards by 0.1 percentage points.

The quarterly profile of GDP reveals an upward trend in annual growth rates in recent years, which continued and accelerated in 2006, leading to a growth rate of 3.8% in the third quarter (with adjusted data). This acceleration has been driven by an improvement in the foreign sector's net contribution, more than offsetting the domestic demand slowdown.

Figure 1
Real growth and convergence of the Spanish economy
Change in GDP (%) and Index EU12=100

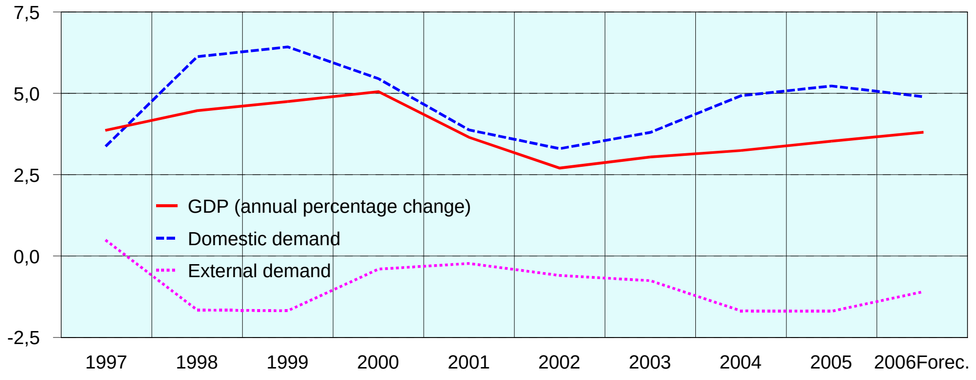


Source: INE, European Commission and Ministry of Economy and Finance.

Despite that, growth continues to be mainly driven by domestic demand, boosted by interest rates that are still low in real terms (though they are rising), immigration flows, a rising female labour participation rate, and job creation. Both consumption expenditure and gross fixed-capital formation are growing rapidly, with particularly strong investment in capital goods, in contrast with signs of a slowdown in residential investment (including a deceleration of housing prices).

As for the foreign sector, one of the most salient features in 2006 was the recovery of exports, boosted by growth in the big European economies and dynamic performance by economies outside the European Union. In the first nine months of the year, exports of goods and services increased by 5.8% in real terms with respect to the same period of 2005, while imports grew by 8.6%; nevertheless the gap is tending to narrow, since the net contribution by foreign demand was -1.0 points in the third quarter, having shrunk from -1.6 points in the same period of 2005.

Figure 2
Composition of GDP growth
Contribution in percentage points

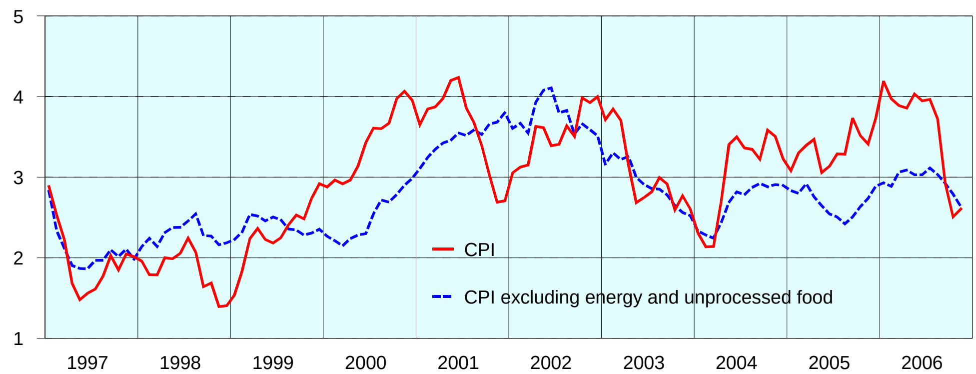


Source: INE and Ministry of Economy and Finance.

As for the supply side, there has been a notable upswing in industrial activity since mid-2005, which has accelerated in 2006, boosted by continuing strength on the part of domestic demand and the aforementioned export recovery.

The labour market is maintaining the good performance of recent years. Employment is growing rapidly, though decelerating. The labour force has also grown at a significant rate, driven by immigration and the rising female participation rate. Despite growth in the labour supply, the unemployment rate has declined steadily, reaching 8.1% in the third quarter of 2006, the lowest since the beginning of 1979. Wages remain moderate, although the compensation of employees accelerated slightly in 2006 in annual average terms, which will be partially offset by a recovery in productivity. Consequently, Unit Labour Costs (ULC) may register a nominal increase of about 2.6% in 2006.

Figure 3
Headline inflation and core inflation
% change y/y



Source: INE.

Inflation climbed during the first seven months of 2006, continuing the upward trend of the previous two years, driven mainly by sharply escalating oil prices. In August, the CPI year-on-year increase dipped in parallel with the decline in world oil prices and also with olive oil prices; as a result, inflation reached 2.6% in November, a decline of 1.4 percentage points in four months. This favourable trend also affected core inflation (i.e. CPI excluding energy and unprocessed foodstuffs), which fell 0.4 points from July to reach 2.6% in November.

3.3. Projections for 2006–2009: baseline scenario

The baseline scenario in 2006-2009 (Table 2) for the Spanish economy[3] projects sustained rapid GDP growth well above 3%, enabling Spain to continue with the process of real convergence with the European Union. Economic growth will continue to be supported fundamentally by domestic demand, although that factor will decline steadily in importance. In contrast, external demand's contribution to economic growth will be increasingly less negative. This more balanced growth pattern will favour a reduction in inflationary tensions. The pace of employment growth is also expected to ease but, since labour force growth will also decelerate, this will enable the unemployment rate to continue falling.

Following an estimated 3.8% GDP growth in 2006, a deceleration of 0.4 percentage points to 3.4% is projected for 2007 due, among other factors, to less favourable monetary conditions and slower world economic growth. In 2008, growth could fall by another 0.1 percentage points to 3.3%, and remain stable in the following year. These figures are slightly higher than those contained in the last Stability Programme Update, because of the upward revision of 2005 GDP growth by the National Statistics Institute (INE) and stronger-than-expected economic growth in 2006, not just in Spain but also throughout the European Union.

The deceleration of domestic demand in this scenario is explained firstly by the expected slowdown in the pace of growth of private consumption expenditure, which will match GDP growth between 2007 and 2009. This trend is compatible with a slight upswing in household saving in 2007, favoured by higher interest rates and the tax reform. Public consumption expenditure is also expected to decelerate, but it will continue to outstrip GDP growth in real terms during the projection period.

Gross fixed-capital formation will decelerate in the coming years while still growing much faster than GDP. This behaviour by capital expenditure will be due basically to projected strong investment in capital goods, favoured by robust domestic and external demand, relatively loose monetary conditions and companies' need to increase productivity in a context of increasingly competitive markets. However, investment growth in construction is expected to decelerate significantly, due to a gradual moderation of housing demand after years of

[3] This scenario includes more recent figures than were available when the 2007 Budget was drawn up, hence the differences between them.

strong growth and maturing expansive cycle, the consequent increase in household debt, and the impact of rising mortgage interest rates.

Table 2
MACROECONOMIC PROSPECTS
Chained volume indices: 2000=100, unless otherwise indicated

	ESA Code	2005(A) Level	2005(A) Rate of change (%)	2006 (F)	2007 (F)	2008 (F)	2009 (F)
1. Real GDP growth	B1*g	117.2	3.5	3.8	3.4	3.3	3.3
2. Nominal GDP (billion euro)	B1*g	905.5	7.8	7.7	6.7	6.6	6.4
Components of real GDP:							
3. Private consumption expenditure (*)	P.3	118.7	4.2	3.7	3.4	3.3	3.3
4. Government consumption expenditure	P.3	126.8	4.8	4.2	4.0	3.9	3.8
5. Gross fixed capital formation	P.51	128.9	7.0	6.3	5.4	4.9	4.6
6. Changes in inventories (% of GDP)	P.52+P.53	59.6	0.2	0.4	0.4	0.3	0.3
7. Exports of goods and services	P.6	116.4	1.5	5.7	6.1	5.6	5.8
8. Imports of goods and services	P.7	135.1	7.0	8.4	7.9	6.8	6.7
			Contributions to real GDP growth				
9. Final domestic demand		122.6	5.2	4.7	4.3	4.1	4.0
10. Changes in inventories	P.52+P.53	59.6	0.0	0.1	0.0	0.0	0.0
11. External balance of goods and services	B.11	451.2	-1.7	-1.1	-0.9	-0.8	-0.7

(*) Includes households and NPISH (non-profit institutions serving households)
(A) Advance
(F) Forecast
Source: INE and Ministry of Economy and Finance.

After a strong recovery in 2006 goods exports growth will slow in 2007 as a result of deceleration by our main markets. Nevertheless, this will be offset by better performance by tourism, so that exports of goods and services will accelerate slightly in 2007 and ease off by a few tenths of a point in the following two years. Imports are expected to continue decelerating in parallel with final demand. Consequently, the foreign sector's net contribution will improve in the coming years, though it will still be negative throughout the projection period.

Though decelerating, job creation will continue to be strong. Also, growth in the labour force will ease off due partly to lower immigration. Both factors will contribute to a continuing decline in the unemployment rate, to 7.6% in 2009.

The various measures adopted in the National Reform Programme plus the gradual decline in the importance of the more labour-intensive sectors, such as construction, will favour a recovery in productivity per worker, continuing the trend already observed in 2006.

The scenario envisages a moderate deceleration in employees' compensation which, coupled with an increase in productivity, will slow growth in ULCs and, consequently, have a positive impact on competitiveness. In monetary terms, ULCs will continue to grow by less than the GDP and private consumption expenditure deflators.

Inflation will decelerate in the coming years, in line with the assumption of stable oil prices, lower pressure from domestic demand, and slower growth by ULCs. In particular, the private consumption expenditure deflator will slow by around 1 percentage point in the projection period to 2.5% in 2009, 0.4 percentage points lower than the GDP deflator. Foreign trade prices are also expected to decelerate; import prices more sharply than export prices (due to expected more favourable performance by commodities) leading to an improvement in the terms of trade.

Table 3
PRICE DEVELOPMENTS
Chained volume indices: 2000=100

	ESA Code	2005 (A)		2006 (F)	2007 (F)	2008 (F)	2009 (F)
		Index	Rate of change (%)				
1. GDP deflator		122.5	4.1	3.8	3.2	3.1	2.9
2. Private consumption deflator (*)		117.4	3.4	3.5	2.7	2.6	2.5
3. Public consumption deflator		118.4	3.6	2.8	2.8	2.7	2.6
4. Gross fixed-capital formation deflator		126.5	5.2	4.8	3.8	3.6	3.3
5. Export price deflator (goods and services)		108.5	4.3	3.9	2.4	1.9	2.0
6. Import price deflator (goods and services)		102.1	3.8	3.8	2.0	1.5	1.7

(*) Includes households and NPISH (non-profit institutions serving households)
(A) Advance
(F) Forecast
Source: INE and Ministry of Economy and Finance.

As for the scenario's risks, the external risks lie mainly in the US economy's imbalances and the consequently possibility of a sharper-than-expected deceleration, which could hurt Europe's large economies (and, therefore, Spain's). Another source of uncertainty is the possibility of rising oil prices, which would increase inflation and hurt real household incomes.

Internally, the risks are concentrated in the current account deficit and in the Spanish households' gross indebtedness, which, in a context of rising interest rates and eventually further increases in oil prices, might lead to a sharper adjustment in private consumption expenditure and, above all, in residential investment. Conversely, a delay in the downturn in housing demand would lead to greater GDP growth in the short term, increasing the possibility of a sharper adjustment later on.

In any event, both the external and internal risks are considered to have a low probability in comparison with the central scenario described in the preceding paragraphs.

Table 4
LABOUR MARKET DEVELOPMENTS (*)

	ESA Code	2005 (A)		2006 (F)	2007 (F)	2008 (F)	2009 (F)
		Level	Rate of change (%)				
1. Employment, persons (million)		**19.2**	**3.8**	**3.4**	**3.1**	**2.9**	**2.8**
2. Employment, FTEQ (million people)		**17.9**	**3.1**	**3.1**	**2.6**	**2.4**	**2.3**
3. Labour productivity, persons (GDP/1) (thousand euro)		**38.5**	**-0.3**	**0.3**	**0.3**	**0.4**	**0.5**
4. Labour productivity, FTEQ (GDP/2) (thousand euro)		**41.2**	**0.4**	**0.6**	**0.8**	**0.9**	**1.0**
5. Compensation of employees (**) (million euro)	D1	**27.6**	**2.6**	**3.2**	**2.8**	**2.7**	**2.6**
6. Unemployment (% of labour force)		**9.2**		**8.3**	**7.8**	**7.7**	**7.6**

(*) National Accounts definition, except the unemployment rate
(**) Compensation of employees, FTEQ
(A) Advance
(F) Forecast
Source: INE and Ministry of Economy and Finance.

3.4. Sectoral balances

The Spanish economy's external borrowing has increased since 2004, reaching 8.6% of GDP in the first three quarters of 2006, i.e. above the average of the main euro area economies. The deterioration in the foreign balance has been concentrated in trade in goods and services, though the other balances have also deteriorated to a lesser extent.

There are many reasons for the increase in the foreign deficit in goods and services. Firstly, rising energy prices have played a major role in increasing Spain's trade deficit because of the economy's high-energy dependence and energy intensity. In the first nine months of 2006, nearly two-thirds of the increase in the trade deficit, in absolute terms, were due to the widening energy deficit, while the non-energy deficit clearly decelerated. Secondly, the Spanish economy grew rapidly, contrasting with slack performance by its main trading partners, with the result that goods imports were much more dynamic than exports until the end of last year. Also, strong price competition from Asian imports in certain traditional segments of the Spanish industry, such as textiles, footwear and toys, plus the accession of new countries to the European Union, led to a replacement of domestic products with imports which was greater than the increase in exports to those countries as a result of their opening.

In the first nine months of 2006, goods exports recovered strongly as the European economy rebounded, and they attained the highest growth rate since 2000 after weak performance in 2005; this trend will continue as the European economy recovers.

Table 5
SECTORAL BALANCES (National Accounts)

	ESA Code	2005 (A)		2006 (F)	2007 (F)	2008 (F)	2009 (F)
		Level (*)	% of GDP				
1. Net lending (+)/borrowing (-) vis-à-vis the rest of the world	**B.9**	**-59.1**	**-6.5**	**-7.5**	**-8.2**	**-8.4**	**-8.7**
- Balance of goods and services		**-48.6**	**-5.4**	**-6.2**	**-6.8**	**-7.1**	**-7.3**
- Balance of primary incomes and current transfers		**-18.9**	**-2.1**	**-2.0**	**-2.1**	**-2.0**	**-1.9**
- Capital account		**8.5**	**0.9**	**0.7**	**0.6**	**0.6**	**0.5**
2. Net lending (+)/borrowing (-) of the private sector	**B.9/EDP B.9**	**-69.2**	**-7.6**	**-8.9**	**-9.2**	**-9.3**	**-9.5**
3. Net lending (+)/borrowing (-) of general government	**B.9**	**10.1**	**1.1**	**1.4**	**1.0**	**0.9**	**0.9**
4. Statistical discrepancy		**-**	**-**	**-**	**-**	**-**	**-**

(*) Billion euro
(A) Advance
(F) Forecast
Source: INE and Ministry of Economy and Finance.

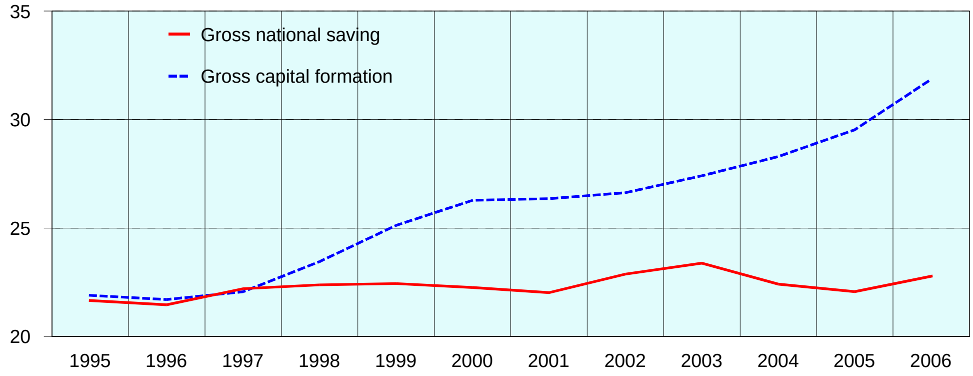
At the same time, exports to the rest of the world performed very well, to that extent that in 2006 their contribution to total export growth was greater than exports to the rest of the EU, even though they account for just 30% of total trade. Exports in sectors such as transport and renewable energy were very dynamic. In the first half of 2006, Spain's share of world exports of goods was the same as in 2005, around 1.8%, after declining slightly from its 2003 peak.

As for services exports, the tourist surplus declined slightly in the first three quarters of 2006, due not so much to tourist arrivals (which increased by 5% in that period) as to a shortening of the average stay, which may be due to a change in the pattern of tourism caused by the profusion of low-cost airlines and the agility and reduction in travel costs caused by the use of new technologies. Nevertheless, tourism revenues rose quarter on quarter in 2006 as the economies of the main source countries for tourists improved, and this had a positive impact on the sector's expectations. Conversely, tourism payments also increased considerably in the period due to Spaniards' increasing propensity to travel abroad. Nevertheless, that is expected to ease off in the future, as observed in the first nine months, in line with private consumption expenditure.

A combined analysis of domestic saving, gross fixed-capital formation and the current account balance reveals that the Spanish economy's high external borrowing is still due to the sharp increase in gross fixed-capital formation. Investment materialised not just in construction but also in capital goods and other products, and is double the level of the main EU countries as a percentage of GDP. Overall, Spain's gross fixed-capital formation is well above the European Union average, while domestic saving is close to that of our trading partners and has been stable in recent years.

The breakdown by institutional sectors reveals that the government sector, which registered a surplus amounting to 1.1% of GDP in 2005, will again contribute to containing the external imbalance in 2006 with a surplus of 1.4% of GDP. Private sector borrowing will increase to 8.9% of GDP as a result of ongoing investment by Spanish business and households, driven by favourable economic prospects, good corporate earnings and the steady pace of job creation. During the projection period, the public sector is expected to keep a moderating influence, generating a surplus every year, while the private sector will continue to draw on foreign savings to finance its investments. The sector of households and NPISH (non-profit institutions serving households) will have a net borrowing requirement during the projection period but that requirement will decline from 2007 onwards due to the rising saving rate and decelerating investment in housing.

Figure 4
Savings and investment in the Spanish economy
As a % of GDP, at current prices



Source: INE (quarterly national accounts).

4. GENERAL GOVERNMENT BALANCE AND DEBT

4.1. Policy strategy

The Stability Programme Update 2006-2009 lends continuity to the fiscal strategy that commenced with the 2005 Budget, whose priority is to attain budgetary stability while also progressing towards improvements in productivity, solidarity, social cohesion and quality in public services.

Commitment to budgetary stability over the economic cycle

The commitment to budgetary stability is evident both in the surpluses projected up to 2009 and in the steady decline in public debt as a percentage of GDP, both of these goals go beyond the requirements of the Stability and Growth Pact. This fiscal approach fits the macroeconomic outlook in the Programme's projection period and provides sufficient room for manoeuvre to eventually absorb any negative budgetary impacts of a worse than expected economic situation without jeopardising the fulfilment of the Community commitments or preventing fiscal policy from playing its necessary stabilising role. In fact, budgetary stability places the public finances in an advantageous position to face longer-term pressures on expenditure as a result of an ageing population or globalisation.

The commitment to sound public finances has been strengthened through the recent amendment to the Budgetary Stability Laws (see chapter 8 of this Update). This reform allows a more realistic application of the budgetary stability principle as it enhances the stabilising role of fiscal policy and fosters greater consensus and participation of all the public administrations in setting the budgetary targets. Although the reform will not fully apply until the 2008 Budget, its main features have been used in the 2007 Budget and in defining the 2007-2009 budgetary targets. In particular, in coherence with the economic growth projections, it has been budgeted for the first time a surplus for the State already in 2007 as well as in the subsequent years. Also for the first time, the budgetary stability objective of the State and the Social Security have been calculated and defined separately, reflecting a strong commitment to financial solvency and providing a guarantee of transparency in the public accounts.

Prioritising productive public expenditure and policies aimed at improving the quality of public finances

This Update continues to foster policies that contribute to increasing the Spanish economy's growth capacity and productivity. For this reason, special attention is devoted to research and development, infrastructure and education spending items. The draft 2007 Budget is the third one in which expenditure is reoriented towards programmes to enhance productivity.

The quality of the public finances will also benefit from the entry into force next year of the direct taxation reform. That reform makes the tax system more efficient by strengthening the incentives to job creation, saving and business investment. The reform is described in more detail in chapter 6.3, which refers to the quality of public finances from the standpoint of revenue. Public policy efficiency is also being reinforced by steps taken to modernise its management techniques, including by reorganising staff and updating equipment (see chapter 6.2).

Guaranteeing the long-term sustainability of public finances to ensure the sufficiency and sustainability of social spending

The third main thrust of the fiscal strategy encompasses steps to guarantee the sufficiency and sustainability of social spending so as to enhance social cohesion by ensuring that the benefits of economic growth flow to all citizens. During the period to which this Update refers, the projected Social Security surplus will be used to continue increasing the pension Reserve Fund year after year, which is estimated to attain 4.0% of GDP after the provision out of the 2007 Budget. The debt will continue to decline as a percentage of GDP and is expected to be below 40% already in 2006, thus releasing funds for areas that can enhance the economy's growth potential and reducing the burden on future generations. These major measures are complemented by the reform of the pension system that was agreed upon by the Government and the social partners in July 2006, with important steps to lengthen working lives and attain a greater balance between contributions and benefits.

The healthcare system's financial viability is also being addressed in the period covered by this Update, during which it will be able to observe the effects of the measures adopted in June 2006 to foster the rational use of medicines and healthcare products, and those adopted in March 2006, in the framework of the Quality Plan for the National Health System, drafted with the Autonomous Communities, to improve the system's quality and cohesion.

4.2. Medium-term budgetary targets (2007-2009)

In accordance with the provisions of the General Budgetary Stability Law that is still in force, on 2 June 2006 the Cabinet approved the budgetary stability objectives for 2007-2009 and the limit on non-financial expenditure in the 2007[4] for the Central Government Budget. Those objectives (detailed in table 6) anticipate some of the features of the reform to the budgetary stability laws that will come into force in January 2007. For example, a target surplus for the State is established for the period and it is calculated separately from the Social Security surplus, thus lending greater transparency to the public accounts. These objectives also fulfil and surpass the Community commitments on discipline in public finances.

Table 6
BUDGETARY OBJECTIVES 2007-2009 APPROVED BY THE SPANISH PARLIAMENT (June 2006)
Lending (+)/Borrowing(-) as a % of GDP

	2007	2008	2009
Central government	0.2	0.2	0.2
Autonomous Communities	-0.1	0.0	0.0
Local government	-0.1	0.0	0.0
Social Security	0.7	0.6	0.6
General government	0.7	0.8	0.8

Source: Ministry of Economy and Finance.

Nevertheless, better performance by the Spanish economy, and by public revenue in particular, with respect to the initial provisions has made it advisable to upgrade the budgetary stability objectives for 2007. The breakdown of the budget balances by public administrations for the period 2006-2009 is detailed in Table 7.

[4] Approved by the Congress on 20 June 2006 and by the Senate on 22 June 2006.

Table 7 BUDGETARY PROJECTIONS							
	ESA Code	2005 Level (billion euro)	2005	2006	2007	2008	2009
			% of GDP				
Net lending (+)/borrowing (-) (EDP. B9)							
1. General government	S. 13	10,239	1.1	1.4	1.0	0.9	0.9
2. Central government	S. 1311	4,102	0.5	0.6	0.3	0.3	0.3
3. Autonomous Communities	S. 1312	-2,729	-0.3	-0.1	-0.1	0.0	0.0
4. Local government	S. 1313	-971	-0.1	-0.2	-0.1	0.0	0.0
5. Social security funds	S. 1314	9,837	1.1	1.1	0.9	0.6	0.6
General government (S. 13)							
6. Total revenue	TR	356,403	39.4	39.8	39.6	39.5	39.5
7. Total expenditure	TE	346,164	38.2	38.4	38.6	38.6	38.6
8. Net lending/borrowing	EDP. B9	10,239	1.1	1.4	1.0	0.9	0.9
9. Interest expenditure	EDP. D41	16,144	1.8	1.6	1.5	1.4	1.3
10. Primary balance		26,383	2.9	3.0	2.5	2.3	2.2
Selected components of revenue							
11. Total taxes		213,096	23.5	23.9	23.8	23.8	23.9
11a. Taxes on production and imports	D.2	110,004	12.1	12.1	12.0	12.0	11.9
11b. Current taxes on income, wealth, etc.	D.5	99,037	10.9	11.4	11.4	11.5	11.5
11c. Capital taxes	D.91	4,055	0.4	0.4	0.4	0.4	0.4
12. Social contributions	D.61	117,415	13.0	13.0	13.0	12.9	12.9
13. Property income	D.4	6,060	0.7	0.7	0.7	0.6	0.6
14. Other		19,832	2.2	2.2	2.2	2.1	2.0
15. Total revenue	TR	356,403	39.4	39.8	39.6	39.5	39.5
p.m.: Tax burden		322,306	35.6	35.9	35.9	35.9	35.9
Selected components of expenditure							
16. Collective consumption	P.32	67,503	7.5	7.3	7.3	7.3	7.3
17. Total social transfers	D. 62+D. 63	200,455	22.1	22.2	22.4	22.4	22.4
17a.Social transfers in kind	P.31=D.63	95,131	10.5	10.6	10.6	10.6	10.6
17b. Social benefits other than social transfers in kind	D.62	105,324	11.6	11.7	11.8	11.8	11.8
18. Interest expenditure	EDP. D.41	16,144	1.8	1.6	1.5	1.4	1.3
19. Subsidies	D.3	8,978	1.0	1.0	1.0	1.0	1.0
20. Gross fixed capital formation	P.51	32,159	3.6	3.7	3.9	3.9	4.0
21. Other		20,925	2.3	2.5	2.6	2.6	2.6
22. Total expenditure	TE	346,164	38.2	38.4	38.6	38.6	38.6
p.m.: Compensation of employees		90,569	10.0	9.9	9.9	9.9	9.9
Source: Ministry of Economy and Finance.							

This Stability Programme Update projects a general government surplus amounting to 1.0% of GDP in 2007, i.e. 0.3 percentage points more than the objective approved in June, while the surpluses for 2008 and 2009 have been upgraded by 0.1 percentage points to 0.9% of GDP in both years. As mentioned before, that upward correction to the 2007 surplus is due to expected positive performance by public revenue in 2006 in a context of economic activity that has proven to be more dynamic than expected, with a knock-on effect on revenue in 2007. This 0.3 percentage point increase in the surplus with respect to the June projection is due to an upward revision of 0.1 percentage points in the Central Government surplus and of 0.2 points in the Social Security surplus.

In this Update, the Medium-Term Objective for public finances is still a "cyclically-adjusted budget balance". This goal was introduced for the first time last year to comply with the 2005 revision of the Stability and Growth Pact. It is a more demanding objective than mere compliance with the Pact, which allows a cyclically-adjusted deficit of up to 1% of GDP. It is consistent with the current fiscal policy strategy as it makes a determined contribution to the long-term sustainability of the public finances. Moreover, none of the conditions for its revision as envisaged in the Pact (every four years, in principle) apply.

It is important to note that, in addition to being consistent with the current fiscal strategy and the fact that it surpasses the fiscal commitments assumed in the context of the EU, budgetary stability is a prudent goal. On one hand, because of the caution with which estimates of the structural or cyclically-adjusted balance should be taken. And on the other, because the very concept of Medium-Term Budget Objective contained in the amended Pact may be revised at Community level to take account of the implicit liabilities in its definition.

4.3. Actual budgetary balances and implications for 2007

The fact that the Spanish economy is growing faster than projected explains why public revenue in 2006 increases as fast as in 2005 and, in any case, significantly faster than projected nominal GDP growth, as shown in the information available to date regarding budgetary execution by the State and the Social Security.

As a result of that performance, it is estimated that public revenue will increase by 0.4 percentage points of GDP in 2006 up to 39.8% of GDP. The increase will be due primarily to taxes, particularly indirect taxes, whose taxable bases (earned income, capital income, capital gains and corporate earnings) have increased rapidly in 2006, in line with growth in economic activity. Indirect taxes will increase by less than direct taxes due primarily to the moderate increase in excises taxes, caused by slow growth in the consumption of hydrocarbons and tobacco (mainly), and the high volume of VAT refunds.

In the context of strong labour market performance in Spain, social security contributions will grow at least as fast as nominal GDP growth and are expected to amount to 13% of GDP in 2006.

On the expenditure side, the most dynamic expenditure items in 2006 will be those related to social welfare benefits (pensions and other benefits) and to increasing public productive capital (gross fixed-capital formation) while the interest burden will again decline as a percentage of GDP due to the decline in the debt/GDP ratio and in the effective interest rate on the debt. Overall, public spending will increase as a share of GDP by 0.2 percentage points to 38.4%. As a result of that trend in public revenue and expenditure, the Public Administrations will end 2006 with a surplus of around 1.4% of GDP, compared with 0.9% projected in the last Stability Programme Update.

Strong growth in public revenue in 2006, and the knock-on effect on 2007 revenue plus a sustained high rate of economic growth (above initial forecasts), are the reasons for upgrading the projected surplus in 2007 to 1.0% of GDP, from 0.7% estimated in the budgetary stability objective approved in June.

As a result of the entry into force of the reform of personal and corporate income taxes (see chapter 6.3) in 2007, direct taxes will remain stable at 11.4% of GDP[5]. In a context of slower price rises (including housing prices), a moderate deceleration in private consumption expenditure, and stable excise tax rates, indirect taxes revenue will increase by slightly less than nominal GDP, i.e. it will decline somewhat as a percentage of that aggregate. Social security contributions are expected to remain stable as a percentage of GDP.

As a result of the trend in taxes and social security contributions described above, government revenue will rise by slightly less than nominal GDP in 2007 and will amount to 39.6% of that aggregate, 0.2 percentage points less than in 2006.

The 2007 Budget maintains and strengthens the Government's priority focus on items of public expenditure (including research, development and innovation, education and infrastructure) which have a more positive impact on the economy's growth potential; at the same time, it focuses on improving the quality of fundamental public services and strengthening the social dimension of public spending, both internally (minimum pensions, long-term care, immigration, etc) and externally (development aid).

Accordingly, it is estimated that public expenditure will increase by 0.2 percentage points of GDP in 2007 to 38.6%, driven primarily by social transfers, both in kind (basically education and healthcare expenditure) and otherwise (pensions, maternity benefits, etc), and by gross fixed-capital formation and other residual items (student grants, capital transfers and development aid, among others).

Finally, interest on the public debt will continue to decline as a percentage of GDP, though not as quickly as in recent years since interest rates have been rising in 2006 after reaching a low in 2005.

In 2008 and 2009, public revenue is expected to be 0.1 percentage points below its 2007 level, while expenditure will rise in line with GDP, maintaining its 2007 weighting (38.6% of GDP).

[5] The budgetary cost of the fiscal reform is estimated at 0.4 percentage points in 2007 and 0.1 percentage points in 2008.

4.4. Structural balance and fiscal stance

Table 8 includes the estimates of the annual change in the cyclically-adjusted primary balance linked to the budgetary objectives of this Update calculated according to different methodologies to estimate the output gap. In particular, the output gap has been estimated using the following three approaches:

- A purely statistical approach based on the Hodrick-Prescott filter. This is the methodology used in the previous Updates in accordance with the exception allowed for Spain, among others countries.

- Two econometric estimates computed by applying the Cobb-Douglas production function methodology of the Output Gap Working Group and the European Commission[6] to two different approaches for the NAIRU: a) making the NAIRU consistent with the long-term real unemployment rate included in this Update[7] and b) using the Commissionn's series.

As Table 8 shows, the level of the output gap differs significantly among the three estimations, highlighting the sensitivity of these results to the methodology and series applied. Consequently, the conclusions about the cyclical position of the economy as well as about the fiscal stance which are based on the level of the cyclically-adjusted balance must be taken with due caution[8].

However, using the annual change in the cyclically-adjusted primary balance as an indicator of the fiscal stance provides more similar outcomes under the three different approaches since all of them achieve a cyclically-adjusted primary surplus which remains quite stable during the whole projection period. Moreover, the reform of personal and corporate income tax will come into force in 2007 while its effects, though attenuated, will persist into 2008. Additionally, the standard methods for setting fiscal policy fail when, as in the case of Spain, the variations in the structural primary balance (upward or downward) are small and the time-scale is very short.

Consequently, the results described in table 8 reveal a neutral, prudent fiscal policy approach. This neutral orientation, which is compatible with the interplay of the automatic stabilisers, will contribute to the economy's nominal stability.

[6] "Calculating potential growth rates and output gaps. A revised production function approach". Céline Denis, Daniel Grenouilleau, Kieran Mc Morrow and Werner Röger. European Commission. Economic Papers number 247. March 2006.
[7] The average of the NAIRU equals the real unemployment rate over the entire period.
[8] Estimations by other national and international analysts also using the production function approach as well as other multivariate statistical approaches achieve very different outcomes, including positive output gaps for the projection period.

Table 8 CYCLICAL DEVELOPMENTS % of GDP, unless otherwise stated					
	2005	2006	2007	2008	2009
1. Real GDP growth (% change)	3.5	3.8	3.4	3.3	3.3
2. Net lending (+)/borrowing (-)	1.1	1.4	1.0	0.9	0.9
3. Interest expenditure	1.8	1.6	1.5	1.4	1.3
DIFFERENT ESTIMATES					
A. H-P FILTER(1)					
Trend GDP growth (% change)	3.5	3.5	3.5	3.4	3.4
✓ Output gap	0.0	0.3	0.2	0.1	0.1
✓ Cyclically- adjusted change in primary balance	0.4(*)	0.0	-0.5	-0.2	-0.1
B. PRODUCTION FUNCTION APPROACH OUTPUT GAP WORKING GROUP/COMMISMION					
B.1. NAIRU: OWN ESTIMATE(2)					
Potential GDP growth (% change)	3.8	3.7	3.7	3.6	3.3
✓ Output gap	-0.2	-0.1	-0.4	-0.7	-0.6
✓ Cyclically- adjusted change in primary balance	0.5(*)	0.1	-0.4	-0.1	-0.1
B.2 NAIRU: COMMISSION ESTIMATE(3)					
Potential GDP growth (% change)	3.7	3.7	3.6	3.6	3.3
✓ Output gap	-0.9	-0.9	-1.1	-1.4	-1.3
✓ Cyclically- adjusted change in primary balance	0.5(*)	0.1	-0.4	-0.1	-0.1

(1) Using the Hodrick-Prescott filter with Lambda=100
(2) Using the production function methodology of the Output Gap Working Group/Commission where the average NAIRU is equal to the average real unemployment rate over the period and the demographic projections of the National Statistics Institute's scenario 1 which contains higher projections for the labour force than the so-called scenario 2 which is the one used by Eurostat.
(3) Using the production function methodology and the Commission's NAIRU approach.

(*) Net of the RENFE debt assumed by the State.

Fuente. Ministry of Economy and Finance.

4.5. Debt levels and developments.

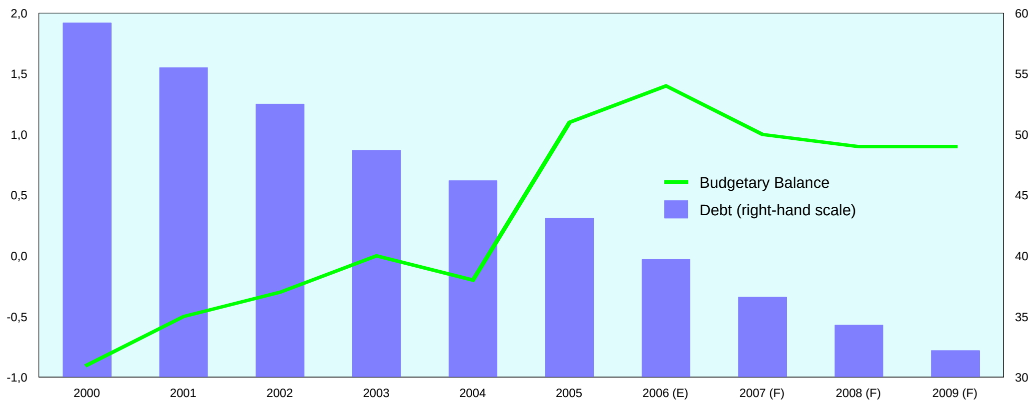
The budgetary outcomes projected in this Stability Programme Update 2006-2009 will enable the public debt to clearly decline steadily as a percentage of GDP during the period, thus strengthening the public finances vis-à-vis future challenges, especially those associated with population ageing. Between 2005 and 2009, the debt is projected to decline by 11 percentage points of GDP to 32.2% at the end of the period (Table 9). This projection assumes that, following relatively high stock-flow adjustments[9] in recent years, the latter returns to approximately its historical average, i.e. 0.8% of GDP.

[9] Adjustment due to net acquisitions of financial assets and other adjustments which, in each period, make it possible to cover the lending (+)/borrowing (-) and the variation in debt drawn up in accordance with the Excessive Deficit Procedure (EDP).

Table 9 GENERAL GOVERNMENT DEBT DEVELOPMENTS % of GDP						
	2005	2006	2007	2008	2009	Change -2009
1. Gross debt	43.1	39.7	36.6	34.3	32.2	
2. Change in gross debt	-3.1	-3.4	-3.1	-2.4	-2.1	-7.6
Contributions to change in gross debt						
3. Primary budget balance	-2.9	-3.0	-2.5	-2.3	-2.2	-7.0
4. Interest expenditure	1.8	1.6	1.5	1.4	1.3	4.2
5. Effect of nominal GDP growth	-3.3	-3.1	-2.5	-2.3	-2.1	-6.8
6. Other factors	1.4	1.1	0.4	0.8	0.8	2.0
p.m.: implicit interest rate on debt	4.16	4.01	4.01	4.05	4.05	
Source. Ministry of Economy and Finance.						

From 2008 onwards, the decline in the debt ratio is slightly slower than in previous periods, partly due to projected lower primary surpluses but primarily to the fact that the impact of nominal GDP growth in reducing the debt ratio declines as the nominal variation in GDP declines along with the previous year's debt ratio.

Figure 5
Deficit and Public Debt
(% of GDP)



Source: Ministry of Economy and Finance and Bank of Spain. (E) Estimation. (F) Forecast.

Accordingly, the primary surpluses envisaged for 2007-2009 will reduce the debt ratio by 7.0 percentage points in that period while nominal GDP growth will contribute an additional 6.8 percentage points reduction. Conversely, interest payments and the stock-flow adjustment will increase the debt ratio by 4.2 and 2.0 percentage points, respectively. The net outcome of those four factors will be a 7.6 points reduction in the debt as a percentage of GDP, to 32.2% at the end of the period.

5. SENSITIVITY ANALYSIS AND COMPARISON WITH PREVIOUS UPDATE

5.1. Sensitivity analysis: alternative growth scenarios and risks

In order to estimate the sensitivity of Spain's public finances (budget balance and debt) to changes in the macroeconomic scenario, it is assumed that real GDP growth is the only variable that changes. Accordingly, an alternative scenario (lower growth scenario) is considered in which real GDP growth is 0.5 percentage points lower than in the baseline scenario in each year of the projection period.

The results are shown in table 10, which reveals that slower economic growth would give rise to a steady decline in the surplus in 2007-2009 with respect to the baseline scenario, with the surplus reaching nearly zero at the end of the projection period, contrasting with 0.9% in 2009 in the baseline scenario.

In the lower growth scenario, the public debt would rise by 0.5, 1 and 1.8 percentage points of GDP in 2007, 2008 and 2009, respectively, to represent 34% of GDP in 2009. That is to say, whereas the baseline scenario projects a 7.6 percentage points decline in the debt ratio in the three-year reference period, the lower growth scenario would provide a 5.7 percentage points decline.

Table 10
SENSITIVITY ANALYSIS
Alternative growth scenarios

	2005	2006	2007	2008	2009
	Baseline growth scenario				
Real GDP growth (%)	3.5	3.8	3.4	3.3	3.3
Budgetary balance (% of GDP)	1.1	1.4	1.0	0.9	0.9
Gross debt (% of GDP)	43.1	39.7	36.6	34.3	32.2
	Lower growth scenario				
Real GDP growth (%)	3.5	3.8	2.9	2.8	2.8
Budget balance (% of GDP)	1.1	1.4	0.8	0.4	0.2
Gross debt (% of GDP)	43.1	39.7	37.1	35.3	34.0
Source: Ministry of Economy and Finance.					

5.2. Sensitivity analysis: interest rates

The analysis of sensitivity to interest rates is performed, as usual, by assuming the yield curve implicit in the calculations of the baseline scenario is shifted upward (higher rates scenario) and downward (lower rates scenario) by 1 percentage point.

Also, it is assumed that the variation in interest rates affects the public accounts alone, with no impact on the other macroeconomic variables, and that the fiscal authorities do not react to the interest rate change by modifying other public revenue or expenditure items. Finally, the new interest rates are assumed to apply only to new debt issued to cover borrowing needs and redemptions in the period.

Table 11 SENSITIVITY ANALYSIS: Interest rates % of GDP					
	2005	2006	2007	2008	2009
High interest rate scenario					
Budget balance	1.1	1.4	1.0	0.8	0.7
Gross debt	43.1	39.7	36.7	34.5	32.5
Baseline scenario					
Budget balance	1.1	1.4	1.0	0.9	0.9
Gross debt	43.1	39.7	36.6	34.3	32.2
Low interest rate scenario					
Budget balance	1.1	1.4	1.1	1.0	1.0
Gross debt	43.1	39.7	36.6	34.1	31.8
Source: Ministry of Economy and Finance.					

The result of the interest rate sensitivity analysis in these conditions is shown in table 11. The fiscal variables' response to the change in interest rates is relatively slow because the average life of Spain's public debt is close to 7 years. At the end of the projection period, shifting the rate curve by 1 percentage point produces deviations with respect to the baseline scenario of around 0.2 percentage points of GDP in the budgetary balance and around 0.3 percentage points of GDP in the debt ratio.

5.3. Comparison with the previous Stability Programme Update.

Table 12 shows that the main differences between this Stability Programme Update and last year's update lie almost entirely in 2006, the baseline year for these projections, whereas the differences are much smaller in 2007 and 2008. This Update estimates 3.8% growth by the Spanish economy in 2006, whereas the previous Update projected 3.3%.

The differences with regard to the budget balance and public debt in 2006 are a logical consequence of the increased estimate of economic growth in this year. The differences in the other two years, 2007 and 2008, are lower (0.1 to 0.2 percentage points of GDP) as regards GDP growth and amount to 0.3 percentage points in the case of the budget balance, due to the revision of objectives and the knock-on effect of the reference year. The difference in debt ratios between the two Updates reveals a reduction of 1.4 percentage points in 2007 and close to 2 percentage points in 2008.

Table 12 DIVERGENCE FROM PREVIOUS STABILITY PROGRAMME UPDATE					
	2005	2006	2007	2008	2009
GDP growth (%)					
Previous update	3.4	3.3	3.2	3.2	
Current update	3.5	3.8	3.4	3.3	3.3
Difference	0.1	0.5	0.2	0.1	
Budgetary balance (% of GDP)					
Previous update	1.0	0.9	0.7	0.6	
Current update	1.1	1.4	1.0	0.9	0.9
Difference	0.1	0.5	0.3	0.3	
Gross debt (% of GDP)					
Previous update	43.1	40.3	38.0	36.0	
Current update	43.1	39.7	36.6	34.3	32.2
Difference	0.0	-0.6	-1.4	-1.7	
Source: Ministry of Economy and Finance.					

6. QUALITY OF PUBLIC FINANCES

6.1. Policy strategy

The quality of public finances holds a central position in the fiscal policy strategy adopted by Spain in 2004. It is addressed from a broad perspective, focusing not only on public revenue and expenditure but also on making the necessary institutional reforms to ensure that quality in public finances is attained and maintained over time. The institutional reforms announced in the previous Update are at an advanced stage of approval; in particular, the reform of the Budgetary Stability Laws has already been approved and the amendment to the system of regional financing is being studied (details about these reforms are included in Chapter 8 of this Update). This chapter provides details of the fiscal rules existing in Spain, in coherence with the Conclusions[10] adopted by the European Union Ministers of Economy and Finance on this issue.

As for expenditure, the strategy aims to prioritise policies that foster an increase in productivity and the economy's growth potential which, in turn, benefit the long-term sustainability of public finances. Therefore, since the 2005 Budget, priority has been given to improving the economy's capitalisation by increasing the level of technological, physical and human capital. In addition to the budgetary effort, this expenditure strategy is complemented by the necessary reforms to make the policies more efficient. They include regulatory reforms, such as the amendment to the rules governing subsidies or the Agency Law,

[10] ECFIN 10th October 2006 on Quality of Public Finances.

together with horizontal measures to improve the quality of public expenditure policies in general by creating the State Agency for the Evaluation of Public Policies and Service Quality.

Regarding revenue, direct taxes have been amended to increase the tax system's efficiency and equity while maintaining the revenue neutrality principle.

6.2. Developments on the expenditure side

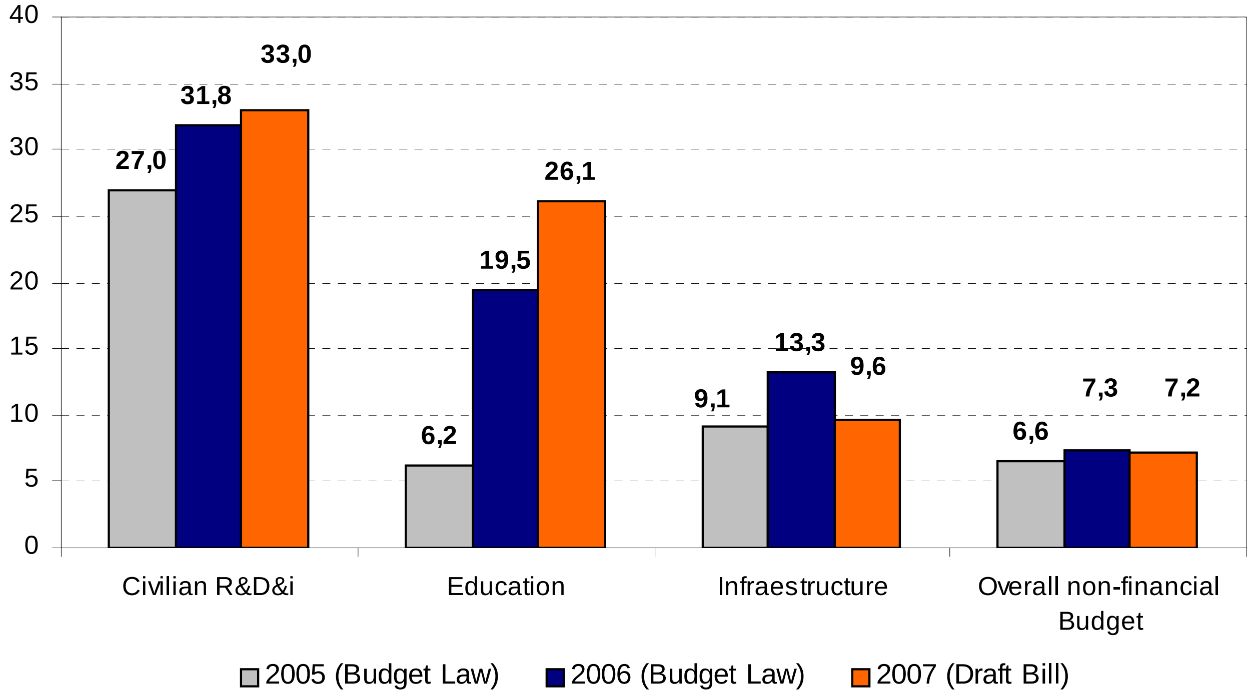
Since the 2005 Budget, public expenditure has given priority to enhancing the economy's growth potential through its impact on productivity: expenditure on research, development and innovation (RDI), infrastructure and education. The Central Government Budgets approved in the current legislature have increased expenditure on civilian RDI, infrastructure and education by 67.4%, 26.9% and 23.6%, respectively, with respect to 2004, while total expenditure rose by 16.6%. This focus will be maintained during the period covered by this Update. In particular, the draft Central Government Budget for 2007 foresees increases in these areas, which are notably higher than overall spending growth.

The commitment to these expenditure policies and the resulting need to ensure a sufficient, continuous flow of funds is manifested in the adoption of medium-term strategic plans and programmes. In 2005, the Government approved the Ingenio 2010 programme, which defines the medium-term strategy to boost RDI and converge with Europe. In particular, that programme sets specific goals to increase RDI spending to 2% of GDP by 2010 (1.6% in 2008), with the private sector contributing 52.5% in 2008 and 55% in 2010. The goal is also to increase the Information Society's share of the economy to 6.4% of GDP by 2008 and 7% by 2010 (vs. 4.8% in 2004).

To this end, Ingenio 2010 mobilises the necessary funds and concentrates them in three priority programmes which were successfully launched in 2006. The CENIT Programme (Strategic National Consortia in Scientific Research) to foster public-private collaboration in strategic integrated industrial research projects; the CONSOLIDER Programme to increase cooperation among researchers in projects by leading consortia and special facilities; and the AVANZ@ Plan to foster the development of the Information Society among citizens, businesses and the public administration, and to narrow the gap with the EU. The draft 2007 Central Government Budget increases the allocation for civilian research by 33% with respect to 2006, doubling the 2004 level of funding. (Figure 6)

In addition to this expenditure, a number of regulatory reforms are being made to promote research. The Agency Law, discussed later, allows research centres to adopt an organisation model under which they can manage resources more flexibly. The new Regulation under the General Subsidies Law makes administrative procedures for public financing of R&D more flexible. The Draft Government Procurement Law gives research centres more agility in contracting, as well as putting this process on-line. The draft amendment to the Universities Law seeks to incentivate the transfer of knowledge to the private sector by fostering cooperation between universities and industry and providing researchers and lecturers with mobility through leaves of absence.

Figure 6
Expenditure Priorities 2005-2007
% Change



Source: Ministry of Economy and Finance. The overall budget includes the State, Central Government, Social Security and other public entities.

Along with policies to promote research and develop infrastructure, the formation of human capital is vital for providing sustained productivity growth. Training is also the main method of promoting equal opportunities and social cohesion. The draft Central Government Budget for 2007 maintains the remarkable allocations to these policies: the allocation for education is 26.1% higher than in 2006, while allocations for professional training for employment are up 11.1%.

Education funding is channelled principally through a policy of student grants and aid, which will increase by 19.9% in 2007 with respect to 2006. The remainder of the allocation is assigned to implementing the new Education Organic Law, notably to provide freely the second level of pre-school. The draft amendment to the Universities Organic Law is also aimed at improving the quality of education.

As regards training, in February 2006 an agreement on professional training for employment was signed which merges the two existing systems (continuous training and occupational training).

The reorientation of public spending towards infrastructure policy is articulated through the 2005-2020 Strategic Infrastructure and Transport Plan (PEIT)[11] and the AGUA Water Programme[12]. These programmes ensure the sustainability of the funding required to overcome the Spanish economy's deficit in physical capital, boost productivity, enhance a more efficient functioning of markets, and strengthen territorial cohesion. The PEIT is the basic planning instrument for infrastructure and the transport system. It sets out the medium and long-term guidelines for action to achieve a quality transport system that is more integrated, safer and more efficient. The AGUA programme reflects the change in water policy in 2004 and it has the following objectives: promote more efficient and effective water management; improve water quality; and preserve the natural heritage.

The draft Central Government Budget for 2007 increases infrastructure expenditure by 9.6% with respect to 2006. Additionally, a sizeable proportion of infrastructure is built via government agencies and corporations controlled by the Infrastructure and Environment Ministries. Investment is the largest item in the entire infrastructure budget.

The Royal Decree creating the State Agency for the Evaluation of Public Policies and Services Quality was approved in December 2006. Its purpose is to promote and conduct assessments of public policies and programmes managed by the Central Government with the aim of fostering rational use of public resources and quality management of services. Each year, the Council of Ministers will approve the list of public programmes and policies, which the Agency must include in its schedule. Also, each year the Agency must present to Congress a report on the state agencies' activities and their commitments to improving the quality of public services. The agency can also assess public policies and programmes managed by the regional governments subject to prior agreement with the latter. The draft Central Government Budget for 2007 assigns 4.9 million euro to the Agency.

The Agency has been created in the context of the State Agencies Law[13], whose goal is to provide the administration with an organisational model that facilitates more flexible, autonomous management (see chapter 8.2). Within this process of improving public services, particular attention is given to modernising the administration's technology through initiatives such as RED060[14] for comprehensive services to citizens and the SARA[15] project which develops new communications platforms within the administration to eliminate the need to present documents already available elsewhere in the administration. The draft Government Procurement Law is a determined effort to manage the procurement process online and to eliminate barriers to bidding for government contracts. The draft Basic Statute of the Public Employee will also have a positive impact on the Administration's internal management.

[11] www.fomento.es
[12] www.mma.es
[13] Act 28/2006 of State Agencies for Improving Public Services.
[14] www.red060.es
[15] www.map.es

6.3. Developments on the revenue side

The reform of personal income tax and corporate income tax, which improves the efficiency and equity of direct taxation, will come into force on 1st January 2007.

The personal income tax reform seeks to make the tax more equitable while favouring economic growth, ensuring sufficient funding, improving the neutrality of taxes on saving, and addressing the challenges posed by ageing and long-term care. The reform includes the following measures:

- It reduces the tax burden on wages. It increases the earned income tax credit, particularly for lower incomes, and widens the tax brackets by reducing their number to four, thus simplifying the tax.
- It reduces the maximum marginal rate from 45% to 43%.
- It establishes more equitable tax treatment of taxpayers' personal and family circumstances by increasing the personal and family tax-free allowances.
- It provides a neutral tax system for income from savings, for reasons of equity and efficiency. All income from savings will now be combined into a single base that is taxed at 18%, regardless of the source (including dividends, with 1,500 euro tax free, and capital gains) and the period over which it was earned.
- It encourages the use of instruments to promote supplementary pensions and the coverage of certain risks. The law favours pensions collected in the form of an annuity, gives tax benefits to employer pension plans, and creates a product designed to encourage long-term saving: the "individual systematic saving plan".
- In the area of long-term care, the law incentivates private service provision by introducing two types of benefit: those aimed at people already in need of long-term care, who may sell their home free of capital gains tax or establish a reverse mortgage on their home (the income from which will not be taxable). And tax deductions for people seeking to insure against potential situations in which they would need long-term care.

The corporate income tax reform is to be phased in gradually and its main aim is to improve efficiency by simplifying the tax structure and making it more neutral in application. The main measures are as follows:

- A five-point reduction in the general rate within two years, from 35% at present to 32.5% in 2007 and 30% in 2008. Small and mid-sized enterprises will benefit from the full 5% cut within one year.
- Simplification of the system of tax deductions, since some have failed to achieve their goals while distorting decision-making by companies. Most tax deductions and credits are eliminated apart from those for double taxation and the reinvestment of profits. Deductions will be phased out over five years, or longer in some exceptional cases. These include the deduction for R&D and technological innovation. In order to enable

companies to adapt to this situation, research and development will be incentivated through rebates on the employer's social security contributions for research personnel.

Other substantial areas of the corporate income tax reform will be completed when the accounting regulations are adapted to International Financial Accounting Standards.

The possibility of adopting tax measures to internalise the negative effect of polluting activities is also being studied; this would contribute to rational, efficient use of energy resources in line with the commitments assumed by the EU based on the "polluter-pays" principle and the Kyoto Protocol on emission reduction. That reform will also reinforce inter-generational solidarity since current resources will be used so that future generations may enjoy a less deteriorated environment.

In parallel with the tax reform, the Law to Prevent Tax Fraud has been approved; it increases the tax inspectorate's powers and ability to respond efficiently, improves the tax administration's information resources and enhances the efficiency of collecting tax debts once fraud is detected. The law focuses particularly on especially serious fraud: real estate, VAT fraud, tax havens and related-party transactions.

7. SUSTAINABILITY OF PUBLIC FINANCES

In accordance with the "Guidelines on the format and content of Stability and Convergence Programmes", this Update includes projections of public expenditure related to population ageing drawn up by the Working Group on Population Ageing attached to the Economic Policy Committee (CPE) and the European Commission. The projections address five categories of public spending: pensions, healthcare, long-term care, education and unemployment; they use demographic and macroeconomic assumptions agreed upon by the Member States, and they assume no changes in economic policy. These projections were ratified by the ECOFIN Council in February 2006 and will be updated in Autumn 2009.

7.1. Long-term budgetary projections

Table 13 summarises the full projections for expenditure in Spain. The December 2005 Stability Programme Update contained only the projections for public expenditure on pensions. As Table 13 shows, total expenditure on the aforementioned five items will increase from 20% of GDP in 2005 to 28.6% in 2050, pensions being the main source of the increase in expenditure, followed by healthcare. Public pension expenditure will increase from 8.7% of GDP expected in 2005 to 15.7% in 2050 due mainly to a rise in the dependency rate (population aged 65+ as a percentage of the labour force) from 24.6% in 2004 to 65.6% in 2050; much faster than the European average, which will rise from 24.5% to 51.4% in the same period.

Table 13 LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES (% OF GDP)						
	2005	**2010**	**2020**	**2030**	**2040**	**2050**
Total pension expenditure Contributory (1+2)	**8.7**	**8.9**	**9.3**	**11.8**	**15.2**	**15.7**
Expenditure on contributory social security pensions *(1)	**7.8**	**8.1**	**8.5**	**11.0**	**14.4**	**15.2**
Old-age and early retirement pensions	5.2	5.2	5.5	7.7	10.9	11.8
Disability	0.9	1.0	1.1	1.2	1.2	1.1
Survivors' pensions	1.7	1.8	1.9	2.1	2.3	2.3
Non social security benefits (2)	**0.8**	**0.8**	**0.8**	**0.8**	**0.7**	**0.5**
Healthcare expenditure	6.1	6.3	6.7	7.3	7.9	8.3
Long-term care expenditure	0.5	0.5	0.5	0.5	0.6	0.8
Education	3.6	3.2	3.2	3.0	2.9	3.1
Unemployment	1.1	0.9	0.7	0.7	0.7	0.7
Total expenditure on ageing	**20.0**	**19.7**	**20.4**	**23.4**	**27.3**	**28.6**
ASSUMPTIONS						
Labour productivity growth	0.8	1.6	2.0	1.7	1.7	1.7
Real GDP growth	3.1	2.8	2.0	1.0	0.4	1.0
Participation rate males (aged 20-64)	85.6	86.9	87.9	87	86.1	87.8
Participation rate females (aged 20-64)	61.5	66.4	72.2	73.5	73.4	74.9
Total participation rates (aged 20-64)	73.6	76.7	80.2	80.3	79.9	81.5
Unemployment rate	10.4	8.7	7.0	7.0	7.0	7.0
Population aged 65+ as % of total population of working age	24.5	25.3	29.8	38.2	52.5	65.6

* Includes minimum pensions.
Source: Baseline Scenario of the Report on Projected Public Expenditure associated with Population Ageing. CPE and Commission, 2006.

In the agreed macroeconomic scenario, Spain ranks second in European Union (behind Cyprus) in the pace of growth of its labour force participation rate in the period 2004-2050. This is due to a large increase in the participation rates of women and older workers (aged 55-64). It is also the EU-15 country, which will experience the fastest reduction in the unemployment rate in the projection period (-3.4 percentage points with respect to 2005). However, although the number of employed will increase by 23% between 2003 and 2025, it will decline by 22% between 2025 and 2050 (the largest decline in the EU-15 in that second period), so that the overall variation in the period will be -3.8%.

One of the most salient outcomes is the deceleration in potential growth due to ageing. During the projection period, the potential growth rate in the EU-25 will halve, from 2.4% to 1.2%. That deceleration could be even sharper in Spain because of the larger decline projected in the contribution from employment at the end of the period.

Based on these expenditure projections, in October 2006 the Commission drew up a Report on the Sustainability of Public Finances, which evaluates the situation of each Member State. The countries are divided into three risk groups based on quantitative indicators (sustainability gaps) and qualitative factors. Spain is in the group of ten Member States considered to have a medium risk. Spain is rated as a country having sound public finances at present, but it is also one where ageing-related expenditure will rise considerably. The Commission's economic policy recommendation is that Spain continues implementing the agreed social security reform (detailed in the following section).

7.2 Policy strategy

The strategy to address the increase expected in age-related expenditure is based on three cornerstones:

- Budgetary stability, which helps to reduce the public debt/GDP ratio and increase the reserve fund assets.
- Greater employment, longer working life and higher productivity.
- A review of the pension, healthcare and long-term cares systems.

Social Security Reserve Fund

The Social Security surplus has led to an increase in allocations to the Social Security Reserve Fund (SSRF), which was created in 2000 to meet future needs in the area of contributory benefits and has grown significantly since then. In 2007, according to the draft Budget, the SSRF will be allocated an extra 6.401 billion euro, bringing the total from 35.741 billion euro in October 2006 to 42.142 billion euro, i.e. equivalent to 8 months' pension expenditure or 4.0% of GDP. The breakdown of the fund by asset class at market prices is shown in Table 14.

Table 14
COMPOSITION OF THE SOCIAL SECURITY RESERVE FUND
(October 2006)

	%
Bank of Spain current account balance	1.3
Spanish short-term government bonds	0.6
Spanish long-term government bonds	56.6
Foreign government bonds	41.5

Source: Ministry of Economy and Finance.

Pension reform

The Agreement on Social Security Measures signed on 13 July 2006 is a step forward in the necessary reform to strengthen the system's finances for the long term under the principles of contributoriness, solidarity and sufficiency that underlie the Toledo Pact. This agreement is a major first package of measures to establish an appropriate balance between improving certain benefits and the need to ensure a financially-sound pension system in line with the Council's Opinion on the previous Stability Programme Update. The main measures are as follows:

- A better match between contributions and pension benefits. Pensioners must accredit 15 years of contributions (currently 12.6 years).
- Assurance of an appropriate balance between the System's revenue and expenditure, by ratifying the commitment to fully separate the funding sources by 2013, so that the supplements to contributory pensions are paid out of general taxes (the State's contribution to this item is rising, having accounted for 31.4% of the total in 2006).
- Reduction in the number of different social security systems by simplifying the system structure into two systems: employed workers and self-employed workers. To this end, the system for farmers is being merged into those two systems. Also, the regulations governing other special social security systems are to be adapted and modernised.
- Introduction of a contributory component into permanent disability pensions so that the benefit is commensurate with the contributions paid. The system for determining the permanent disability pension for common illnesses has been modified to apply the same coefficient for years of contribution as is used in calculating retirement pensions, thus avoiding the use of this benefit as a means of covering retirees with insufficient contributions.
- Survivors' pensions are again classified as replacement income, and they now cover de facto partners.
- The forms of early retirement have been rationalised. The age of 61 is established as the threshold for qualifying for any form of early retirement, including partial retirement.

The agreement also contains measures to incentivate the prolongation of the working life:

- Workers who delay their retirement beyond the age of 65 will receive a higher pension. For every year by which retirement is postponed, the pension will rise by 2% in general and by 3% for people who have been contributing for over 40 years.
- Extension to employees aged over 59 on indefinite contracts of existing social security rebates for persons over 60 who have been working for the employer for at least 5 years.
- Rationalisation of the use of partial retirement: workers qualify after at least 6 years with the employer and with 30 years' contributions; the

working day may be reduced by at least 25% (currently 15%) and at most 75% (currently 85%). These requirements will be phased in over 4 years

Control of healthcare expenditure

To rationalise healthcare expenditure, the following measures have been adopted to improve management and financing of the National Health System:

- The Quality Plan for the National Health System, drafted with the Autonomous Communities, was approved in March 2006; it contains 189 measures and has a budget of 65 million euro. Actions under this Plan will improve the system's quality and cohesion, foster healthy lifestyles, reduce inequality in health, particularly between men and women, support planning and development of the healthcare system's human resources, foster clinical excellence through assessment, and exploit information technology to improve health care through the Online Healthcare programme in the framework of the AVANZ@ Plan.
- The Law for Guarantees and Rational Use of Medicines was approved in June 2006; it fosters efficient use of resources through measures to make prescription and medication more efficient and to provide the system with stability and regulatory certainty. The law will provide savings in the National Health System and, with the other actions in the Strategic Plan of Pharmaceutical Policy, will contribute to the control of pharmaceutical spending that began with this legislature. As a result, pharmaceutical expenditure increased by 12.1% in 2003, 6.4% in 2004 and 5.6% in 2005 and continues to slow in 2006.

8. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

8.1. National Fiscal Rules

In coherence with the importance that the European Ministers of Economy and Finance attach to fiscal rules, the following two sections provide detailed information about the rules on balances that will come into force in January 2007 and the rules limiting indebtedness by the territorial administrations.

a) Budget balance rules: reform of the Budgetary Stability Laws

The national fiscal rules about the budget balance were recently amended through the reform of Spain's Budgetary Stability laws, as approved in May 2006[16]. These laws will come into force on 1 January 2007 and will therefore affect the budgets drafted thereafter, i.e. commencing with the 2008 budget. Nevertheless, the rules on the public deficit to finance increases in investment on productive programmes will apply from the date the law comes into force.

[16] The new fiscal reform comprises Law 15/2006 to amend General Budgetary Stability Law 18/2001 and Organic Law 3/2006 to amend Organic Law 5/2001, which complemented the General Budgetary Stability Law.

This reform strengthens budgetary stability by providing national fiscal rules which are truly stabilising and it introduces more transparent criteria and procedures to ensure its implementation in all the administrations.

The reform provides more realistic fiscal rules as it adapts the principle of budgetary stability to the economy's cyclical position. The budgetary objectives are defined for a 3-year period based on the economy's cyclical position expected in those years. The stability objective will be established each year using a GDP growth threshold below which governments may incur a deficit and another threshold over which governments must budget a surplus. Between the two thresholds, governments must at least balance the budget. These economic growth thresholds are adopted by the Cabinet for a three-year period; they were established at 2% and 3% of GDP for the first three years of the law.

The Ministry of Economy and Finance is in charge of determining the cyclical position of the economy. To this end, it was decided that the Ministry itself should draft a report on the cyclical position, discarding other options such as commissioning it from independent entities. Nevertheless, the report will be drafted after consulting and considering the main reports and projections in Spain and the European Union. In particular, the Ministry must consult with the National Statistics Institute and the Bank of Spain, and take account of the projections by the European Central Bank and European Commission.

For the first time, the Spanish law requires the State, the Autonomous Communities (AC) and certain local governments (LG) which are assigned tax revenue by the Central Government to attain surpluses in periods of fast growth; this is more demanding than the European Stability and Growth Pact.

A deficit is allowed in periods of weak economic growth. Nevertheless, apart from being exceptional due to reasons of economic weakness, deficits are capped at 1% of GDP, with the following distribution among the parties: State 0.20% of GDP; AC 0.75% of GDP; LG 0.05% of GDP. This cap ensures that Spain's fiscal rules are fully compatible with the fiscal commitments assumed in the framework of the EU while reinforcing the stabilising function and avoiding a pro-cyclical bias.

A second key feature of the reform is that it makes the principle of budgetary stability compatible with the need to enhance productivity. For this reason, the State, AC and LG are allowed to present a deficit when it is used to finance increases in investment in productive programmes, including RDI. Nevertheless, the deficit arising from those programmes is capped at 0.5% of GDP for these administrations as a whole, broken down as follows: State 0.20% of GDP; AC 0.25% of GDP; LG 0.05% of GDP. This limit continues to provide considerable scope to comply amply with the Stability and Growth Pact, even in the event that economic performance allowed an additional deficit of up to 1% of GDP. Also, the requirements for acceptance of these programmes are defined. Specifically, it must be accredited that the programmes increase public investment, that at least 30% of the programmes are funded with the gross savings of the proposing administration, and that the investments contribute to improving economic productivity and competitiveness. The decision to accept an investment programme must take account of the proposing administration's indebtedness. Also, the obligation to budget a surplus in periods of rapid economic growth will be modulated taking account of the degree of convergence with the EU in terms of RDI and the development of the Information Society.

Another basic objective of the reform is to reinforce consensus, commitment and involvement in fiscal discipline at all levels of government. Therefore, a new mechanism is introduced to determine the stability objective of the territorial administrations, based on dialogue and negotiation. The overall stability objective of the AC is set by the Government after a period of consultation with all the AC. Once the overall objective is approved, the individual objective of each AC is defined through bilateral negotiation. Moreover, in order to enhance the solidarity principle, the role of the Autonomous Communities' Fiscal and Financial Policy Board and of the National Commission of Local Administrations is reinforced.

The reform makes each administration's budgetary targets more transparent and visible, strengthening each one's joint responsibility to the principle of budgetary stability. In particular, the objectives for the State and the Social Security are established separately.

Other features are aimed at improving the application of the stability principle and increasing the transparency of the public accounts. The reform toughens the indebtedness requirements for any AC or LG that fails to comply with the budgetary stability objective and it highlights that the State will not assume or be liable for the commitments arranged by the AC, LG or the bodies associated with them. If there is a risk of any administration failing to comply with the stability objective, the Government may issue a warning. If the objective is breached and there is a larger deficit, an economic and financial rebalancing plan must be drafted.

To improve transparency, the budgets for the State, AC and LG and their settlements must allow verification of compliance with the stability objective and with the EU regulations on national accounts. Moreover, the disclosure requirements for the AC and LG will be increased and the information will be entered into a public database.

b) Indebtedness rules

The rules on budget balances are complemented by the indebtedness rules existing for the Territorial Administrations. The Autonomous Communities' debt is subject to the restrictions in the Autonomous Communities Financing Law[17], and to the March 2003 decision by the Fiscal and Financial Policy Board to limit the

[17] Organic Law 8/1980.

level of indebtedness. The Local Administrations' indebtedness is subject to the Law regulating Local Treasuries[18].

The Autonomous Communities Financing Law established the rules under which AC may borrow at terms of over one year. In particular, the loan must be solely for investment and the amount of the annual payments, including interest and redemption payments, may not exceed 25% of current revenue. Additionally, in order to borrow abroad, to issue bonds or to otherwise appeal to public credit, these administrations require authorisation from the State. The authorisation may be based on the degree of compliance with the budgetary objectives. Moreover, short-term credit transactions to cover treasury needs, which do not require State authorisation in principle, are also subject to State authorisation when there is a situation of breach of the budgetary stability principle in which the deficit has exceed the target in the absence of an economic and financial adjustment plan approved by the Fiscal and Financial Policy Board.

In 2003, the Fiscal and Financial Policy Board approved a decision to coordinate the Autonomous Communities' indebtedness and ensure that it is compatible with the budgetary stability objectives. It caps each Autonomous Community's debt at its amount of outstanding debt at 31 December 2002. There are three exceptions to this general rule: increases in debt to finance changes in financial assets which fall under the definition of ESA 95, debt required to finance a deficit accepted under the framework of a refloating plan as envisaged in the stability laws, and changes due to variations in the composition of the public administrations sector. Under this rule, since 2003 the Autonomous Communities and the government have agreed upon an indebtedness programme each year. The debt referred to in the agreement is calculated in accordance with the Protocol on the Excessive Deficit Procedure. That agreement therefore complements the stability laws by introducing specific indebtedness rules.

The Law Regulating Local Treasuries reflects the regulations on local government indebtedness by setting short-term indebtedness limits and trigger points which, if exceeded, lead to application of an administrative authorisation system to the long-term debt. In any event, the local administrations require State authorisation if they plan to issue bonds or arrange transactions with non-resident entities or in a currency other than the euro. In other cases, and referring solely to long-term debt, local administrations only require authorisation from the State (or the Autonomous Community, as the case may be) if their debt exceeds 110% of their current revenues or they have a net negative saving rate.

8.2. Approval of the Agencies Law

The Agencies Law[19], approved in June 2006, includes a new organisational formula for the Central Government, which gives public management greater

[18] Legislative Royal Decree 2/2004, of 5 March.
[19] Law 18/2006 on State Agencies to improve Public Services.

autonomy and flexibility while strengthening oversight mechanisms and effectiveness and promoting a culture of responsibility for results.

The agencies' management model will be based on the following basic features: transparency of the public services, management by objectives, autonomy in management and responsibility for results, enhancement of planning mechanisms, cooperation between administrations and institutional participation, and assessment of public policies and service quality.

The creation of a state agency requires prior authorisation by a law, which determines the goals of the agency that is to be created in the form of a Royal Decree issued by the Cabinet. The state agency law itself includes authorisation to the Government to create 12 agencies[20]. Notable among them is the authorisation to create the State Agency for the Evaluation of Public Policies and Service Quality, as discussed in chapter 6.2. The draft Central Government Budget for 2007 provides a mechanism for including the agencies in the budget system as they are formed.

8.3. Reform of the Autonomous Communities Financing System

The reform's objective is to increase the symmetry of the Autonomous Communities' powers in terms of revenue and expenditure in order to correct the current pressures on expenditure that are due to limited joint fiscal responsibility. The reform will reinforce the principles of neutrality, autonomy and equity by enhancing the system's transparency and stability. A working group has been established within the Fiscal and Financial Policy Board to analyse the problems of the existing system of financing Autonomous Communities that do not have devolved taxation powers and the Autonomous Cities as a basis for beginning a revision of the current system.

8.4. Other reforms with an impact on the budgetary scenario

The Law on Personal Autonomy and Long-Term Care, approved in December 2006, is this legislature's most ambitious reform in the area of social policy as it configures the fourth pillar of the welfare state (in addition to the national health system, the education system and the pension system). It establishes a system for protecting the individual rights of people who have lost a degree of personal autonomy.

Gradual implementation will commence in 2007 with the goal of covering 1,125,190 people who have lost autonomy in any of the three categories: mild, severe and total.

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[20]Official State Gazette, Higher Council for Scientific Research, State Antidoping Agency, State Agency (SA) for Immigration and Emigration, SA for Air Safety, SA for Safety in Terrestrial Transport, SA for the Performing Arts and Music, SA for Meteorology, SA for International Development Aid, Carlos III State Agency for Research into Biomedicine and Health Science, and the SA for Evaluation, Financing and Planning of Scientific and Technical Research.

Long-term care for such people currently depends on the Autonomous Communities while the Central Government provides funds to level resources through financial cooperation agreements with the Autonomous Communities. Municipal governments also provide social services as established by State and regional regulations (obligatory in the case of municipalities with over 20.000 inhabitants). Despite the significant increase in recent year, the coverage of social services is still low.

The new law establishes a minimum degree of care which will be guaranteed financially by the State, and a second level to be implemented through cooperation and financing between the State and the Autonomous Communities. The Autonomous Communities may develop a third level of additional care for citizens.

The draft Central Government Budget for 2007 guarantees the availability of the funds required to start up the initial activities. It allocates 400 million euro in 2007, in addition to the 200 million euro allocated in the 2006 budget.

9. CONCLUSION

Public finances are an important asset of the Spanish economy. Sound public finances enable the development of a strategy in which economic growth and productivity are the main pillars and challenges of Spain's economic policy. Far from restricting the policies that boost economic growth, Spain's fiscal policy is a fundamental tool in enabling it to meet the Lisbon objectives by providing quality finances.

The fiscal objectives foreseen also contribute to creating a stable macroeconomic scenario as the best way to provide the certainty that the economic players need to support their production, consumption and investment decisions.

This favourable starting point does not prevent other reforms to address any challenges that may arise beyond this programme's horizon or other reforms to reinforce fiscal policy efficiency and effectiveness. Therefore, in addition to the budgetary objectives themselves, this update details the reforms that have been approved or are under consideration, covering the reform of the budgetary stability laws, the tax reform, the social security reform or the new Agencies Law.