COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 19.2.2008
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Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated stability programme of Spain, 2007-2010

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. General background

The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies[1], which is part of the Stability and Growth Pact, stipulates that each Member State has to submit, to the Council and the Commission, a stability or convergence programme and annual updates thereof. Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes. The first stability programme of Spain was submitted in December 1998. In accordance with the Regulation, the Council delivered an opinion on it on 15 March 1999 on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee. As regards updated stability and convergence programmes, the regulation foresees that these are assessed by the Commission and examined by the Committee and if necessary and following the same procedure as set out above, the updated programmes may be examined by the Council.

2. Background for the assessment of the updated programme

The Commission has examined the most recent update of the stability programme of Spain, submitted on 21 December 2007, and is recommending a Council opinion on it (see box for the main points covered by the assessment).

In order to set the scene against which the budgetary strategy in the updated stability programme is assessed, the following paragraphs summarise:

(1) the most recent assessment of the country's position under the preventive arm of the Stability and Growth Pact (summary of the Council opinion on the previous update of the stability programme)

(2) the orientations for budgetary policies adopted by the April 2007 Eurogroup

(3) the March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies

(4) the Commission's assessment of the October 2007 implementation report of the national reform programme.

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[1] OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

2.1. The assessment in the Council opinion on the previous update

In its opinion of 27 March 2007, the Council summarised its assessment of the previous update of the stability programme, covering the period 2006-2009, as follows. “The Council considers that the medium term budgetary position is sound and the budgetary strategy provides a good example of fiscal policies conducted in compliance with the Stability and Growth Pact. Maintaining a strong budgetary position, thus avoiding an expansionary fiscal stance, is important in the light of large and rising external imbalances and the existing inflation differential with the euro area”. In view of the projected increase in age-related expenditure, the Council invited Spain to "further improve the long term sustainability of public finances with additional measures to contain the future impact of ageing on spending programmes".

2.2. Orientations for budgetary policies adopted by the Eurogroup in April 2007

On 20 April 2007, with a view to improving the coordination of fiscal policies in the euro area, Eurogroup ministers discussed national budgetary developments in 2007 and the preliminary policy outlook for 2008 and their implications for the euro area.

Reaffirming their adherence to the sound fiscal policy principles of the revised Stability and Growth Pact and to national fiscal rules, Ministers committed to (i) build on the better-than-expected budgetary outcomes in 2006 to pursue more ambitious budgetary targets than those set in the end-2006 updates of the stability programmes; (ii) implement their 2007 budgets as planned, avoiding expenditure overruns, and using unexpected extra revenues to reduce government deficit and debt; and (iii) carefully design fiscal policy plans for 2008 so as to accelerate the adjustment towards the MTO for Member States which have not reached it and for those which have reached it to avoid feeding macroeconomic imbalances overall[2].

2.3. March 2007 update of the country-specific broad economic policy guidelines in the area of budgetary policies

On 27 March 2007, the Council adopted a recommendation on the 2007 update of the broad guidelines for the economic policies of the Member States and the Community and on the implementation of Member States' employment policies[3]. In the area of budgetary policies, Spain was encouraged "to focus on pension and health care reforms which also impact favourably on long term fiscal sustainability". In addition, all euro area Member States were recommended to “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” and “to improve the quality of public finance by reviewing public expenditures and taxation, with the intention to enhance productivity and innovation, thereby contributing to economic growth and fiscal sustainability”.

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[2] The entire statement can be found at: www.gouvernement.lu/salle_presse/actualite/2007/04/20pm_krecke_berlin/MTBR_EG_conclusions-finalCLEAN.rtf

[3] OJ L 92, 3.4.2007, p. 23.

2.4. 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[4]. This can be summarised as follows.

Spain's national reform programme identified 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 identified 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 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.

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[4] 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)" - COM(2007) 803, 11.12.2007.

Box: Main points covered by the assessment

As required by Article 5(1) (for stability programmes) and Article 9(1) (for convergence programmes) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as a benchmark to meet its MTO;
- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2007 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability[5];
- the degree of consistency with the national reform programme, submitted by Member States in the context of the Lisbon strategy for growth and jobs, and its October 2007 implementation report. In its cover note of 7 June 2005 to the European Council on the broad economic policy guidelines for the period 2005-2008, the ECOFIN Council stated that the national reform programmes should be consistent with the stability and convergence programmes;
- compliance with the code of conduct[6], which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

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5 Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU" - COM(2006) 574, 12.10.2006 - and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

6 "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.

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On the updated stability programme of Spain, 2007-2010

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

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

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On [4 March 2008] the Council examined the updated stability programme of Spain, which covers the period 2007 to 2010[8].

(2) 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 asset markets, especially in the housing sector. Moreover, successive labour market reforms significantly reduced structural unemployment. In parallel, a number of imbalances have emerged, such as a widening external deficit and a persistent 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

7 OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

8 The update was submitted more than 3 weeks beyond the 1 December deadline set in the code of conduct.

negatively impact on the long-term sustainability of public finances, mainly as a result of increasing pressure from pension expenditure.

(3) 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[9], 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. 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.

(4) 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-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. Budgetary implementation in 2007 was broadly in line with the April 2007 Eurogroup orientations for budgetary policies.

(5) 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

[9] 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.

update presents, building on the better-than-expected 2007 outturn, somewhat better targets for 2008 and 2009 against a broadly similar macroeconomic background.

(6) 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.

(7) 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.

(8) Spain appears to be at medium risk with regard to the sustainability of public finances in spite of a low and decreasing debt ratio. 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.

(9) The stability programme is fully consistent with the October 2007 implementation report of the national reform programme (NRP). 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.

(10) 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 strategy.

(11) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps in the required and the optional data[10].

[10] In particular, table 1b (price developments), item 3 (HICP); table 1c (labour market developments), item 6 (compensation of employees) and the data on the functional classification of public expenditure are missing.

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.

In view of the above assessment, while maintaining a strong budgetary position, Spain is invited to further improve the long-term sustainability of public finances with additional measures to contain the future impact of ageing on spending programmes.

Spain is also invited to improve compliance with the submission deadline for stability and convergence programmes specified in the code of conduct[11].

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[11] Late submissions affect the effectiveness and consistency of the multilateral surveillance process.

Comparison of key macroeconomic and budgetary projections

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

Notes:

[1] Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2] Based on estimated potential growth of 3.5%, 3.7%, 3.4% and 3.2% respectively in the period 2006-2009.

[3] There are no one-off and other temporary measures in the most recent programme and Commission services' autumn forecast.

[4] Private consumption deflator.

Source:

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