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COMMISSION OF THE EUROPEAN COMMUNITIES

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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, 2008-2011

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. In particular, it introduced greater flexibility in the application of the rules governing the excessive deficit procedure, notably with regard to definition of "exceptional circumstances" and the setting of deadlines for the correction of an excessive deficit.

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.

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 16 January 2009, and has adopted a recommendation for a Council opinion on it.

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

(1) the Commission Communication of 26 November 2008 (“A European Economic Recovery Plan”);

(2) 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).

2.1. The Commission Communication of 26 November 2008 (“A European Economic Recovery Plan”)

In view of the unprecedented scale of the global financial and economic crisis, the European Commission has called for a European Economic Recovery Plan (EERP)[2]. The plan proposes a co-ordinated counter-cyclical macro-economic response to the crisis in the form of an ambitious set of actions to support the economy consisting of (i) an immediate budgetary impulse amounting to € 200 bn. (1.5% of EU GDP), made up of a budgetary expansion by Member States of € 170 bn. (around 1.2% of EU GDP) and EU funding in support of

[1] OJ L 209, 2.8.1997, 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] Communication from the Commission to the European Council of 26 November 2008 - COM(2008) 800.

immediate actions of the order of € 30 bn. (around 0.3 % of EU GDP); and (ii) a number of priority actions grounded in the Lisbon Strategy and designed to adapt our economies to long-term challenges, continuing to implement structural reforms aimed at raising potential growth. The plan calls for the fiscal stimulus to be differentiated across Member States in accordance with their positions in terms of sustainability of government finances and competitive positions. In particular, for Member States outside the euro area with significant external and internal imbalances, budgetary policy should essentially aim at correcting such imbalances. The plan was agreed by the European Council on 11 December 2008. In this context, Member States were asked to submit an addendum to their updated stability or convergence programme, so as to reflect the measures taken in the context of the Recovery Plan. The examination of how measures (budgetary measures as well as structural measures) contribute to the recovery process in the short term is made in the opinions of stability convergence programmes.

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

In its opinion of 4 March 2008, the Council summarised its assessment of the previous update of the stability programme, covering the period 2007-2010, as follows. “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 this assessment, 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”.

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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[3], 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 [10 March 2009] the Council examined the updated stability programme of Spain, which covers the period 2008 to 2011.

(2) According to the Commission services' January 2009 interim forecast, Spanish GDP would have decelerated in 2008 to 1¼% in real terms. Spain is facing domestic and external adjustment challenges. Domestically, the housing sector is contracting, while the price of dwellings is falling. Externally, the persistent current account deficit gap has lead to rapidly growing indebtedness, resulting in rising interest payments abroad. These imbalances have been aggravated by the financial crisis. Since the first half of 2008, the Spanish authorities have adopted various measures to stimulate economic activity. They include temporary and permanent tax cuts and investment projects, amounting to 2¼% of GDP in 2009, as well as a series of structural reforms. In addition to these discretionary measures, public finances are severely affected by the economic downturn, which limits the space for further fiscal impulses without jeopardising a sound long-term budgetary position. Therefore, Spain is facing the challenge of enhancing potential growth in a protracted downturn, while facilitating the correction of the existing macroeconomic imbalances.

[3] OJ L 209, 2.8.1997, p. 1. The documents referred to in this text are available at: http://ec.europa.eu/economy_finance/about/activities/sgp/main_en.htm.

(3) The macroeconomic scenario underlying the programme envisages that GDP will contract by 1.6% in real terms in 2009 and recover in 2010 and 2011 with real GDP growth at 1.2% and 2.6% respectively. The acceleration would mainly be driven by domestic demand, while the external deficit is projected to decline from above 9% of GDP in 2008 to 5½% in 2011. The programme takes into account the stimulus measures adopted in response to the economic downturn, but does not present explicit estimates of their impact on real GDP growth. Assessed against currently available information[4], this scenario appears to be based on slightly favourable growth assumptions for 2009 and markedly favourable thereafter. On the back of a reduction in the balance of goods and services deficit, the programme envisages a decline of the external deficit from 9.2% of GDP in 2008 to 5.4% of GDP in 2011.

(4) For 2008, general government deficit is estimated at 3.4% of GDP[5] in the Commission services' January 2009 interim forecast, in line with the figure contained in the updated stability programme. However, this is much lower than the target of a surplus of 1.2% of GDP set in the previous update. The budgetary deterioration results from both discretionary measures and a much weaker economic activity. The fall of direct tax revenue reflects a combination of personal and corporate tax cuts and a significant fall in corporate profits, linked to feeble asset markets, including real estate. Indirect tax revenue fell due to the deceleration in consumer spending and particularly to the contraction of transactions in dwellings, as well as revenue-reducing measures of a one-off nature, such as changes to VAT payments and returns. Expenditure overruns reflect in particular the working of automatic stabilisers through higher social transfers, including unemployment benefits.

(5) The update plans a budget deficit of 5.8% of GDP in 2009, against a projection of 6.2% in the Commission services' interim forecast. The worsening of the budget balance is explained by the adoption of a number of discretionary measures amounting to around 2¼% of GDP, but also by the working of automatic stabilisers in response to the economic downturn (estimated at around 1% of GDP). The discretionary measures include the November 2008 stimulus package (slightly below 1¼ % of GDP). The package foresees the creation of a Central Government Fund for Local Public Investment, endowed with ¾% of GDP, with the aim of carrying out new public works. Revenue-reducing one-off measures amount to around ¾% of GDP, including the modification of the system for VAT returns and the reduction in personal income withholding tax for tax payers with mortgages. Overall, the stance of fiscal policy will be expansionary in 2009, in line with the recommendation of the EERP.

(6) After peaking in 2009, the headline deficit is expected to fall to below 4% of GDP in 2011. Similarly, the primary balance will reach a deficit of 1.9% of GDP by 2011, which compares with a deficit of 4.1% in 2009. In structural terms, the government deficit will increase from 3½% of GDP in 2008 to 4¾% in 2009 reflecting the budgetary impact of discretionary measures, but also the fall in revenue related to the on-going adjustment in the real estate sector. Nevertheless, the update sets up a fiscal adjustment path, projecting improvements in the structural balance of 1¼% and

[4] The assessment notably takes into account the Commission services' January 2009 interim forecast, but also other information that has become available since then.

[5] In view of the reported breach of the Treaty reference value, the Commission prepared on 18 February 2009 a report under Article 104(3) of the Treaty.

slightly above ½% of GDP in 2010 and 2011 respectively. As a result, the programme envisages a reduction in the structural deficit to 2¾ % in 2011[6]. According to the programme, the goal of this adjustment is to regain the medium-term budgetary objective (MTO) of a balanced position, but it is not expected to be met within the programme period. The improvement in 2010 can partly be explained by the temporary nature of the stimulus package adopted in November 2008. Apart from this, the programme does not spell out measures underpinning the projected decline in the structural balance. Government gross debt, estimated at 39.5% of GDP in 2008, is projected to increase by approximately 14 points over the programme period. In addition to the rise in the deficit and the decline in GDP growth, the acquisition of assets from banks within the framework of the financial rescue package contributes to the rise in the debt ratio.

(7) The budgetary outcomes are subject to downside risks throughout the programme period. First, the macroeconomic scenario projected in the update appears to be based on favourable growth assumptions, particularly for the outer years of the programme. Second, budgetary targets for 2010 and 2011 are not backed up by measures, other than the announced discontinuation of the November 2008 package. Moreover, regional and local governments are allowed to incur deficits in 2009 without the usual obligation of presenting a rebalancing plan. The evolution of the debt ratio may be less favourable than projected in the update, given the risks to the macroeconomic scenario and the budgetary targets, and the uncertainty about the impact of the guarantees granted in the context of the financial rescue package. However, the increase in debt linked to recapitalisations could be (partly) reversed if the support scheme and the financial operations linked to it were successful.

(8) 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. While the strong budgetary position until 2007 contributed to partly offsetting the projected long-term budgetary impact of ageing populations, the contrary would result from the budgetary developments projected in the programme. Also, if the 2009 budgetary position as projected by the Commission services' interim forecast is to be taken as the starting point, the sustainability gap would widen substantially in relation to the last update. Achieving high primary surpluses over the medium term and implementing further structural measures aimed at curbing the substantial increase in age-related expenditures would contribute to reducing the high risks to the sustainability of public finances.

(9) The medium-term budgetary framework has been instrumental in promoting an appropriate fiscal planning and shows an overall good track record, although the latter has worsened since 2008. No reforms to this framework are planned. However, the programme outlines several reforms aimed at improving the quality of public finances. On the revenue side, these include a reduction in the tax burden on earned income through a personal income tax credit of up to 400 euro per taxpayer, a mechanism for advancing the tax credit for mortgage payments, the elimination of wealth tax and the second phase of the corporate income tax reform, as well as measures aimed at

[6] Using the recalculated cyclically-adjusted balance, based on the information in the programme, and the definition of one-offs and other temporary measures applied by the Commission services, the structural balance would be -3.1% of GDP in 2008, -4.1 in 2009, and -3.4 in 2010.

improving the functioning of the tax system, such as the possibility of obtaining VAT refunds on a monthly basis. On the expenditure side, priority is being given to productive expenditure along with the need to rein in intermediate public consumption. 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.

(10) The Spanish authorities have adopted a range of measures to stabilise the financial sector. This includes an increase of the amount of the Deposit and Investment Guarantee Fund (from 20,000 to 100,000 euro per account-holder and bank) and the creation of the Financial Asset Acquisition Fund in order to promote lending to companies and individuals, endowed with 30 billion euro (close to 3% of GDP), including the possibility of an expansion up to 50 billion euro. Moreover, the authorities decided to grant exceptional authorisations to the Ministry of Economy and Finance to award State guarantees for new funding transactions by Spanish-resident banks in 2009 up 100 billion euro (10% of GDP), maturing between three months and three years, and to acquire securities issued by Spanish-resident banks in order to strengthen their own funds.

(11) The Spanish government adopted significant discretionary fiscal measures in response to the economic downturn. The stimulus package for 2009 is in line with the EERP agreed in December 2008 by the European Council and represents an adequate response to the economic downturn, yielding a temporary support to economic activity in 2009. It mainly focuses on investment (less than 1% of GDP), household purchasing power (¾% of GDP), and business and SME (¾% of GDP). Measures amounting to less than 1¼% of GDP were already planned in specific packages in April and August 2008, while the rest includes new actions adopted in a fiscal impulse package presented in November 2008 (slightly below 1¼% of GDP). This November 2008 package is timely, targeted and temporary. They broadly respond to the main policy objectives in terms of the short term outlook. The update also includes a series of structural measures, which are part of the longer-term policy reform agenda, but help to address the current challenges posed by the downturn. These measures are related to the medium-term reform agenda and the country-specific recommendations proposed by the Commission on 28 January 2009 under the Lisbon Strategy for Growth and Jobs. They aim at enhancing the growth potential, strengthen competitiveness and employment as well as supporting incomes of disadvantaged groups, and include the transposition of the services directive.

(12) The overall fiscal stance in the programme is expansionary in 2009 and mildly restrictive in 2010. More specifically, the programme targets for 2010 a reversal of the 2009 fiscal expansion and a further structural improvement in 2011. However, taking into accounts risks to the budgetary plans, the reversal in 2010 requires further action to be effective. The programme projects the headline deficit to remain above the 3% of GDP reference. The deficit reduction envisaged in the programme for 2010 and beyond is not backed up by measures.

(13) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme provides some gaps in the required and optional data[7].

The overall conclusion is that the sharp slowdown of economic activity and some discretionary measures led to a deficit above 3% of GDP in 2008, after a prolonged period in which the Spanish public finances were close to balance or in surplus. The updated stability programme aims at a significant fiscal impulse in 2009 in line with the EERP to counteract the continued slowdown in economic activity. This will lead to a widening of the government deficit, while the debt ratio remains comfortably below 60% of GDP. Restoring fiscal sustainability should therefore be an absolute priority. The favourable macroeconomic assumptions may imply a lower contribution of economic growth to fiscal consolidation than envisaged in the programme, while the adjustment path is not fully backed up with concrete measures. In addition, fostering the quality of public finances is important also with a view to underpinning a smooth adjustment of the economy in the light of the imbalances it is faced with.

In view of the above assessment, Spain is invited to:

(i) Implement the measures in line with the EERP as planned, while avoiding a further deterioration of public finances in 2009, and carry out with determination the planned structural adjustment in 2010 and beyond, backing it up with measures, and strengthening the pace of budgetary consolidation if cyclical conditions are better than projected.

(ii) Improve the long-term sustainability of public finances by implementing the adopted measures aimed at curbing the increase in age-related expenditure;

(iii) Ensure that fiscal consolidation measures are also geared towards enhancing the quality of the public finances as planned in the light of the needed adjustment of the economy to address existing imbalances.

Spain is also invited to improve compliance with the data requirements of the code of conduct.

[7] In particular, compulsory data on one-offs and other temporary measures (table 2), and optional data on HICP (table 1b), labour productivity per hour worked (table 1c), general government expenditure by function (table 3), structural balance (table 5) and detailed information on debt developments (table 4) - such as differences between cash and accruals in the general government debt developments, net accumulation of financial assets, privatisation proceeds, valuation effects and others, liquid financial assets, net financial debt,- are not provided.

		2007	2008	2009	2010	2011
Real GDP (% change)	**SP Jan 2009**	**3.7**	**1.2**	**-1.6**	**1.2**	**2.6**
	COM Jan 2009	3.7	1.2	-2.0	-0.2	n.a.
	SP Dec 2007	*3.8*	*3.1*	*3.0*	*3.2*	*n.a*
HICP inflation (%)	**SP Jan 2009**	**n.a.**	**n.a.**	**n.a.**	**n.a.**	**n.a.**
	COM Jan 2009	2.8	4.1	0.6	2.4	n.a.
	SP Dec 2007	*2.7*	*3.3*	*2.7*	*2.8*	*n.a*
Output gap[1] (% of potential GDP)	**SP Jan 2009**	**1.4**	**0.3**	**-2.6**	**-3.2**	**-2.7**
	COM Jan 2009[2]	1.5	0.8	-2.3	-3.4	n.a.
	SP Dec 2007	*-0.9*	*-1.4*	*-1.9*	*-1.6*	*n.a*
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	**SP Jan 2009**	**-9.7**	**-9.2**	**-6.6**	**-5.8**	**-5.4**
	COM Jan 2009	-9.7	-9.0	-6.7	-6.2	n.a.
	SP Dec 2007	*-9.0*	*-8.9*	*-8.8*	*-8.7*	*n.a*
General government revenue (% of GDP)	**SP Jan 2009**	**41.0**	**37.0**	**37.5**	**38.3**	**38.7**
	COM Jan 2009	41.0	36.8	36.4	36.9	n.a.
	SP Dec 2007	*40.800*	*40.4*	*40.4*	*40.3*	*n.a*
General government expenditure (% of GDP)	**SP Jan 2009**	**38.8**	**40.4**	**43.3**	**43.1**	**42.6**
	COM Jan 2009	38.8	40.2	42.6	42.5	n.a.
	SP Dec 2007	*39.0*	*39.2*	*39.2*	*39.1*	*n.a*
General government balance (% of GDP)	**SP Jan 2009**	**2.2**	**-3.4**	**-5.8**	**-4.8**	**-3.9**
	COM Jan 2009	2.2	-3.4	-6.2	-5.7	n.a.
	SP Dec 2007	*1.8*	*1.2*	*1.2*	*1.2*	*n.a*
Primary balance (% of GDP)	**SP Jan 2009**	**3.8**	**-1.9**	**-4.1**	**-2.9**	**-1.9**
	COM Jan 2009	3.8	-1.8	-4.6	-4.0	n.a.
	SP Dec 2007	*3.4*	*2.7*	*2.6*	*2.6*	*n.a*
Cyclically-adjusted balance[1] (% of GDP)	**SP Jan 2009**	**1.6**	**-3.5**	**-4.7**	**-3.4**	**-2.8**
	COM Jan 2009	1.6	-3.7	-5.2	-4.2	n.a.
	SP Dec 2007	*2.2*	*1.8*	*2.0*	*1.9*	*n.a*
Structural balance[3 4] (% of GDP)	**SP Jan 2009**	**1.6**	**-3.5**	**-4.7**	**-3.4**	**-2.8**
	COM Jan 2009	1.6	-3.3	-4.6	-4.2	n.a.
	SP Dec 2007	*2.2*	*1.8*	*2.0*	*1.9*	*n.a*
Government gross debt (% of GDP)	**SP Jan 2009**	**36.2**	**39.5**	**47.3**	**51.6**	**53.7**
	COM Jan 2009	36.2	39.8	46.9	53.0	n.a.
	SP Dec 2007	*36.2*	*34.0*	*32.0*	*30.0*	*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 3.0%, 1.8%, 1.0% and 0.9% respectively in the period 2007-2010.

[3] Cyclically-adjusted balance excluding one-off and other temporary measures. No one-offs are included in the most recent programme. One-off and other temporary measures are below ½% of GDP in 2008 and above ½% in 2009, all deficit-reducing, are included in the Commission services' January 2009 interim forecast.

[4] Using the recalculated cyclically-adjusted balance, based on the information in the programme, and the definition of one-offs and other temporary measures applied by the Commission services, the structural balance would be - 3.1% of GDP in 2008, -4.1 in 2009, and -3.4 in 2010.

Source:

Stability programme (SP); Commission services' January 2009 interim forecast (COM); Commission services' calculations.