



EUROPEAN COMMISSION  
DIRECTORATE GENERAL  
ECONOMIC AND FINANCIAL AFFAIRS

Brussels, 3.03.2008  
ECFIN/50398/08-EN

**SPAIN : MACRO FISCAL ASSESSMENT**  
**AN ANALYSIS OF THE DECEMBER 2007 UPDATE OF THE STABILITY**  
**PROGRAMME**

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The Stability and Growth Pact requires each EU Member State to present an annual update of its medium-term fiscal programme, called “stability programme” for countries that have adopted the euro as their currency and “convergence programme” for those that have not. The most recent update of Spain’s stability programme was submitted on 21 December 2007.

The attached technical analysis of the programme, prepared by the staff of, and under the responsibility of, the Directorate-General for Economic and Financial Affairs (DG ECFIN) of the European Commission, was finalised on 3 March 2008. Comments should be sent to Javier Yaniz Igal who worked on the assessment in Dir F ([Javier.Yaniz-Igal@ec.europa.eu](mailto:Javier.Yaniz-Igal@ec.europa.eu)). The main aim of the analysis is to assess the realism of the budgetary strategy presented in the programme as well as its compliance with the requirements of the Stability and Growth Pact. However, the analysis also looks at the overall macro-economic performance of the country and highlights relevant policy challenges.

The analysis takes into account (i) the Commission services’ autumn 2007 forecast, (ii) the code of conduct (“Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes”, endorsed by the ECOFIN Council of 11 October 2005) and (iii) the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. Technical issues are explained in an accompanying “methodological paper” prepared by DG ECFIN.

Based on this technical analysis, the European Commission adopted a recommendation for a Council opinion on the programme on 19 February 2008. The ECOFIN Council is expected to adopt its opinion on the programme on 4 March 2008.

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All these documents, as well as the provisions of the Stability and Growth Pact, can be found on the following website:

[http://ec.europa.eu/economy\\_finance/about/activities/sgp/main\\_en.htm](http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm)

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## SUMMARY AND CONCLUSIONS

As part of the preventive arm of the Stability and Growth Pact, each Member State that uses the single currency, such as Spain, has to submit a stability programme and annual updates thereof. The most recent programme, covering the period 2007-2010, was submitted on 21 December 2007.

Spain has been enjoying a long period of sustained growth averaging 3¾% over the last twelve years, well above the euro area (at around 2%). Persistently low real interest rates and dynamic demographics have been feeding strong domestic demand and job creation as well as an unprecedented growth in the housing sector. Moreover, successive labour market reforms significantly reduced structural unemployment. In parallel, a number of imbalances have emerged or persisted, such as a widening external deficit and the inflation differential with the euro area, while productivity growth was consistently low. Regarding public finances, a successful expenditure-based consolidation process took place since the mid-nineties, which improved the government balance from a deficit of around 6% of GDP to a close-to-balance position in 2000 and a comfortable surplus since 2005. Total tax receipts have grown by about 4¼ percentage points of GDP since the mid-nineties boosted by a tax-rich growth pattern. Going forward, population ageing might negatively impact on the long-term sustainability of public finances, mainly as a result of increasing pressure from pension expenditure.

The macroeconomic scenario underlying the programme envisages that real GDP growth will decelerate from 3.8% in 2007 to 3.1% on average over the rest of the programme period. Assessed against currently available information<sup>1</sup>, this scenario appears to be favourable throughout the programme period. In 2008, inflationary pressures, lower growth expectations, as well as the developments in the housing sector are expected to weigh on disposable income and point towards lower GDP growth than projected in the programme. Also the growth composition presented in the programme is favourable, in particular concerning the adjustment path of the residential construction sector. While the programme expects a deceleration of investment in dwellings, the Commission services' autumn 2007 forecast projects a contraction of the sector, starting already in 2008, implying a stagnation of total investment in 2009. However, due to lower imports the contribution of net exports to growth could improve compared to the programme. Finally, the programme's projections for inflation appear on the low side in the light of the most recent available information on food and oil prices. The Spanish economy would be currently growing at around its potential and would find itself in neutral times in 2007, slipping towards bad times at the end of the period.

For 2007, the general government surplus is estimated at 1.8% of GDP in the Commission services' autumn 2007 forecast, against a target of 1% of GDP set in the previous update of the stability programme. Half of the difference can be explained by the positive base effect from 2006. The other half results from higher-than-targeted revenue growth in 2007, which was however partly offset by higher-than-budgeted expenditure growth. Recent information points to the possibility of a better final outcome above 2% of GDP, owing to even higher-than-expected revenues in 2007, especially from direct taxes, reflecting the high dynamism of corporate profits. The better-than-

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<sup>1</sup> The assessment takes also into account the Commission services' autumn 2007 forecast and the Commission assessment of the October 2007 implementation report of the national reform programme.

expected budgetary outcomes in 2006 were used to pursue more ambitious budgetary targets than those set in the end-2006 update of the stability programme, although some municipal and regional expenditure overruns were recorded.

Within the broad goal of maintaining macroeconomic and budgetary stability, the most recent update of the stability programme aims at respecting the medium-term objective (MTO), which is a balanced position in structural terms (i.e. in cyclically-adjusted terms net of one-off and other temporary measures), by a comfortable margin. The headline general government surplus is targeted to decline from 1.8% of GDP in 2007 to 1.2% of GDP in 2008 and to remain stable thereafter. The deterioration in 2008 stems from a small increase in the expenditure ratio and a decline in the revenue ratio by ½ percentage point of GDP. Direct taxes are expected to fall by ¼ percentage point of GDP in 2008 as a result of lower economic growth and the ongoing impact of the 2007 tax reform. After 2008, revenue and expenditure components are assumed to remain broadly stable. The primary balance is planned to decline from an estimated surplus of 3.4% of GDP in 2007 to 2.7% in 2008, remaining broadly stable thereafter. The structural balance calculated according to the commonly agreed methodology is projected to slightly decline from 2¼% in 2007 to 1¾% in 2008 and to increase to around 2% in 2009 and 2010. Compared with the previous programme, the new update presents, building on the better-than-expected 2007 outturn, somewhat better targets for 2008 and 2009 against a broadly similar macroeconomic background.

The risks to the budgetary projections in the programme appear broadly balanced in 2008, but outcomes could be worse than projected in 2009 and 2010. Specifically, in 2008, the impact of possibly lower economic growth would be broadly offset by the positive base effect from higher revenues in 2007 than estimated in the programme. However, the favourable macroeconomic assumptions for 2009 and 2010 would not be compensated by other factors, which points to the risk of lower budgetary surpluses. In particular, tax revenue projections may turn out to be optimistic on the back of less buoyant corporate profits and housing market. On the other hand, Spain has a good track record of budgetary consolidation.

In view of this risk assessment, the budgetary stance in the programme seems sufficient to maintain the MTO by a large margin throughout the programme period. The fiscal policy stance implied by the update is in line with the Stability and Growth Pact throughout the period. It is also in line with the April 2007 Eurogroup orientations for budgetary policies for the year 2008. The projected weakening in the structural surplus in 2008 cannot be regarded as entailing a pro-cyclical stance but partly reflects a decline in the tax revenue as a percent of GDP resulting from a slowing of the economy and the fading housing boom.

Spain appears to be at medium risk with regard to the sustainability of public finances. The long-term budgetary impact of ageing is well above the EU average, mainly as a result of a relatively high increase in pension expenditure as a share of GDP over the coming decades. The budgetary position in 2007, reflected in a strong primary surplus as well as a low and decreasing debt ratio, contributes to offsetting the projected long-term budgetary impact of ageing populations. However, this is not sufficient to fully cover future spending pressures. Maintaining high primary surpluses over the medium term and implementing further measures aimed at curbing the substantial increase in age-related expenditures would contribute to reducing risks to the sustainability of public finances.

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the October 2007 implementation report of Spain's national reform programme (NRP). The Commission's

assessment was that Spain is making good progress in the implementation of its national reform programme. Further implementation of new laws and measures across the seven key policy areas were deemed essential in order to increase employment and productivity and progress towards full GDP per capita convergence with EU-25. Against the background of strengths and weaknesses identified and the evidence on progress made, the Commission recommended that Spain is recommended to give highest priority to the challenges in the areas of: competition in the energy sector and education. In addition, Spain should also focus on the areas of external deficit and inflation, competition in professional services and retail markets, regulatory framework, environment, labour market segmentation, immigration, skill levels, access to childcare, housing market, and fiscal sustainability. The stability programme is fully consistent with the October 2007 implementation report of the national reform programme. In particular, the update provides a qualitative assessment of the overall impact of the NRP within the medium term fiscal strategy as well as sufficient information on the direct budgetary costs associated with some of the reforms envisaged in the NRP, e.g. R&D, education and infrastructures. The budgetary strategy in the programme is broadly consistent with the country-specific broad economic policy guidelines and the guidelines for euro area Member States in the area of budgetary policies issued in the context of the Lisbon.

The overall conclusion is that the medium-term budgetary position is sound with high general government surpluses above the MTO and a relatively low debt ratio. However, given favourable economic growth assumptions and the end of the housing boom, the projected government revenue might turn out to be on the high side. In this context, a careful assessment of the impact on the general government balance of permanent tax cuts and/or expenditure increases will be crucial to maintain a strong budgetary position and to ensure the long-term sustainability of public finances, which is at medium risk. Fostering productivity-enhancing expenditure items, such as R&D, infrastructure and education, is important to underpin a smooth adjustment of the economy in the light of large external imbalances, the contraction of the housing sector and the existing inflation differential with the euro area.

### Comparison of key macroeconomic and budgetary projections

		2006	2007	2008	2009	2010
Real GDP (% change)	<b>SP Dec 2007</b>	<b>3.9</b>	<b>3.8</b>	<b>3.1</b>	<b>3.0</b>	<b>3.2</b>
	COM Nov 2007	3.9	3.8	3.0	2.3	n.a.
	<i>SP Dec 2006</i>	3.8	3.4	3.3	3.3	<i>n.a.</i>
HICP inflation (%)	<b>SP Dec 2007<sup>4</sup></b>	<b>3.4</b>	<b>2.7</b>	<b>3.3</b>	<b>2.7</b>	<b>2.8</b>
	COM Nov 2007	3.6	2.6	2.9	2.7	n.a.
	<i>SP Dec 2006<sup>4</sup></i>	3.5	2.7	2.6	2.5	<i>n.a.</i>
Output gap <sup>1</sup> (% of potential GDP)	<b>SP Dec 2007</b>	<b>-1.1</b>	<b>-0.9</b>	<b>-1.4</b>	<b>-1.9</b>	<b>-1.6</b>
	COM Nov 2007 <sup>2</sup>	-0.6	-0.5	-0.9	-1.8	n.a.
	<i>SP Dec 2006</i>	-0.9	-1.2	-1.5	-1.6	<i>n.a.</i>
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	<b>SP Dec 2007</b>	<b>-8.1</b>	<b>-9.0</b>	<b>-8.9</b>	<b>-8.8</b>	<b>-8.7</b>
	COM Nov 2007	-8.1	-8.7	-9.1	-9.3	n.a.
	<i>SP Dec 2006</i>	-7.5	-8.2	-8.4	-8.7	<i>n.a.</i>
General government balance (% of GDP)	<b>SP Dec 2007</b>	<b>1.8</b>	<b>1.8</b>	<b>1.2</b>	<b>1.2</b>	<b>1.2</b>
	COM Nov 2007	1.8	1.8	1.2	0.6	n.a.
	<i>SP Dec 2006</i>	1.4	1.0	0.9	0.9	<i>n.a.</i>
Primary balance (% of GDP)	<b>SP Dec 2007</b>	<b>3.4</b>	<b>3.4</b>	<b>2.7</b>	<b>2.6</b>	<b>2.6</b>
	COM Nov 2007	3.5	3.4	2.7	2.1	n.a.
	<i>SP Dec 2006</i>	3.0	2.5	2.3	2.2	<i>n.a.</i>
Cyclically-adjusted balance <sup>1</sup> (% of GDP)	<b>SP Dec 2007</b>	<b>2.3</b>	<b>2.2</b>	<b>1.8</b>	<b>2.0</b>	<b>1.9</b>
	COM Nov 2007	2.1	2.0	1.6	1.4	n.a.
	<i>SP Dec 2006</i>	1.8	1.5	1.6	1.6	<i>n.a.</i>
Structural balance <sup>3</sup> (% of GDP)	<b>SP Dec 2007</b>	<b>2.3</b>	<b>2.2</b>	<b>1.8</b>	<b>2.0</b>	<b>1.9</b>
	COM Nov 2007	2.1	2.0	1.6	1.4	n.a.
	<i>SP Dec 2006</i>	1.8	1.5	1.6	1.6	<i>n.a.</i>
Government gross debt (% of GDP)	<b>SP Dec 2007</b>	<b>39.7</b>	<b>36.2</b>	<b>34.0</b>	<b>32.0</b>	<b>30.0</b>
	COM Nov 2007	39.7	36.3	34.6	33.0	n.a.
	<i>SP Dec 2006</i>	39.7	36.6	34.3	32.2	<i>n.a.</i>

**Notes:**

<sup>1</sup> Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.

<sup>2</sup> Based on estimated potential growth of 3.5%, 3.7%, 3.4% and 3.2% respectively in the period 2006-2009.

<sup>3</sup> There are no one-off and other temporary measures in the most recent programme and Commission services' autumn forecast.

<sup>4</sup> Private consumption deflator.

**Source:**

*Stability programme (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations*



## 1. INTRODUCTION

Spain submitted its ninth update of the stability programme, covering the period 2007-2010, on 21 December 2007<sup>2</sup>, three weeks beyond the 1 December deadline specified in the Code of Conduct on the content and format of stability and convergence programmes without providing any reason for such delay. The update was approved by the Spanish government on 21 December but does not provide information on its status vis-à-vis the Parliament.

This assessment is further structured as follows. Section 2 discusses key challenges for public finances in Spain, with a particular focus on the correction of external imbalances. Section 3 assesses the plausibility of the macroeconomic scenario underpinning the public finance projections of the stability programme against the background of the Commission services' economic forecasts. Section 4 analyses budgetary implementation in the year 2007 and the medium-term budgetary strategy outlined in the new programme. Taking into account risks attached to the budgetary targets, it also assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact. Section 5 reviews recent debt developments and medium-term prospects, as well as the long-term sustainability of public finances. Section 6 discusses the quality of public finances and structural reforms, while Section 7 analyses the consistency of the budgetary strategy outlined in the programme with the national reform programme and its implementation reports and with the broad economic policy guidelines. The annexes provide a detailed assessment of compliance with the code of conduct, including an overview of the summary tables from the programme (Annex 1) and selected key indicators of past economic performance (Annex 2).

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<sup>2</sup> The English version was delivered on 27 December 2007

## 2. KEY CHALLENGES FOR PUBLIC FINANCES WITH A PARTICULAR FOCUS ON THE CORRECTION OF EXTERNAL IMBALANCES

### 2.1. Introduction

Since the mid-1990s, Spain has been growing at an average rate of 3¾% per year. Although this is not the highest growth rate attained in an expansion over the last four decades, it is the longest period of sustained growth above the euro area since the late sixties. Domestic demand, especially consumption and investment in dwellings, has outperformed GDP, while the external sector has contributed negatively to growth. In line with economic activity, employment growth has also been highly dynamic, with Spain contributing to almost half the total job creation in the euro area. As a result, the unemployment rate has drastically fallen, close to the euro area average. This has allowed the employment rate to rise steadily, becoming comparable to that of the other euro area members and, although still below, approaching the Lisbon target of 70% for 2010. The economy benefited from labour market reforms, declining real interest rates and major migration inflows<sup>3</sup>. On the fiscal front, a successful consolidation process took place, which improved government balances from a strong deficit in the mid-1990s to a comfortable surplus 2006 (table 1).

**Table 1: Key economic indicators**

	1995	2006
GDP growth	2.8	3.9
GDP per capita *	78.8	92.6
Employment rate	50.6	66.0
Unemployment rate	18.4	8.6
Saving rate **	21.7	21.8
Investment rate **	21.4	30.4
Trade (goods) deficit **	-3.1	-8.1
Current account deficit **	-0.2	-8.8
Gen Gov Balance **	-6.0	1.8
Public debt **	62.7	39.7
<i>pro memoria:</i>		
Nominal short-term interest rates	9.4	3.1
Inflation (HICP)	4.6	3.6
* Measured in current PPS as percentage of the euro area average.		
** in % of GDP		
<i>Source : Ameco</i>		

In parallel, a number of imbalances have emerged. In the first place, the external deficit has been widening and, from a balanced position in 1995, is currently close to reach two-digit figures. Second, the inflation differential with the euro area is relatively high and persistent and, together with deceiving productivity growth, is deteriorating the

<sup>3</sup> For a more detailed analysis see European Commission (2006), "The EU economy: 2006 review", Directorate-General for Economic and Financial Affairs, European Economy, main series, n° 6/2006.

competitiveness of the Spanish economy. Finally, the dynamism of the housing sector has brought about a huge increase in both households' and non-financial corporate indebtedness and has increased the exposure of these sectors to financial shocks. Yet, the housing sector is currently oversized and an adjustment with corresponding job losses seems inevitable.

In this context, fiscal policy can play an important role to diminish the risks associated to widening external imbalances. The previous update of the stability programme provided a relevant indication of the future role that Spain will give to fiscal policy through a description of budgetary and other economic policy measures to be taken in the following years. In its economic assessment of the previous update of the stability programme, the Commission services pointed out that fiscal consolidation could help reduce the external deficit and partially ease inflationary pressures. On top of this, fiscal policy should also seek to achieve higher economic efficiency by redistributing expenditure with an aim to prioritizing productivity-enhancing measures. Finally, while no risks for the sustainability of public finances seem to exist in the short term, population ageing and slow productivity growth cloud the outlook for long-term sustainability. Implementing a fiscal policy independent of the short and medium-term political cycle would be crucial to ensure the long-term sustainability of public finances. Further reforms of the pension system, which would better align contributions and benefits, coupled with a moderation of health care spending growth, would be a step forward in the right direction.

This section looks at the factors explaining the developments in the current account balance and the role played by public finances, paying particular attention to the quality of the fiscal consolidation process underway since the mid-nineties. Section 2.2 describes recent developments of the current account balance by especially looking at the sectors originating the widening external financial needs and what economic factors behind this process. Section 2.3 reviews the process of fiscal consolidation in Spain, its contribution to developments in the net external position of the country, and its quality. Section 2.4 discusses the role of the fiscal policy both as a stabilizing tool and as an instrument to enhance economic efficiency.

## **2.2. The external deficit: where does it come from?**

The current account deficit of Spain reached €83 billion or 8½% of GDP in 2006, and, according to the Commission services autumn 2007 forecasts, it might attain 9¼% this year (Figure 1)<sup>4</sup>. It is the second highest external deficit among OECD countries in absolute terms after that of the US and implies that the exposure of the Spanish economy to financial turmoil is high. The widening external deficit of the Spanish economy has led to a significant increase in the cumulated stock of liabilities relative to the rest of the world and, although the external debt position is comparable to that of other members of the Euro area, its rapid increase is cause for concern.

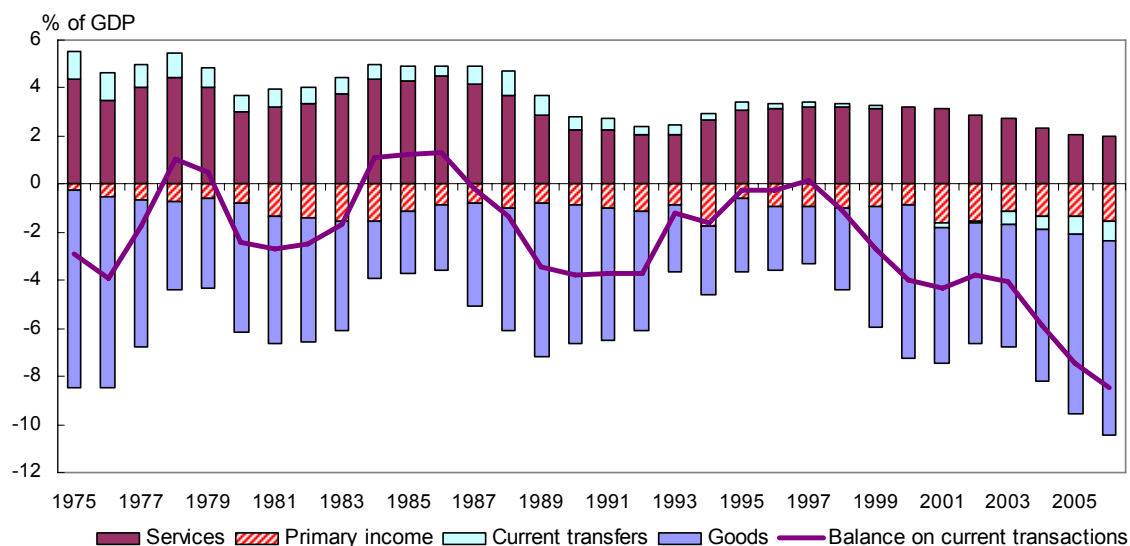
Borrowing requirements in Spain are the financial mirror image of a growth model, in which corporate and households' investments are generating an unprecedented private demand for credit. The widening external deficit is reflecting increasing financial needs

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<sup>4</sup> For a more detailed analysis see Cabrero, A. and J. Yaniz, 2007, The Spanish external deficit: cyclical or structural?, European Commission Directorate-General for Economic and Financial Affairs, Country Focus, Volume 4, Issue 1

of the private sector to finance investment, rather than a reduction in total savings. Specifically, total domestic savings have remained broadly constant in terms of GDP, while total investment rose from 21½ to 30¼% of GDP between 1995 and 2006. The bulk of this increase is accounted for residential investment (5% of GDP) and, to a lesser extent, other investment (2% of GDP), while investment in equipment increased by 1¼% of GDP and other construction, thus including infrastructure investment, rose by only ½% of GDP.

**Figure 1: Current account**



Source: AMECO

Overall, developments in the current account balance would reflect expectations about future incomes and the international cost of borrowing. With a view to smoothing consumption, countries with high future income expectations would borrow today, thus recording a worsening of their external position. Therefore, enhancing the growth potential of the economy seems paramount for such expectations to be fulfilled.

However, the Spanish growth model might not bring the expected boost in the productive capacity of the economy. Although other investment includes items such as intangible investments, it seems that the bulk of the increase in total investment and, therefore, the widening of the external deficit and debt, is not feeding the productive capital stock of the economy and potential growth, which is at the basis of the possibility of paying liabilities back without hampering future economic welfare. While the solvency of Spanish borrowers does not seem to be at risk in the short term, in the medium and long run any widening of the already extensive recourse to external saving might lead to additional pressure on the economy, in the form, for example, of increasing risk premia.<sup>5</sup>

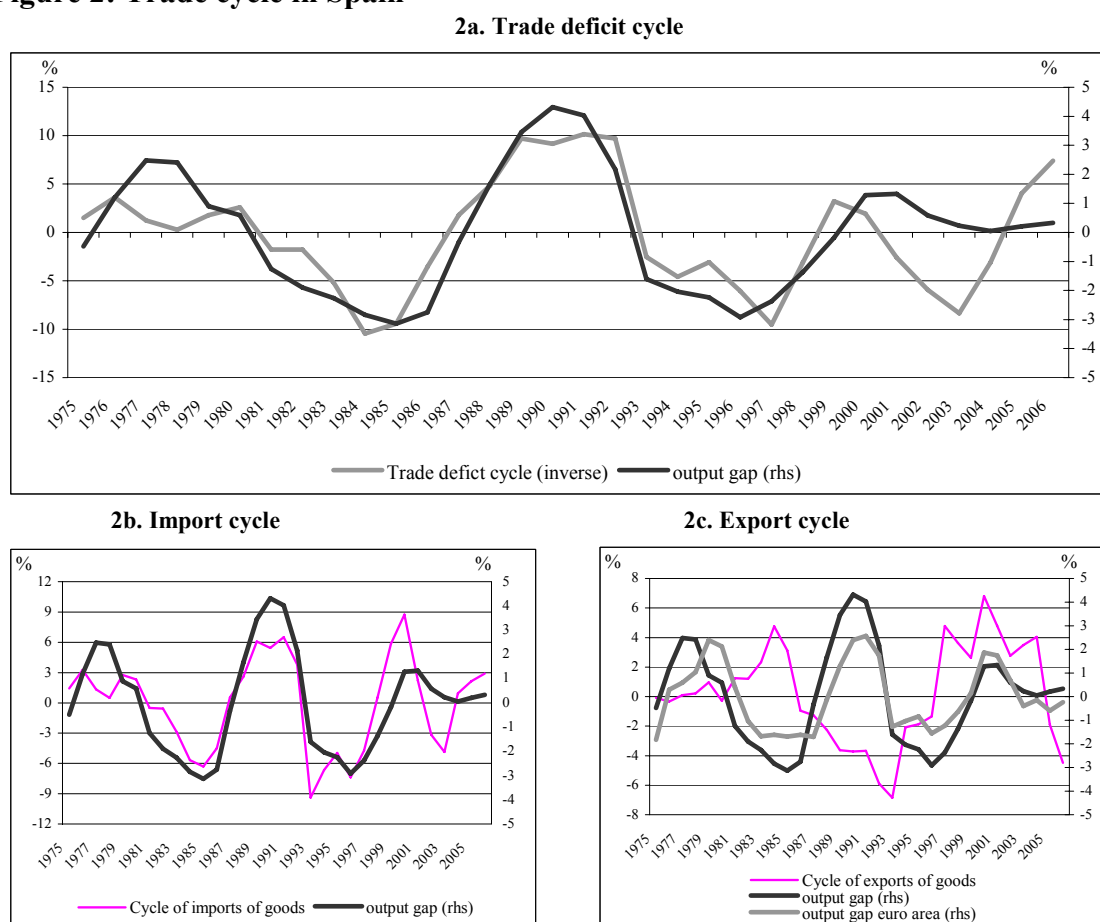
All the sub-balances of the Spanish current account have deteriorated since the mid-1990s. Surpluses in the balance of services are shrinking, due in particular to less net tourism inflows, and deficits in the balance of primary incomes and current transfers are increasing on the back of large capital inflows in the past and unprecedented immigration, which translate into large current transfers to the rest of the world.

<sup>5</sup> For a more detailed analysis on how the external deficit is financed, please see Cabrero, A., L.A. Maza and J. Yaniz, 2007, Spain's external deficit: how is it financed?, European Commission Directorate-General for Economic and Financial Affairs, Country Focus, Volume 4, Issue 7.

However, it is the deterioration of the trade balance that explains the bulk of the external deficit.

Within this context, the imbalances would be the result of three different kinds of factors. First, there are cyclical factors, reflecting strong and sustained growth and, to a lesser extent, the sluggish economic activity of Spain's main trade partner, namely the euro area. Second, there is also a factor associated to the increase in the energy bill, which may have had a direct and substantial impact on nominal imports. Finally, structural factors associated with persistent inflation differentials between Spain and the euro area, together with low productivity growth, and the concomitant deterioration in competitiveness, could explain why growth in exports has always been below that of imports, especially since 1998.

**Figure 2: Trade cycle in Spain**



(\*) Trade cycle and output gap estimated using HP filter ( $\lambda=100$ )

Source: AMECO and own calculations

Although most analysts agree with this taxonomy of factors, the balance of opinion is less clear-cut about the relative importance of each one<sup>6</sup>. Some evidence would suggest, however, that structural factors might be the most significant of the three. Figure 2a

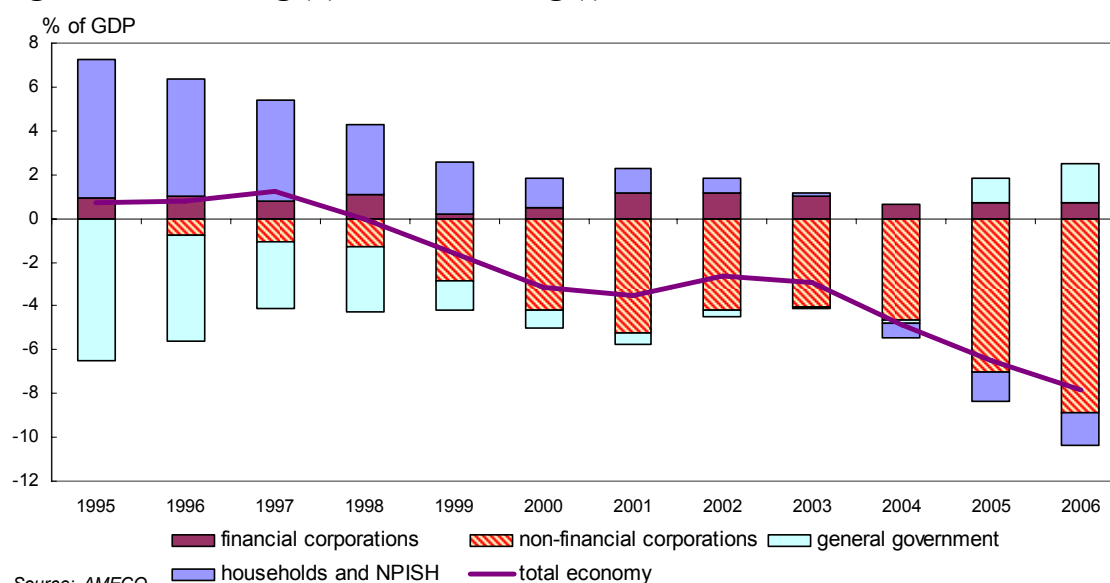
<sup>6</sup> See Allard, C., M. Catalan, L. Everaert and S. Sgharry (2005), "Explaining differences in External Sector Performance Among Large Euro Area Countries", *IMF, Country Report N° 05/401*, and BBVA (2006), "El déficit Exterior de la Economía Española", *Servicio de Estudios – Banco Bilbao Vizcaya Argentaria (BBVA)*, Situación España, marzo 2006, p. 8 – 11.

indicates that, while the correlation between the output gap<sup>7</sup> and the cyclical part of the trade deficit seems quite strong until 2000, it becomes weaker thereafter. In other words, although sluggish growth in Spain's main trade partners and strong domestic demand can largely explain the insufficient net export growth until 2000, these cyclical factors fall short of explaining the size of the current trade deficit over the last five years.

Interestingly, while the cycle of imports have to a certain extent followed the Spanish business cycle (see Figure 2b), the cyclical component of exports seems to be independent, not only from the Spanish but also from the euro-area cycle, which is relatively synchronised with the Spanish cycle (see Figure 2c). Consequently, sluggish export growth would be explained by factors of a more structural nature.

The increase in borrowing needs has been driven by a steady worsening of the net financial position of both households and corporations, on the back of a strong fall in risk premia and an easing of financial conditions (see Figure 3). Households have abandoned their traditional role as suppliers of funds to the rest of the economy. At the same time, corporations have seen their borrowing position worsening strongly. This deterioration in private balances has been partially offset by an increase in public sector savings, which has been playing a buffer role in satisfying the increasing financial needs of private agents.

**Figure 3: Net lending (+) / Net borrowing (-). Sectoral breakdown**



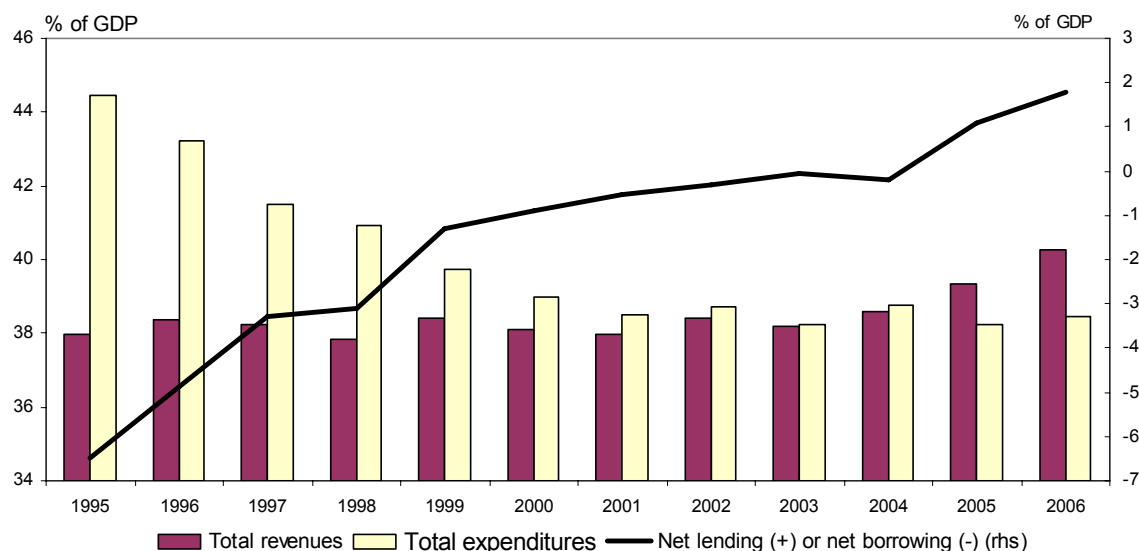
### 2.3. External deficit and fiscal consolidation

The fiscal consolidation process over the last decade aimed first at fulfilling the Maastricht criteria on general government deficits and debts, and, then, at attaining a close-to-balance position, in compliance with the Stability and Growth Pact. In only five

<sup>7</sup> The output gap has been estimated by Cabrero and Yaniz (2006), op. cit., using an HP filter ( $\lambda = 100$ ) instead a production function. Given the particular growth model of the Spanish economy during the recent past, the common agreed methodology for the calculation of the output gap based on the production function might overestimate potential output.

years, between 1995 and 2000, a deficit of well above 6% was reversed into a position of balance and since then, fiscal balances have continued to improve, reaching a surplus of about 1¾% of GDP in 2006.

**Figure 4: General government balance**



Source: AMECO

Over the whole period 1995-2006, fiscal consolidation was largely expenditure-based (see Figure 4). Total government expenditures fell by 6 percentage points of GDP to attain 38½% in 2006, while total government receipts rose by slightly above 2 percentage points of GDP, attaining 40¼% in 2006<sup>8</sup>. However, such long-run developments actually conceal two substantially different sub-periods and processes of fiscal consolidation. In the first one, until 2000, which brought the Spanish public finances to the close-to-balance position, consolidation took place exclusively on the expenditure side, while in the second one, up until now, consolidation has been mainly of a revenue-based nature.

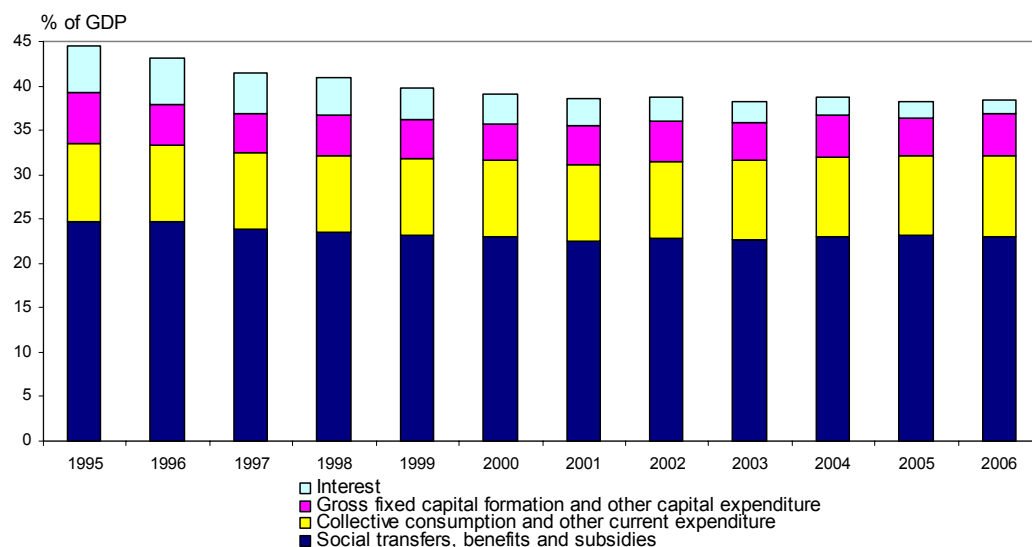
Specifically, between 1995 and 2000, total revenues remained broadly constant as a percentage of GDP, while expenditures fell by almost 6 percentage points, more than a half of which is accounted for by the fall in interest payments and the reduction in capital spending (see Figure 5). The rest is due to a reduction in social transfers, benefits and subsidies, while intermediate consumption remained unchanged in terms of GDP. Therefore, half of the spending retrenchment until the early 2000 affected primary current expenditures. In the second period, since 2000, fiscal consolidation on the expenditure side has been relatively marginal. However, this figure actually conceals a re-composition of spending items with a shift from interest payments to public consumption and, to a lesser extent, to capital spending. As a result, public consumption has been growing well above nominal GDP and, overall, also above domestic demand since the early 2000.

Consequently, the surplus recorded in the most recent past came from the revenue side, namely from tax revenues. Between 2000 and 2006, total government receipts grew by

<sup>8</sup> It is worth underlining that tax receipts increased by more than 4 percentage points of GDP during the same period.

slightly more than 2 percentage points of GDP. This increase has largely taken place in 2005 and 2006 and almost fully explains the improvement in the Spanish fiscal accounts from a balanced position in 2002-2004 to a surplus in 2006.

**Figure 5: General government expenditure**



Source: AMECO

Since the contribution of interest payments to fiscal consolidation is fading out on the back of shrinking debt and rising interest rates, and also given the relatively weak control of primary current expenditure during the 2000s, the sustainability of public surpluses largely depends on the extent to which the increase in revenues can be considered as permanent. This issue has been discussed by C. Martínez-Mongay, L. A. Maza and J. Yaniz<sup>9</sup> by looking at the main drivers behind tax revenues in Spain. According to the authors, the combination of a steady appreciation of the real effective exchange rate, the reduction of the risk premia and the increase in population in Spain has been supportive of a demand-based growth model, highly rich in taxes. While exports, which have a low tax content, are not growing as fast as the whole economy, private consumption and the boom in the housing market are pushing VAT revenues up. The economic boom is raising extraordinary profits, especially linked to real estate and financial operations, and consequently revenues from corporate taxes. This asset boom has induced significant changes in the composition of GDP and, especially, in the main tax bases.

Within this framework, the authors discussed and assessed the extent to which the high tax revenues and elasticities recorded in Spain during the last decade can be associated with asset-related changes in the composition of GDP. If so, the increase in government receipts since the mid-1990s might fade out once the current expansion and its associated composition effects taper off. To carry out this assessment, two indicators of the asset boom have been identified and the bases for indirect and direct taxes modified accordingly. The indicator of developments in the housing market has been built on the basis of the market value of new buildings, while corporate profits have been estimated from price-earning ratios (PER) of quoted enterprises in the Spanish stock exchange (see Box 1).

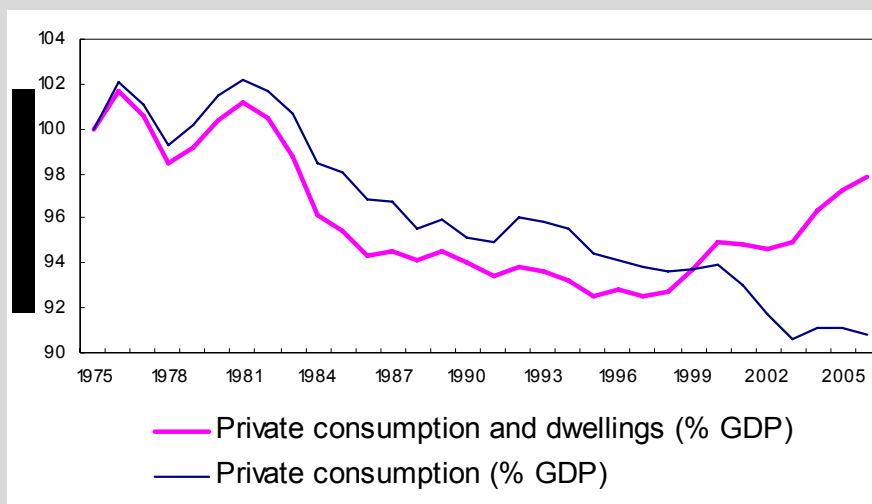
<sup>9</sup> See C. Martínez-Mongay, L. A. Maza and J. Yániz (2007), "Asset Booms and Tax Receipts: The case of Spain, 1995-2006" *European Commission Directorate-General for Economic and Financial Affairs*, Economic Papers, Number 293.



### Box 1. Estimating housing spending and taxable profits

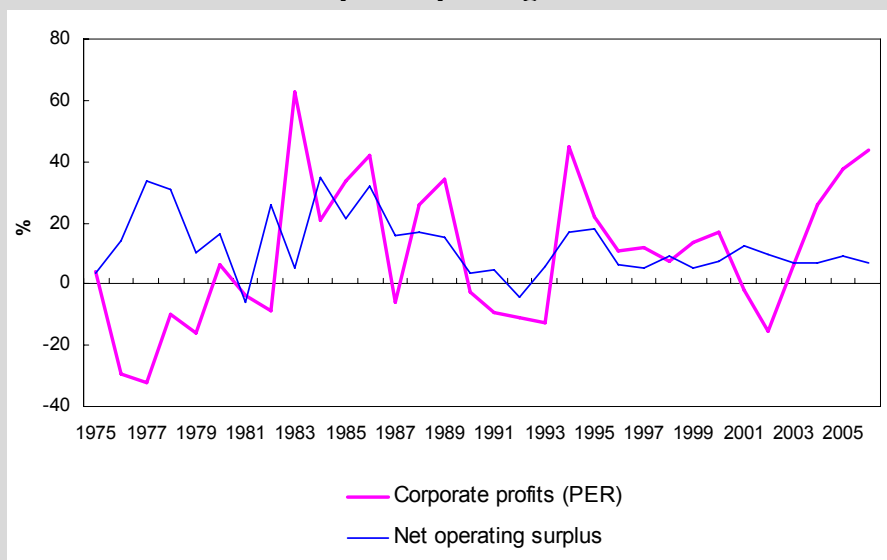
In order to obtain a proxy of the market value of new dwellings, which is added to the typical measure of private consumption to estimate the base for indirect taxes, Martínez-Mongay, Maza and Yaniz (2007) propose to multiply the number of new dwellings built each year by the average price per square meter and by 90 square meters as the average dwelling surface. Specifically, in 1995, at 5% of GDP, the share was close to its historical low (4.8% of GDP in 1994), but quickly grew to reach 7% in 2000, above the so far maximum of the series in the mid-1970s. The share had attained more than 11% of GDP in 2006 (see figure below).

#### Tax base for indirect taxes



Concerning corporate taxes, the authors consider a proxy to taxable profits based on the available series of the ratio of the value of the shares (the value of the firm) in the stock exchange to profits (the so-called price-earning-ratio, PER). An index for corporate profits is then obtained by dividing the stock exchange index by the PER, which leads to a series of corporate growth rates directly comparable with alternative measures of taxable profit growth. It seems to better correspond to actual developments of this item (see figure below).

#### Corporate profit growth



A first assessment, based on a direct decomposition of the changes in tax revenues into composition, discretionary and other effects, leads to composition effects of about 2¼% of GDP. This figure would only include those effects directly associated to VAT on housing and to corporate taxes. It would not therefore take account of possible negative effects induced in other bases, such as labour costs, the weight of which has been falling during the last decade, or additional positive effects induced in others such as some indirect taxes or certain component of personal incomes. This first estimate of composition effects seems confirmed by econometric analyses of the determinants of tax revenues and tax elasticities, which would provide estimates of net impacts. Overall, econometric analyses would indicate that about 75% of the increase in the share-to-GDP of tax revenues observed between 1995 and 2006 might be of a transitory nature and would fade out with the asset boom.

#### **2.4. The role of fiscal policy: a stabilizing tool and a way to achieving higher economic efficiency**

The composition of the recent fiscal consolidation process may raise some doubts as regards its sustainability in the medium term. On the one hand, primary current expenditure, most of the items of which are subject to long-run positive trends, has been affected by the fiscal retrenchment only marginally, while public consumption has been growing at a faster pace than GDP, thus feeding into an already dynamic domestic demand. On the other hand, the significance of composition effects in the current economic expansion, associated to an asset boom, does not seem to guarantee the buoyancy of the current tax revenues in the medium term. It therefore seems appropriate for the Spanish policymakers to carefully take account of such potentially transitory composition effects when assessing the fiscal stance and designing fiscal policy. The implementation of a more decisive restrictive fiscal policy could have helped cool down currently domestic demand pressures, push down imports and, therefore, alleviate current account deficits.

Moreover, the current worsening of the external sector, not only reflects buoyant domestic demand, but also a deterioration of the competitive position of the country of a structural nature. An appropriate fiscal policy should take into account the dual nature of the problem, cyclical and structural, but the emphasis should be put on decisively implementing policies aiming at tackling the structural problems of the Spanish economy. Policies aiming to eliminate structural factors behind inflation, enhance productivity growth and foster innovation need to be vigorously implemented in order to reverse the structural deterioration of the external accounts.

Furthermore, as the Spanish competitive position is still based on a price-based model, and given the persistent inflation differential with the euro area, a sustainable improvement of the competitive position of the country requires a changeover towards a specialisation pattern based on product differentiation underpinned by higher productivity growth. Now that the Spanish society has reached a broad consensus on the need to maintain stability-oriented macroeconomic policies, the productivity goal must be brought to the top of the economic policy agenda in order to carry out the necessary structural changes. The Lisbon strategy is the framework within which to achieve this rebalancing of the external sector in that it puts the emphasis on tackling structural factors. The awareness of the need for structural reforms was already shown in the Spanish National Reform Programme. The determined implementation of the announced measures is key to tackling the competitiveness bottlenecks of the Spanish economy.

While the fight against inflation would mainly concern changes in the regulatory framework, with a relatively modest role to be played by fiscal policy, investment in knowledge and other forms of capital to boost productivity could be enhanced through a change in the composition of public spending towards productive investments of all kind. This would complement private initiatives and should help increase potential growth. Moreover, the integration of the financial participation of regional governments in R&D projects into a comprehensive holistic strategy would represent a further step in the right direction by assuring the adequate co-ordination among government tiers. Finally, promoting innovation among SMEs is also crucial, as most of Spanish jobs and exporting capacities are linked to this category of businesses.

With respect to human capital, measures to further increase investment in education seem to represent a must. However, it would be desirable that the objective of higher spending pointed more decisively to education excellence by preventing learning problems at primary education level, better integrating immigrant children in schools and improving the quality of secondary education to reduce early school leaving. Additionally, universities could still play a more dynamic role as research centres in close co-operation with private corporate and public R&D strategies. In sum, enhanced knowledge and human capital investment would reflect the commitment towards a long-sighted policy, or, in other words, it would represent the most adequate fiscal policy.

### 3. MACROECONOMIC OUTLOOK

This section assesses the plausibility of the macroeconomic scenario (economic activity, labour market, costs and prices) underpinning the public finance projections of the programme. It also examines whether good or bad economic times in the sense of the Stability and Growth Pact prevail. Finally, it describes how the macroeconomic vulnerabilities identified in the preceding section are expected to develop according to the programme.

#### 3.1. Economic activity

The macroeconomic outlook presented in the update projects real GDP growth to decrease from 3.8% in 2007 to 3.1% in 2008, remaining broadly stable thereafter (Table 2). Given that the update estimates a gradual deceleration of potential output from 3.5% in 2007 to 3.2% in 2010, these real GDP projections assume that economic growth would situate slightly below potential in 2008 to fully converge with it in 2010.

**Table 2: Comparison of macroeconomic developments and forecasts**

	2007		2008		2009		2010
	COM	SP	COM	SP	COM	SP	SP
Real GDP (% change)	3.8	3.8	3.0	3.1	2.3	3.0	3.2
Private consumption (% change)	3.4	3.2	2.7	2.8	2.4	2.7	2.9
Gross fixed capital formation (% change)	6.3	5.9	3.0	3.1	0.6	2.7	3.7
Exports of goods and services (% change)	4.6	5.7	4.7	5.4	4.6	5.4	5.7
Imports of goods and services (% change)	6.5	7.2	5.2	5.5	4.2	5.2	5.5
<i>Contributions to real GDP growth:</i>							
- Final domestic demand	4.8	4.6	3.4	3.5	2.5	3.3	3.5
- Change in inventories	0.0	0.0	0.0	0.0	-0.1	0.0	0.0
- Net exports	-0.9	-0.8	-0.5	-0.4	-0.1	-0.3	-0.3
Output gap <sup>1</sup>	-0.5	-0.9	-0.9	-1.4	-1.8	-1.9	-1.6
Employment (% change)	3.0	3.0	2.1	2.2	1.7	2.0	2.2
Unemployment rate (%)	8.1	8.2	8.5	8.2	9.1	8.1	7.9
Labour productivity (% change)	0.8	0.8	0.8	0.9	0.6	1.0	1.1
HICP inflation (%)	2.6	n.a.	2.9	n.a.	2.7	n.a.	n.a.
GDP deflator (% change)	3.1	3.2	3.1	3.4	2.9	3.1	3.3
Comp. of employees (per head, % change)	2.8	3.7	3.0	4.0	2.8	3.5	3.4
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-8.7	-9.0	-9.1	-8.9	-9.3	-8.8	-8.7
<p><u>Note:</u></p> <p><sup>1</sup>In percent of potential GDP, with potential GDP growth according to the programme as recalculated by Commission services.</p> <p><u>Source:</u></p> <p>Commission services' autumn 2007 economic forecasts (COM); Stability programme (SP)</p>							

The external assumptions of the update are fully in line with those of the Commission services autumn 2007 forecast.

The programme projects a fall of GDP growth in 2008 on the basis of a deceleration of domestic demand, namely private consumption and investment in dwellings. Private consumption should ease on the back of, among other factors, tighter monetary and financial conditions and lower growth inside and outside the EU. Additionally, the activity in the housing sector should suffer from higher interest rates, a deceleration of prices, as well as a moderation in household disposable income growth.

According to the programme, in 2009 and 2010, the Spanish economy should keep growing at around the same rate as in 2008 on the back of strong dynamism of both private consumption and total investment. Indeed, stable investment growth rates with respect to 2008 would explain the update's projections of still healthy job creation, unemployment decline and strong disposable income growth, which would, in turn, help sustain private consumption.

The update does not provide quantitative information on the details of each investment subcomponent, which prevents a more detailed assessment of the drivers behind macroeconomic developments. Specifically, the programme assumes a deceleration of investment in dwellings instead of a contraction. Investment in dwellings should slow down in 2008 and 2009, to stabilise in 2010 at an equilibrium level determined by demographic trends, which would in part be compensated by sustained investment in other sectors, such as public construction. This should allow for a stabilization of gross fixed capital investment growth rates between 2008 and 2009, and even an acceleration in 2010.

More in detail, according to the update, GDP growth would continue to be exclusively sustained by domestic demand over the programme period, although its contribution to growth is projected to fall from 4½pp in 2007 to 3½pp in 2008, remaining broadly stable thereafter. Private consumption might slow down from 3¼% in 2007 to bottom out at 2¾% between 2008 and 2010. Gross fixed capital formation growth rate should halve in 2008 from 6% in 2007, then gently decelerate to 2¾% in 2009 and, finally, rebound to 3¾% in 2010.

The negative contribution of net exports to growth would decline from 0.8 percentage points in 2007 to 0.4 percentage points in 2008 and 0.3 percentage points in 2009 and 2010. This would be the reflection of persistently higher import growth during the last decade, the current level of which is around 25% higher than that of exports. As a result, although export growth is projected to remain at a broadly similar level as that of imports between 2008 and 2010, the contribution of the external sector would remain in negative territory.

Overall, the macroeconomic scenario presented in the programme can be considered as favourable in 2008 and markedly favourable thereafter. The adjustment path depicted in the update differs substantially from that presented in the Commission services' autumn 2007 forecast. For 2008, headline GDP growth projected in the update and in the Commission services autumn 2007 forecast broadly coincide. However, recent information, i.e. higher-than-expected inflationary pressures and lower growth expectations in both the euro area and the US, as well as the impact of the current financial turmoil, should weigh negatively on disposable income. This would point to lower GDP growth, leading to the conclusion that growth assumptions in the programme are favourable. In 2009, GDP is expected to increase by 3% according to the programme, markedly favourable when compared with 2.3% in the Commission forecast. Finally, the growth projection of 3.2% for 2010, although in line with estimates of potential growth for the period 2007-2009 calculated following the commonly agreed methodology, appears markedly favourable when assessed against the trends behind the autumn forecast described above.

A relevant divergence concerns the adjustment path of the housing sector. The autumn forecast is also based on the hypothesis that investment in dwellings will reach a new equilibrium level in around three years, based on structural determinants such as

demographics. However, this new equilibrium can only be attained via a contraction of the sector and not via a deceleration as presented in the update. Specifically, in 2007, the number of start-ups may have reached about 700 000 new units, well above the historical average of around 250 000. Demographic trends would point to around 400 000-500 000 new units per year as the average potential demand for housing in the coming years. As a result, the adjustment of the sector should necessarily materialize via a contraction of activity levels of around 1/3 (or 3pp of GDP), and not through a mere deceleration of growth rates. According to the Commission services' analysis using the most recent available information, the number of new start-ups is already declining and might translate into negative investment growth rates in 2008, once on-going projects will be finalized.

The update then assumes that other investment subcomponents can successfully compensate the slowdown of the real estate sector, sustaining gross fixed capital formation growth rates in 2009. In contrast, the Commission services' analysis concludes that the magnitude of the contraction of the housing sector implies that, in order to attain the update's total investment growth rates in 2009 and 2010, investment in equipment and public investment should receive an impulse, which can be considered as highly optimistic. All in all, the autumn forecast projects a further deceleration of gross fixed capital formation in 2009, close to stagnation. As a result, employment and private consumption should further slow down. In the same vein, projections for 2010 in the update would be markedly on the high side. The ongoing contraction of the housing sector and the continuous deceleration of private consumption projected for 2008 and 2009 would point towards a growth rate below that presented in the update.

Specifically, while the update expects in 2009 a stabilization of private consumption growth at around 2¾%, the autumn forecast projects a further slowdown to 2½%. Additionally, according to the update, gross fixed capital formation growth should decelerate slightly from around 3% in 2008 to 2¾% in 2009 on the back of a deceleration of residential investment. In contrast, the autumn forecast projects total investment growing by a marginal 0.6% in 2009, due to a contraction of investment in housing of around 10%.

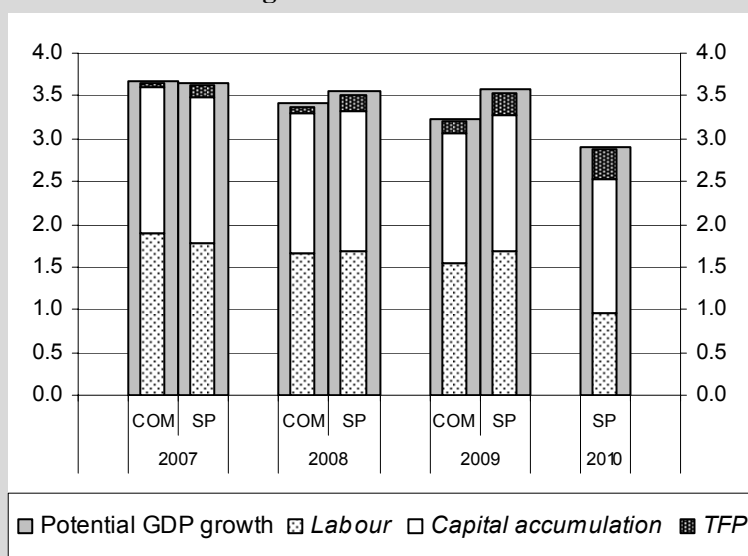
Concerning cyclical developments, the output gap estimates on the basis of the Commission services calculations, based on the information in the programme and according to the commonly agreed methodology point to a negative and widening output gap until 2009 and a narrowing, although still negative, in 2010. Indeed, the expectations of higher economic expansion in the update lead to a more negative output gap than those calculations using the information provided in the autumn forecast.

## Box 2: Potential growth and its determinants

The graph below presents the potential growth estimates on the basis of the Commission services calculations, based on the information in the programme and according to the commonly agreed methodology. Potential growth rates remain rather stable at around 3.5% until 2009 in view of still buoyant employment growth and high rate of investment. However, in 2010, potential growth appears to fall to 3% driven by a lower contribution of labour. The estimates are broadly coincidental in 2007 and slightly higher than those implied by the Commission services' autumn 2007 forecast thereafter..

The contribution of labour to potential growth should remain broadly stable at around 1¼% between 2007 and 2009 and fall sharply to 1% in 2010, in line with a moderation of active population growth. The contributions of a further decline in unemployment and of a participation rate increase should be modest, as the programme only projects a slight decline in unemployment of around ½ of one percentage point until 2009. Moreover, the participation rate might not increase substantially from current levels, above 70% of the population of working age. In sum, the increase of employment and, therefore, of potential output seems to be especially dependent on an increase of population, i.e. additional migrant inflows.

Potential growth and its determinants



The contribution of capital accumulation to potential growth would decelerate slightly from 1¼% percentage points in 2007 to 1½pp over the rest of the programme horizon. Although investment in construction is projected to decelerate, it should be partially compensated by robust investment in equipment. However, the Commission services autumn 2007 forecast, by projecting a contraction of investment in housing, leads to a slightly lower capital deepening contribution, which bottoms out at 1½% in 2009. Given the particular investment structure of the Spanish economy, the commonly agreed methodology might be overestimating the capital deepening due to the relatively higher weight in terms of GDP of residential construction in Spain (9% of GDP compared to 5% in the euro area), which also accounts for a large share of the increase in total investment. This kind of investment has a lower capacity for generating future growth, but the commonly agreed methodology does not discriminate among investments.

The TFP contribution to potential growth should increase marginally to attain almost ½ of one percentage point in 2010. This seems to mirror the slight acceleration of productivity projected in the programme, but does not imply a substantial change in the growth composition of the economy.

## 3.2. Labour market and cost and price developments

The programme projects employment growth at 3% in 2007, which should slow down to 2-2¼% over 2008-2010. As a result of the still robust projection for job creation, the unemployment rate is expected to fall slightly from 8.2% in 2007 to 7.9% in 2010. These figures represent the continuation of recent past trends, but turn out to be optimistic when compared to the scenario depicted in the Commission services' autumn 2007 forecast, especially for 2009 and 2010. Specifically, and explained mainly by the contraction of the construction sector, employment growth should decelerate to 2.1% in 2008 and to 1.7% in 2009. As a result, unemployment should rise to around 8½% and 9% in 2008 and 2009, respectively.

The update concludes that the assumed transitory deceleration of employment in construction in 2008 and 2009 will be in part rapidly compensated by a recovery of more capital-intensive sectors. This seems to be the reason why employment creation accelerates in 2010. Both the autumn forecast and the most recent available information suggest that this scenario for employment would be optimistic. As explained in section 3.1, the adjustment of the housing sector might imply a sharper employment contraction than that projected in the programme. Furthermore, there are no signs so far of alternative sectors taking the lead as new sources of job creation that can quickly absorb the employment destroyed.

As the update does not provide information on HICP, the outlook for price inflation is assessed on the basis of the private consumption deflator. According to the programme, the deflator should increase from 2¾% in 2007 to 3¼% in 2008, easing to 2¾% in 2009 and 2010. The autumn 2007 forecast for the HICP needs to be complemented with the most recent available information, given the acceleration of prices during the last months of 2007 on the back of rising energy and food prices<sup>10</sup>. Against this background, the projections included in the update are slightly on the low side. The inflation differential between Spain and the euro area attained 1¼pp at the end of 2007, slightly above its historical average at around 1pp. Indeed, the inflationary effect associated with higher oil and food prices in 2007, as in past price shocks, has been stronger in Spain than in the euro area.

Export and import deflators project an improvement of the real effective exchange rate, which should allow for a reduction of the nominal trade deficits. However, more expensive exports should deteriorate further the competitiveness of the economy, and might be in contradiction with the projected rebalancing of the growth pattern.

Compensation of employees per head is projected to grow above inflation expectations at around 3¾% in 2007, 4% in 2008, easing to 3½% in 2009 and 2010, well above the private consumption deflator. This implies positive real wage growth rates over the programme period and might be inconsistent with the projected robust job creation. According to the update, unit labour costs would grow at around 3% in 2007 and 2008, easing to around 2½% in 2009 and 2¼% in 2010. Although the Commission services' autumn 2007 forecast projects lower wage growth and unit labour costs, the update's forecast seems plausible in the light of the most recent available information on price and wage developments.

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<sup>10</sup> In the Commission services autumn 2007 forecast, HICP projections are broadly in line with the deflator of private consumption.



### 3.3. Macroeconomic challenges

Since the mid-1990s, thus encompassing the run-up to EMU and EMU itself, the Spanish economy has grown at an average rate of 3¾%, compared with around 2% in the euro area. Strong GDP growth has led to a process of convergence in real GDP per capita, which rose from 80% of the euro area average in the mid-1990s to an estimated 95.5%. In parallel, a number of macroeconomic imbalances have emerged. In the first place, the external deficit has been widening and, from a balanced position in 1995, is currently close to reach two-digit figures. Second, the inflation differential with the euro area is relatively high and persistent and, together with deceiving productivity growth, is dragging competitiveness to the Spanish economy. Finally, the dynamism of the housing sector has brought about a huge increase in both households' and non-financial corporate indebtedness and has increased the exposure of these sectors to financial shocks. Yet, given demand projections, the housing sector is currently oversized and an adjustment seems inevitable, leading to job losses.

*External imbalances:* In 2007, the current account deficit is projected to have reached 9¼% of GDP, its worst record in 25 years. Traditionally, Spain's trade deficit has been partially offset by surpluses in other external balances, particularly the services trade as a result of large net tourism inflows, but, since 2005, the current account deficit has been as large as the trade deficit. Additionally, the deficit of the balance of current primary incomes is increasing due to a widening external debt and increasing interest rates. Furthermore, the balance of current transfers is also under pressure on the basis of rising migrant transfers.

While cyclical factors, namely strong domestic and weak foreign demand, and the transitory effect of the increase in oil prices certainly have some bearing on the deterioration of the current account balance, structural factors, linked to persistent competitiveness losses, also play a significant role. In the past, attempts to rebalance external accounts relied on the exchange rate instrument. However, as devaluation is no longer an available option since accession to the monetary union, the accent should be put on rolling out policies designed to enhance productivity growth – in other words, implementing the Lisbon agenda. This remains crucial to increase exports by recovering lost competitiveness and, as a result, rebalancing the external accounts.

*Inflation differential:* Although cyclical and monetary conditions play a non-negligible role, the persistence of the inflation differential between Spain and the euro area seems to be explained mainly by structural elements. Income convergence, higher wage growth coupled with lower productivity growth than in the euro area, and the presence of non-competitive behaviour and market rigidities in some sectors seem to be the key elements behind the persistently higher inflation in Spain.

Moreover, the Balassa-Samuelson effect does not appear to be a significant factor in explaining the inflation differential. The cumulative effect of inflation differentials has thus started to jeopardise Spanish competitiveness as the real effective exchange rate has appreciated. Liberalisation initiatives therefore need to be complemented by measures aiming to increase effective competition through a deeper process of market deregulation.

*Private sector indebtedness:* Ever higher investment needs have brought about increasing borrowing requirements. While the savings rate has remained broadly constant over the last decade at a rate around 22% of GDP, total investments have grown by almost 10

percentage points of GDP, and could attain 32% of GDP in 2007. Half of the investment growth is attributable to housing investment.

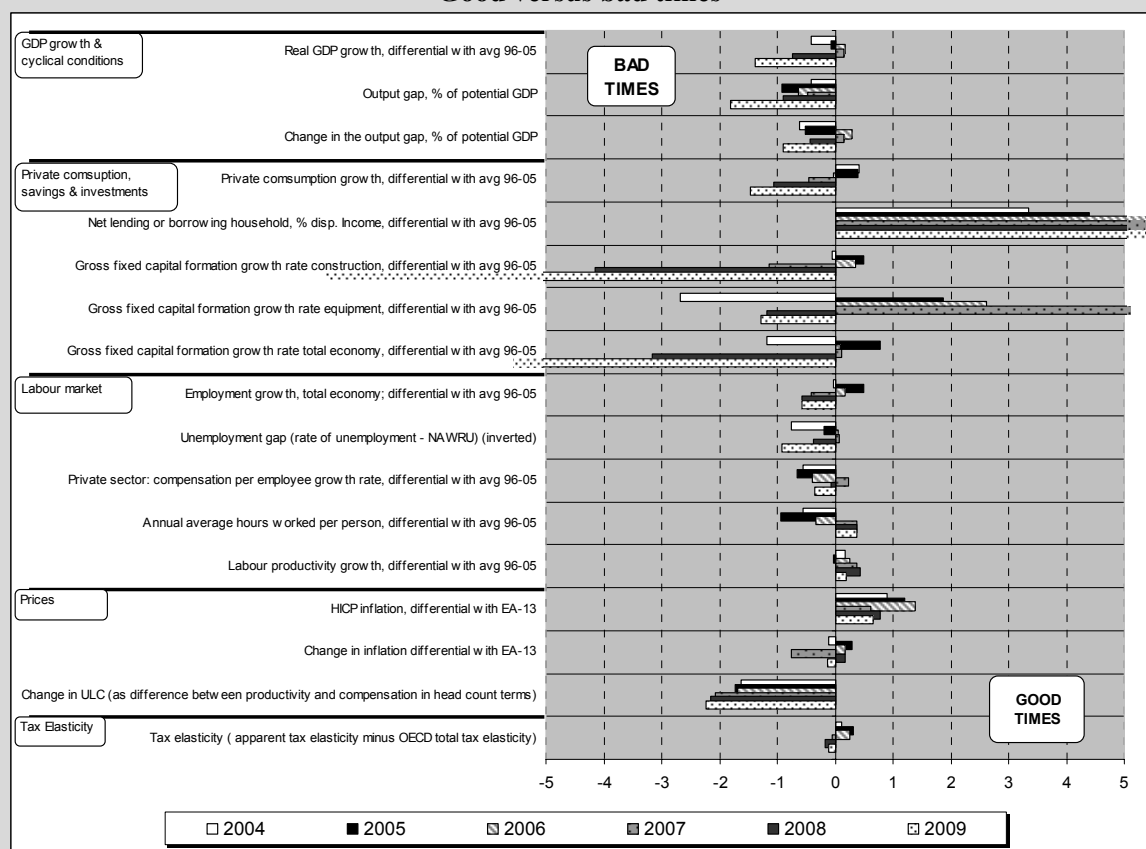
This has increased the exposure of households and non-financial corporate to financial shocks. Furthermore, an overwhelming majority of mortgages have been signed at variable interest rates. Although Spanish private borrowers seem to be, at least in aggregate terms, in a healthy financial position, implying that risks of massive repayment failures in the short term are not high, credit demand is pushing up private borrowers indebtedness at a strong pace, putting a question mark on their medium term solvency.

### Box 3: Good or bad economic times?

According to the code of conduct, the assessment of whether the economy is experiencing good or bad economic times starts from the output gap, but draws on an overall economic assessment, which should also take into account tax elasticities. The figure below presents a set of macroeconomic indicators drawn from the Commission services' autumn 2007 forecast. Overall, the economy seems to be in neutral times in 2007, but slipping towards bad times thereafter, taking into account tax elasticities in the period 2007-2009.

The mechanical interpretation of the output gaps estimated using the common agreed methodology based on the production function would place Spain in "bad times". However, given the particular growth model of Spain, in which population is growing fast and investment in construction plays a predominant role in gross fixed capital formation, the commonly agreed methodology might be overestimating the potential output of Spain. Yet, among other factors, inflation differentials with the euro area, strong employment growth rates leading to a sustained reduction of unemployment, and widening external imbalances, together with high tax elasticities, would suggest that, at least, the Spanish economy is growing at around its potential and would find itself in neutral times in 2007, slipping towards bad times at the end of the period.

#### Good versus bad times



#### 4. GENERAL GOVERNMENT BALANCE

This section consists of four parts. The first part discusses budgetary implementation in the year 2007 and the second presents the medium-term budgetary strategy in the new update. The third analyses the risks attached to the budgetary targets in the programme. The final part assesses the appropriateness of the fiscal stance and the country's position in relation to the budgetary objectives of the Stability and Growth Pact.

##### 4.1. Budgetary implementation in 2007

Table compares the 2007 revenue and expenditure targets (as a percentage of GDP) from the previous and the most recent update of the stability programme. The difference between the revenue and expenditure targets for 2007 and the projected outcome is decomposed into a base effect, a GDP growth effect and a revenue / expenditure growth effect<sup>11</sup>:

- The base effect captures the part of the difference that is due to the actual outcome for 2006 being different from what was projected in the previous update in the programme (either because the actual revenue / expenditure level in 2006 was different from the estimated outturn in the previous programme or because GDP turned out to be different from the scenario in the previous update of the programme). The base effect therefore also captures the effect of GDP revisions.
- The GDP growth effect captures the part of the difference that is related to current GDP growth projections turning out higher or lower than anticipated in the previous update of the programme.
- The revenue / expenditure growth effect captures the part of the difference related to the revenue / expenditure growth rate in 2007 turning out to be higher or lower than targeted in the previous update of the programme.

Table 3 shows that, while the previous update targeted a surplus of 1% of GDP, the most recent programme estimates a budgetary outturn of 1.8% of GDP, fully in line with the Commission services' autumn 2007 forecast. This divergence of 0.8 pp. between both updates can be largely explained by a revenue surprise of 1¼ pp. of GDP, only partially compensated by expenditure overruns of less than ½ pp. of GDP.

Specifically, (i) the base effect associated with higher-than-expected revenues in 2006 would explain 0.6 pp. of GDP, which compares with 0.2 pp. of GDP of expenditure surprise, leading to an overall base effect from 2006 amounting to 0.4 pp. of GDP; (ii) the revenue growth effect in 2007, closely related to tax elasticities above the unit would explain 0.7 pp., whereas spending overruns in 2007 are estimated to have attained 0.3 pp. of GDP

Furthermore, according to the most recent available information, revenue in 2007 could be even higher than projected in the update and in the autumn forecast. The revenue surprise might attain almost 1½ pp. of GDP leading to a surplus slightly above 2% of GDP. Specifically, strong revenues would be mainly fuelled by direct taxes, which might finally grow by around 20%, representing an extra revenue of about ¼ pp. of GDP

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<sup>11</sup> A fourth, residual component is usually small, except if there are very large differences between both updates (the full mathematical decomposition is in the methodological paper mentioned above).

compared with the projections in the update, led by buoyant corporate profits as well as by non-labour income of households, associated to the asset boom.

The previous update expected a decline of revenues in GDP terms of around ¼ pp. on the basis of the implementation of a tax reform aiming at reducing direct taxes and, under the assumption of tax elasticities close to the unit. The main features of the reform, adopted in 2006 with effects since January 2007, can be summarized as follows: (i) the marginal top rate is lowered by 2 points, from the current 45% to 43%; (ii) the number of tax brackets is reduced from 5 to 4; and (iii) all saving products will be taxed at a single flat rate of 18%; (iv) with respect to corporate taxes, the general tax rate should gradually ease from the current 35% to 30% by 2011. In the case of small and medium enterprises the rate would go down from 30% to 25%. However, total revenues have finally increased by around ½ pp. of GDP mainly because high direct tax elasticities have more than offset the cost of the reform.

**Table 3: Budgetary implementation in 2007**

	2006		2007	
	Planned	Outcome	Planned	Outcome
	SP Dec 2006	SP Dec 2007	SP Dec 2006	SP Dec 2007
Revenue (% of GDP)	39.8	40.4	39.6	40.8
Expenditure (% of GDP)	38.4	38.6	38.6	39.0
Government balance (% of GDP)	1.4	1.8	1.0	1.8
Nominal GDP growth (%)			6.7	7.1
Nominal revenue growth (%)			6.2	8.2
Nominal expenditure growth (%)			7.3	8.2
<b>Revenue surprise compared to target (% of GDP)</b>				<b>1.2</b>
<i>Of which</i> <sup>1</sup> : 1. Base effect				0.6
2. GDP growth effect on the denominator				-0.1
3. Revenue growth effect				0.7
<i>Of which: due to a marginal elasticity of total revenue w.r.t. GDP larger than 1</i> <sup>2</sup>				0.6
<b>Expenditure surprise compared to target (% of GDP)</b>				<b>0.4</b>
<i>Of which</i> <sup>1</sup> : 1. Base effect				0.2
2. GDP growth effect on the denominator				-0.1
3. Expenditure growth effect				0.3
<b>Government balance surprise compared to target (% of GDP)</b>				<b>0.8</b>
<i>Of which</i> : 1. Base effect				0.4
2. GDP growth effect on the denominator				0.0
3. Revenue / expenditure growth effect				0.4
<b>Notes:</b> <sup>1</sup> A positive base effect points to a higher-than-anticipated outcome of the revenue / expenditure ratio in 2006. A positive denominator effect indicates lower-than-anticipated economic growth in 2007. A positive revenue / expenditure growth effect points to higher-than-anticipated revenue / expenditure growth in 2007. The three components may not add up to the total because of a residual component, which is generally small. <sup>2</sup> Equal to (2)+(3). A positive sign means that the marginal elasticity of revenue with respect to GDP exceeds one.				
<b>Source:</b> <i>Commission services</i>				

## 4.2. The programme's medium-term budgetary strategy

This section describes the medium-term budgetary strategy outlined in the programme - and how it compares with the one in the previous update - as well as the composition of the budgetary adjustment, including the broad measures envisaged.

#### 4.2.1. The main goal of the programme's budgetary strategy

The government's key general budgetary objectives are (i) maintaining macroeconomic and budgetary stability; (ii) fostering productivity and (iii) contributing to market efficiency through transparent and efficient regulation. The update sets an MTO of a balanced budget (in structural terms) for the general government, which it aims to maintain by a large margin throughout the programme period. This is the same as in the previous update of the stability programme. There is a continuity of the fiscal strategy compared with the budgetary plans set out one year ago, although, building on higher-than-expected revenues in 2007, the targets for 2008 and 2009 are  $\frac{1}{4}$  pp. of GDP higher on the back of a similar macroeconomic scenario. After attaining  $1\frac{3}{4}\%$  of GDP in 2007, the surplus is projected to slightly fall to around  $1\frac{1}{4}\%$  of GDP in 2008 and to remain stable at that level until 2010. The primary surplus is expected to decline from just below  $3\frac{1}{2}\%$  in 2007 to  $2\frac{3}{4}\%$  in 2008 remaining broadly stable thereafter.

**Table 4: Evolution of budgetary targets in successive programmes**

		2006	2007	2008	2009	2010
General government balance (% of GDP)	<b>SP Dec 2007</b>	<b>1.8</b>	<b>1.8</b>	<b>1.2</b>	<b>1.2</b>	<b>1.2</b>
	<i>SP Dec 2006</i>	<i>1.4</i>	<i>1.0</i>	<i>0.9</i>	<i>0.9</i>	<i>n.a.</i>
	COM Nov 2007	1.8	1.8	1.2	0.6	n.a.
General government expenditure (% of GDP)	<b>SP Dec 2007</b>	<b>38.6</b>	<b>39.0</b>	<b>39.2</b>	<b>39.2</b>	<b>39.1</b>
	<i>SP Dec 2006</i>	<i>38.4</i>	<i>38.6</i>	<i>38.6</i>	<i>38.6</i>	<i>n.a.</i>
	COM Nov 2007	38.6	38.4	38.7	39.4	n.a.
General government revenue (% of GDP)	<b>SP Dec 2007</b>	<b>40.4</b>	<b>40.8</b>	<b>40.4</b>	<b>40.4</b>	<b>40.3</b>
	<i>SP Dec 2006</i>	<i>39.8</i>	<i>39.6</i>	<i>39.5</i>	<i>39.5</i>	<i>n.a.</i>
	COM Nov 2007	40.4	40.2	40.0	39.9	n.a.
Structural balance <sup>1</sup> (% of GDP)	<b>SP Dec 2007</b>	<b>2.3</b>	<b>2.2</b>	<b>1.8</b>	<b>2.0</b>	<b>1.9</b>
	<i>SP Dec 2006</i>	<i>1.8</i>	<i>1.5</i>	<i>1.6</i>	<i>1.6</i>	<i>n.a.</i>
	COM Nov 2007	2.1	2.0	1.6	1.4	n.a.
Real GDP (% change)	<b>SP Dec 2007</b>	<b>3.9</b>	<b>3.8</b>	<b>3.1</b>	<b>3.0</b>	<b>3.2</b>
	<i>SP Dec 2006</i>	<i>3.8</i>	<i>3.4</i>	<i>3.3</i>	<i>3.3</i>	<i>n.a.</i>
	COM Nov 2007	3.9	3.8	3.0	2.3	n.a.
<p><u>Note:</u>  <sup>1</sup>There are no one-off and other temporary measures in the most recent programme and Commission services' autumn forecast</p> <p><u>Source:</u>  <i>Stability programmes (SP); Commission services' autumn 2007 economic forecasts (COM)</i></p>						

Commission services' calculations on the basis of the information in the programme according to the commonly agreed methodology project the structural balance to decline from  $2\frac{1}{4}\%$  in 2006 and 2007 to  $1\frac{3}{4}\%$  in 2008. It should then increase slightly to around 2% in 2009 and 2010. Although structural balances need to be interpreted with caution in the case of Spain, this would point to a slightly expansionary fiscal policy stance in 2008 and broadly neutral thereafter. Compared with the previous programme, the new update confirms the planned adjustment against a broadly unchanged macroeconomic scenario, although structural levels would remain around  $\frac{1}{4}$  pp. of GDP higher than in the previous update, building on higher-than-expected revenues in 2007.

More in detail, a broadly stable path of the structural balance using the information provided by the programme contrasts with that projected using the Commission services' autumn 2007 forecast, according to which, structural balances should constantly decrease from around 2% in 2006 and 2007 to slightly below  $1\frac{1}{2}\%$  in 2009. This is largely explained again by a favourable macroeconomic scenario presented in the programme

and would point towards a slightly expansionary fiscal policy stance also at the end of the programme's period.

**Table 5: Composition of the budgetary adjustment**

(% of GDP)	2006	2007	2008	2009	2010	Change: 2010-2007
<b>Revenue</b>	<b>40.4</b>	<b>40.8</b>	<b>40.4</b>	<b>40.4</b>	<b>40.3</b>	<b>-0.5</b>
<i>of which:</i>						
- Taxes on production and imports	12.4	12.1	12.1	12.1	12.1	<b>0.0</b>
- Current taxes on income, wealth, etc.	11.7	12.2	12.0	12.1	12.1	<b>-0.1</b>
- Social contributions	13.0	13.0	13.0	13.0	13.0	<b>0.0</b>
- Other (residual)	3.3	3.5	3.3	3.2	3.1	<b>-0.4</b>
<b>Expenditure</b>	<b>38.6</b>	<b>39.0</b>	<b>39.2</b>	<b>39.2</b>	<b>39.1</b>	<b>0.1</b>
<i>of which:</i>						
- Primary expenditure	37.0	37.4	37.7	37.8	37.7	<b>0.3</b>
<i>of which:</i>						
Compensation of employees	10.0	10.1	10.2	10.2	10.2	<b>0.1</b>
Intermediate consumption	5.0	5.1	5.2	5.2	5.2	<b>0.1</b>
Social payments	14.1	14.2	14.3	14.3	14.2	<b>0.0</b>
Subsidies	1.0	1.0	1.0	1.0	1.0	<b>0.0</b>
Gross fixed capital formation	3.8	3.9	3.9	4.0	4.1	<b>0.2</b>
Other (residual)	3.0	3.1	3.1	3.1	3.0	<b>-0.1</b>
- Interest expenditure	1.6	1.6	1.5	1.4	1.4	<b>-0.2</b>
<b>General government balance (GGB)</b>	<b>1.8</b>	<b>1.8</b>	<b>1.2</b>	<b>1.2</b>	<b>1.2</b>	<b>-0.6</b>
<b>Primary balance</b>	<b>3.4</b>	<b>3.4</b>	<b>2.7</b>	<b>2.6</b>	<b>2.6</b>	<b>-0.8</b>
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	<b>0.0</b>
<b>GGB excl. one-offs</b>	<b>1.8</b>	<b>1.8</b>	<b>1.2</b>	<b>1.2</b>	<b>1.2</b>	<b>-0.6</b>
Output gap <sup>1</sup>	-1.1	-0.9	-1.4	-1.9	-1.6	<b>-0.7</b>
Cyclically-adjusted balance <sup>1</sup>	2.3	2.2	1.8	2.0	1.9	<b>-0.3</b>
<b>Structural balance<sup>2</sup></b>	<b>2.3</b>	<b>2.2</b>	<b>1.8</b>	<b>2.0</b>	<b>1.9</b>	<b>-0.3</b>
<i>Change in structural balance</i>		<i>-0.1</i>	<i>-0.4</i>	<i>0.2</i>	<i>-0.1</i>	
Structural primary balance <sup>2</sup>	3.9	3.8	3.3	3.4	3.3	<b>-0.5</b>
<i>Change in structural primary balance</i>		<i>-0.1</i>	<i>-0.5</i>	<i>0.1</i>	<i>-0.1</i>	
Notes:						
<sup>1</sup> Output gap (in % of potential GDP) and cyclically-adjusted balance as recalculated by Commission services on the basis of the information in the programme.						
<sup>2</sup> Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.						
<i>Source:</i>						
<i>Stability programme; Commission services' calculations</i>						

#### 4.2.2. The composition of the budgetary adjustment

The declining path for the surplus projected in the update is reflecting not only lower revenue (½ pp. of GDP), but also an increase in primary spending (about ¼ pp. of GDP), which more than offsets the projected fall in interest payments until 2010.

Revenue is projected to decrease by ½ pp. of GDP over the programme period (from 40¾% in 2007 to 40¼% in 2010). Specifically, the decline concentrates in 2008 (40.4%). According to the update, the decline in 2008 reflects in part the economic deceleration and in part the on-going impact of the direct tax reform implemented in 2007, which lowered personal income and corporate tax rates from 2007 onwards. The reform will particularly affect corporate taxes in 2008. The update does not assess the impact of this

reform on tax revenue. On the other hand, the bulk of the reduction concentrates in the category of other revenues, although the programme does not provide further details.

Apart from the effects of the on-going reform of direct taxes, two new tax credits have been introduced in the personal income system. First, new births or adoptions qualify for a new one-off payment of € 2 500, amounting to around €1 billion (0.1% of GDP). Second, a tax credit for citizens living in rental accommodation, with the aim of applying comparable tax treatment to real estate acquisition. This measure will represent around €350 million (0.04% of GDP) and will affect the 2009 Budget.

Expenditures would not depart significantly from 39% of GDP over the programme horizon. Specifically, from 39% in 2007, public expenditure should increase to 39¼% in 2008 and 2009 to return again to around 39% in 2010. Primary expenditure is envisaged to increase by 0.3 percentage points of GDP, from 37½% in 2007 to 37¾% in 2010, mainly on the back of higher public investment, which should grow by around 5% per year in real terms over the programme horizon, well above real GDP. The other subcomponents of primary expenditure should grow at around the same rate as GDP. Specifically, compensation of employees and intermediate consumption are expected to increase by a meagre 0.1 percentage point of GDP until 2010, while social transfers (in kind and other than in kind) are set to remain stable in GDP terms. The envisaged debt reduction (see Section 5.1) should bring interest payments down by around ¼ pp. of GDP.

By subsectors of the general government, social security is the source of the bulk of the surplus of the general government balance over the programme period. Specifically, in 2007, the central government is expected to register a surplus of around ¾% of GDP, while regional and local entities would each record a close-to-balance budget. The surplus of the social security sector should attain around 1% of GDP. Between 2008 and 2010, the central government is expected to keep the small surplus slightly below of ½% of GDP, whereas regional and local governments should keep a close-to-balance position. In line with the recent past, the social security subsector is envisaged to keep recording still high surpluses of about ¾ of one percentage point until 2010.

#### **Box 4: The budget for 2008**

The 2008 Budget Law was sent for approval by the government to the Parliament on 25 September 2007 and adopted by the latter on 20 December 2007. It targets a general government surplus of 1.2% of GDP. According to this target, surpluses are expected from the social security (0.8% of GDP) and from the central government (0.4% of GDP), being both the regional and local governments in a close-to balance-position.

The main priorities of the 2008 Budget Law represent a continuation of those set out in the latest years' Budget Laws. Specifically, the Budget aims at (i) strengthening competitiveness by promoting education and productivity-enhancing expenditure such as public R&D, (ii) further investing in infrastructures and (iii) raising social expenditure such as pensions and unemployment benefits. Spending on these policies is projected to increase above nominal GDP.

Compared with the 2007 budget plans, total revenue is set to increase by slightly above 5% in nominal terms. Direct taxes, after having deducted the impact of several measures on personal income and corporate taxes, are still expected to grow by 6%. This is similar to the nominal rate of growth projected for indirect taxes (6%), which, in turn, appears consistent with the slight deceleration in private consumption projected in the macroeconomic scenario of the Budget Law.

Concerning the revenue side, the most measures refer to the effect in 2008 of the reform personal



income and corporate tax law implemented in 2007. Likewise, a new tax allowance in the personal income tax for birth or adoption of a child and, the tax-brackets and bases of personal income tax will be fully deflated for the first time in more than ten years. The impact of all these measures is expected to amount to around € 5 billion (0.5% of GDP) of lower revenues.

Central Government expenditure is projected to grow by around 7% in nominal terms. However, some productive expenditure is set to increase well beyond the average rate. R&D expenditure is projected to grow at 17% to attain 0.7% of the GDP. Education spending should increase by 14%, amounting to 0.3% of GDP. This only covers the small part under the direct control of the central government, since most education spending is directly managed by regional governments. Investment is budgeted to grow by 16%.

#### **Main measures in the budget for 2008**

Revenue measures*	Expenditure measures**
<ul style="list-style-type: none"> <li>○ Reform of direct taxes (-0.3% of GDP)</li> <li>○ New allowance for child born (-0.1% of GDP)</li> <li>○ Tax brackets full deflation (-0.1% of GDP)</li> </ul>	<ul style="list-style-type: none"> <li>○ Public R&amp;D (0.1% of GDP)</li> <li>○ Infrastructures (0.1% of GDP)</li> </ul>

\* Estimated impact on general government revenue.

\*\* Estimated impact on general government expenditure.

Sources: Commission services and 2008 Budget Law.

### **4.3. Risk assessment**

This section discusses the plausibility of the programme's budgetary projections by analysing various risk factors. For the period until 2009, Table 6 compares the detailed revenue and expenditure projections in the Commission services' autumn 2007 forecast, which are derived under a no-policy change scenario, with those in the updated programme.

**Table 6: Comparison of budgetary developments and projections**

(% of GDP)	2006	2007		2008		2009		2010
	COM	COM	SP	COM	SP	COM <sup>1</sup>	SP	SP
<b>Revenue</b>	<b>40.4</b>	<b>40.2</b>	<b>40.8</b>	<b>40.0</b>	<b>40.4</b>	<b>39.9</b>	<b>40.4</b>	<b>40.3</b>
<i>of which:</i>								
- Taxes on production and imports	12.4	12.3	12.1	12.1	12.1	12.1	12.1	12.1
- Current taxes on income, wealth, etc.	11.7	11.9	12.2	12.0	12.0	12.1	12.1	12.1
- Social contributions	13.0	12.9	13.0	12.8	13.0	12.7	13.0	13.0
- Other (residual)	3.4	3.1	3.5	3.1	3.3	3.1	3.2	3.1
<b>Expenditure</b>	<b>38.6</b>	<b>38.4</b>	<b>39.0</b>	<b>38.7</b>	<b>39.2</b>	<b>39.3</b>	<b>39.2</b>	<b>39.1</b>
<i>of which:</i>								
- Primary expenditure	36.9	36.8	37.4	37.2	37.7	37.8	37.8	37.7
<i>of which:</i>								
Compensation of employees	10.0	10.0	10.1	10.1	10.2	10.2	10.2	10.2
Intermediate consumption	5.0	5.0	5.1	5.2	5.2	5.4	5.2	5.2
Social payments	14.1	14.2	14.2	14.4	14.3	14.6	14.3	14.2
Subsidies	1.0	0.9	1.0	0.9	1.0	0.8	1.0	1.0
Gross fixed capital formation	3.8	3.9	3.9	4.0	3.9	4.0	4.0	4.1
Other (residual)	3.0	2.8	3.1	2.7	3.1	2.8	3.1	3.0
- Interest expenditure	1.6	1.6	1.6	1.5	1.5	1.5	1.4	1.4
<b>General government balance (GGB)</b>	<b>1.8</b>	<b>1.8</b>	<b>1.8</b>	<b>1.2</b>	<b>1.2</b>	<b>0.6</b>	<b>1.2</b>	<b>1.2</b>
<b>Primary balance</b>	<b>3.5</b>	<b>3.4</b>	<b>3.4</b>	<b>2.7</b>	<b>2.7</b>	<b>2.1</b>	<b>2.6</b>	<b>2.6</b>
One-off and other temporary measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>GGB excl. one-offs</b>	<b>1.8</b>	<b>1.8</b>	<b>1.8</b>	<b>1.2</b>	<b>1.2</b>	<b>0.6</b>	<b>1.2</b>	<b>1.2</b>
Output gap <sup>2</sup>	-0.6	-0.5	-0.9	-0.9	-1.4	-1.8	-1.9	-1.6
Cyclically-adjusted balance <sup>2</sup>	2.1	2.0	2.2	1.6	1.8	1.4	2.0	1.9
<b>Structural balance<sup>3</sup></b>	<b>2.1</b>	<b>2.0</b>	<b>2.2</b>	<b>1.6</b>	<b>1.8</b>	<b>1.4</b>	<b>2.0</b>	<b>1.9</b>
<i>Change in structural balance</i>		-0.1	-0.1	-0.4	-0.4	-0.3	0.2	-0.1
Structural primary balance <sup>3</sup>	3.7	3.6	3.8	3.1	3.3	2.9	3.4	3.3
<i>Change in structural primary balance</i>		-0.2	-0.1	-0.4	-0.5	-0.3	0.1	-0.1
<b>Notes:</b> <sup>1</sup> On a no-policy-change basis. <sup>2</sup> Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the information in the programme. <sup>3</sup> Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.  <b>Source:</b> Stability programme (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations								

Headline balances for 2008 coincide in the programme and in the Commission projections. However, in 2009, the update's estimation is ½ pp. higher than that of the Commission. This difference between the update and the autumn forecast can be largely explained by the favourable macroeconomic scenario presented in the programme. Indeed, as explained in Section 3, the Commission services' autumn 2007 forecast projects a sizeable deceleration of economic activity, not only in 2008, but also in 2009. The programme assumes a quick return from very high tax elasticities to values close to unity. As a result, the GDP share of revenues remains stable with respect to its 2008 level, in line with the Commission services' autumn 2007 forecast. In contrast, on the expenditure side, while the update plans also a stabilization in terms of GDP, the Commission services project an increase of around ¾ pp. of GDP, in part explained by the role played by the automatic stabilisers.

As mentioned in Section 3 above, the budgetary projections in the update are based on slightly favourable growth assumptions in 2008 and a markedly favourable

macroeconomic scenario in 2009 and 2010, which poses a downside risk to the budgetary projections in the programme.

The updated stability programme presents an alternative, not fully fledged scenario of ½ percentage point of lower GDP growth between 2008 and 2010 than the central one, without providing complementary explanation on the economic fundamentals behind such GDP deceleration, resulting in a declining budgetary surplus from 1.8% of GDP in 2007 to 0.9% in 2008, 0.7% in 2009 and 0.4% in 2010, compared with a stable 1.2% of GDP between 2008 and 2010. Commission services' simulations of the cyclically-adjusted balance under the assumptions of (i) a sustained 0.5 percentage point deviation from the real GDP growth projections in the programme over the 2007-2010 period; (ii) trend output based on the HP-filter and (iii) no policy response (notably, the expenditure level is as in the central scenario), reveal that, by 2010, the cyclically-adjusted balance is 0.7 percentage point of GDP below the central scenario. Hence, in the case of persistently lower real growth, additional measures of around 0.7 percentage point of GDP would be necessary to keep the public finances on the path targeted in the central scenario.

**Table 7: Assessment of tax projections**

	2008			2009			2010
	SP	COM	OECD <sup>3</sup>	SP	COM <sup>1</sup>	OECD <sup>3</sup>	SP
Change in tax-to-GDP ratio (total taxes)	-0.2	-0.2	0.3	0.1	0.0	0.3	0.0
Difference (SP – COM)	0.0		/	0.1		/	/
of which <sup>2</sup> :							
- discretionary and elasticity component	0.5		/	0.8		/	/
- composition component	-0.3		/	-0.4		/	/
Difference (COM - OECD)	/	-0.5		/	-0.3		/
of which <sup>2</sup> :							
- discretionary and elasticity component	/	-0.4		/	-0.2		/
- composition component	/	-0.1		/	0.0		/
p.m.: Elasticity to GDP	0.9	0.9	1.1	1.0	1.0	1.1	1.0
<b>Notes:</b> <sup>1</sup> On a no-policy change basis. <sup>2</sup> The composition component captures the effect of differences in the composition of aggregate demand (more tax rich or more tax poor components). The discretionary and elasticity component captures the effect of discretionary fiscal policy measures as well as variations of the yield of the tax system that may result from factors such as time lags and variations of taxable income that do not necessarily move in line with GDP, e.g. capital gains. The two components may not add up to the total difference because of a residual component, which is generally small. <sup>3</sup> OECD ex-ante elasticity relative to GDP. <b>Source:</b> <i>Commission services' autumn 2007 economic forecasts (COM); Stability programme (SP); Commission services' calculations; OECD (N. Girouard and C. André (2005), "Measuring Cyclically-Adjusted Budget Balances for the OECD Countries", OECD Working Paper No. 434).</i>							

Concerning 2008, the most relevant budgetary measure presented in the programme consists of the implementation of the reform of personal income and corporate taxes, which entered into effect in 2007, but whose impact should still be sizeable in 2008, especially on corporate taxes. The update does not provide a quantitative estimation of the cost of the reform, but, using the information provided in the 2008 Budget Law, the impact for direct tax collection in 2008 would amount to around 0.3% of GDP. Additionally, the new allowance granted to households per new child born or adopted (€ 2,500) would imply a reduction of direct tax collection of around 0.1% of GDP, as it has been implemented mainly as a tax credit. Without the expected impact of both discretionary measures, the reform and the new allowance for households, revenues

should have attained 40.8% of GDP in 2008, the same figure as in 2007. This stabilization in terms of GDP, once revenues netted out from such discretionary measures, implies a quick return of tax elasticities from very high values to historical trends close to the unit. Therefore, the underlying revenues estimates are coherent with the macroeconomic scenario presented in the update.

The programme projects a slight increase in expenditure in terms of GDP from 39% in 2007 to 39.2% in 2008. The envisaged increase in current primary expenditures (by 0.3% of GDP) should be partially offset by the estimated reduction of interest payments (0.1%). This overall projection appears to be plausible when compared to the Commission services' autumn 2007 forecast. Leaving aside the plausibility of the macroeconomic scenario, risks from the expenditure side appear limited.

Spain has a good track record in respecting the budgetary plans presented in the different stability programmes (figure 6). More in detail, the central government has respected in the past years its planned expenditure ceiling (Table 8). Overruns for general government expenditure have amounted annually to around ¼% of GDP in the past years and mainly reflect increases in regional spending.

**Table 8: Experience of expenditure ceilings for the central government**

(in million EUR)	2002	2003	2004	2005	2006	2007*
<b>Total expenditure</b>						
Ceiling (non financial)		114517	117260	124526	133947	142927
Outcome		113787	114743	122754	130374	140543
<i>Deviation (outcome minus ceiling; %)</i>		-0.6	-2.1	-1.4	-2.7	-1.7
<i>* Projection: Commission services' calculations</i>						
<i>Source: Successive stability programmes;</i>						

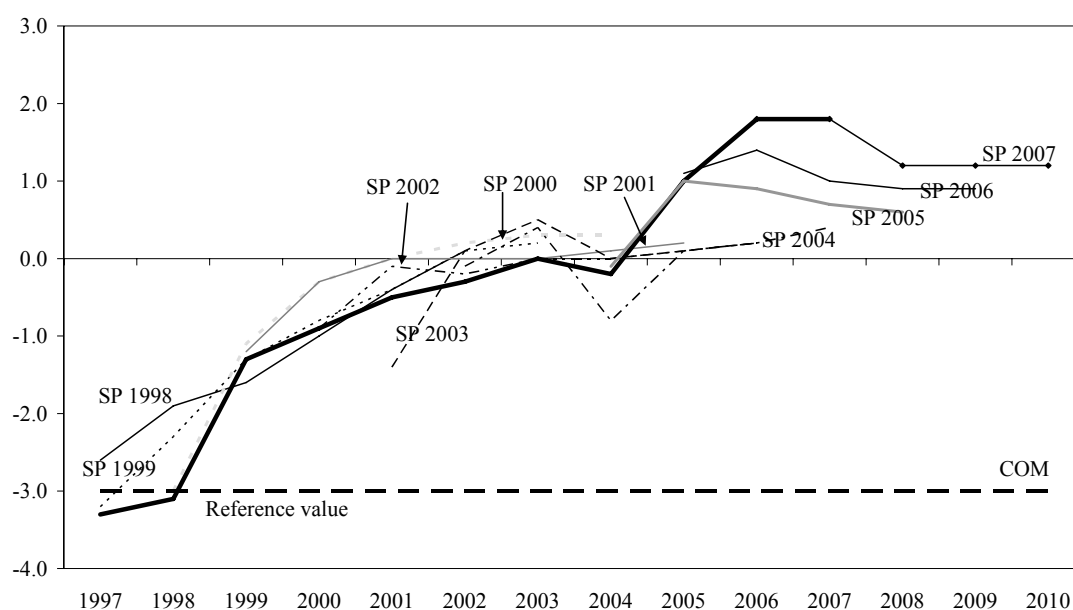
Risks for the budgetary targets in 2008 should come mainly from the macroeconomic scenario. As explained in Section 3, according to the most recent available information, economic growth in 2008 could be lower than projected in the update. This could lead to a reduction of the budgetary surplus estimated in the update of around 0.2% of GDP. However, the most recent available information also points to higher-than-expected revenues in 2007, which could push the estimated surplus by around 0.2% of GDP to 2% of GDP, with carry-over effects into 2008. Both effects would broadly cancel out each other. As a result, the budgetary outlook for 2008 presented in the update would be plausible.

Although the risks to the budgetary targets seem broadly balanced in 2008, a note of caution must be sounded, as the public finance situation is vulnerable to a sharper-than-expected adjustment in the growth pattern of the country, which is currently based on private consumption and investment in dwellings. Indeed, the current surplus position partly reflects exceptionally high revenues from some tax bases, such as those more closely associated to the asset boom, i.e. transactions of new dwellings and corporate profits. The unwinding of negative composition effects associated to the adjustment of the housing sector and the decline of extraordinary corporate profits might put some additional downward pressure on revenue<sup>12</sup>.

<sup>12</sup> For a more detailed analysis on composition effects, please see: C. Martínez-Mongay, L. A. Maza and J. Yániz (2007), "Asset Booms and Tax Receipts: The case of Spain, 1995-2006" *European Commission Directorate-General for Economic and Financial Affairs*, Economic Papers, Number 293.

In 2009 and 2010, the update does not provide information about new budgetary measures and, hence, seems to be framed within a no-policy-change scenario. Revenues are projected to remain broadly stable and should fall by a marginal 0.1% of GDP in 2010. The programme assumes, therefore, tax elasticities close to the unit. Expenditure is also expected to remain stable in GDP terms. Overall, these projections are coherent with the macroeconomic scenario depicted in the update, in which GDP growth would remain stable at around its potential.

**Figure 6: Government balance projections in successive programmes (% GDP)**



*Source: Commission services' autumn 2007 forecast (COM) and successive stability programmes*

However, as explained in Section 3, compared to the Commission services' autumn 2007 forecast, the macroeconomic scenario can be considered as markedly favourable until the end of the programme period. As a result, the adjustment of the construction sector and the deceleration of private consumption should weigh negatively on tax revenues. On the other hand, the role played by the automatic stabilisers would imply an additional increase of certain social spending such as higher unemployment benefits. All in all, this could reduce the budgetary surplus by around 0.6% of GDP in 2009 and by a similar amount in 2010.

Overall, the risks to the budgetary targets appear broadly balanced in 2008 and tilted towards the negative side in 2009 and 2010.

#### **4.4. Assessment of the fiscal stance and budgetary strategy**

The table below offers a summary assessment of the country's position relative to the budgetary requirements laid down in the Stability and Growth Pact. In order to highlight the role of the preceding analysis of the risks that are attached to the budgetary targets presented in the programme, this assessment is done in two stages: first, a preliminary assessment on the basis of the targets taken at face value and, second, the final assessment also taking into account risks.

Taking into account that the risks to the budgetary targets are broadly balanced in 2008 and, although they are tilted towards the negative side in 2009 and 2010, the budgetary stance in the programme seems sufficient to maintain the MTO (a balanced position in structural terms) by a large margin throughout the programme period, as also envisaged in the update. By the same token, a safety margin against breaching the 3% deficit ceiling with normal cyclical fluctuations is provided in every year.

**Table 9: Overview of compliance with the Stability and Growth Pact**

	<b>Based on programme<sup>3</sup></b> (with the targets taken at face value)	<b>Assessment</b> (taking into account risks to the targets)
• Safety margin against breaching 3% of GDP deficit limit <sup>1</sup>	throughout programme period	throughout programme period
• Achievement of the MTO	throughout programme period	throughout programme period
• Fiscal stance in line with Pact <sup>2</sup> ?	in line	in line
<p>Notes:</p> <p><sup>1</sup>The risk of breaching the 3% of GDP deficit threshold with normal cyclical fluctuations, i.e. the existence of a safety margin, is assessed by comparing the cyclically-adjusted balance with the minimum benchmark (estimated as a deficit of around 1¼% of GDP for Spain). These benchmarks represent estimates and as such need to be interpreted with caution.</p> <p><sup>2</sup>According to the Stability and Growth Pact, countries which have already achieved their MTO should avoid pro-cyclical fiscal policies in “good times”.</p> <p><sup>3</sup>Targets in structural terms as recalculated by Commission services on the basis of the information in the programme.</p> <p><u>Source:</u> Commission services</p>		

For countries in MTO, such as Spain, the Stability and Growth Pact requires that pro-cyclical fiscal policies in good times be avoided. Overall, Spain cannot be regarded as planning pro-cyclical fiscal policies in good times over the programme period. The projected weakening in the structural surplus in 2008 seems to indicate that the fiscal stance might be slightly expansionary. As Spain cannot be considered as experiencing "good times" in 2008, its fiscal stance is in line with the Pact.

As shown in Table 5 above, between 2007 and 2010, there is a mild loosening of fiscal policy (deterioration in the structural balance of ¼% of GDP and in the primary structural balance of ½% of GDP). Specifically, there is a loosening of around ½% of GDP in the structural balance in 2008, a slight tightening of around ¼% of GDP in 2009 and a broadly neutral fiscal stance in 2010. The assessment of economic conditions in chapter 3 above shows that Spain can be considered as experiencing ‘neutral’ economic times in 2008, possibly slipping towards bad times already in 2009.

## 5. GOVERNMENT DEBT AND LONG-TERM SUSTAINABILITY

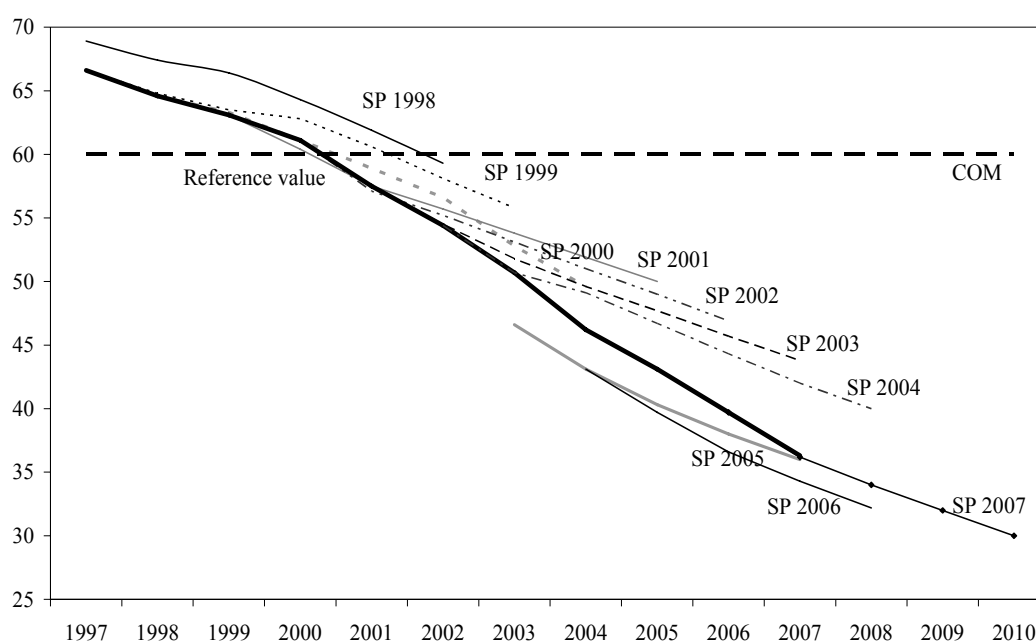
This section is in two parts. A first part describes recent debt developments and medium-term prospects, including risks to the outlook presented in the programme. A second part takes a longer-term perspective with the aim of assessing the long-term sustainability of public finances.

### 5.1. Recent debt developments and medium-term prospects

#### 5.1.1. Debt projections in the programme

According to the update, the government debt ratio will be kept on a downward path throughout the programme period and should remain well below the 60% of GDP Treaty reference value, as illustrated in Figure 7 and Table 10. Specifically, the debt-to-GDP ratio is expected to steadily decline from 36¼% of GDP in 2007 to 30% of GDP in 2010. The Commission services' autumn 2007 forecasts projected the general government debt in a similar downward path, although due to a more optimistic GDP projection, the update expects a sharper decline of public debt of around 1 percentage point until 2009.

**Figure 7: Debt projections in successive programmes (% of GDP)**



*Source: Commission services' autumn 2007 forecast (COM) and successive stability programmes*

The programme projects the stock-flow adjustment to increase from 1% of GDP in 2007 to 1¼% in 2008, remaining stable thereafter. Further provisions to the Social Security System Pension Fund, as well as financial investments in public companies, such as the national railway infrastructure company, ADIF, appear to be behind such developments.

**Table 10: Debt dynamics**

(% of GDP)	average 2002-05	2006	2007		2008		2009		2010
			COM	SP	COM	SP	COM	SP	SP
<b>Gross debt ratio<sup>1</sup></b>	<b>47.6</b>	<b>39.7</b>	<b>36.3</b>	<b>36.2</b>	<b>34.6</b>	<b>34.0</b>	<b>33.0</b>	<b>32.0</b>	<b>30.0</b>
Change in the ratio	-3.1	-3.4	-3.4	-3.5	-1.7	-2.2	-1.5	-2.0	-2.0
<i>Contributions<sup>2</sup>:</i>									
<b>Primary balance</b>	<b>-2.2</b>	<b>-3.5</b>	<b>-3.4</b>	<b>-3.4</b>	<b>-2.7</b>	<b>-2.7</b>	<b>-2.1</b>	<b>-2.6</b>	<b>-2.6</b>
<b>“Snow-ball” effect</b>	<b>-1.2</b>	<b>-1.5</b>	<b>-1.0</b>	<b>-1.0</b>	<b>-0.5</b>	<b>-0.7</b>	<b>-0.2</b>	<b>-0.6</b>	<b>-0.5</b>
<i>Of which:</i>									
Interest expenditure	2.2	1.6	1.6	1.6	1.5	1.5	1.5	1.4	1.4
Growth effect	-1.5	-1.5	-1.4	-1.4	-1.0	-1.1	-0.8	-1.0	-1.0
Inflation effect	-2.0	-1.6	-1.1	-1.2	-1.1	-1.2	-0.9	-1.0	-1.0
<b>Stock-flow adjustment</b>	<b>0.4</b>	<b>1.6</b>	<b>1.0</b>	<b>1.0</b>	<b>1.6</b>	<b>1.3</b>	<b>0.8</b>	<b>1.2</b>	<b>1.2</b>
<i>Of which:</i>									
Cash/accruals diff.	-0.4	-1.1		n.a.		n.a.		n.a.	n.a.
Acc. financial assets	1.0	2.7		n.a.		n.a.		n.a.	n.a.
<i>Privatisation</i>	<i>0.0</i>	<i>0.0</i>		<i>n.a.</i>		<i>n.a.</i>		<i>n.a.</i>	<i>n.a.</i>
Val. effect & residual	-0.1	0.0		n.a.		n.a.		n.a.	n.a.

Notes:

<sup>1</sup>End of period.

<sup>2</sup>The change in the gross debt ratio can be decomposed as follows:

$$\frac{D_t}{Y_t} - \frac{D_{t-1}}{Y_{t-1}} = \frac{PD_t}{Y_t} + \left( \frac{D_{t-1}}{Y_{t-1}} * \frac{i_t - y_t}{1 + y_t} \right) + \frac{SF_t}{Y_t}$$

where  $t$  is a time subscript;  $D$ ,  $PD$ ,  $Y$  and  $SF$  are the stock of government debt, the primary deficit, nominal GDP and the stock-flow adjustment respectively, and  $i$  and  $y$  represent the average cost of debt and nominal GDP growth (in the table, the latter is decomposed into the growth effect, capturing real GDP growth, and the inflation effect, measured by the GDP deflator). The term in parentheses represents the "snow-ball" effect. The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual effects.

Source:  
Stability programme (SP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations

### 5.1.2. Assessment

Overall, the general government gross debt reduction path presented in the update appears plausible. After having taken into account the most recent information on the implementation of the 2007 budget, which points to a primary balance of around 3½% of GDP, the projections in the programme are broadly in line with the Commission services' autumn 2007 forecast. In 2008, a small deviation of around ½% of GDP is explained in broadly equal parts by a favourable macroeconomic scenario and by a higher stock-flow adjustment projected in the update. In 2009, the markedly favourable macroeconomic scenario depicted in the programme brings about that, in spite of ½% of GDP higher stock-flow adjustment projection, the update expects a reduction of debt to 32% of GDP compared to 33% of GDP in the autumn forecast.

The projected pace of debt reduction does not seem to be subject to major risks. According to the high-interest-rate scenario included in the update, which projects a market interest rate increase of 1 percentage point per year, the debt-to-GDP ratio would fall to 30.3% in 2010, only ¼% above the target in the central scenario. The programme assumes that the new rates apply only to new debt. The response to the change in interest rates is rather low because the average term of Spain's public debt is about 7 years.



## 5.2. Long-term debt projections and the sustainability of public finances

This section analyses the long-term sustainability of public finances. It uses long-term projections of age-related expenditures to calculate sustainability gap indicators and make long-term government debt projections so as to assess the sustainability challenge the country concerned is facing.

### 5.2.1. Sustainability indicators and long-term debt projections

Table 11 shows the evolution of government spending on pensions, healthcare, long-term care for the elderly, education and unemployment benefits according to the EPC's projections and property income received by general government according to an agreed methodology.<sup>13</sup> Non age-related primary expenditure and primary revenue is assumed to remain constant as a share of GDP.

**Table 11: Long-term age-related expenditure: main projections**

(% of GDP)	2004	2010	2020	2030	2040	2050	Change up to 50
<b>Total age-related spending</b>	20.1	19.7	20.4	23.4	27.3	28.6	8.5
- Pensions	8.6	8.9	9.3	11.8	15.2	15.7	7.1
- Healthcare	6.1	6.3	6.7	7.3	7.9	8.3	2.2
- Long-term care	0.5	0.5	0.5	0.5	0.6	0.8	0.2
- Education	3.7	3.2	3.2	3.0	2.9	3.1	-0.6
- Unemployment benefits	1.1	0.9	0.7	0.7	0.7	0.7	-0.4
<b>Property income received</b>	0.6	0.7	0.7	0.6	0.6	0.5	-0.1

*Source: Economic Policy Committee and Commission services.*

The projected increase in age-related spending in Spain is above the EU average, rising by 8.5% points of GDP between 2004 and 2050. This is particularly due to a relatively large increase in pension expenditure, by 7.1 p.p. of GDP. The increase in health-care expenditure is projected to be 2.2 p.p. of GDP, also above the EU average. For long-term care, the projected increase of 0.2 p.p. of GDP up to 2050 is below the EU average.

**Table 12: Sustainability indicators and the required primary balance**

Value of which:	2007 scenario			Programme scenario		
	S1	S2	RPB	S1	S2	RPB
Value	-0.3	2.7	6.6	0.2	3.3	6.7
Initial budgetary position (IBP)	-3.3	-3.2	-	-2.8	-2.7	-
Debt requirement in 2050 (DR)	-0.5	-	-	-0.5	-	-
Long-term change in the primary balance (LTC)	3.5	5.9	-	3.5	5.9	-

*Source: Commission services.*

Based on the long-term budgetary projections, sustainability indicators can be calculated. Table 12 shows the sustainability indicators for the two scenarios; the 2007 scenario assumes that the structural primary balance in 2007 is unchanged for the rest of the programme period and the programme scenario assumes that the programme's budgetary plans are fully attained. In the "2007 scenario", the sustainability gap (S2) which satisfies the intertemporal budget constraint would be 2.7% of GDP<sup>14</sup>. Compared with the results

<sup>13</sup> See the accompanying "methodological paper" for a description of the property income projections.

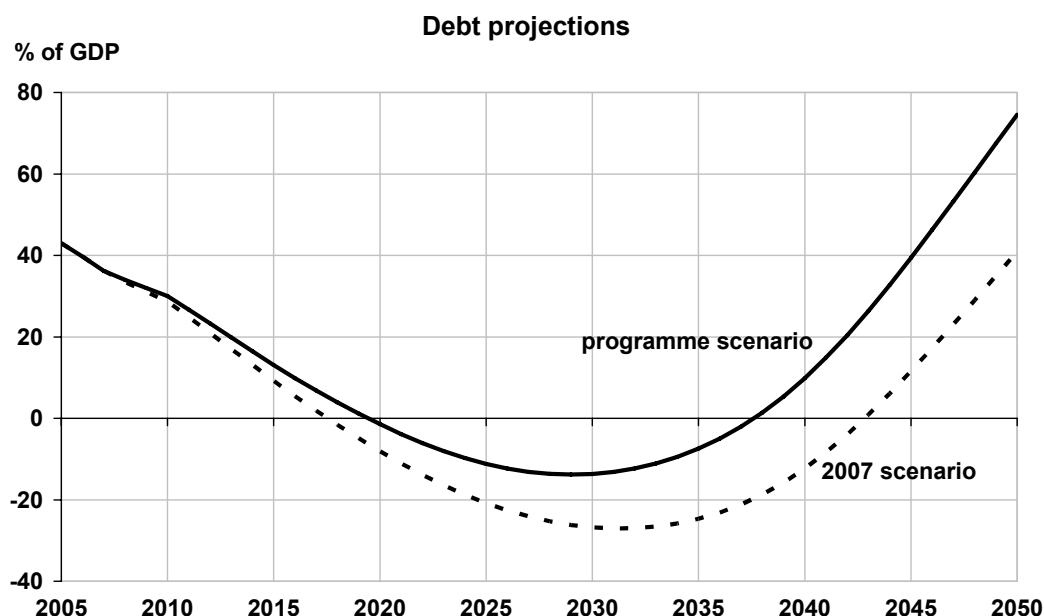
<sup>14</sup> The sustainability gap (S1) that assures the debt ratio reaching 60% of GDP by 2050 would be -0.3% of GDP.

of the assessment of the previous year, the sustainability gap has remained almost unchanged. The initial strong budgetary position with a structural primary balance of 3.8% of GDP contributes to the reduction of gross debt and the accumulation of financial assets. According to both sustainability gaps, the long-term budgetary impact of ageing is high. The planned reduction in the primary balance over the programme period has a negative impact on the sustainability gap, showing the importance of maintaining a strong structural budgetary position to contain risks to the sustainability of public finances.

The required primary balance (RPB) is about 6¾% of GDP, much higher than the structural primary balance of about 3¼% of GDP in the last year of the programme's period.

The sustainability gap indicators would increase by up to ¼% of GDP if the planned budgetary adjustment was to be postponed by 5 years, highlighting that budgetary savings can be made if action is taken sooner rather than later.

**Figure 8: Long-term projections for the government debt ratio**



*Source: Commission services*

Another way to look at the prospects for long-term public finance sustainability is to project the debt-to-GDP ratio over the long-term using the same assumptions as for the calculations of the sustainability indicators. The long-term projections for government debt under the two scenarios are shown in Figure 8. The gross debt ratio is currently below the 60% of GDP reference value, estimated in the programme at just below 40% of GDP in 2007. According to the “2007 scenario”, the debt ratio is projected to decline until the 2030s and thereafter increase very steeply for the remaining projection period, although not breaching the 60% of GDP reference value before 2050. In the “programme scenario”, the debt ratio decline up to 2030 would be less pronounced than in the 2007

scenario and would breach the reference value in the second half of 2040s, reaching around 75% of GDP by 2050<sup>15</sup>.

### *5.2.2. Additional factors*

To reach an overall assessment of the sustainability of public finances, other relevant factors are taken into account, which in addition allow to better appreciate where the main risks to sustainability are likely to stem from.

First, the decline in the structural budget balance until 2009 as planned by the programme is also projected by the Commission services' autumn forecast; in the latter even more steeply. This gives additional plausibility to the less favourable sustainability projection in the "programme scenario".

Second, a small amount of assets are being accumulated in the Social Security Reserve Fund (FRSS) (planned to reach 4.7% of GDP at the end of 2008, according to the programme), in order to pre-fund part of future government spending on pensions.<sup>16</sup>

Third, an Agreement on Social Security Measures between the government and social partners entered into force in January 2008. Benefit levels and coverage have been extended, while the minimum contribution period required for pension entitlement has been prolonged. Conditions for early retirement have been somewhat tightened. The stability programme does not provide an estimate of the fiscal impact of this measure. Further, substantial pension reforms are not mentioned in the programme.

### *5.2.3. Assessment*

Spain appears to be at medium risk with regard to the sustainability of public finances.

The long-term budgetary impact of ageing is well above the EU average, mainly as a result of a relatively high increase in pension expenditure as a share of GDP over the coming decades. The budgetary position in 2007 as estimated in the programme, which is similar to the starting position of the previous programme, contributes to offsetting the projected long-term budgetary impact of ageing populations. However, this is not sufficient to fully cover future spending pressures. Maintaining high primary surpluses over the medium term and implementing further measures aimed at curbing the substantial increase in age-related expenditures would contribute to reducing risks to the sustainability of public finances.

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<sup>15</sup> It should be recalled, however, that being a mechanical, partial-equilibrium analysis, the long-term debt projections are bound to show highly accentuated profiles. As a consequence, the projected evolution of debt levels should not be seen as a forecast similar to the Commission services' short-term forecasts, but as an indication of the risks faced by Member States.

<sup>16</sup> At the end of 2006 according to the programme, the portfolio consisted of 54.1% Spanish government bonds, which is already consolidated within general government. The remainder is held in foreign government bonds, which would slightly reduce gross debt adjusted for assets held by public pension funds. Currently, the fund's share of foreign debt is capped at 50%.

## **6. STRUCTURAL REFORM, THE QUALITY OF PUBLIC FINANCES AND INSTITUTIONAL FEATURES**

The 2007 update outlines several measures, the objective of which is, on top of budgetary stability, the increase of the quality of public finances.

On the expenditure side and in line with previous updates of the Stability Programme, the priority is to foster the economy's growth potential by enhancing productivity growth. This would be pursued by increasing public accumulation of physical, human and knowledge capital through spending programmes on infrastructures, education and R&D. The programme underlines the role of the State Agency for the Assessment of Public Policy and Service Quality as a step forward in the promotion of a culture of assessment, which should enhance the efficiency and quality of public services.

As from 2005, priority is given to the items that have the greatest capacity to enhance the economy's potential growth by fostering productivity: R&D+i, education and infrastructure, which grow much faster than total expenditure. Specifically, the 2008 Budget increases the allocation to civilian research by 17½% with respect to 2004. Additionally, a new programme for R&D, Euroingenio, was implemented in 2007 with the goal of increasing Spain's share in the Seventh Framework Programme. Concerning education, the update announces an increase of 14% for education in the Budget. However, this refers to the Central government, which only manages around 5% of total expenditure in education. No information is provided about the rest 95%, which is included in the Autonomous Communities' budgets. Finally, infrastructure expenditure would grow by 9½% aiming at improving roads, trains and water supply.

On the revenue side, the most relevant development refers to the reform of the personal income and corporate taxes, which, although entered into effect in January 2007, will still impact 2008 due to the implementation of the calendar of measures. The most relevant of that measures correspond to the general rate of the corporate tax, which will be reduced from 35% to 30% in 2008. Additionally, two new allocations have been introduced in the personal income system. First, new births or adoptions are qualified for a new one-off payment of € 2,500, amounting to around 0.1% of GDP. Second, a tax credit for citizens living in rental accommodation, with the aim of applying comparable tax treatment to real estate acquisition. This measure will represent around 0.04% of GDP and will affect the 2009 Budget.

In addition, a new Tax Fraud Prevention Act has been adopted seeking to prevent various types of tax fraud, such as VAT, vehicle tax or real estate. Finally, the increased number of services offered via Internet should decisively contribute to facilitate the fulfilment of taxpayers' obligations.

## **7. CONSISTENCY WITH THE NATIONAL REFORM PROGRAMME AND WITH THE BROAD ECONOMIC POLICY GUIDELINES**

The measures presented in the stability programme as described in preceding sections are in line with the National Reform Programme (NRP) and the progress recorded in the Implementation Report of the National Reform Programme (IR-NRP) submitted in October 2007 in the context of the renewed Lisbon strategy for growth and jobs. Specifically, the update states that the expenditure policies, e.g. annual increases of around 20% of R&D expenditures are the result of medium-term strategic plans and programmes, the most relevant of which is the NRP.

In this vein, the update provides a qualitative assessment of the overall impact of the NRP within the medium term fiscal strategy as well as sufficient information on the direct budgetary costs associated with the reforms envisaged in the NRP, e.g. R&D, education and infrastructures. In sum, the update is fully consistent with the NRP.

### **Box 5: The Commission assessment of the October 2007 implementation report of the national reform programme**

On 11 December 2007, the Commission adopted its Strategic Report on the renewed Lisbon strategy for growth and jobs, which includes an assessment of the October 2007 implementation report of Spain's national reform programme<sup>17</sup> and is summarised as follows.

Spain's national reform programme identifies two over-arching policy objectives related to growth and employment: culminating the real convergence of Spain with the EU-25 in terms of per capita income and increasing the employment rate to 66% by 2010. In order to achieve these two main objectives, the programme identifies seven key policy areas, which encompass budgetary stability, a R&D strategy, a better environment for business, the achievement of higher competition, infrastructure development, a better functioning of the labour market and better education and human capital.

The Commission's assessment is that Spain is making good progress in the implementation of its National Reform Programme. Further implementation of new laws and measures across the seven key policy areas are now essential in order to increase employment and productivity and progress towards full GDP per capita convergence with EU-25.

Against the background of strengths and weaknesses identified, the Commission recommends that Spain is recommended to take action in the areas of competition in the energy sector and education.

Against the background of progress made, the Commission recommends that Spain is encouraged to also focus on the areas of external imbalances and inflation, competition in professional services and retail markets, regulatory framework, environment, labour market segmentation, immigration, skill levels, access to childcare, housing market, and fiscal sustainability.

Tables 13 and 14 provide an overview of whether the strategy and policy measures in the stability programme are consistent with the broad economic policy guidelines in the area of public finances issued in the context of the Lisbon strategy for growth and jobs. The first table makes the assessment against the integrated guidelines for the period 2005-

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<sup>17</sup> Communication from the Commission to the European Council, "Strategic report on the renewed Lisbon strategy for growth and jobs: launching the new cycle (2008-2010)", 11.12.2007, COM(2007)803.

2008, adopted by the Council in July 2005. The second table makes the assessment against the country-specific recommendations / points to watch and the recommendations for the euro area, adopted by the Council in March 2007. The budgetary strategy in the stability programme is broadly consistent with the country-specific recommendations / points to watch and the recommendations for the euro area.

**Table 13: Consistency with the broad economic policy guidelines (integrated guidelines)**

Broad economic policy guidelines (integrated guidelines)	Yes	Steps in right direction	No	Not applicable
<b>1. To secure economic stability</b>				
– Member States should respect their medium-term budgetary objectives. As long as this objective has not yet been achieved, they should take all the necessary corrective measures to achieve it <sup>1</sup> .	X			
– Member States should avoid pro-cyclical fiscal policies <sup>2</sup> .	X			
– Member States in excessive deficit should take effective action in order to ensure a prompt correction of excessive deficits <sup>3</sup> .				X
– Member States posting current account deficits that risk being unsustainable should work towards (...), where appropriate, contributing to their correction via fiscal policies.		X		
<b>2. To safeguard economic and fiscal sustainability</b>				
In view of the projected costs of ageing populations,				
– Member States should undertake a satisfactory pace of government debt reduction to strengthen public finances.				X
– Member States should reform and re-enforce pension, social insurance and health care systems to ensure that they are financially viable, socially adequate and accessible (...)		X		
<b>3. To promote a growth- and employment-orientated and efficient allocation of resources</b>				
Member States should, without prejudice to guidelines on economic stability and sustainability, re-direct the composition of public expenditure towards growth-enhancing categories in line with the Lisbon strategy, adapt tax structures to strengthen growth potential, ensure that mechanisms are in place to assess the relationship between public spending and the achievement of policy objectives and ensure the overall coherence of reform packages.	X			
<b>Notes:</b> <sup>1</sup> As further specified in the Stability and Growth Pact and the code of conduct, i.e. with an annual 0.5% of GDP minimum adjustment in structural terms for euro area and ERM II Member States. <sup>2</sup> As further specified in the Stability and Growth Pact and the code of conduct, i.e. Member States that have already achieved the medium-term objective should avoid pro-cyclical fiscal policies in “good times”. <sup>3</sup> As further specified in the country-specific Council recommendations and decisions under the excessive deficit procedure. <b>Source:</b> <i>Commission services</i>				

**Table 14: Consistency with the broad economic policy guidelines (country-specific recommendations and points to watch)**

Broad economic policy guidelines (country-specific recommendations and points to watch)	Yes	Steps in right direction	No	Not applicable
<b>1. Country-specific recommendations</b>				
– None in the macroeconomic area				X
<b>2. Points to watch</b>				
– pension and healthcare reforms which also impact favourably on long term fiscal sustainability		X		
<b>3. Recommendations for euro area Member States</b>				
– Make use of the favourable cyclical conditions to aim at or pursue ambitious budgetary consolidation towards their medium-term objectives in line with the Stability and Growth Pact, hence striving to achieve an annual structural adjustment of at least 0.5% of GDP as a benchmark				X
– Improve the quality of public finances by reviewing public expenditure and taxation, with the intention to enhance productivity and innovation, thereby contributing to economic growth and fiscal sustainability	X			
<i>Source: Commission services</i>				

\* \* \*

## Annex 1: Compliance with the code of conduct

This annex provides an assessment of whether the programme respects the requirements of Section II of the code of conduct (guidelines on the format and content), notably as far as (i) the model structure (Annex 1 of the code of conduct); (ii) the formal data provisions (Annex 2 of the code of conduct); and (iii) other information requirements is concerned.

### (i) Model structure

The update broadly adheres to the code of conduct as far as its table of contents is concerned. It notably follows the model structure in Annex 1 of the code of conduct

### (ii) Data requirements

The update broadly adheres to the code of conduct as far as data requirements are concerned. It notably provides most compulsory and optional data specified in the standard tables in Annex 2 of the code of conduct, as amended by the September 2007 EFC. Compulsory missing data refer to Table 1c (labour market developments), item 6 (compensation of employees). Optional missing data are the following: Table 1b (price developments): item 3 (HICP); Table 1c (labour market developments): items 2 (employment in hours) and 5 (productivity per hour); however, the programme provides employment and productivity in full time equivalent terms. Table 3 (general government expenditure by function). Table 4 (general government debt developments): details on the SFA and “other relevant variables”; Table 7 (long-term sustainability of public finances): no information on other age-related expenditures, interest expenditure and revenues is provided. The tables on the following pages show the data presented in the December 2007 update of the stability programme, following the structure of the tables in Annex 2 of the code of conduct. Compulsory data are in bold, missing data are indicated with grey-shading.

### (iii) Other information requirements

The table below provides a summary assessment of the adherence to the other information requirements in the code of conduct. .

The SCP...	Yes	No	Comments
<i>a. Involvement of parliament</i>			
... mentions status vis-à-vis national parliament.		X	
... indicates whether Council opinion on previous programme has been presented to national parliament.		X	
<i>b. Economic outlook</i>			
... (for euro area and ERM II Member States) uses “common external assumptions” on main extra-EU variables.	X		
... explains significant divergences with Commission services’ forecasts <sup>1</sup> .	X		
... bears out possible upside/downside risks to economic outlook.		X	
... analyses outlook for sectoral balances and, especially for countries with high external deficit, external balance.	X		
<i>c.. Budgetary strategy</i>			
... presents budgetary targets for general government balance in relation to MTO and projected path for debt ratio.	X		
... backs budgetary targets by indication of broad measures necessary to achieve them and analyses their quantitative effects on balance.	X		
... specifies state of implementation of measures.	X		
<i>d. Sensitivity analysis</i>			
... includes comprehensive sensitivity analyses and/or develops alternative scenarios showing impact on balance and debt of: a) changes in main economic assumptions b) different interest rate assumptions	X		
<i>g. Broad economic policy guidelines</i>			
... provides information on consistency with broad economic policy	X		



The SCP...	Yes	No	Comments
guidelines of budgetary objectives and measures to achieve them.			
<i>h. Quality of public finances</i>			
... describes measures to improve quality of public finances, both revenue and expenditure sides.	X		
<i>i. Long-term sustainability</i>			
... outlines strategies to ensure sustainability.	X		
... includes common budgetary projections by the AWG and all necessary additional information (esp. new relevant information).	X		
<i>j. Other information</i>			
... includes information on implementation of existing national budgetary rules and on other institutional features of public finances.	X		
Notes: SCP = stability/convergence programme; <sup>1</sup> To the extent possible, bearing in mind the typically short time period between the publication of the Commission services' autumn forecast and the submission of the programme. <u>Source:</u> Commission services			

Table 1a. Macroeconomic prospects

	ESA Code	2006	2006	2007	2008	2009	2010
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. Real GDP</b>	B1*g	122	3.9	3.8	3.1	3.0	3.2
<b>2. Nominal GDP</b>	B1*g	981	8.0	7.1	6.7	6.2	6.6
<b>Components of real GDP</b>							
<b>3. Private consumption expenditure</b>	P.3	123.3	3.8	3.2	2.8	2.7	2.9
<b>4. Government consumption expenditure</b>	P.3	133.8	4.8	5.3	5.2	4.6	4.0
<b>5. Gross fixed capital formation</b>	P.51	137.6	6.8	5.9	3.1	2.7	3.7
<b>6. Changes in inventories and net acquisition of valuables (% of GDP)</b>	P.52 + P.53	52.9	0.2	0.2	0.2	0.2	0.2
<b>7. Exports of goods and services</b>	P.6	123.7	5.1	5.7	5.4	5.4	5.7
<b>8. Imports of goods and services</b>	P.7	147.2	8.3	7.2	5.5	5.2	5.5
<b>Contributions to real GDP growth</b>							
<b>9. Final domestic demand</b>		-	5.0	4.6	3.5	3.3	3.5
<b>10. Changes in inventories and net acquisition of valuables</b>	P.52 + P.53	-	0.1	0.0	0.0	0.0	0.0
<b>11. External balance of goods and services</b>	B.11	-	-1.2	-0.8	-0.4	-0.3	-0.3

Table 1b. Price developments

	ESA Code	2006	2006	2007	2008	2009	2010
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. GDP deflator</b>		127.6	4.0	3.2	3.4	3.1	3.3
<b>2. Private consumption deflator</b>		121.5	3.4	2.7	3.3	2.7	2.8
<b>3. HICP<sup>1</sup></b>		n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>4. Public consumption deflator</b>		122.8	3.7	2.3	3.4	2.5	2.6
<b>5. Investment deflator</b>		133.1	4.7	3.5	3.2	3.2	3.4
<b>6. Export price deflator (goods and services)</b>		112.8	4.0	2.3	2.7	2.6	2.7
<b>7. Import price deflator (goods and services)</b>		105.7	3.5	1.3	2.3	1.7	1.6

<sup>1</sup> Optional for stability programmes.

Table 1c. Labour market developments

	ESA Code	2006	2006	2007	2008	2009	2010
		Level	rate of change	rate of change	rate of change	rate of change	rate of change
<b>1. Employment, persons<sup>1</sup></b>		20.0	3.7	3.4	2.9	2.7	2.9
<b>2. Employment, hours worked<sup>2</sup></b>		18.5	3.2	3.0	2.2	2.0	2.2
<b>3. Unemployment rate (%)<sup>3</sup></b>		8.5	-	8.2	8.2	8.1	7.9
<b>4. Labour productivity, persons<sup>4</sup></b>		38.5	0.1	0.4	0.2	0.3	0.4
<b>5. Labour productivity, hours worked<sup>5</sup></b>		41.5	0.7	0.8	0.9	1.0	1.1
<b>6. Compensation of employees</b>	D.1	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>7. Compensation per employee</b>		28.5	3.0	3.7	4.0	3.5	3.4

<sup>1</sup> Occupied population, domestic concept national accounts definition.<sup>2</sup> National accounts definition. FTE data<sup>3</sup> Harmonised definition, Eurostat; levels.<sup>4</sup> Real GDP per person employed.<sup>5</sup> Real GDP per hour worked (FTE data)

Table 1d. Sectoral balances

% of GDP	ESA Code	2006	2007	2008	2009	2010
<b>1. Net lending/borrowing vis-à-vis the rest of the world</b>	B.9	-8.1	-9.0	-8.9	-8.8	-8.7
<i>of which :</i>						
- Balance on goods and services		-6.1	-6.3	-6.3	-6.1	-5.8
- Balance of primary incomes and transfers		-2.7	-3.4	-3.3	-3.4	-3.3
- Capital account		0.7	0.7	0.7	0.5	0.4
<b>2. Net lending/borrowing of the private sector</b>	B.9	-10.0	-10.8	-10.1	-10.0	-9.9
<b>3. Net lending/borrowing of general government</b>	EDP B.9	1.8	1.8	1.2	1.2	1.2
<b>4. Statistical discrepancy</b>		0.0	0.0	0.0	0.0	0.0

Table 2. General government budgetary prospects

	ESA Code	2006	2006	2007	2008	2009	2010
		Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Net lending (EDP B.9) by sub-sector							
1. General government	S.13	17942	1.8	1.8	1.2	1.2	1.2
2. Central government	S.1311	6200	0.6	0.8	0.4	0.4	0.4
3. State government	S.1312	-17	0.0	-0.1	0.0	0.0	0.0
4. Local government	S.1313	-927	-0.1	0.0	0.0	0.0	0.0
5. Social security funds	S.1314	12686	1.3	1.1	0.8	0.8	0.8
General government (S13)							
6. Total revenue	TR	396280	40.4	40.8	40.4	40.4	40.3
7. Total expenditure	TE <sup>1</sup>	378338	38.6	39.0	39.2	39.2	39.1
8. Net lending/borrowing	EDP B.9	17942	1.8	1.8	1.2	1.2	1.2
9. Interest expenditure	EDP D.41	16126	1.6	1.6	1.5	1.4	1.4
10. Primary balance <sup>2</sup>		34068	3.4	3.4	2.7	2.6	2.6
11. One-off and other temporary measures <sup>3</sup>		-	0.0	0.0	0.0	0.0	0.0
Selected components of revenue							
12. Total taxes (12=12a+12b+12c)		240382	24.5	24.8	24.6	24.7	24.7
12a. Taxes on production and imports	D.2	121273	12.4	12.1	12.1	12.1	12.1
12b. Current taxes on income, wealth, etc	D.5	114417	11.7	12.2	12.0	12.1	12.1
12c. Capital taxes	D.91	4692	0.5	0.5	0.5	0.5	0.5
13. Social contributions	D.61	127076	13.0	13.0	13.0	13.0	13.0
14. Property income	D.4	7636	0.8	0.9	0.9	0.9	0.9
15. Other <sup>4</sup>		21186	2.2	2.1	1.9	1.8	1.7
16=6. Total revenue	TR	396280	40.4	40.8	40.4	40.4	40.3
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995) <sup>5</sup>			36.5	36.8	36.7	36.8	36.7
Selected components of expenditure							
17. Compensation of employees + intermediate consumption	D.1+P.2	147805	15.1	15.2	15.4	15.4	15.4
17a. Compensation of employees	D.1	98475	10.0	10.1	10.2	10.2	10.2
17b. Intermediate consumption	P.2	49330	5.0	5.1	5.2	5.2	5.2
18. Social payments (18=18a+18b)		138523	14.1	14.2	14.3	14.3	14.2
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	25805	2.6	2.6	2.7	2.7	2.6
18b. Social transfers other than in kind	D.62	112718	11.5	11.6	11.6	11.6	11.6
19=9. Interest expenditure	EDP D.41	16126	1.6	1.6	1.5	1.4	1.4
20. Subsidies	D.3	9796	1.0	1.0	1.0	1.0	1.0
21. Gross fixed capital formation	P.51	36874	3.8	3.9	3.9	4.0	4.1
22. Other <sup>6</sup>		29214	3.0	3.1	3.1	3.1	3.0
23=7. Total expenditure	TE <sup>1</sup>	378338	38.6	39.0	39.2	39.2	39.1
p.m.: Government consumption (nominal)	P.3	177978	18.1	18.2	18.6	18.8	18.8

<sup>1</sup> Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.<sup>2</sup> The primary balance is calculated as (EDP B.9, item 8) plus (EDP D.41, item 9).<sup>3</sup> A plus sign means deficit-reducing one-off measures.<sup>4</sup> P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91).<sup>5</sup> Including those collected by the EU and including an adjustment for uncollected taxes and social contributions (D.995), if appropriate.<sup>6</sup> D.29+D.4 (other than D.41)+ D.5+D.7+D.9+P.52+P.53+K.2+D.8.

**Table 3. General government expenditure by function**

% of GDP	COFOG Code	2005	2010
1. General public services	1	n.a.	n.a.
2. Defence	2	n.a.	n.a.
3. Public order and safety	3	n.a.	n.a.
4. Economic affairs	4	n.a.	n.a.
5. Environmental protection	5	n.a.	n.a.
6. Housing and community amenities	6	n.a.	n.a.
7. Health	7	n.a.	n.a.
8. Recreation, culture and religion	8	n.a.	n.a.
9. Education	9	n.a.	n.a.
10. Social protection	10	n.a.	n.a.
11. Total expenditure (=item 7=23 in Table 2)	TE <sup>1</sup>	n.a.	n.a.

<sup>1</sup> Adjusted for the net flow of swap-related flows, so that TR-TE=EDP B.9.

**Table 4. General government debt developments**

% of GDP	ESA Code	2006	2007	2008	2009	2010
<b>1. Gross debt<sup>1</sup></b>		39.7	36.2	34.0	32.0	30.0
<b>2. Change in gross debt ratio</b>		-3.4	-3.5	-2.2	-2.0	-2.0
<b>Contributions to changes in gross debt</b>						
<b>3. Primary balance<sup>2</sup></b>		-3.4	-3.4	-2.7	-2.6	-2.6
<b>4. Interest expenditure<sup>3</sup></b>	EDP D.41	1.6	1.6	1.5	1.4	1.4
<b>5. Stock-flow adjustment</b>		1.6	0.9	1.3	1.2	1.2
<i>of which:</i>						
- Differences between cash and accruals <sup>4</sup>		n.a.	n.a.	n.a.	n.a.	n.a.
- Net accumulation of financial assets <sup>5</sup>		n.a.	n.a.	n.a.	n.a.	n.a.
<i>of which:</i>						
- privatisation proceeds		n.a.	n.a.	n.a.	n.a.	n.a.
- Valuation effects and other <sup>6</sup>		n.a.	n.a.	n.a.	n.a.	n.a.
<b>p.m.: Implicit interest rate on debt<sup>7</sup></b>		4.1	4.2	4.4	4.5	4.5
<b>Other relevant variables</b>						
6. Liquid financial assets <sup>8</sup>		n.a.	n.a.	n.a.	n.a.	n.a.
7. Net financial debt (7=1-6)		n.a.	n.a.	n.a.	n.a.	n.a.

<sup>1</sup> As defined in Regulation 3605/93 (not an ESA concept).

<sup>2</sup> Cf. item 10 in Table 2.

<sup>3</sup> Cf. item 9 in Table 2.

<sup>4</sup> The differences concerning interest expenditure, other expenditure and revenue could be distinguished when relevant.

<sup>5</sup> Liquid assets, assets on third countries, government controlled enterprises and the difference between quoted and non-quoted assets could be distinguished when relevant.

<sup>6</sup> Changes due to exchange rate movements, and operation in secondary market could be distinguished when relevant.

<sup>7</sup> Proxied by interest expenditure divided by the debt level of the previous year.

<sup>8</sup> AF1, AF2, AF3 (consolidated at market value), AF5 (if quoted in stock exchange; including mutual fund shares).

**Table 5. Cyclical developments**

% of GDP	ESA Code	2006	2007	2008	2009	2010
<b>1. Real GDP growth (%)</b>		3.9	3.8	3.1	3.0	3.2
<b>2. Net lending of general government</b>	EDP B.9	1.8	1.8	1.2	1.2	1.2
<b>3. Interest expenditure</b>	EDP D.41	1.6	1.6	1.5	1.4	1.4
<b>4. One-off and other temporary measures<sup>1</sup></b>		0.0	0.0	0.0	0.0	0.0
<b>5. Potential GDP growth (%)</b>		3.6	3.5	3.4	3.3	3.2
contributions:						
- labour		1.7	1.7	1.6	1.5	1.4
- capital		1.7	1.7	1.7	1.6	1.6
- total factor productivity		0.2	0.2	0.2	0.2	0.3
<b>6. Output gap</b>		0.3	0.5	0.2	-0.1	-0.1
<b>7. Cyclical budgetary component</b>		0.1	0.3	0.1	0.0	0.0
<b>8. Cyclically-adjusted balance (2 - 7)</b>		1.7	1.5	1.1	1.2	1.2
<b>9. Cyclically-adjusted primary balance (8 + 3)</b>		3.3	3.1	2.6	2.6	2.6
<b>10. Structural balance (8 - 4)</b>		1.7	1.5	1.1	1.2	1.2

<sup>1</sup>A plus sign means deficit-reducing one-off measures.

**Table 6. Divergence from previous update**

	ESA Code	2006	2007	2008	2009	2010
<b>Real GDP growth (%)</b>						
Previous update		3.8	3.4	3.3	3.3	n.a.
Current update		3.9	3.8	3.1	3.0	3.2
Difference		0.1	0.4	-0.2	-0.3	n.a.
<b>General government net lending (% of GDP)</b>	EDP B.9					
Previous update		1.4	1.0	0.9	0.9	n.a.
Current update		1.8	1.8	1.2	1.2	1.2
Difference		0.4	0.8	0.3	0.3	n.a.
<b>General government gross debt (% of GDP)</b>						
Previous update		39.7	36.6	34.3	32.2	n.a.
Current update		39.7	36.2	34.0	32.0	30.0
Difference		0.0	-0.4	-0.3	-0.2	n.a.

**Table 7. Long-term sustainability of public finances**

% of GDP	2005	2010	2020	2030	2040	2050
Total expenditure	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Of which: age-related expenditures	20.0	19.7	20.4	23.4	27.3	28.6
Pension expenditure	8.7	8.9	9.3	11.8	15.2	15.7
Social security pension	7.8	8.1	8.5	11.0	14.4	15.2
Old-age and early pensions	5.2	5.2	5.5	7.7	10.9	11.8
Other pensions (disability, survivors)	2.6	2.8	3.0	3.3	3.5	3.4
Occupational pensions (if in general government)	0.8	0.8	0.8	0.8	0.7	0.5
Health care	6.1	6.3	6.7	7.3	7.9	8.3
Long-term care ( <i>this was earlier included in the health care</i> )	0.5	0.5	0.5	0.5	0.6	0.8
Education expenditure	3.6	3.2	3.2	3.0	2.9	3.1
Other age-related expenditures	1.1	0.9	0.7	0.7	0.7	0.7
Interest expenditure	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Total revenue	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Of which: property income	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<i>Of which</i> : from pensions contributions (or social contributions if appropriate)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Pension reserve fund assets	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<i>Of which</i> : consolidated public pension fund assets (assets other than government liabilities)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
<b>Assumptions</b>						
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	87.0	86.1	87.8
Participation rates 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+ over total population	24.5	25.3	29.8	38.2	52.5	65.6

**Table 8. Basic assumptions**

	2006	2007	2008	2009	2010
Short-term interest rate <sup>1</sup> (annual average)	3.1	4.3	4.4	4.3	4.3
Long-term interest rate (annual average)	3.8	4.3	4.4	4.5	4.5
USD/€ exchange rate (annual average) (euro area and ERM II countries)	1.26	1.36	1.42	1.42	1.42
Nominal effective exchange rate	0.8	2.2	1.0	0.0	0.0
(for countries not in euro area or ERM II) exchange rate vis-à-vis the € (annual average)	n.a.	n.a.	n.a.	n.a.	n.a.
World excluding EU, GDP growth	6.0	5.6	5.3	5.4	5.5
EU GDP growth	3.0	2.9	2.4	2.4	2.5
Growth of relevant foreign markets	9.1	6.9	6.3	6.3	6.5
World import volumes, excluding EU	8.5	8.1	7.4	7.9	8.0
Oil prices (Brent, USD/barrel)	66.2	70.6	78.8	76.0	76.0

<sup>1</sup>If necessary, purely technical assumptions.

**Annex 2 Table: Key economic indicators**

	Spain						Euro area					
	Averages			2005	2006	2007	Averages			2005	2006	2007
	'96 - '05	'96 - '00	'01 - '05				'96 - '05	'96 - '00	'01 - '05			
<b>Economic activity</b>												
Real GDP (% change)	3.7	4.1	3.3	3.6	3.9	3.8	2.1	2.7	1.4	1.5	2.8	2.6
<i>Contributions to real GDP growth:</i>												
<i>Domestic demand</i>	4.5	4.7	4.3	5.3	5.1	4.7	2.0	2.7	1.3	1.7	2.6	2.4
<i>Net exports</i>	-0.8	-0.6	-1.0	-1.6	-1.2	-0.9	0.1	0.0	0.1	-0.1	0.2	0.2
Real GDP per capita (PPS; EU27 = 100)	97	94	100	103	105	105	113	114	112	110	110	109
Real GDP per capita (% change)	2.7	3.7	1.7	1.9	2.3	2.4	1.6	2.5	0.8	0.9	2.3	2.2
<b>Prices, costs and labour market</b>												
HICP inflation (%)	2.9	2.6	3.2	3.4	3.6	2.6	1.9	1.5	2.2	2.2	2.2	2.0
Labour productivity (% change)	0.4	0.3	0.5	0.4	0.7	0.8	1.2	1.5	0.8	1.0	1.4	1.1
Real unit labour costs (% change)	-1.0	-0.6	-1.3	-1.7	-1.6	-1.0	-0.5	-0.6	-0.5	-0.8	-0.9	-0.8
Employment (% change)	3.6	3.9	3.3	4.1	3.7	3.1	1.2	1.5	0.9	0.9	1.5	1.6
Unemployment rate (% of labour force)	12.5	14.6	10.5	9.2	8.5	8.1	9.1	9.8	8.5	8.9	8.3	7.3
<b>Competitiveness and external position</b>												
Real effective exchange rate (% change)	0.5	-1.2	2.1	0.4	1.2	1.3	-1.3	-5.5	2.8	-2.6	-0.6	0.6
Export performance (% change) <sup>1</sup>	0.9	1.7	0.0	-2.3	-2.2	-0.4	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-2.3	-0.6	-4.1	-6.5	-8.1	-8.7	0.8	0.9	0.7	0.3	0.0	0.1
<b>Public finances</b>												
General government balance (% of GDP)	-1.5	-2.8	-0.1	1.0	1.8	1.8	-2.3	-2.1	-2.5	-2.5	-1.5	-0.8
General government gross debt (% of GDP)	56.2	63.2	49.2	43.0	39.7	36.3	70.6	72.2	69.0	70.3	68.6	66.6
Structural balance (% of GDP) <sup>2</sup>	n.a.	n.a.	0.3	1.4	2.1	2.0	n.a.	n.a.	-2.6	-2.1	-1.1	-0.7
<b>Financial indicators</b>												
Short-term real interest rate (%) <sup>3</sup>	0.3	2.0	-1.3	-2.0	-0.9	1.2	1.3	2.5	0.6	0.3	1.2	2.0
Long-term real interest rate (%) <sup>3</sup>	1.6	3.1	0.1	-0.8	-0.2	1.3	n.a.	n.a.	1.9	1.5	1.9	2.1
<b>Notes:</b> <sup>1</sup> Market performance of exports of goods and services on export-weighted imports of goods and services of 35 industrial markets. <sup>2</sup> Cyclically-adjusted balance net of one-off and other temporary measures; available since 2003. <sup>3</sup> Using GDP deflator.												
<b>Source:</b> <i>Commission services</i>												