STABILITY PROGRAMME UPDATE

KINGDOM OF SPAIN

2012 - 2015

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EXECUTIVE SUMMARY

The Spanish economy is facing significant financial and economic imbalances. This document presents the Spanish medium and long-term policy that the Government of Spain deems necessary and adequate to tackle them. The economic policy strategy begins with the diagnosis and quantification of the initial imbalances. On the basis of this diagnosis, targets and necessary measures to address them have been defined, together with their implementation timetable and their expected effects. This strategy is presented done within the EU protocol framework for the 2012-2015 Stability Programmes update.

Imbalances in the Spanish economy

The Spanish economy has accumulated significant economic and financial imbalances whose magnitude and severity must be recognised. These imbalances are interrelated, thus generating negative dynamics which must be reversed. They relate to three areas: financial imbalances, negative growth and high unemployment.

On the one hand, there are serious financial imbalances. Public deficit for 2011 was 8.5% of GDP whereas the target had been set for 6%, which has cast some doubts on the country's capacity for budgetary consolidation. Public debt has increased during the last four years, causing concern, notwithstanding the fact that Spain's debt level remains below the European average. In fact, it has gone from 36.3 of GDP in 2007 to an expected 79.8% of GDP for 2012.

On the other hand, private debt has reached a very high level, after a period of strong borrowing growth until 2008. Private debt is mainly linked to the construction sector, and mostly to real estate. These high levels of debt are mostly dependent on external sources leading to a significant external indebtedness, 165% of GDP in 2011.

Additionally, the Spanish economy is giving signs of limited capacity for growth. Since the beginning of the 2008 crisis, it has only enjoyed a brief period of slight growth which dried up in the middle of 2011. There has been a drop in activity since then, leading at the end of the year to a quarter on quarter GDP reduction of 0.3 %, for its last quarter. This drop in activity is explained by the exhaustion of the previous fiscal impulse and by the credit crunch.

Finally, unemployment has risen from about 8% in 2007 to 22.85% of the working population at the end of 2011, according to data from the Working Population Census (*Encuesta de Población Activa*)

These imbalances are interconnected. A high public deficit increases public debt, discouraging investment and undermining investor confidence, and requires a prompt correction, which, in turn, damages short-term economic growth and employment.

Nevertheless, important adjustments have been made throughout the last few years. These adjustments are reflected in a more satisfactory evolution of some macroeconomic magnitudes. Spain's current account deficit is expected to reach 1.4% of GDP in 2012, in contrast with 10% of GDP in 2007, this last figure revealing the limits of the previous expansive phase. Moreover, current account surplus is expected to be achieved in 2013. Such a surplus has been traditionally an indicator of the beginning of economic recovery in Spain.

This strong deficit correction is explained by the good performance of goods and services exports which have been gaining international market shares. Export dynamics shows the potential of Spanish companies and their competitiveness gains.

Simultaneously, increases in prices have notably moderated. Inflation for March this year has been 1.9%, which implies a 0.8 differential in favour of Spain with regards to the Euro zone.

In spite of these corrections, the initial imbalances remain significant and do not show a clear downtrend. As a result they have a negative impact on economic prospects and on confidence, while the risk premium on the Spanish debt remains excessively high.

Economic policy strategy

On the basis of these imbalances, the Spanish government has designed an economic policy strategy for the medium and long term aimed at laying the foundations for the recovery of production and employment and at boosting trust in the Spanish economy. Spain has overcome difficult situations in the recent past and it has done it through commitment to economic stability and structural reforms. Therefore, the ability to overcome these kinds of challenges has been already proven.

Insofar as a good number of the financial imbalances have been built up for several years, the target cannot be their immediate correction but to place them on a path of gradual and steady adjustment so that they may converge below European average levels. Private debt is already on the path of redress but the growing trend in public debt must be reversed. Hence, ambitious goals have been set for deficit reduction in all Public Administrations for 2012-2015.

Therefore, the economic policy of the Government sets fiscal consolidation as the major priority. The goal to be achieved is the highest correction of budgetary imbalance in the shortest period of time. Specifically, the highest adjustment effort will be carried out during the first years of this Stability Programme, with the greatest adjustment coming in the first year. The targets are, 5.3% of GDP for 2012, 3% of GDP for 2013, 2.2% of GDP for 2014, and 1.1% of GDP for 2015, achieving budgetary balance in 2016.

In order to achieve these public deficit targets, primary surpluses will have to be reached from the beginning of 2013, putting a brake on the public debt uptrend in the first stage, and reversing that trend at the beginning of 2014. Specifically, public debt is expected to decrease from 82.3% of GDP in 2013 to 81.5% of GDP in 2014 and to 80.8% of GDP in 2015.

This gradual drop in public debt as a percentage of GDP will add to the reduction of private debt, thus placing the aggregated debt closer to average European levels.

In any case, the strong budgetary adjustment established for this year will have a negative impact on economic activity, with an estimated drop of 1.7% of GDP. However, fiscal consolidation together with an ambitious programme of structural reforms will have a positive impact on investment and business confidence, and also on the proper functioning of the product and factor markets. A positive growth of 0.2% of GDP is expected for 2013, thus initiating a gradual path of production and employment recovery. Continuous recovery will allow for a GDP growth of 1.4% in 2014 and of 1.8% in 2015.

Summary table. Stability Programme, Main Data
% of GDP, unless indication to the contrary.

	2011	2012	2013	2014	2015
1.Real GDP growth (% change)	0.7	-1.7	0.2	1.4	1.8
2.Public Administrations. Lending (+) / borrowing (-) .	-8.5	-5.3	-3.0	-2.2	-1.1
3.Primary budgetary balance	-6.1	-2.2	0.2	1.0	2.0
4.Gross debt	68.5	79.8	82.3	81.5	80.8
5.Net Lending (+)/Borrowing (-) with the rest of the world.	-3.4	-0.9	0.8	1.4	1.8

Fiscal strategy

In order to achieve these budgetary consolidation targets, numerous initiatives have been taken in different areas which will have an impact in the short, medium and long term. The strategy is based on fiscal governance reforms which guarantee sound and transparent public accounts at all levels of Public Administration, not only for the State but also for the Autonomous Regions and Local Governments. In fact, the main deviation for the 2011 deficit occurred in the Autonomous Regions, which resulted in the need to ensure full transparency in their accounts as well as the capacity for early control and correction. To this effect, the Organic Law on Budgetary Stability and Financial Sustainability, recently approved, is a case in point. This law not only sets deficit and debt targets for all Administrations but also provides mechanisms for transparency and monitoring so that the guarantees of compliance with the deficit goals are institutionally stronger.

In addition, financial support measures for the Autonomous Regions have been set. Particularly, the Financial Fund for Payment to Suppliers, aimed at regularizing the payments due to suppliers of Territorial Administrations thereby reducing the accumulated arrears. A credit line from the Instituto de Crédito Oficial (ICO) provides funds to meet repayments in the capital markets. Both mechanisms are associated with strict economic conditionality, geared towards guaranteeing the necessary adjustment measures to be carried out in order to meet the deficit targets.

Other initiatives have been also adopted towards the streamlining of Administrations and their corresponding agencies and public companies. Among them, there are measures aimed at eliminating overlaps within different areas of the Administration, and others aimed at the rationalisation of the number of local institutions and their responsibilities.

Moreover, reforms that aim at passing on to the consumer part of the cost of the public services provided are also being implemented. In this regard the recently adopted reforms in the fields of Education and Health Care stand out, as well as progress in the reform of the energy sector, which aims at bringing the price of the service closer to the production cost. Likewise, progress is being made in reforms that will affect other services such as transport.

Furthermore, other measures are being devised to improve the management of public resources, substantially reducing operational costs in Public Administrations. A case in point is the progress being made with regard to the joint procurement of services by different levels Administrations.

Finally, tax increases have been adopted, which have a direct and significant impact on the reduction of public deficit. An important package of spending cuts and tax raising measures which apply this year, both to the Central Administration and to the Local Administrations should also be highlighted.

Throughout this year, budgetary execution will be promptly monitored at all levels of the Administration so that when deviations are spotted, necessary correcting measures will be undertaken to redress them.

Structural reforms

An ambitious programme of structural reforms has also been undertaken by the Spanish government to foster growth and confidence in the economy, together with the reforms and measures already mentioned, which reflect unflinching commitment to budgetary discipline. They are a set of policies on the supply side to improve the functioning of the economy, to increase potential growth and to have a positive impact on production and employment in the medium term.

These aforementioned reforms will correct the identified structural weaknesses both in the factor markets as well as in those of goods and services, improving the regulatory environment and making the economy more dynamic. Some of these measure stand out, such as the already adopted reforms affecting the financial system and the labour market, and others on energy, transport, retail distribution, strengthening of the single domestic market and the property rental market, among others. They cover a wide and ambitious range of policies to be found in the National Reform Programme (Programa Nacional de Reformas, PNR).

Comparison with the Stability Programme for 2011-2014

The new Stability Programme presents two fundamental differences with regard to the previous one. It starts from a higher deficit than envisaged for 2011 (8.5% rather than the 6% target) and from very different growth prospects. Growth forecasted for 2012 is -1.7% rather than 2.3%, estimated in the previous programme. The average growth for the years 2012-2014 in the 2011 Stability Programme was estimated to reach 2.4% whereas in the new Stability Programme average growth for these two years is 1.6%.

As far as the structural deficit is concerned, the previous programme predicted an adjustment of 5.4 percentage points between 2011 and 2013, both years included. We can see in the new programme that the structural deficit contraction for those years widens to 5.8 p.p. More specifically, the structural effort for the year 2012 alone will rise to 3.8 p.p., which, together with 0.7 p.p for 2011, means a higher degree of effort than that committed for the two years in the 2011 Stability Programme, that is 4.5 rather than 4.3 p.p. The average structural effort between 2012 and 2013 would be 2 p.p. in the current case, which is higher than 1.5 p.p. required by the Stability Pact. The effort made through the years 2012-2015 would be approximately 2.3 p.p.

Sustainability of Public Finances

With regard to the sustainability of public finances in the long term, between 2010 and 2060, the foreseen increase in expense items for this purpose, in other words, Pensions, Healthcare, long-term care, Education and Unemployment is 4 p.p. of GDP, up to 27.6% of GDP. This means a significant reduction compared to the projected increase in the previous estimate, which was 8.2 p.p of GDP.

Quality of Public Finances.

The fiscal strategy seeks to optimise the quality of public finances. The first requirement for quality is sustainability, and that is why austerity becomes imperative in the current situation. Within the given austerity framework, efforts are aimed at rationalising expenditure, with cuts mostly directed at inefficient spending. The revenue structure and the strengthening of fiscal governance have also been tools pursuing the same goal.

On the expenditure side, the guiding principle has been the rationalisation of expenditure, which had been growing structurally based on cyclic revenues, and which was unsustainable. A huge effort of revision has been made following efficiency criteria, avoiding overlapping and superfluous expenses. A big effort in the reduction of current expenditure has also been made, an adjustment that has a lesser knock-on impact on the rest of the economy than other measures, as the spending reduction of 16.9% for the Ministries in the 2012 General State Budget shows.

On the revenue side, the starting point is that the tax structure has been very reliant on the building sector. This sector yielded important cyclical revenues, which were managed as if they were structural. The Revenue System will be adapted to the new economic structure in line with international recommendations about optimal taxation. Hence, the measures have been aimed at increasing tax bases, through the elimination of distortions, upgrading of tax structures, introducing progressive complementary mechanisms and combating tax fraud. Indirect taxation on products of rather inelastic demand has also been increased.

Fiscal governance

Empirical evidence shows that public deficit is less probably and fiscal policy goals more credible when fiscal governance is adequate.

Spain is strengthening fiscal governance, as shown by the recent Organic Law on Budgetary Stability and Financial Sustainability, which involves an improvement on the previous fiscal rules.

This law sets the general principle of budgetary balance for the Public Administrations. It also limits public debt to 60% of GDP (or the value which the EU provisions may establish in the future). It introduces the EU expenditure rule; that is, the variation in Public Administrations' expenditure can never be higher than the reference growth rate of GDP for the Spanish economy in the medium term. Finally, this law strengthens transparency and sets a specific procedure for monitoring the budgetary design and execution at all administrative levels in such a way that a rapid correction of deviations is possible. As a last resort, it is even possible to intervene in Territorial Administrations in order to implement correcting measures.

In short, this update of the Stability Programme lays out the strategy, objectives, and fiscal policy measures of the Government of Spain for the short, medium and long term. Ambitious goals are set for the deficit correction, focusing on the first years of the programme, in both nominal and structural terms, with a higher effort than that committed to in the previous updating of the Stability Programme. These adjustments will be instrumental in achieving primary surpluses from 2013 onwards, initiating thus the path of recovery in 2014 for the reduction of public debt, and setting the guarantee of sustainability for public finances.

1. INTRODUCTION

This update updating of the Stability Programme for the 2012-2015 period, together with the update updating of the National Reform Programme, presents the Spanish Government's economic policy for the next four years. This policy will impact both in the short term, especially on the reduction of public deficit, and in the medium and long term, as it aims at a significant structural improvement of the way the economy operates.

The Stability Programme has been drawn up in accordance with the recommendations made by the European Council to Spain on 30th November, 2009, concerning excessive deficit procedures. The opinion of the Council has also been taken into consideration with regard to the previous Stability Programme (9th July, 2011), the Euro Plus Pact and ECOFIN conclusions of 13th March, 2012 concerning the Early Warning Mechanism. The measures included in the National Reform Programme are also consistent with the priorities set by the European Council of 1st and 2nd March: fiscal consolidation, credit restoration, the promotion of growth and competitiveness; the reduction of unemployment and the modernisation of Public Administration.

The new Stability Programme is structured as follows:

Chapter 2 describes the economic framework within which the Spanish economy is expected to develop through the period 2012-2015.

Chapter 3 explains thoroughly the fiscal strategy to tackle deficit and debt. A new section has been introduced dealing with fiscal consolidation in Territorial Administrations, given its great importance in reaching the consolidation goals.

Chapter 4 compares the present strategy with that of the previous year and Sensitivity exercises are conducted consistently with the Stability Programme`s rules.

Chapter 5 introduces the long-term dimension to analyse sustainability of public accounts.

Chapter 6 assesses the fiscal strategy laid out here from the point of view of quality of Public Finances.

Chapter 7 describes the institutional framework within which fiscal policy operates.

Finally, a technical annex on potential growth is included.

2. ECONOMIC SITUATION AND OUTLOOK

2.1. Macroeconomic adjustment in 2011

The slight economic recovery of the Spanish economy that began at the start of 2010 continued on into the first half of 2011. This was primarily sustained by a dynamic external demand. Nevertheless, in the summer of that year the recovery was cut short due to the depletion of fiscal incentives and to the intensification of tensions in financial markets which negatively affected financial conditions and served to worsen confidence of economic agents which had already begun a downward turn before the onset of summer. In this context the GDP experienced a moderate expansion, in volume, in the first two quarters of 2011 (0.4% and 0.2% quarter on quarter respectively), facing stagnation in the third quarter and shrinking to 0.3% in the fourth quarter of the year. The GDP experienced an annual average increment of 0.7% in 2011 after closing the previous year close to stagnation.

In turn, national demand showed signs of intense contraction, subtracting 1.8 percentage points to the interannual GDP growth rate in 2011,eight tenths more than the previous year, with the only non-contributing factor being capital goods investment. After a slight recovery in the second quarter, both households and non- profit institutions consumption decelerated slightly in the third quarter with a downward turn in the last quarter, showing a quarter to-quarter reduction of 1%. On the whole 2011 private consumption showed an average annual decline of 0.1% after an increase of 0.8% in the preceding year. The prime determining factor in the evolution of household spending was the decline of gross disposable income resulting primarily from the deterioration of the labour market, and the weakening of net financial household wealth. In this context, household´s savings rate continued its decline, reaching 11.6% of the gross disposable income, as opposed to 13.9% in the year ending 2010. Family savings together with the net positive transfer balance was sufficient to finance its investment, showing in the same period a lending capacity equivalent to 2.3% of the GDP. This allowed for household debt to stand at 81.5% of the GDP in the fourth quarter of 2011, 4.3 percentage points below the value registered in the same quarter of 2010, basing, for the most part, this deleveraging on the adjustment of residential investment.

In the second quarter of the last year, the net Government final consumption spending continued to contract, for the most part reflecting the fiscal consolidation measures taken by the different Administrations. On the whole the year closed with an average annual setback of 2.2%, after a slight increase (0.2%) in 2010.

Throughout 2011, housing investment continued to shrink at more moderate rates than in the previous year, although in the final quarter the rhythm of decline intensified, with a quarter on quarter variation of -2.3%, one and a half points less than the previous year, ending the fiscal year with an annual descent of 4.9% or half that of the previous year. Housing prices continued their descent at an increasing rate, registering a decline of 7% in the final quarter, a figure similar to that of 2009. I*nvestment in other construction* followed a route parallel to that of housing investment, reflecting the process of public deficit reduction and the tightening of financial conditions, resulting in a decline of 11.2% in 2011, only slightly higher than that of 2010. In line with the shrinking nature of national demand and the slowdown of exports, capital investment lost fuel last year, showing an interannual variation at 1.4%, as opposed to 5.1% registered in 2010. At the same time factors such as deteriorating economic prospects along with the restriction of credit contributed to postpone the investment projects of Spanish businesses.

Nevertheless, non-financial corporations advanced in a deleveraging process that had begun at the end of 2010, placing the debt (loans/securities other than shares and other equity), in the fourth quarter of 2011, at 134.6% of the GDP, 6.3 points below that registered in the preceding year. In 2011 non-financial enterprises showed financing capacity for the second consecutive year: 1.1% of GDP in the fourth quarter of the year.

As has already been noted, the principal driving force of the Spanish economy in 2011 was the foreign sector that contributed 2.5 percentage points to the annual variation of the GDP. A figure four decimal points lower than the contribution registered in the deepest moments of the international financial crisis (2.9 percentage points in 2009, after contributing nine tenths in 2010). This resulted in an appreciable increase (9%) of the exports of goods and services with imports reaching a virtual standstill (-0.1%), following the robust advances of both flows in the previous year (exports 13.5%, imports 8.9%).

In the first three quarters of 2011, exports of goods were quite positive, with quarterly advances between 0.7% and 4.1%, running parallel to the evolution of world trade levels. Nevertheless, the distortion generated by the earthquake and subsequent tsunami that occurred in Japan in March,2011, and the later disruption of global supply chains in worldwide distribution patterns, along with the consequent acceleration of the reintroduction of these chains in the following quarter had a negative effect on trade. Exports of goods and services suffered a setback of 1.6% in the fourth quarter of 2011 due to the fall in activity in main Spanish export markets, with falls in GDP of Germany, Italy, the United Kingdom, Belgium, Portugal and the Netherlands, countries which account for more than 40% of our exports of goods and services.

Nevertheless, despite the results shown in the fourth quarter, the performance of exports of goods and services in 2011 was very positive on the whole, given that its annual growth (9%) far exceeded the growth of worldwide trade in goods and services (6.8%), according to estimates made by the IMF, which suggests an increase in the world market share. In terms of goods, the difference was even clearer with the exports of Spanish goods growing up by 9.5% and world trade in goods by 5.6%, according to the Central Planning Bureau of the Netherlands. In comparison with the strongest economies of the European Union, the annual balance of the exports of Spanish goods and services was the most favourable: Germany (8.2%), France (5%), Italy (5.6%) and the United Kingdom (4.8%).

Imports *of goods and services* dropped by one tenth, a reflection of the demonstrated declines in net spending, gross fixed capital formation, and the slowdown in exports. This evolution contrasted sharply with the growth of 8.9%

experienced in the previous year, a rate that can be broken down into a slight increase in the imports of goods (six tenths) and declines in both foreign tourism and other services (-4.6% and -2.5% respectively), against a significant increase in the goods sector (11.3%) in 2010 and more modest increases in the service sector (0.4% and 1.2%).

The overall balance of goods and services with the rest of the world, in nominal terms, almost reached an equilibrium in 2011, and the rest of the current transactions (primary income and current transfers) generated a deficit of 3.4% of the GDP in 2011 on the whole, six tenths less than the previous year and more than six points below the historic maximum registered in 2007 (9.6% of the GDP). All of the previously mentioned categories, with the exception of primary income, contributed to this new decline in the trade deficit, the fourth consecutive correction. The trade deficit (-3.7% of the GDP) was reduced by eight tenths with respect to 2010, the surplus in the service sector (3.2% of the GDP) improved by a similar amount, with an advance of three tenths in the surplus in the tourism sector (3.1% of the GDP) and a change in the sign of balance of non-touristic services registering a surplus of 0.1% of the GDP, in contrast to a deficit of 0.4% of the GDP of the previous year. Lastly, the current transfer deficit remained constant at 0.9% of the GDP and the capital transfers surplus, at 0.5% of the GDP. On the other hand the primary income deficit increased by nine tenths, reaching 2.4% of the GDP.

In 2011employment continued its adjustment showing a decline of 2% over the year as a whole, compared with an even greater decline experienced in the previous year (2.6%). Nevertheless, this rate partly obscures distinctive behaviours of employment in the different quarters, showing a relative improvement in the second and intensifying the adjustment in the rest of the year. The worsening of the labour market ran parallel to the decline in economic activity in Spain which changed its orientation at the beginning of the second semester of 2011. As a consequence the unemployment rate peaked at 21.6% of the active working population, 1.5 points over the previous year.

The adjustment of employment in 2011 and the growth of the GDP (0.7%) brought the growth of apparent labour productivity to 2.8%, with an acceleration of two tenths over the previous year. This behaviour in productivity resulted in a prolongation of the adjustment of the unit labour cost (ULC) and an improvement in external competitiveness.

The loss of employment in the last year affected permanent employment, while temporal employment managed to remain steady, with the temporary employment rate increasing by four tenths of a percentage point reaching 25.3%. In turn, part time workers increased by 2.2% against the descent of full time workers (2.5%), which raised the part time rate to 13.8%, half a point higher than in the previous fiscal year.

In this context labour costs continued showing signs of moderation, although wages per worker showed a slight increase of 0.8%, against the stagnation of 2010. Nevertheless, it should be noted that this stagnation is also the result of the reduction in wages of civil servants in the same period and the wage freezes of

2011. The slight increase in remuneration of employees and other labour cost indicators in that period would be much higher if the calculations were limited to the private sector alone. The ordinary salary component showed an increase in 2011 of 1%, which supposes a negative wage drift of 1.4 points with respect to the increases agreed through collective bargaining, an evolution consistent with the current adverse market situation and the economic climate.

The intense destruction of employment and the rise in the unemployment rate in the current period of economic crisis has brought to the forefront the structural weaknesses of the labour market. In order to face these weaknesses, the Government has presented a labour market reforms which came into force February 10, and which are currently in the process of being amended in Parliament, to reinforce several aspects. This reform is intended to eliminate rigidities and inefficiencies observed in the current functioning of the labour market. A series of measures has been taken to improve collective bargaining and to maximize the internal flexibility of businesses with the aim of providing viable alternatives to the destruction of employment and to favour the efficiency of the labour market through the reduction of duality, the promotion of indefinite contracts and other forms of work that will help to increase the employability of the worker.

Inflation, as estimated by the interannual variation rate of the Harmonized Consumer Price Index (HCPI), shows an annual average increase of 3.1%, 1.1 points above that registered in the previous year and four tenths higher than that registered in the Euro zone as a whole. This upswing has a transient nature, given that it responds primarily to the impact of oil and the rest of the raw materials that began in the middle of 2010 and that was prolonged through the first four months of 2011. In fact, since May 2011 the interannual rate of inflation of the HCPI began a downward turn, reinforced also by the discounted effect of the VAT increase that took effect in July of 2010 and at the end of the year. For this reason, the interannual rate of inflation is situated at 2.4%, a half point lower than that of the previous year.

The underlying inflation had an average annual value of 1.6%, notably inferior to that of global inflation, although this rate was seven tenths greater than one year earlier and one tenth less than that of the Eurozone. An important part of the upturn of global inflation in 2011 was due to imported inflation, as reflected in the UVI´s of imports for consumption, which experienced an annual average growth of 5.6% against 1.2% of the previous year.

The reduction of inflation throughout 2011 was due, in great part, to the correction of various scalar effects previously mentioned. Nevertheless, in addition to these naturally transitory effects it is worth mentioning the influence of other favourable elements. Among which, the most notable are, the moderation of labour costs per unit of product, a result of the improvement of productivity, the moderation of labour costs, a weakening consumer demand and the possible deceleration of import prices other than from the oil sector.

2.2 Macroeconomic scenario assumptions

The macroeconomic scenario's underlying assumptions are shown in table 2.2.1. They have been drafted in accordance with the EC common assumptions used to develop the 2012-2015 Stability Programme, as well as the latest IMF projections and our own estimates.

Table 2.2.1 MACROECONOMIC BASIC ASSUMPTIONS					
	2011	2012(F)	2013(F)	2014(F)	2015(F)
Short-term interest rates (three-month Euribor)	1.4	0.8	0.9	0.9	0.9
Long-term interest rates (ten-year debt)	5.4	5.4	4.7	4.2	3.7
Exchange rate (USD/euro)	1.4	1.3	1.3	1.3	1.3
Nominal effective rate of the euro area (% change)	0.5	-3.4	0.1	0.0	0.0
World, excluding EU GDP growth	4.2	4.2	4.3	5.2	5.6
EU DGP growth	1.5	0.1	1.4	2.0	2.0
EU export markets growth (volume)	8.5	4.9	6.0	7.2	8.0
World import volumes, excluding EU	7.5	5.6	6.2	7.7	8.5
Oil prices(Brent, level in USD/barrel)	111.5	119.5	113.5	113.5	113.5

(F) Forecast
Sources: European Commission and Ministry of Economy and Competitiveness.

The growth path for GDP, international trade has been established, and Spanish export markets has been established, on the basis of the framework of growth in the Euro-zone and in the EU for 2012, which shows the last EC interim projections as well as those for world growth, excluding the European Union. In the case of the Spanish export markets, growth projections of 2.5% and 4.2% for 2012 and 2013, respectively, are foreseen, which implies downward revisions of 0.7% p.p. for both years compared to EC estimates of Autumn 2011.

Some indicators have been published since the last macroeconomic table was developed by the Government for 2012, in mid-February, and the present scenario, that point to a less intense recession in the Euro-zone than initially forecasted. For example, the PMI indicators in the Euro-zone for the first quarter would be consistent with quarter-on-quarter drop of -0.1% or -0.2%, which is a higher figure than -0.3% estimated by the EC in its February interim projections. Along the same lines, OECD composite leading indicators and other confidence indicators, like the German IFO, point in the direction of a less deep and shorter recession than expected. Taking this into consideration, the central Euro-zone scenario for growth has been re-assessed upwards with respect to the official table of 2nd of March and a somehow higher growth has been assumed for the Spanish export markets in 2012.

The remaining variables regarding external trade, oil price and raw materials, nominal effective exchange rate, and euro/dollar exchange rates are taken directly from the EC common assumptions. Considering accentuated risks especially in relation to the oil price in the present projection, a sensitivity analysis will be carried out later including gradual increase of price/Brent barrel of up to 80%.

With regard to interest rates, short-term rates are assumed to be nearly stable for the whole projection horizon, in line with the BCE policy of fostering economic recovery in the absence of inflationary tensions. Two aspects must be considered in relation to the long-term public debt rates. On the one side, for the free-risk rate, the ten-year German bond is used, which according to the

common assumptions would increase to 30 basic points in 2013. From that time on, this rate would be considered constant.
On the other side, possible changes in the risk premium faced by the Spanish public debt, must be taken into account. At the moment of writing this report, the risk premium was about 400 b.p., bearing in mind that this figure will not be representative for the current year. The average value of risk premium is assumed to reach 360p.b in 2012, although the average value has a high probability of sensitive downward deviations. Risk premium for 2013 and following years will gradually decrease due to the reduction of the main country-risk perceptions of by the markets: fiscal risk and financial risk. The first risk component is expected to be reduced as a result of the higher degree of credibility provided by both the correct execution of the committed fiscal consolidation path and the implementation of the Organic Law for Budget Stability. Quantifying the reduction of spreads involves a degree of uncertainty. Cumulative narrowing until 2015 has been estimated at 200 b.p., a little more than half the premium paid at present, which does not seem to be an unreal assumption in a central scenario of properly functioning fiscal and financial reform.

The distribution of this decline also involves some additional assumptions. Given the heavy tax burden of the Spanish fiscal adjustment and the expected impact of fiscal, financial, labour market and structural reforms for 2012, a decrease of 100 b.p. for 2013 is expected, and another 50 b.p. for 2014 and 2015. Since the risk-free interest rate will rebound slightly in 2013, the long-term rate will be trimmed 70 b.p. on a net basis. However, in the following years a reduction of 50 b.p. in premium risk will be entirely transferred to the public debt interest rate.

2.3 2012-2015 Scenario

Conditioning factors. Impact of structural reforms

Growth for the Spanish Economy between 2012 and 2015 will be conditioned by the following factors:

a) **Debt reduction in the private sector**, whose clearer reflection was the current account deficit of 10% of GDP recorded in 2007. In GDP terms, this leveraging has been decreasing since the middle of 2010.

Since the debt reduction trend started, progress insofar in the recovery of net financial wealth/GDP of private agents has been unequal: while companies have increased theirs around 7% since the last quarter of 2010 to the last of 2011, household wealth has decreased slightly during the same period.

This performance is geared towards the structural correction of mismatches in the balance sheets of these sectors of the economy and have unavoidable effects on expenditure decisions. Consumption and the purchase of housing for households and investment in productive equipment for companies will show mild rates of growth.

b) **Consolidation of public finances**. Since 2009 Spain has been in the framework of the Excessive Deficit Procedure and, consequently, has the obligation of reaching a joint borrowing necessity for all Administrations of 3% of GDP in 2013. This is also an absolute requirement to achieve a stable environment for growth in the short term. Moreover, the deviation in budgetary targets in which Public Administrations incurred in 2011, led to additional financing needs of 2.5 p.p., which is higher than quoted in the Stability Programme for 2011-2014. It requires an additional adjustment in 2012 and 2013, which will accentuate the contractive orientation of fiscal policy at a moment when the Spanish economy already shows a clearly negative cyclical gap.

The reduction of the financing needs in 2012 for the Public Administrations of 8.5% to 5.3% of GDP will involve a structural adjustment of nearly 4 p.p., which will yield net negative effects on growth. These effects will gradually fade away in the medium term as compensatory non-Keynesian effects start to show, in the shape of greater confidence, reduction in the risk premium borne by internationally traded liabilities, and so forth.

The same can be said for 2013, although with lesser magnitude, since structural adjustment that year will be about half than in 2012, approximately 2 p.p. The cyclical gap will start closing throughout the year and it will reduce financing needs. Finally, the structural adjustment in 2014 and 2015 will be significantly more modest, of about 0.4 p.p., accumulated during those two years, which will contribute to a greater extent to the recovery of growth rates between 1% and 2%.

In any case, the effects of this fiscal consolidation must be highlighted since they are clearly positive despite their cost in the short-term in terms of economic growth. This effort will allow public debt to initiate a downward trajectory starting in 2014, which will contribute positively to the reduction of debt vis à vis the rest of the world, as there is a shift towards a positive current account balance. As the perception of a lasting reduction of public liabilities takes root there will be a positive aggregated income effect, re-launching sound growth. If these results are achieved within the framework of a simple and transparent fiscal rule like the one found in the Organic Law on Budgetary Stability and Financial Sustainability, there will be an improvement in the predictability of fiscal policy and the quality of decision-making by the private agents.

c) **Moving towards a balanced housing market**. With nearly 90.000 houses starts in 2011, last year marked a minimum since the adjustment of the market begun in 2007. However, 2011 has also been the first year when the stock of unsold new houses has begun decreasing, which, having reached above 700.000 units has gone down to around 55.000.

   On the basis of the information available for housing demand, which had showed year-on-year very significant falls at the end of 2011, the scenario envisages a slow adjustment of the market. Hence, the number of houses starts will be reactivated very gently, only in response to further stock reduction. There will be approximately 105.000 houses initiated in 2015 compared to 90.000 houses starts in 2011; although this change will imply positive year-on year gentle growth rates in gross capital formation in residential construction for the last two years of the projection period. Gradual opening of credit channels in the medium-term and an additional adjustment of real prices –partially linked to the financial reform- will make possible for the latent demand, based mainly on growth and demographics, to increasingly show up. Note, however, that the number of house starts foreseen for 2015 would still be about a seventh of the amount recorded for 2006.

d) **Recovery in the international environment**. In spite of a relative improvement in the international economy, certain downside risks prevail over world growth. The IMF analyses in its spring WEO the main downside risks, which affect not only specific areas but also global economy as a whole. In the Euro-zone, these risks could be generated by a combined spiral of problems in bank balance sheets and a continued lack of confidence in the sovereign debt which may further increase financing costs more than expected. In the emerging markets, risks derive from potential impairment of quality of bank balance sheets due to low profitability of some investments made during the expansion phase, which may yield a credit slowdown. In the USA and Japan, difficulties to reduce the bulky fiscal deficits could bring about sharp falls of liability pricing with follow up repercussions for their holders. Finally, a total freeze on oil exports from Iran, without alternative in the short term, could bring about a fall of up to 1point in world GDP growth with respect to the base scenario.

Bearing in mind these risks, the central scenario depicted in the spring WEO is one of moderate recovery for 2013, as the main imbalances are being corrected in each particular area. Thus, major economies in the planet will be growing between 1 and 2 points more in 2013 than in 2012; the Euro-zone would improve between -0.5 and 0.3%, with Germany going from 0.6% to q.5% . Outside the Euro-zone, the United Kingdom would go from 0.8 to 2%, United States would practically maintain its GDP rate of progression at 2.4% (three-tenths more than in 2012), the emergent economies would accelerate from 5.7% to 6% and, as a whole, the world´s GDP would jump from 3.5% to 4%.

Therefore, if forecasts are fulfilled, this international framework would have a bearing on a clearly positive contribution to Spanish exports for the years after 2012. Besides, Spanish companies are supposed to take this expansion opportunity not only because of previous know-how in the export markets during the hardest years of crisis, which show in the export figures of the last years, in which upward surprises have been constant, but also because of gains in competitiveness thanks to the labour market reform, among other factors.

e) **Structural reforms**. NPR2012 (National Reform Programme 2012) justifies both, labour and financial reforms, and also the introduction of the Organic Law on Budgetary Stability and Financial Sustainability and the rest of on-going structural reforms which are a supply shock and yield positive effects in the long run on GDP and employment for the Spanish economy.

Labour market reform operates through the alteration of different labour market structural parameters, such as the reduction of market power for negotiating parties in the market, the reduction of hiring costs, increase in job searching efficiency, decline in the rate of labour shedding due to lesser seasonality and higher internal flexibility for business organisation, which leads to gains in total factor productivity. These parametric changes have an impact on prevention of job loss compared to other downswing phases (and also on job creation, higher than in other expanding phases, as the cyclical gap starts closing); higher consumption, not only beginning with positive income effects but also because of lower inter-temporal substitution elasticity given by a lower temporality rate. Likewise, it fosters more dynamic investment in productive capital dragged by higher hiring, which increases marginal capital productivity.

A complement to labour market reform is the battery of structural reforms that the Government intends to put into practice in order to continue stimulating competition in the markets of goods and services. These structural reforms are described comprehensively, together with their approval calendar, in the National Reform Programme 2012 which is attached to this Stability Programme 2012-2015.

As far as the financial reform is concerned, the NRP has mainly estimated the impact through cost reduction of external financing for financial intermediaries, passed on to the cost of domestic financing. It has also been assumed that the introduction of the Organic Law on Budgetary Stability and Financial Sustainability would mean an estimated higher probability of government reaction to deviations in the announced path of debt to GDP stocks, with an additional cut of risk premium. This easing in the cost of external financing would have an impact on liabilities and would filter down to, with gradual higher intensity, the domestic financing cost borne by families and business, raising their wealth and stimulating investment and employment.

Finally, the NRP also assesses the effects of the new payment system to suppliers to Territorial Administrations, in some additional GDP growth of 0.5 p.p. and 100.000 new jobs between 2012 and 2013.

These reforms are being simultaneously introduced in 2012, with increasing effects along the projection horizon, except those already mentioned to pay suppliers, which concentrate their effects in 2012 and 2013. Some precautions were introduced as to the temporal distribution of effects from the labour and financial reforms in order to adapt their results to the real environment in which these reforms take place. Specifically, the cumulative effects of the labour market reform were supposed to start moving at a slower pace than envisaged in the simulation exercise. Considering both the negative fiscal shock, which superimposes labour market reform, and the existence of a relatively low degree of capacity utilisation in the producing sector, decisions of plant enlargement and productive equipment will be delayed. Regarding transferring the lower cost of external financing to the cost of domestic capital, the pass-through rate was assumed to be only 40% annually, in order to accommodate demand considerations, the need for reduction of debt ratios before lowering the cost of credit and convenience of re-structuring banking balance sheets thanks to the higher margins taken by intermediaries. In order to

allow for an even more conservative hypothesis in the present scenario the transfer was assumed to be slower so that the impact will be reduced 20% annually for the period 2012-2015.
This insertion hypothesis in the macroeconomic scenario implies that while the labour market reform takes full effect in the period 2010-2020 (the one analysed in the NRP) the decline in risk premium does not, for the same interval of time, even though they provided the most substantial chunk of total impulse. In that scenario, labour market reform provides 4.5 p.p. to the level of long-term output and reduces unemployment by 800.000 people. The reductions of risk premium add another 1.8 p.p. to the level of long-term GDP, while the quantitative effects of the financial reform contribute 0.8 p.p. to the GDP level. Furthermore, other previous reforms such as the transposition of the Services Directive in 2010 or the 2011 reform of pensions will jointly inject an additional 1.6 p.p. to potential GDP.

The effects of these reforms and others, which could not be estimated in the NRP this year, can be quantified in the long term; which is the scenario contemplated in the present document. The development of these reforms, as has been mention above, is not immediate and less so if the imbalances carried over are considered.

It is obvious that these reforms will be active for the 2012-2015 period, and they will be fully operational in 2013. A rapid estimate of their joint effects on the GDP annual growth would place them at approximately 3 or 4 tenths of annual growth as an average for this first year. Their main transmission channels in the macroeconomic framework would be private consumption, private gross fixed capital formation and exports, albeit indirectly, through a greater increase in external competitiveness, fostered by the reforms. At the same time, they affect GDP growth through all its components: total factor productivity, capital and labour input.

Moreover, when the effects of both reforms are simultaneously combined in the macroeconomic framework, they deserve particular consideration. Each of the reforms, when viewed separately, yield an clear substitution effect, reduction of salaries in the short term and of real cost of capital utilisation. Together they cause an ambiguous effect on the relative cost of utilisation of both productive factors. Nevertheless, the application of both reforms goes hand in hand with positive wealth effects, all the more so as there is progress in their application. This will make increases in the quantity demanded of both factors compatible with the uncertainty of the relative price movement or their proportions within productive processes.

Scenario

This scenario for Spain contemplates the continuation of the contractive trend observed in the middle of 2011, together with a tight fiscal adjustment in 2012, which will lead to a GDP drop of 1.7%. In the course of time as the cyclical gap starts closing, fiscal efforts will be reduced and the positive effects of the reform on the supply side will gradually make themselves felt, the growth will start spiking to 0.2%, 1.4% and 1.8% respectively. Structural reforms account for between 0.5 and 0.6 p.p. of GDP growth for 2013; this contribution will be increasing further during the following years.

Table 2.3.1 MACROECONOMIC PROSPECTS Chained volume indices. Year 2008 = 100, unless otherwise stated.							
	Code SEC	**2011 (A)**	**2011 (A)**	**2012 (F)**	**2013 (F)**	**2014 (F)**	**2015 (F)**
		Level	**% annual change**				
1. Real GDP	B1*g	96.9	0.7	-1.7	0.2	1.4	1.8
2. Nominal GDP. Thousands of millions of €	B1*g	1073.4	2.1	-0.7	1.9	3.0	3.5
Components of real GDP							
3. Private consumption expenditure (*)	P.3	96.3	-0.1	-1.4	-1.1	0.6	1.1
4. Government final consumption expend.	P.3	101.7	-2.2	-8.0	-4.6	-1.9	-2.8
5. Gross fixed capital formation	P.51	74.2	-5.1	-9.0	-0.5	2.4	3.0
6. Change in stocks (GDP%)	P.52+P.53	88.9	0.0	0.0	0.0	0.0	0.0
7. Exports of goods and services	P.6	110.8	9.0	3.5	6.9	7.5	8.0
8. Imports of goods and Services	P.7	90.0	-0.1	-5.1	1.3	5.4	6.2
Contributions to real GDP growth							
9. Domestic final demand		-	-1.7	-4.4	-1.6	0.4	0.8
10. Change in stocks	P.52+P.53	-	0.0	0.0	0.0	0.0	0.0
11. External balance	B.11	-	2.5	2.7	1.8	1.0	1.0

(*) It also includes households and non-profit institutions serving households (ISFLSH)
(A) Advancement; (F) Forecast
Sources: National Institute of Statistics (INE) Ministry of Economy and Competitiveness

With regard to the composition of growth during this period, the common denominator is the weakness in domestic demand which will show only slightly positive contributions in 2014. This phenomenon can be explained by the on-going deleveraging of the private sector but also by the follow-up of the Government´s fiscal effort, which reverts onto the available income and onto the corporate gross operating surplus in the short term, in this way limiting the possibilities of consumption expenditure and investment. Similarly, the expected evolution of employment has a negative influence on consumption.

Conversely, the contribution of the external sector will be positive and significant during these two years, although decreasing, from 2.7 in 2012 to 1 p.p. in 2015. As time passes domestic demand progressively takes over as the source of growth. However, the contribution of external demand will still be higher than domestic demand in 2015. Nonetheless, it should be understood that a substantial share of the contribution of external demand to growth is structural, as it is the result of the re-composition of the production towards a sector with a greater exporting tendency than construction.

The rates of growth, which will be between 1% and 2% for all these years, in consumption expenditure will be compatible with financing capabilities for households. This evolution of consumption is also compatible with furthering the debt reduction process. More specifically, for the four years covered by this Programme, the household sector will be able to generate 70.000 million Euros, which applied to the remaining liability stock could reduce it by about 8%. Bearing in mind the change in nominal GDP, being constant at the level of current financial assets, the debt/GDP ratio could practically go back to the levels of late 2003, which would mean a substantial degree of advancement in deleverage.

Real disposable income, being the main determining factor in private consumption within the context of a moderate evolution of credit, is influenced by the unemployment path, which is more benign than in the past, especially at the beginning of 2013, and by the fiscal consolidation policies, some of which, such as cutting subsidies will have a negative influence, and others a positive effect, mainly from 2014 when the temporary increase in Personal Income Tax will be removed. However, also starting in 2014, there will be some possibilities for intertemporal smoothing of the consumption profile, both because there will be a bigger fluidity in the credit channels and because of expectations of a firmer recovery and a decrease of the future tax burden.

Regarding public consumption, it shows a downward evolution of historical proportions in 2012, as its reduction represents more than a third of the total effort to be made by the Public Administrations this year. Public consumption, therefore, will become the component of national demand which will contribute more negatively to growth during the current year. As the intensity of structural effort decreases during the next years the demand will experience gradually smoother falling rates, although still of a large magnitude, which will weigh down national demand 0.7 p.p. annually on average, considering only the direct effect.

The gross fixed capital formation will experience a severe drop in 2012 (-9%), due mainly to the inertia trailed from 2011 and the on-going adjustment in the residential market. In spite of the impact caused by structural reforms in 2013, there will be a negative adjustment that year, due to the weight of corporate debt, but its evolution will be more positive from the beginning of that year since positive shocks of different kinds will collect and deleveraging will move ahead. In any case, the weight of deep cuts in public investment until 2015 will have a negative influence on the gross fixed capital formation in the construction sector, whose year-on-year rates will not be in positive territory until 2014.

Exports of goods and services will follow, in general terms, the growth of Spanish export markets, with a higher elasticity which means accumulated share gain for all the 4 years. They will also profit from nominal unit labour cost drops (as an average 1% annually along the projection horizon), most of which are expected to transfer to competitive gains vis-à-vis our main trading partners, taking into account suppression of export prices(1) Real competitive gains would contribute 0.5-0.6 p.p. in average terms to growth of exports between 2012 and 2015. Regarding its composition, exports of services will keep their weight of a third over the exports of goods and services, in line with the tendency of the last years.

Imports of goods and services would develop in line with the final demand, experiencing a sharp fall in 2012 and recovering during the following years. Elasticity with respect to final demand rises with respect to the average results of the last decade, which is in line with the partial substitution of construction by other productive sectors with higher import trends. Negative contribution is

[1] It is assumed that in 2012 and 2013, labour cost saving could be amplified by a contraction in business margins, due to the domestic demand weakness.

expected (that is to say, contraction in import growth) from real effective exchange rate, mainly due to the growth of domestic prices somewhat below those of our main trading partners.

From the point of view of supply, the most innovative pattern of reference present in this scenario is the greater downward flexibility of wages per employee. Following the tenets of the negative wage drift, already observed in 2011, and reinforced by the labour market reform of company agreements, slight moderate growth is expected of wages per employee in 2012, and even a slight decrease in 2013. All the above will contribute, in addition to greater opportunities for increased flexibility in the organisation of work at firms, to alleviate labour shedding.

Table 2.3.2 LABOUR MARKET(*)

	Code ESA	2011(A)	2011(A)	2012(F)	2013(F)	2014(F)	2015(F)
		Level	Annual change in %				
1.Employment, persons (million)		18,412.9	-2.0	-3.6	-0.3	0.8	1.1
2. Employment, full time equivalent(million)		17,164.8	-2.0	-3.7	0.4	0.7	1.0
3.Labour productivity (thousands of Euro)		57.2	2.8	1.9	0.5	0.6	0.7
4.Labour productivity, full time equivalent(thousands of euros)		61.4	2.8	2.0	0.6	0.7	0.8
5.Compensation per employee (**) (thousands of Euros)	D.1	33.7	0.8	0.2	-0.4	0.2	0.3
6.Unit labour cost		-501,573	-1.9	-1.7	-1.0	-0.5	-0.5
7.Compensation per employee (thousands of Euros)		-	-1.0	-3.5	-0.7	0.9	1.2
8.Unemployment rate (% of active population)			21.6	24.3	24.2	23.4	22.3

(*) Data in National Accounts terms, except unemployment rate.
(**) Compensation per employee, full-time equivalent.
(A)advance; (F) Projection
Sources: National Statistics Institute and Ministry of Economy and Competitiveness.

Even in the years of more robust growth, 2014 and 2015, the growth of individual salaries is expected to be small, significantly below the private consumption deflator. This structural change will make possible not only a much more adjusted correlation between real salaries and productivity but also a reshaping of the margins in the business sector (an average annual drop of real labour unit costs around 2%, between 2012 and 2015) and make several years of closure of the cyclical gap compatible with a growth of prices below 2%, as the progress made is retained as far as the contribution of external demand is concerned.

Table 2.3.3 PRICE EVOLUTION

	Cod ESA	2011(A)	2011(A)	2012(F)	2013(F)	2014(F)	2015(F)
		Level	Annual change in %				
1.GDP deflator		101.9	1.4	1.0	1.6	1.6	1.7
2.Private consumption deflator(*)		104.4	3.2	1.6	2.2	1.7	1.9
3.Harmonized index of consumer prices (HICP)		116.4	3.1	1.0	1.2	1.5	1.7
4.Public consumption deflator		101.0	0.4	0.4	0.6	0.7	0.7
5. Gross fixed capital formation deflator		100.4	2.0	-0.1	0.4	1.6	2.2
6 Exports deflator(goods and services)		101.2	4.5	2.6	2.6	3.0	3.0
7.Imports deflator(goods and services)		104.2	7.8	2.7	2.4	2.9	3.1

(*) Includes households and non-profit institutions serving households.
(A) Advance; (F) Forecast
Sources: National Institute of Statistics and the Ministry of Economy and Competitiveness.

The overall effect of the labour market reform finds its clearest synthesis in the evolution of employment since the relationship between output-employment becomes more favourable in 2012, which is the first year of the labour market reform introduction. More competitive wage bargaining conditions, the mitigation of persistence mechanism of nominal salaries, as well as less burdensome costs of utilization of labour services will lead to less labour shedding. Besides, in spite of the loss of weight of construction investment in the global demand, the threshold of job creation will be lowered, in such a way that, in a central scenario, it can be assumed that, with GDP growth rates slightly higher than 1%, a small volume of employment can already be created.

Let us go deeper into the way the labour market reform contributes to job creation. The labour market affects job creation by bearing on two different variables. On the one hand, reducing the maintenance cost of vacancies in business reduces the number of hours worked per employee. On the other, fostering hiring by reducing the total cost of labour services, the impact will be higher as positive effects of the demand associated to the reform cease to be felt, because of consumer expectations and incentives for capital investment. The net effect is positive in terms of National Accounts – full time equivalent employment - the job creation effect prevailing. In any case, this impulse will be more perceptible over the years, since the negative impact on demand of fiscal adjustments will fade away and the positive effects of the reform will predominate. This is precisely the pattern which the macroeconomic scenario in the present Stability Programme lays out.

This performance of employment in addition to a workforce in mild decline will bring about a changing pattern in the rate of unemployment starting in 2013. The reduction in the active population will be due to demographics as well as the psychological effect associated to the level of unemployment that had been reached. Unemployment will go down one tenth in 2013 followed by more significant drops, around 1 percentage point for both, 2014 and 2015.

Finally, labour market reform partly breaks with the traditional countercyclical pattern of apparent productivity in Spain. Although in 2013, the first year in which the reform will yield significant results, apparent productivity will slow down, in the following years its rate of growth will rise, up to 0.8% in 2015. The underlying reason has to be found in the improvement in total factor productivity (TFP) induced by the reform, not only because there are better possibilities of efficiently combining the productive factors but also because of the human capital accumulation it fosters, through the decrease of temporality rates. The more intense growth of TFP would be behind the improvement of real wages in the medium term, which is not to be found in the projection horizon. Simulations carried out with the REMS model reveal that the level of real wages, in sufficiently long horizons, would be even above that achieved before the reform application.

In short, innovations introduced by the reform are very significant in regard to the labour market adjustment process in a context of weak demand. On the one side, real wages lead the adjustment, instead of labour shedding, thanks to wage restraint. Furthermore, thanks to greater productivity induced by the reform, the real wages will end up rising after a first phase of fall. Thus, greater wage flexibility induced by the labour market reform has clearly positive global effects, not only for the economy as a whole but also for labour in the sense that it prevents further jobs losses and it promotes gains in real wages in the medium term as compared to the present situation.

Finally, the significant reduction of the financing needs of the Spanish economy between 2012 and 2015 is the outcome of the persistent lending capacity of households and firms, as well as the result of the continuous reduction of the financing needs of Public Administrations. The shift from a financing need of 3.4% GDP in 2011 to a lending capacity of 1.8% in 2015 will bring about a reduction of external debt stock for the Spanish economy. Even the most resilient stocks variables (external debt) improve as they will be positively affected by the accumulation of remedial flows through the period starting at the beginning of the cyclical contractive phase.

Although the reduction of debt, by its very nature, cannot be immediate, it has been considered that the inflection point will generate new reductions of risk premium, which has been borne by Spanish public debt, reinforcing the beneficial effects of reforms, which have been contemplated in the NRP and the present macroeconomic scenario.

Table 2.3.4 SECTORAL BALANCES

% of the GDP	Code SEC	2011(A)	2012(F)	2013(F)	2014(F)	2015(F)
1. Net lending (+)/borrowing (-) vis à vis the rest of the world.	8.9	-3.4	-0.9	0.8	1.4	1.8
-Balance of goods and services		-0.6	2.1	4.0	5.0	5.9
-Balance of primary incomes and current transfers		-3.3	-3.5	-3.7	-4.0	-4.5
-Capital account		0.5	0.5	0.5	0.5	0.5
2. Net lending (+)/borrowing (-) of the private sector	8.9	5.1	4.4	3.8	3.6	2.9
3. Net lending (+)/borrowing (-) of the private sector	EDP 8.9	-8.5	-5.3	-3.0	-2.2	-1.1
4. Statistical discrepancy		-	-	-	-	-

(A)Advance; (F)Forecast
Source: National Institute of Statistics and Ministry of Economy and Competitiveness.

As the table above shows for sectorial balances, the capacity for joint financing of all the private sector remains robust throughout the 4 years under analysis, moving from 4.4% of GDP in 2012 to 2.9% in 2015, which will allow for substantial progress in debt reversal. The capacity for private financing for this period is a guarantee for the continuation of the corrective process for some more years, possibly to the late years of the current decade. This adjustment is asymmetric in time from the phase of debt stockpiling to its reduction, the latter being longer. This asymmetry has a dampening impact on potential growth, which will exceed a rate of 2% only at the end of the decade. This change is consistent with an aspect of potential growth, sometimes insufficiently highlighted in its statistical definition, which is the necessary compatibility with intertemporal financial restraints for the economy as a whole.

3. PUBLIC DEFICIT AND PUBLIC DEBT

3.1. The Public Administrations in 2011

In 2011, the Spanish Public Administrations recorded a deficit of 8.5% of GDP, compared with a deficit of 9.3% registered in 2010. The 2011 deficit represents a negative deviation of 2.5 percentage points of GDP compared to the 6% target, set in the 2011-2014 Stability Programme Update.

Table 3.1.1

PUBLIC ADMINISTRATIONS IN 2011

% of GDP

	Central Administration		Autonomous Regions		Local Corporations		Social Security		Total Public A.	
	2010	**2011**	**2010**	**2011**	**2010**	**2011**	**2010**	**2011**	**2010**	**2011**
Total revenues	**14.0**	**13.4**	**13.6**	**12.5**	**6.5**	**5.8**	**14.8**	**14.7**	**36.3**	**35.1**
Direct taxes	6.0	5.5	2.7	3.2	0.8	0.8	0.0	0.0	9.5	9.5
Indirect taxes	5.3	3.9	3.0	3.9	2.1	2.0	0.0	0.0	10.3	9.8
Social security contributions	1.2	1.2	0.0	0.0	0.0	0.0	12.0	11.7	13.3	13.0
Other	1.5	2.8	7.8	5.4	3.7	3.0	2.7	3.0	3.1	2.9
Total expenses (EDP)	**19.0**	**16.4**	**17.1**	**17.2**	**7.2**	**6.6**	**15.0**	**14.8**	**45.6**	**43.6**
Wages and salaries	2.3	2.3	7.3	7.0	2.0	2.0	0.3	0.2	11.9	11.5
Intermediate consumption	1.0	1.0	2.6	2.6	1.9	1.8	0.1	0.1	5.6	5.4
Social transfers in-kind (via market)	0.2	0.1	2.7	2.5	0.1	0.1	0.1	0.1	3.0	2.8
Social benefits	1.3	1.3	0.3	0.4	0.1	0.1	13.5	13.5	15.3	15.2
Interest (PDE)	1.7	2.1	0.3	0.5	0.1	0.1	0.0	0.0	1.9	2.4
Subsidies	0.2	0.2	0.4	0.3	0.2	0.2	0.4	0.3	1.2	1.1
Gross capital formation	1.0	0.9	1.3	1.0	1.5	0.9	0.0	0.0	3.8	2.8
Other expenses	11.3	8.6	2.1	2.9	1.3	1.6	0.6	0.5	2.9	2.5
Financing capacity (+) or need (-). (1)	**- 5.0**	**-2.9**	**-3.5**	**-4.7**	**-0.6**	**-0.8**	**-0.2**	**-0.1**	**-9.3**	**-8.5**
p.m.: Public consumption	3.9	3.8	12.8	12.3	4.0	3.8	0.5	0.4	21.1	20.3
Public debt (EDP)	46.4	52.1	11.4	13.1	3.4	3.3	0.0	0.0	61.2	68.5

(1) Includes the effect of settlement with territorial governments.

Source: Ministry of Finance and Public Administration, Ministry of Economy and Competitiveness and Banco de España

By category, the deviation was mainly caused by revenue performance. According to the previous Stability Programme provisions, **22.9 billion euros in a diversion of 26.2** were due to both current and capital revenues (in terms of national accounts). Among them, the deviation recorded in taxes on production and imports (10.2 billion), direct taxes on income and wealth (4.4 billion), and social security contributions (3.1 billion) stand out. On the spending side, a deviation of about 2.6 billion in intermediate consumption was observed, together with a deviation of 1 billion in public wages and 2 billion in interest expenses.

This deviation was due, in part, to the national and international economic context of lower economic growth and greater financial stress from that anticipated in drafting the Stability Programme. Thus, compared to a projected

1.3% in 2011, the real GDP grew by 0.7% that year. This led to a marked deterioration in employment which decreased by 2% compared to an expected 0.2% increase. This situation resulted, in public accounts terms, in much lower than expected tax revenues and social contributions.

In this sense, measuring the budgetary slippage originating from cyclical factors through the "surprise" in the cyclical balance recorded in the year is usually the conventional procedure, although in this case it might not be the most accurate measure, as it is an aggregate measure. Indeed, besides being affected by variations across the path of potential growth, not enough attention is given to the difficulty of gauging the actual cyclical sensitivity of some taxes, such as Property Transfer and Stamp Duty. Thus, an approach that through individual tax revenue equations takes account of the variation of its bases can be a more accurate method to try to really identify the purely cyclical source of the deviation.

Table 3.1.2

ONE-OFF OPERATIONS OF THE PUBLIC ADMINISTRATIONS IN 2011

Millions of Euros

	Central Administration	Autonomous Regions	TOTAL
Expenses	**2,311**	**1,700**	**4,011**
Impairment losses on Unnim shares owned by the FROB	594		594
Local investment funds provided by the FEIL and the FEES	799		799
Costs incurred as a result of expropiations by the Ministry of Development	600		600
State-owned enterprises (Universal Postal Service financing)	318		318
Autonomous Regions expenditure on health and social services in previous years		1,354	1,354
Autonomous region investments (made either by the public administrations or by state-owned enterprises)		346	346
Revenue	**2,001**	**-**	**2,001**
Public dominion frequency bands canon	2,001	-	2,001

On the other hand, there were some one-off impacts that explain more than 4 billion euros of the deviation on the expenditure side, as detailed in the previous table. However, these expenses were reduced by 2 billion of additional revenue from the public dominion frequency bands canon.

More than two thirds of the overall Public Administrations' budget deviation originated in the Autonomous Regions. The deficit of this sub-sector in 2011 implied a deviation of 1.6 percentage points (the deficit refined of the effect arising from the negative settlement of 2009 was 2.9 percentage points against a target of -1.3% of GDP). The Central Administration deficit exceeded its target by 0.3 percentage points (-5.1% against a target deficit of -4.8% of GDP) while the Social Security Administration, in the context of a deteriorating labour market, incurred a deficit of 0.1% of GDP, when a surplus of 0.4% was expected. Finally, the Local Corporations deviated from their initial goal less than a tenth of a percent, registering a deficit of 0.4%.

The deficit reduction in 2011 of 0.8 pp of GDP, fell exclusively on the reduction of public spending (2 pp), while income saw a decline of 1.1 pp. This decrease was due mainly to the fall in indirect taxes, closely linked to falling domestic demand, while the direct taxes, driven by fiscal consolidation measures taken by the Government with effect in 2011, grew moderately and maintained their weight in GDP.

Taxes fell 1.1% last year. This decrease was much lower than that experienced by the aggregate tax base, thanks to the tax collection push derived from Government action. Tax collection by the State in cash terms (including income tax, VAT and special tax transferred to territorial governments) is estimated to reach 7.8 billion euro, without which tax revenues would have experienced a 3.5% fall. This decline is more in line with that recorded by the aggregate tax base, whose evolution was more negative than what national accounts estimated for the main macroeconomic aggregates, in particular as regards to VAT (domestic demand) and Corporate Tax (gross operating surplus).

Table 3.1.3
STATE BUDGET IMPLEMENTATION (*)

Items	Millon Euros				% Change	
	2010 Settlement (1)	2011 Initial Budget (2)	2011 Settlement (3)	Deviation (3) - (2)	(2)/(1)	(3)/(1)
1. Non-financial revenue	**127,337**	**106,020**	**104,145**	**-1,875**	**-16.7**	**-18.2**
Taxes	111,087	91,381	88,026	-3,355	-17.7	-20.8
Direct taxes	59,262	55,239	53,382	-1,857	-6.8	-9.9
Personal income tax	*39,326*	*35,494*	*33,544*	*-1,950*	*-9.7*	*-14.7*
Corporate	*16,198*	*16,008*	*16,611*	*603*	*-1.2*	*2.5*
Other	*3,738*	*3,737*	*3,227*	*-510*	*0.0*	*-13.7*
Indirect taxes	51,825	36,142	34,644	-1,498	-30.3	-33.2
VAT	*38,486*	*24,968*	*25,355*	*387*	*-35.1*	*-34.1*
Special Taxes	*10,338*	*8,179*	*6,325*	*-1,854*	*-20.9*	*-38.8*
Other	*3,001*	*2,995*	*2,964*	*-31*	*-0.2*	*-1.2*
Other revenues	16,251	14,639	16,119	1,480	-9.9	-0.8
2. Non-financial payments	**179,572**	**150,056**	**151,095**	**1,039**	**-16.4**	**-15.9**
Wages and salaries	26,975	26,982	27,420	438	0.0	1.7
Purchases	4,632	3,385	4,319	934	-26.9	-6.8
Interest	19,638	27,421	22,204	-5,217	39.6	13.1
Current transfers	104,656	74,618	79,892	5,274	-28.7	-23.7
Contingency fund		2,472		-	-	-
Real Investments	8,782	5,817	6,895	1,078	-33.8	-21.5
Capital transfers	14,890	9,362	10,365	1,003	-37.1	-30.4
3. Cash balance (1-2)	**-52,235**	**-44,036**	**-46,950**	**-2,914**	**-15.7**	**-10.1**
Pro-memoria: National accounting						
Non-financial resources	141,061		137,056			-2.8
Non-financial use (EDP)	192,353		168,312			-12.5
Financing Capacity (+) or need (-) (EDP)	**-51,292**		**-31,256**			**-39.1**
As % of GDP	-4.88		-2.91			

* The settlements data include revenues and payments of budget and non-budget operations and so are different from table 3.2.1
Source: Ministry of Finance and Public Administration

Among the main taxes levied by the State, income tax - before subtracting the share of the other Public Administrations- increased its revenue by 4.2%, driven by regulatory measures and the dynamism of withholding capital gains and of the share net differential. Indeed, the 2010 share differential accrued in 2011 increased by 6.0% as a result of the increased tax rate of the net special tax base from 18% to 19% or 21% and the reduction of the deduction for housing acquisition. The withholding on earnings increased by 1.1% and, thanks to the dynamism of dividends and interest from bank deposits, as did the capital withholdings by 7.4%. Meanwhile, personal income tax returns decreased by 12.6% due to the lower amount requested and the elimination of the tax deduction for children born.

Corporate tax revenues grew by 2.5%, compared with nearly 20% drop in 2010. This growth is due to the reduction of tax refunds and to the regulatory changes introduced by Royal Decree-Law 9/2011 of 19 August, which raised the rates of the instalment payments for companies with annual sales exceeding 20 million euro and limited the ability to offset negative tax bases from previous years. Tax withholdings from capital gains were a dynamic element of the tax.

In indirect taxation, **VAT revenue, also in terms of total revenue, rose by 0.4% in 2011,** as a result of the positive effect of the increase of the tax rates from July 2010. Without this effect, VAT revenues would have fallen about 6.5%, in a context in which all the elements of final expenditure subject to the tax (private consumption, government expenditure and home purchase) recorded a decline.

Finally, **Special taxes revenue fell by 4.2% in 2011 (excluding income tax, VAT and special tax transferred to territorial governments),** in response to the negative evolution of the main consumption goods subject to these taxes, mainly fuels and tobacco. Thus, the tax on hydrocarbon reduced its revenue by 6.3% and the tax on tobacco by 2.3%. Only the tax on electricity registered a slight increase, 0.7% driven by a moderate increase in electricity charges.

As for public spending, it should be noted that most of the adjustment came from public investment, which reduced its weight in GDP by 1.1 pp, to stand at 2.8%, with a remarkable fall (37%) in Local Governments investment. Meanwhile, social benefits, the largest expenditure item, increased by 1.6%, although its share in GDP fell 0.1 percentage points.

Finally, a debt interest was the only item which increased its share in GDP, reflecting mainly the debt´s and interest rates´ growth in recent years. In 2011, the debt/GDP ratio increased by 7.3 pp, reaching 68.5%, due almost exclusively to the period´s deficit and to GDP growth as the impact of other factors (stock-flow adjustment) on the increase of the debt ratio was almost nil last year.

3.2. Government Budget for 2012

3.2.1. Government Budget for 2012

The Government has designed an austere budget for 2012, adequate to the Spanish public finances situation, and rigorous, as it is based on a realistic macroeconomic scenario. The target of this budget is to reduce deficit from 8.5% in 2011 to 5.3% in 2012, starting the consolidation path that will allow achieving the 3% of GDP deficit goal in 2013.

Table 3.2.1 STATE BUDGET FOR 2012	Million Euro			% Variation 2012/2011	
	Initial 2011 Budget	2011 Settled budget	Initial 2012 Budget	Budget / Budget	Settled Budget
1. Revenue	**106,020**	**104.331**	**119,233**	**12.5**	14.3
Taxes	**91,381**	**88,035**	**75,941**	**-16.9**	**-13.7**
Other revenues	**14,639**	**16,296**	**43,292**	**195.7**	**165.7**
2. Total Expenditure	**150,056**	**158,465**	**152,630**	**1.7**	**-3.7**
Personnel and Purchasing	**30,367**	**31,739**	**30,577**	**0.7**	**-3.7**
Interest Payments	**27,421**	**22,208**	**28,876**	**5.3**	**30.0**
Investments	**5,817**	**6,895**	**5,280**	**-9.2**	**-23.4**
Transfers (1)	**83,980**	**97,623**	**85,520**	**1.8**	**-12.4**
Contingency Fund	**2,472**		**2,377**	**-3.8**	
3. Non-budget transactions*		**7,184**			
3. Cash Balance (1-2)	**-44,036**	**-46,950**	**-33,397**	**-24.2**	**-28.9**
Memorandum:					
Territorial Administrations Taxes	**72,897**	**72,855**	**91,856**	**26.0**	**26.1**
Total taxes**	**164,278**	**160,890**	**167,797**	**2.1**	**4.3**
Total revenues**	**178,917**	**177,186**	**211,089**	**18.0**	**19.1**
Territorial Administrations Financing (AATT)	**28,034**	**35,412**	**36,489**	**30.2**	**3.0**
Commitments from previous years			**2,270**		
Expenditures excluding Territorial Administrations financing and previous year liabilities	**122,022**	**115,869**	**113,870**	**-6.7**	**-1.7**
Interests, UE, civil service pensions and other committed expenses	55,774		56,280	0.9	
Ministry departments	66,248		57,591	-13.1	

(1) Current and capital.

* These non-budget operations represent mostly lower expenses due to the compensation in advances to the Autonomous Regions in 2009, within the new financing Framework of the System. This represents lower taxes in 2011 due to an item not yet applied.

** Budgetary revenues.

Source: Ministry of Finance and Public Administrations

The 2012 budget will reduce State deficit by more than 17 billion euros, 1.6 points of GDP, but the austerity effort it involves is much higher. The existence of unavoidable cost increases, such as those corresponding to interest payments, the funding of Territorial Administrations and Civil Service Pensions, among others, the actual adjustment to be made by the State amounts to 2.5 points of GDP.

According to the budget summary contained in Table 3.2.1, non-financial revenue of the State budget for 2012 will increase by 14.3%, comparing the 2012 budget with the budget execution of 2011. Meanwhile, budget expenditure will decrease by 3.7% when compared to 2011 execution, resulting in a cash deficit of 33.4 billion euros, 3.1% of GDP. Taking into account the adjustments necessary to turn the cash deficit in National Accounts terms, the State deficit in would be 36.9 billion euros (3.5% of GDP), thus fulfilling the objective of budgetary stability for 2012.

However, the mentioned budget summary reflects a distorted picture of revenues and spending for 2012 as a result of the 2010 settlement of the financing system of the Autonomous Regions. This settlement represents a significant reduction in state tax revenues, amounting to 24.8 billion euros, and a remarkable increase in current transfers received, amounting to 22.4 billion euros. These circumstances imply that state tax revenues fall by 13.7%, and the share of Regional Treasuries in them increases by 26.1%, while non-tax revenues register an extraordinary rise, due to the State's positive balance in the Global Sufficiency Fund. This positive balance is explained because 2010 settlement yields of this resource are determined under the new funding system, which establishes greater tax assignments and less transfers, while deliveries against 2010 were determined under the previous funding system. For these reasons, the most representative figures of the State income budget are those corresponding to total tax revenues, before computing tax assignments to the Regional Governments. In this regard, total taxes in 2012 will grow by 4.3% after rising 1.3% in 2011.

The overall tax revenue collection forecasted for 2012 amounts to 167.8 billion euros, an increase of 6.9 billion, 4.3% more, compared to the 2011 tax collection. This growth is the result of the tax measures adopted by the Government in 2011 and 2012, whose impact is estimated at 12.3 billion euros. Without such measures, tax collection in an unfavourable macroeconomic context would decline as a result of the contraction of the bases of the main taxes. According to the assumptions of the macroeconomic scenario and regardless of policy changes, tax bases fall at a rate close to 3%, with special emphasis on spending subject to VAT and on the tax base of corporate tax.

The main tax measures adopted in 2012 primarily affect direct taxes. Their nature and the estimated effect on tax revenue are presented in Table 3.2.2. The first measure, included in Royal Decree-Law 20/2011, of 30 December, is the application of a temporary and progressive supplementary levy, in the Personal Income tax. This levy will be applied in the years 2012 and 2013, with percentages ranging from 0.75% for the lowest incomes up to 7% on incomes above 300,000 euros. It also includes an additional levy for savings income in percentages ranging from 2% for yields of up to 6,000 euros to 6% for yields above 24,000 euros. This supplementary levy, which entered into force early this year, is expected to accrue additional revenue of 4.1 billion euros.

Table 3.2.2 IMPACT OF TAX MEASURES IN 2012

ITEM	Million Euros
A. Personal Income Tax	**4,100**
1. Additional taxes (including corporate tax and non-residents (IRNR)	4,100
B. CORPORATE TAX	**5,350**
1. Deferred tax benefit	210
2. Accelerated depreciation	840
3. Financial expenses	1,050
Instalment payments accounting result	2,500
5. Tax on foreign dividends	750
C. OTHER DIRECT TAXES	**2,500**
1. Special levy	2,500
D. SPECIAL TAXES	**150**
1. Tobacco	150
E. DUTIES	**214**
1. Court fees	214
TOTAL IMPACT OF TAX MEASURES	**12,314**

Source: Ministry of Finance and Public Administrations

A second group of measures, referred to in Royal Decree-Law 12/2012 of 30 March, are intended to increase the effective taxation of corporates and the taxation hidden income and are expected to generate additional resources on a temporary basis. With the changes in corporate tax, large companies which generally have greater fiscal capacity, are required a bigger contributory effort. The main changes affecting the corporate tax are as follows:

Tax benefits of goodwill are deferred. Specifically, tax deductibility of goodwill, arising in business acquisitions and corporate restructuring operations, is limited, to a maximum annual limit of one hundredth of its amount. This temporary measure will provide revenues of 210 million euros.

A minimum threshold is introduced for calculating the instalment tax payments of entities with a net turnover over 20 million euros. Specifically, it establishes a minimum instalment payment, which shall not be less than 8% of the positive outcome of the consolidated profit and loss statement for the three, nine or eleven first months of the calendar year, after subtracting the tax loss carryforwards. This temporary measure will provide an income of 2.5 billion euros.

Limits to the deduction of interest expenses are indefinitely introduced. This measure establishes a limit on the deductibility of net financial expenses of up to 30% of the year operating profit. With this measure an income of 1.05 billion euros will be generated.

A special temporal tax of 8% is imposed on foreign income This special tax allows the repatriation of dividends or the transfer of shares in entities that despite doing business abroad are located in areas that prevent the application of the exemption scheme provided in the regulation. This measure will generate revenues of 750 million euros.

It incorporates, with a permanent character, limits to the freedom of depreciation for large companies. For small and medium business, freedom to decide depreciation is linked to job creation. However, for those taxpayers who have not fully amortized investments at the entry into force of the Royal Decree Law12/2010, may deduce depreciation with a limit of 20%of the tax base resulting before the deduction of the depreciation and the offsetting of negative tax bases. The limit is raised up to 40% for those investments made before the RDL 12/2012 that were linked to job creation. This measure will produce an income of 840 million euros.

Table 3.2.3 STATE TAX REVENUES
(Including the share of Territorial Administrations)

	Million Euros			Variation in %	
	(1) Collection 2010	(2) Collection 2011	(3) 2012 Budget	(2) / (1)	(3) / (2)
	86,913	**89,640**	**98,720**	**3.1**	**10.1**
Direct taxes	66,977	69,803	73,106	4.2	4.7
Personal income Tax	16,198	16,611	19,564	2.5	17.8
Corporate Tax	2,564	2,040	2,411	-20.4	18.2
Non-residents (IRNR)	1,174	1,186	3,639	1,0	206.8
Other	**71,886**	**71,249**	**69,077**	**-0.9**	**-3.0**
Indirect taxes	49,079	49,302	47,691	0,5	-3.3
VAT	19,806	18,982	18,426	-4.2	-2.9
Special	9,913	9,289	9,094	-6.3	-2.1
Hydrocarbon	7,423	7,253	6,884	-2.3	-5.1
Tobacco	2,470	2,440	2,448	-1.2	0.3
Other	3,001	2,965	2,960	-1.2	-0.2
Other	**158,799**	**160,889**	**167,797**	**1.3**	**4.3**
Total taxes					

Source: Ministry of Finance and Public Administrations

On the other hand, a special programme has been approved to encourage Personal Income Tax, Corporate Tax and Non-resident Income Tax taxpayers to regularise their tax status, declaring those hidden assets or rights, in line with the recommendations of the OECD in the framework of fiscal fraud fighting. It is estimated that this measure will generate revenues of 2.5 billion euros in 2012, and will widen the tax base for the future. Similarly, changes that will result in increased revenues generated by the Special Tax on Tobacco Products have been approved s.

As already noted, these tax measures significantly impact direct taxes revenues, for which it is expected a 10.1% growth in 2012. Indirect taxation in the context of a reduction in consumption, housing, and public spending will accentuate the fall recorded in 2011, decreasing by 3% (Table 3.2.3).

The 4.7% increase in income tax revenue compared to 2011, is due to the additional tax in force since January. However, the expected revenue increase, 3.3 billion euros, amounts for less than the impact of discretionary measures, 4.1 billion euros, due to the estimated evolution of employment and therefore labour income.

The corporate tax revenue is expected to increase by 17.8% due to the limitations introduced in the adjustments applicable to corporates´ taxable income, as well as to the changes in the instalment tax payments calculation system.

The VAT revenue will decrease by 3.3%, reflecting the deterioration of all the components of the taxable basis, especially Public Administrations´ spending. Finally, special taxes revenues will decrease by 2.9%, in a context of a reduced consumption of the goods subject to these taxes.

In short, all these adopted tax measures are expected to increase revenue for t 2012 by around 12.3 billion euros, of which around 10 billion correspond to temporary measures. As for the extraordinary measures to encourage the regularisation of hidden assets and rights, although strictly speaking they are one-off, they will allow the return to the tax system of the profits arising from these assets.

On the expenditure side, the budget includes the necessary austerity measures to meet the State deficit target of 3.5% of GDP in 2012, i.e. 36.9 billion euros. Thus, taking into account the estimations of the State's non-financial revenues, national accounting adjustments amounting to 3.58 billion euros, and the expenditure corresponding to the funding mechanism of Territorial Administrations, the non-financial spending limit set out in the budget is reduced to 116.1 billion Euros, under the 118.5 billion euros ceiling approved by Parliament,. Within this limit, State prior years obligations, amounting to 2,270 million euros, must be met, which reduces the effective spending limit for 2012 to 113.8 billion and implies a decrease of 6.7% over the State Budget for 2011, Table 3.2.1. The decrease will be even higher for ministerial spending. Ministries will reduce their non-financial budgets by 13.1%. If financial costs are also taken into account, excluding the contribution to the European Stability Mechanism, the available expenditure for Ministries is reduced by 16.9%.

The budget for 2012 also includes the measures approved by the Royal Decree-Law 20/2011. This established a public employment replacement rate of 0% with the exception of certain groups whose rate stands at 10%. It also extends public employees working week to 37.5 hours in all public administrations, and freezes Public employees' wages with respect to 2011. These measures, together with public job offer restrictions, determine a decrease in public staff spending of 2.6% over the 2011 budget. However, the expected 7.9% increase in civil service pensions expenditure, generates an increase in personnel costs of 1.3% over the 2011 Budget.

The expenditure on current spending in goods and services is reduced by 10.7% after deducting liabilities from previous years, reflecting the strong austerity that must be applied to all Ministries. Financial expenses increase by 5.3%, due to the increased volume of public debt. Current transfers, excluding those of the funding system of Territorial Administrations, are reduced by 8.6%, once prior period liabilities have been deducted. The reduction affects almost all current transfers, with some exceptions such as transfers to supplement pensions to meet the minimum Social Security pension. Meanwhile, capital transfers fell by 46.4%. Finally, real investments, once deducted liabilities from previous years, decrease by 19.6% compared to the 2011 budget.

The extension of the 2011 budget, caused by the general elections, has not meant a reduction in the fiscal consolidation effort, as in order to ensure adequate compliance with deficit targets, the Government approved on 30 December, an agreement of non-availability of credit that would allow to reduce the expenditure on the first months of the year, until the effective entry into force of the new budget for 2012.

3.2.2. The Social Security Budget in 2012

The Social Security System budget for 2012 foresees revenues of 119.8 billion euros, representing an increase on the provisional execution for 2011 of 1.6%, while the spending will increase to around 119.8 billion euros, a growth, in the same terms, of 1.2%, which means that the budget will be balanced at the end of the fiscal year, compared with the deficit of 532 million recorded in 2011 (Table 3.2.4).

Revenues –of which social contributions constitute the main element -, will increase by 0.9% despite the expected decrease in the number of contributors, mainly as a result of the increase in the contribution bases and the fraud control plan announced by the Government (Plan against illegal employment and Social Security fraud). Note that the decreasing number of contributors will be inferior, in any case, to the decline in social security affiliations, as the unemployed still contribute to the system while they receive unemployment benefits and may voluntarily continue to do so, even if they do not receive any benefits, through Social Security special agreements.

Table 3.2.4 SOCIAL SECURITY 2012 BUDGET					
	Million euros			% Change	
	(1) Initial 2011 Budget	(2) Settlement 2011 (P)	(3) Initial 2012 budget	(3) / (1)	(3) / (2)
Revenues	**123,406**	**117,969**	**119,884**	**-2.9**	**1.6**
Social Contributions	110,447	105,355	106,323	-3.7	0.9
Companies and employees	99,977	95,057	96,048	-3.9	1.0
Unemployed	10,384	10,190	10,154	-2.2	-0.4
Other contributions	86	108	121	41.1	12.2
Current transfers	8,154	8,337	8,930	9.5	7.1
Of which: from the State	8,092	8,297	8,868	9.6	6.9
Other revenues	4,805	4,277	4,631	-3.6	8.3
Expenditures	**118,827**	**118,501**	**119,883**	**0.9**	**1.2**
Personnel and Purchasing	4,097	3,917	3,899	-4.8	-0.5
Current transfers	114,279	114,308	115,683	1.2	1.2
Occupational pensions	99,090	99,528	101,954	2.9	2.4
Temporary incapacity	7,009	6,295	5,799	-17.3	-7.9
Other current transfers	8,181	8,485	7,930	-3.1	-6.5
Other expenses	450	276	301	-33.2	9.2
Balance	**4,579**	**-532**	**1**		
(P) Provisional					

The other major element of Social Security revenue are transfers received from the State for which a 6.9% increase is expected over the 2011 settlement. Such transfers are intended primarily to complement the minimum pension, a set of non-contributory benefits and the long term care system expenditures.

With regard to the expenses, its main component, contributory pensions, will grow by 2.4%. This increase is estimated in regards of the increasing number of pensioners, the substitution effect and the 1% pensions updating. Finally, following the trend of recent years, other current transfers (temporary disability and others) will decrease by 7%.

3.3. Fiscal strategy 2012-2015

The present Stability Programme Update contains budgetary projections up to 2015. Within a multi-annual perspective, budget balance is achieved from 2016 onwards, eliminating the borrowing needs of the Public Administrations.

In the short term, the Government's priority is to achieve a 3% of GDP deficit, as committed in the Euro group, which implies a 5.5 p.p. decline in the nominal deficit in 2012-2013. To that end, the Government has designed an extremely austere budget for 2012, based on a realistic macroeconomic scenario. This will lower the Central Government's deficit to 3.5% of GDP in 2012, down from the 5.1% recorded in 2011 (Table 3.3.1).

Table 3.3.1 BUDGET FORECAST
(Excessive Budget Procedure)

	SEC code	2011 (A) (mill. €)	2011 (A) % of GDP	2012 (F) % of GDP	2013 (F) % of GDP	2014 (F) % of GDP	2015(F) % of GDP
Capacity (+)/Need (-) of financing (EDP. B9)							
1. Total Public Administrations	**S. 13**	**-91.344**	**-8.5**	**-5.3**	**-3.0**	**-2.2**	**-1.1**
2. Central Government	S. 1311	-54,739	-5.1	-3.5	-2.5	-1.9	-1.1
3. Autonomous Regions	S. 1312	-31,541	-2.9	-1.5	-0.5	-0.3	0.0
4. Local Councils	S. 1313	-4,069	-0.4	-0.3	0.0	0.0	0.0
5. Social Security Administrations	S. 1314	-995	-0.1	0.0	0.0	0.0	0.0
Public Administrations (S. 13)							
6. Total revenues	TR	377.085	35.1	36.3	36.9	36.6	36.6
7. Total expenditures	TE	468,429	43.6	41.6	39.9	38.8	37.7
8. Net lending (+) / borrowing (-)	EDP. B9	-91,344	-8.5	-5.3	-3.0	-2.2	-1-1
9. Interests payment	EDP. D41	25,791	2.4	3.2	3.3	3-2	3.1
10. Primary balance		-65,553	-6.1	-2.2	0.2	1.0	2.0
11. Temporary measures			0.0	1.0	0.8	0.0	0.0
Revenue Breakdown							
12. Total taxes		210,111	19.6	20.4	21.2	20.9	21.3
12a. Indirect taxes	D.2	104,971	9.8	9.8	10.6	10.5	10.4
12b. Direct taxes	D.5	101,610	9.5	10.3	10.3	10.1	10.5
12c. Taxes on capital	D.91	3,530	0.3	0.3	0.3	0.3	0.3
13. Social security contributions	D.61	139,868	13.0	13.2	12.7	124	12.2
14. Investment Income	D.4	9,819	0.9	1.0	1.0	1.0	0.9
15. Other revenues		17,287	1.6	1.7	2.0	2.3	2.2
16. Total revenue	**TR**	**377,085**	**35.1**	**36.3**	**36.9**	**36.6**	**36.6**
p.m.: Fiscal pressure		333,623	31.1	32.1	32.4	31.9	32.0
Expenditure Breakdown							
17. Employee wages + intermediate consumption (17a+17b)	D.1+P.2	180,908	16.9	15.4	14.3	13.5	12.9
17a. Employee wages	D.1	122,926	11.5	10.9	10.3	9.7	9.2
17b. Intermediate consumption	P.2	57,982	5.4	4.5	3.9	3.8	3.7
18. Social transfers (18= 18a+18b)		193,566	18.0	18.6	18.6	18.3	17.9
of which unemployment benefits		30,772	2.9	2.9	2.8	2.5	2.3
18a. Social transfers in kind via market	D.63 (1)	30,080	2.8	2.8	2.6	2.6	2.5
18b. Social benefits (not in kind)	D.62	163,486	15.2	15.9	15.9	15.8	15.5
19. Interest	EDP D.41	25,791	2.4	3.1	3.3	3.2	3.1
20 Subsidies	D.3	11,325	1.1	0.9	0.7	0.7	0.7
21. Gross fixed capital formation	P.5	29,623	2.8	1.7	1.5	1.4	1.5
22. Capital transfers		10,589	1.0	0.6	0.6	0.6	0.6
23. Other expenditures		16,627	1.6	1.3	1.0	1.0	1.0
24. Total expenditure	**TE**	**468,429**	**43.6**	**41.6**	**39.9**	**38.8**	**37.7**
p.m.: Public consumption	P.3	217,675	20.3	18.9	17.8	17.0	16.1

(1) D.63 = D.6311+D.63121+D.63131
(A) On-going; (F) Forecast
Source: Ministry of Economy & Competitiveness and Ministry of Finance & Public Administrations

Moreover, the Autonomous Regions and Local Corporations, have assumed a commitment to lower their deficit in 2012 to 1.5% and 0.3% of GDP, respectively, down from 2.9% and 0.4% in 2011. These commitments have been assumed in the Consejo de Política Fiscal y Financiera and the Comisión Nacional de Administración Local, the bodies representing Territorial Administration. Finally, the Social Security System is expected to submit a balanced budget at year-end.

To ensure the fiscal consolidation path to which the Kingdom of Spain is committing in this Stability Programme Update, the Government has adopted a series of legislative measures, some whose effects will be temporary and others with structural impact. Two of the measures were referred to in the preceding section, i.e., Royal Decree-Law 20/2011 of 30 December on urgent budgetary, tax and financial measures to correct the budget deficit, and Royal Decree-Law 12/2012 of 30 March, introducing tax and administrative measures aimed at lowering the budget deficit. In addition, in April 2012 the Government adopted other Royal Decree-Laws to further reduce the structural-spending of the Autonomous Regions', mainly healthcare and education. The aim is to guarantee the sustainability of these services by providing them on a sound financial basis.

Given the situation of Spanish public finances, which must be corrected to regain economic growth and employment creation, in September 2011 the Parliament amended Article 135 of the Spanish Constitution. This amendment gives the maximum legal status to the fiscal rule limiting structural deficit and public debt to the benchmark value laid down in the Treaty on the Functioning of the European Union. The Organic Law on Budgetary Stability and Financial Sustainability enacted in late April develops the content of the aforementioned Article 135 of the Spanish Constitution. Spain is thus one of the first countries to include the European economic governance package in its domestic legal system.

By correcting the shortcomings in the former Budgetary Stability Law and guaranteeing continuous and automatic adaptation to European legislation, the Organic Law on Budgetary Stability and Financial Sustainability, further discussed in another section of this Update, constitutes a powerful legal tool for reinforcing fiscal discipline at all levels of Government.

The budgetary projections reflected in Table 3.3.1 have been formulated on the grounds of the above legal provisions. Consolidation will be most intense in 2012 and 2013, when the budget deficit must be lowered to 3% of GDP. In 2012-2013, the Central Government must lower its deficit by 2.6 percentage points, the Autonomous Regions by 2.4, Local Corporations by 0.4 and the Social Security Administration by 0.1p.p.

The fiscal consolidation strategy for 2012-2015, based primarily on reducing public spending, will be completed by measures designed to raise tax revenues. Around 75% of the decline in public spending will affect current expenditure and the remaining 25%, capital expenditure. Most of the revenue growth will come from action geared to expanding the tax base or raising rates.

This bias toward spending cutbacks seeks primarily to reduce the structural deficit, eliminating the major inefficiencies in Government finances without imposing unnecessary growth restrictions on the economy in the form of a disproportionately heavier tax burden. Moreover, this fiscal pathway is designed to identify and eliminate the most superfluous spending, consistently pursuing more effective public services while preserving the items of expenditure that are most important to stabilising economic activity and the elements that guarantee actual equal opportunities for all members of society.

Revenue measures. Some of these measures, such as those concerning Corporate Tax, were described earlier in connection with the 2012 General State Budget. The above calculation included permanent measures only; i.e., transitional provisions such as the special levy on personal income or the Corporate Tax measures mentioned earlier were excluded. Moreover, of the permanent measures, priority was given to indirect taxation, for its impact on growth is less distortive. This discussion will be resumed in the section on the quality of public finance. The Wealth Tax, which will bring in an extra 560 million euros, must also be factored into the calculations.

In 2013, once economic recovery is underway and depending on domestic demand, tax restructuring will be addressed, in which certain indirect taxes will be targeted to the benefit of payroll taxation. In a scenario of economic recovery, this change will drive job creation.

A number of aspects have been considered in connection with Social Security contributions. Firstly, relevant measures in 2012 include a 1% rise in the maximum wage base, in light of the expected CPI, and the introduction of a bill to combat irregular employment and Social Security fraud.

Further to that legislation, action will be adopted to combat Social Security fraud, seeking to bring underground employment into the open, prevent both the undue application of employers' Social Security bonuses or discounts and fraud in law in the securing of benefits, and identify fraudulent situations in the access to and receipt of other Social Security system benefits.

To this end, the resources for inspection will be reinforced and activities and cooperation with other bodies will be intensified. Moreover, two bills will be introduced. The first adopts a comprehensive approach to combating irregular employment and Social Security fraud, while the second amends the Penal Code by making exemption from penal liability contingent upon payment of the tax evaded and raising the fines for evading Social Security tax, among other provisions. Moreover, in 2013 as part of the re-assessment of both this legislation and indirect taxation, measures may be adopted that would be geared to lowering employers' labour costs.

In their Economic-Financial Rebalancing Plans for 2012, the **Regional Governments** have announced (mostly permanent) measures designed to raise their revenues. The most prominent of these include the reduction or elimination of regional income tax deductions, such as the housing deduction for youths; the establishment of regional taxes on electric power facilities that have an environmental impact and on the elimination of waste in rubbish tips; the establishment of or, as appropriate, the increase in sales tax on certain hydrocarbons; and the upward revision of public levies and prices (on items such as municipal solid waste treatment, environment and nature conservation, regulation and inspection of commercial and industrial activities and farming projects co-funded with the European Union), fines and penalties and real estate sales taxes. As a result of all these measures, additional proceeds of around 3.5 billion euros will be earned, net of the aforementioned revenues from the Wealth Tax.

In the context of the Plan for Payment of Local Government Suppliers, the Adjustment Plans submitted to the Ministry of Finance and Public Administration by 2,700 Local Corporations, in turn, envisages a 22.9 billion euro increase in revenues in 2012-2022, 1.58 billion of which accruing in 2012, primarily as a result of rises in local tax rates. Assuming that these measures will be implemented at an approximately even pace, an additional 6.58 billion euros could be raised by 2015.

Table 3.3.2 lists the discretional measures to be adopted during the validity of this Programme as discussed above and their impact on revenues. The most prominent discretional measures will be adopted in 2012, as noted earlier in this section.

Table 3.3.2 Discretionary Measures						
	2011	2011	2012	2013	2014	2015
	Sum	% of GDP				
1. Total revenues to constant policies	377,085	35.1	34.4	36,2	36.6	36.6
2. Discretionary tax revenue	-	-	1.9	0.7	0.0	0.0
Source: INE and Ministry of Economy and Competitiveness and Ministry of Finance and Public Administrations						

The main measures adopted in 2012 will entail amendments to the Personal Income, Corporate, Wealth and Property taxes, while the effects of the disappearance of the temporary Personal Income Tax measures and the re-structuring of indirect and payroll taxes will be felt in subsequent years. The dates on which the measures will enter into force are provided in the table.

The Code of Conduct for formulating the Stability Programme provides that when spending growth exceeds the GDP growth benchmark, certain items may be deduced. This is naturally not applicable to the present Programme, in which spending growth, being negative, is obviously lower than the benchmark. Supplementary information is nonetheless provided in Table 3.3.3. on incoming EU funds, which would be the sole item that could be computed in the event of a possible decline in public spending.

Table 3.3.3 Expenditure Cofinanced by the EU Budget						
	2011	2011	2012	2013	2014	2015
	Sum	% of GDP				
1. Expenditure in programs fully cofinanced by the EU budget	12,697	1.2	1.3	1.2	1.2	1.1
Source: INE and Ministry of Economy and Competitiveness and Ministry of Finance and Public Administrations						

Reduction in current expenditure. Numerous proposals in this field are being made by Ministries and Public Administrations. Some have already a quite precise quantification of the budgetary impact. In contrast, others could have not been approved owing to time constraints, although they will be approved in the coming months in view of their advanced state of preparation, as they present a substantial potential for generation of savings. The following proposals are noteworthy for their potential contribution to deficit reduction. First are those prepared by the central administration and then those prepared by the regional authorities.

- **Elimination of certain competences assumed by local authorities** to be approved in 2012, with potential savings of 3.5 billion euros in 2013. The plan includes policies such as grouping of municipalities, which are defined by population ranges. Hence, municipalities shall be considered as such only if they surpass a certain population threshold. Further, provincial councils may become the focal point for the provision and planning of public services to the public regardless of their place of residence, which would allow for eliminating expenditure redundancies by city councils and inefficient planning. Additionally, a basic law would specify the boundaries of municipalities' competences, outside of which municipalities would be unable to engage in other activities: nor could city councils assume competences delegated through the majority of agreements.

- **Plan for Rationalisation of Property Holdings of General State Administration.** The objective of this measure is to achieve better exploitation of state property, with the aim of laying down consistent rules for managing the nearly 55,000 buildings forming part of the General Inventory of Property Holdings of the General State Administration. The plan seeks to define homogeneous criteria for valuation of goods, management of assets, occupancy of spaces and planning of projects, works and general services of maintenance and upkeep. The budgetary impact will amount to at least 100 million euros in rents, from and including 2013, in principle.

- **Plan for Reorganisation and Rationalisation of Public Business and Foundation Sector in Autonomous Regions and Local Authorities.** The plan seeks to reduce the number of public enterprises and regional foundations in 2012 and promote control, efficiency and the reduction of public expenses managed by the autonomous regions' instrumental sector. Under this plan, some 20% of such bodies and entities may disappear.

- **Plan against absenteeism of public employees and rationalisation of temporary disability in the MUFACE regime (to be approved in 2012).** This would include the following: changes in full remuneration of the first 90 days of temporary disability of MUFACE; no payment of subsidies for temporary disability and elimination of license for illness for civil servants subject to medical controls that are discharged or for unjustified absence for medical examination; shorting of the terms for issue and submission to personnel bodies of medical leave forms for temporary disability under the MUFACE regime; change in formula for terms under the aforesaid regime.

  The measure will have a highly positive budgetary effect, although it is difficult to quantify in advance. First, it will increase civil servants' productivity and reduce hiring needs. It will also have a positive impact on the expenses of MUFACE, which will begin to pay out illness subsidies from the fourth month after the start of the illness, as per the reform of requirements for payment of subsidies and the change in the basis of calculation from months to days.

- **Possible measures to limit early retirements in 2013** which will lead to an increase in the minimum age for early retirement.

- **Elimination of state bodies and bodies duplicated by Autonomous Regions.** The Autonomous Regions have duplicated some of the bodies of the state, such as the Court of Auditors, the Competition Court, the Ombudsman and the Council of State, thus generating redundancies and unnecessary costs. In addition all the Autonomous Regions have their own statistics agencies and some their own audiovisual councils or data protection agencies, etc. The estimated effect will amount to approximately 250 million euros, from and including **2013**.

- **Measures for rationalisation of health and pharmaceutical expenditure aimed at ensuring the sustainability of the national health system contained in the Royal Decree Law 16/2012 of 20 April,** the combined savings of which would amount to approximately 7.2 billion euros a year. The savings would be generated especially among Autonomous Regions and include savings in wage remuneration, intermediate consumption and in-kind transfers. These measures include: greater participation of users in the system, differentiating between pensioners and active workers and with different rates for the chronically ill in both groups; centralisation of procurement, with the resulting savings owing to bulk purchases; purchasing by the State directly from the suppliers of Autonomous Regions, with the resulting savings from early payment; application of reference prices to equivalent therapeutic groups; further promotion of generic pharmaceutical products; control over the number of prescriptions per patient; delinking the user contribution from status as pensioner and linking of contribution to income; limiting access of non-residents to certain services; ending of public funding for medications of very low therapeutic value or with very low market prices, except for the lowest incomes. In terms of the timing of the effect, it is estimated that half of the total potential savings will be achieved in 2012, while the full savings will be attained in 2013.

- **Measures aimed at ensuring the sustainability of the dependency system:** delaying inclusion in the dependent system of those dependents of grade 1 until at least 2014; advancing in effective application of user monetary contributions to the system by means of coordinated development of regional regulations; revision of the entire system of social security subsidies and monetary benefits to make them consistent with the entirety of the benefits in the dependency system. Estimated savings would be at least **1 billion euros a year**, of which approximately 600 million would be generated in 2012.

- **Measures to contain expenditure in education pursuant to Royal Decree Law 14/2012 of 20 April, with savings of some 4 billion euros a year, which would affect personnel, intermediate consumption and other current revenues**. These measures would include an increase in classroom hours of teaching staff; reduction of student/teacher ratios in primary, secondary and baccalaureate education; revision of the system of dedication of university professors; a freeze of the regulatory implementation of the increase in the retirement age of teaching and research personnel to the age of 75; approximating the public prices of academic services to their cost, which would involve introduction of surcharges in tuitions and matriculations; introduction of the principle of budgetary stability in universities; limitation on the hiring of new personnel in universities; elimination of the option of creating new wage items or variable remuneration; rationalising the number of degrees that can be re-configured by means of university cooperation and inclusion in educational organisation of factors such as the minimum number of students; modifying the criteria for appointment of substitutes and covering absences of less than 10 days with the institution's own resources; elimination/suspension of requirement to offer at least two modules of baccalaureate under the terms of the LOE and postponement of implementation of the modules of 2,000 hours envisaged in the LOE for intermediate and advanced-level training cycles. Approximately one third of the effects of the plan will become visible in 2012, while it will become fully operative in 2013.

Autonomous Regions are also making important proposals for consolidation of expenditure backing this medium-term fiscal path set out by the Government. Specifically, the proposals set out in the rebalancing plans submitted to the Council of Financial and Fiscal Policy would allow for an overall reduction of expenditure of 5.7 billion euros only in 2012 and would serve as the basis for further reductions in the coming years. The main measures in this group would be the following:

- **In personnel expenditure**. In this field, measures include a , reduction of the number and remuneration of high officials and similar positions in the administration and in entities comprising the regional public sector, limitation on the number of staff except in essential public services, control of overtime, measures to control public employment, non-replacement, no recruitment for public employment and extinguishment of positions; required reporting by regional finance departments for modifications in relations of job positions or in conditions that entail greater public expenditure; mandatory retirement at the age of 65 with null replacement rate, increase of annual ordinary hours, reduction of number of trade union shop stewards and elimination of additional vacation days, days off for death, surgery, etc. for seniority.

- **Measures to control health expenditure**, such as reduction of the portfolio of services provided, freeze in career developments, reduction in substitutions, increase in working hours of interim staff, elimination of additional vacation periods, reorganisation of staff in continuous primary care, elimination of wage bonuses for fixed afternoon hours in primary care and in special tasks, reduction in medical standbys, modification of conditions of healthcare partnerships, partial closure of hospitals, reduction in children's dental plans, strict application of dietary product instructions, etc. Also worthy of note are plans for public-private partnerships in management of health care services with a view to enhancing management and progressing in organisational efficiency.

- **Control measures in education.** Some of these measures will anticipate even broader measures under consideration by the Ministry of Education, Science and Sport discussed above. Specifically, the plan calls for eliminating bonuses for extended working days and continued attention, eliminating extracurricular activities, reducing substitutions, increasing the working day of interim personnel, increasing the number of students per class, optimising teaching hours savings, splitting up of units in educational institutions, reduction of staff sizes, elimination of seniority bonuses and elimination of coexistence programmes and classrooms.

- **Measures in procurement of goods and services not part of the foregoing headings**. These include improvements in the contracting of service and supplies, establishment of centralised purchasing platforms, renegotiation of service and supply contracts, renegotiations of leases and electronic tenders; rationalisation of consumption of energy and telephone utilities in buildings, through grouping and reorganisation of administrative spaces to optimise usage, pursuit of energy efficiency, reduction in opening hours of public buildings, reduction in spending on official supplies; centralisation of maintenance services of medical equipment, especially high technology units; adjustments in fleet of vehicles (vehicle maintenance, fuel costs, etc.); limitation of actions of repair, maintenance and upkeep of property holdings and equipment used by the administration; non-replacement of inventory materials, furniture, electronic or computer equipment, unless deterioration should render them useless; integration of telephone information hotlines for the public and centralisation of Public Information Offices; reduction of edition and publication expenditures; reduction of expenditure in protocol and representation; restrictions on the performance of studies, technical work and consultancy by external enterprises and on use of courier transport.

- Under **current and capital transfers**, advances will be made in the rationalisation of subsidies, with reductions in transfers to universities or selective cutbacks in certain social benefits such as housing assistance for young people, benefits for infants, centres for the elderly, etc. Also, cutbacks will be made in contributions to entities in the public sector of Autonomous Regions as part of plans to reorganise and restructure the regional public business and foundation sector, and the system for management of regional television stations will be modified.

- **Other measures** will include disposal of real investments such as vehicles or shares in private enterprises, or plans to optimise property holdings, with operating concessions in ports owned by regional governments and disposal of certain properties.

In their recent adjustment plans, **local authorities** have also presented a broad range of measures to rein in spending, amounting to a 16.3 billion euros in the 2012-2022 period. Proposed measures mainly involve limiting wages in mercantile contracts or wages of senior management, with clear limitations in basic remuneration and linkage of variable remuneration to criteria of competitiveness and performance; reduction in trusted personnel and their adjustment to the size of the local authority; reconsideration of the number of externalised contracts, in accordance with activities that can be performed by current municipal personnel; sharp reduction in the provision of non-mandatory services; reduction in administrative burdens for individuals and enterprises; reductions in the number of minor contracts entered into, with greater prevalence of the principle of lowest bidding price and dissolution of public enterprises with substantial losses in relation to the size of their equity, with no offsetting capital add-ins allowed by local authorities.

The final across-the-board strategy for all public authorities is the disposal of both real and financial assets, with diverse effects on budgets (the former directly reduces the deficit, while the latter would have an indirect budgetary impact by cutting the stock of debt). Autonomous Regions and city councils have already announced some asset disposals in their economic and financial plans, although it is still early for any even approximate quantification of their scale. The State may also sell some sound properties in the 2012-2015 period, provided market conditions allow and transactions are designed in a way to allow for proper private provision of any services in the public interest arising from the management of such assets.

In short, and to avoid any timing problems in 2012 and 2013, aggregate savings of all these measures over these two years on both the revenue and expenditure side of the budget will be analysed, for this period accounts for the bulk of the fiscal adjustment described in this Stability Programme. In revenue, discretionary measures would be available, amounting to some 28 billion euros. These would be comprised of measures envisaged in the 2012 budget, except for exceptional measures aimed at bringing to the surface hidden assets, owing to their transitional nature, increase in real estate property tax, measures to increase the revenue of Autonomous Regions announced in economic and financial plans (roughly 3.5 billion) and any actions aimed at restoring indirect taxation and social security contributions. In expenditure, the main contributions would come from the healthcare and educational reforms (approximately 11 billion), elimination of certain competences assumed by city councils, reduction of capital expenditure and the total savings from other reforms described above, such as the restructuring of the regions' public sector, elimination of redundancies, measures on early retirement, savings in the dependency system, reorganisation of the network of regions commercial offices, etc.. These measures are sufficient not only to accomplish the structural adjustment in these two years, but to cover payment of cumulative interest in these years and increases in contributory pensions. [2]

[2] Only the largest scale measures are included herein. Not included is the Rationalisation Plan of State Properties, which may add in a further 100 million euros starting in 2013.

Table 3.3.4 Breakdown of revenue and expenditure measures		
Revenue	**2012**	**2013**
Income tax	4,100	1,000
Corporate tax	5,300	
Tax regularisation	2,500	
Wealth tax	560	
Duties on tobacco and other items	360	
National insurance evasion activity	1,900	
Real estate property tax	900	
Revenue from Autonomous Regions	3,500	
Other		8,000
Total	**19,120**	**9,000**
Expenditures	**2012**	**2013**
Education	1,333	2,667
Health care	3,600	3,600
Justice	128	
Social services	613	387
Duplicities	100	150
Competences assumed by local councils		3,500
Regional state-owned enterprise sector streamlining*		
State contributions to capital	5,070	
Early retirements		300
State current purchases	300	
Total	**11,144**	**10,604**
*** Awaiting quantification**		
	2012	**2013**
Total savings (increased revenue and reduced expenditure)		
(And lower expenses)	30,264	19,604

From a functional standpoint, the adjustments introduced in the Stability Program have an impact on both the weight of public expenditure in the GDP and its composition. As shown on table 3.3.4, between 2010 and 2015, the overall weight of Government expenditure in GDP falls 8.6 points, from 45.6% in 2010 to 37% in 2015.

The only Government role that actually increases its weight as a percent of GDP is the general public services. The reason for this is that it includes debt interest payments, which is among the few budget items with nominal growth due to the need to finance the deficit for the period in question. In fact, between 2010 and 2015, the weight of debt interest payments grows by 1.2 points of GDP. If we ignore the impact of higher interest payments, the fall in weight of other items in public services expenditures in GDP is in fact slightly greater than that of total public expenditure (19%).

Social protection shows the smallest percentage cutback (-5%) of all other items, except for general public services, because of the additional effort required to accommodate current pension payments to retirees.

The next areas with the smallest percentage decrease as a percent of GDP are Education and Health Services in an attempt to limit the impact of fiscal adjustments on expenditure in these functions. The remaining functions take on a greater proportion of cutbacks.

On the other end, the largest percentage decrease falls in housing, community services and the economic affairs. The latter's trend clearly shows the highest decrease in investment expenditure.

Table 3.3.5 Change in expenditure structure by function

	Expenditure over 2010 GDP	Expenditure over 2015 GDP	% Change
PUBLIC ADMINISTRATIONS (S.13)			
01 General public services	5.2	5.4	3.9
02 Defense	1.1	0.8	-30.4
03 Public order and security	2.1	1.5	-28.9
04 Economic matters	5.2	2.4	-53.0
05 Enviromental protection	0.9	0.5	-43.9
06 Housing & community services	1.2	0.5	-61.0
07 Health care	6.5	5.1	-21.5
08 Recreational activities, culture & religion	1.6	0.8	-48.3
09 Education	4.9	3.9	-21.3
10 Social protection	16.9	16.1	-5.0
Total expenditure	**45.6**	**37.0**	**-19.0**

3.4. Public Debt

Stock of outstanding public debt as a percentage of GDP will be 11.3 p.p. of GDP greater than in 2011. This considerable increase with respect to 2011 will impact above all the stock-flow adjustment by 5.5 GDP points as follows: 3.9 p.p. in operations payables which are considered as debt in the accounting of the Excessive Deficit Procedure (EDP); 2.2% in supplier invoices; 0.9% in non-recourse factoring; 0.8% from ICO loans to suppliers; 1.0 for acquiring FADE rights and 0.5 in acquiring other net assets.

Looking beyond the current year, the debt dynamics is shown in the table 3.4.1. Stock rises smoothly till 2013, and then drops starting 2014. It is important to highlight that both the contribution of the primary deficit and nominal GDP growth to debt accrual will be negative as of 2013.

This forecast must be regarded as conservative, because both the stock-flow adjustment considered (1% of GDP between 2013 and 2015) and the interest burden considered, which incorporates a higher margin than the one correspondent to the central scenario, for debt interest rates may be higher than those considered in the main assumptions. These two assumptions, particularly the stock-flow adjustment, are important in critical years, such as 2014, in which, as a result of the negative stock flow adjustment (originated from possible revenues from privatizations), debt will show a downward trend as of that year.

Table 3.4.1 PUBLIC DEBT DYNAMICS
% of GDP

	2011	2012	2013	2014	2015	Change 2011-2015
1. Gross debt (levels)	68.5	79.8	82.3	81.5	80.8	12.3
2. Change in gross debt	7.3	11.3	2.6	-0.9	-0.7	12.3
Factors contributing to the change in debt levels						
3. Primary budget deficit	6.1	2.2	-0.2	-1.0	-2.0	-1.1
4. Interest	2.4	3.1	3.3	3.2	3.1	12.7
5. Arising from the effect caused by nominal GDP growth	-1.3	0.5	-1.5	-2.4	-2.8	-6.1
6. Other factors (debt–deficit adjustment)	0.0	5.5	1.0	-0.6	1.0	6.9
p.m.: Implicit interest rate	4,02	4,58	4,17	4,01	3,97	

Source: Ministry of Economy and Competitiveness

3.5. Structural balance and nature of fiscal policy

In order to analyse fiscal policy orientation, this update uses the potential output of the Spanish Economy following the methodology used by the European Commission and as agreed within the Output Gap Working Group. However, some changes have been introduced, both methodological and in statistical in order to arrive at more precise and consistent estimations vis-à-vis the current cycle that the Spanish economy is experiencing. These changes are shown in table 3.5.1. Nevertheless, none of these should be taken as significant deviations from the method proposed by the EC.

Specifically, short term population projections as published by the INE in October 2011 have been used (that includes 2012) and the potential component of the Total Factor Productivity (TFP) has been estimated by applying the Hodrick-Prescott filter. This compares against the Eurostat population forecasts and the Kalman filter used in the European Commission methodology. The population forecast of the INE is used because it is more recent than that published by the EUROSTAT and so includes more updated information. With respect to the removal of the cyclical component from the TFP with Kalman filter, Spain has already stated in the Output Gap Working Group its concerns over the suitability of this method to reflect the trend of this variable in the Spanish case. In any case, Annex 1 shows the results of applying the Kalman filter to the TFP.

The production function method, based on a theoretical approach, can help evaluate the contribution that different production factors have on potential growth. It is important to highlight that these are estimates and so subject to a certain degree of uncertainty resulting from the large amount of information required and the simplifying assumptions used. In addition to these factors, it is very difficult to measure the impact that the economic crisis will have in the potential output.

Table 3.5.1 CYCLICAL PERFORMANCE(1) % of GDP, unless otherwise specified					
	2011	**2012**	**2013**	**2014**	**2015**
1. Real GDP growth (% change)	0.7	-1.7	0.2	1.4	1.8
2. Borrowing requirements (Excess (+)/Deficit (-))	-8.5	-5.3	-3.0	-2.2	-1.1
3. Interest	2.4	3.1	3.3	3.2	3.1
4. Temporary measures	0,.0	1.0	0.8	0.0	0.0
5. Potential GDP growth (% change)	0.4	-0.3	-0.4	-0.3	-0.2
Contributions:					
- labour	-0.4	-0.9	-1.1	-1.0	-1.1
- capitall	0.5	0.3	0.2	0.3	0.3
- total factor productivity	0.3	0.4	0.4	0.5	0.5
6. Output gap	-4.2	-5.6	-5.0	-3.4	-1.5
7. Cyclical balance	-1.8	-2.4	-2.1	-1.5	-0.6
8. Structural balance (2-7)	-6.7	-2.9	-0.9	-0.7	-0.5
9. Primary structural balance (8+3)	-4.3	0.2	2.4	2.5	2.7

(1) Using potential GDP (production function). Potential TFP estimated using the Hodrick-Prescott filter.
Source: Ministry of Economy and Competitiveness

As shown in Table 3.5.1., potential GDP drops slightly in 2012, 0.3% year-on-year, which is the result of a greater negative contribution to growth by the labour factor and a lower positive contribution by the capital factor, which are offset to a certain extent by a higher positive contribution of the TFP. In turn, the contraction of the labour factor reflects the considerable growth in structural unemployment (NAIRU) and a decrease in the working age population as a result of a drop in migratory flows. Specifically, it is necessary to underline the role of NAIRU in keeping potential negative growth even until 2015, due to the high unemployment rates expected, which put upward pressure on the natural or equilibrium unemployment rate forecasted by the Phillips curve.

With regards to the negative potential growth between 2012 and 2015, it should be mentioned that it some aspects of the method proposed by the EC could actually be contributing to underestimating the potential growth via the contribution of the labour factor, since it ignores the impact that the labour market reform will have on the NAIRU. Indeed, the labour reform should influence the Phillips curve, at least as a shock, through weaker trade union negotiation clout, or less persistence in setting nominal wages. These are elements that are typically used in any classic model to determine endogenous NAIRU in a labour market characterised by imperfect competition. If it took these impacts into account, NAIRU should show a more positive trend and the contribution of labour would be less negative, thus increasing the potential growth rate.

In addition to this issue with the NAIRU, other aspects, such as the downward revision of population series of the INE 2011 forecasts and the impact of lower hours per employee that may result from the labour market reform act, would also contribute towards a more negative impact of the labour factor to potential growth. So it is appropriate to use INE's latest forecasts since it represents a more updated and closer to reality source than the EUROSTAT series. With respect to the hours/employee series, its slowdown is the result of the falling costs of vacancies due to the labour market reform.

Notwithstanding, it must be borne in mind that potential negative growth will not continue beyond 2015. The extrapolation of the series involved in the production function of that year, would show a potential growth of 1,2% in 2018 and this trend would consolidate thereafter.

In any case, given current potential GDP estimates and the real GDP estimates for 2012, this year's negative output gap would be greater than last year's, but starting 2013 the gap closes gradually to reach -1,5% at the end of the forecast period.

A breakdown of the deficit into cyclical and structural components reveals a considerable structural effort in 2012, of 3.8 pp plus an additional 2 pp in 2013, in order to reach the 3% financing need target in 2013. This 3.8 pp reduction plus the cutback effort conducted in 2011 (0.7 pp), is actually higher than the 4.3 pp structural effort included in the 2011 Stability Programme which covers 2011 and 2012. If the fiscal effort was measured by the decrease of the primary structural deficit, it would be somewhat lower (5.3 pp), due to the increase in interest payments recorded for this period, but despite this, it is nevertheless quite significant.

Fiscal policy stance for 2012 and 2013, as seen by this fiscal trend, is one of significant contraction, especially when considering the cyclical gap in those two years. During 2014 and 2015, given the proximity of the structural balance to the medium-term objective (MTO) currently set for Spain, the fiscal policy orientation is practically neutral, as it deducts only four tenths of structural deficit throughout these years, and so gradually reaches its objective without introducing additional tension on economic growth. Also, it has to be pointed out that the one-off tax measures introduced in 2012 will have disappeared, so the structural balance for said year is clearly significant as compared to the MTO.

It must be noted that when the calculation is done using the alternative TFP method, with Kalman filter, the results are no different from a qualitative standpoint, while the quantitative difference is of lesser importance when compared to the size of the structural effort that has been implemented. More specifically, the effort in 2012 would be 3.8 pp, the same as with the previous method, and adding this to the 2011 0.8 pp effort yields a total effort which is 1 tenth higher or 4.6p.p. The pace of structural adjustments slows significantly in 2014 and 2015, or the same as before. However, the total factor productivity shows a far more moderate growth in subsequent years because construction will have a much lower weight in GDP, mostly due to the fact that the cyclical component of this variable is linked to a capacity usage index that does not include the construction industry. The result is higher negative potential growth and greater output gaps that accrue in the years prior to the forecast period, and so the cyclical balances are more negative and the structural balances are smaller. In fact, according to this method, a structural surplus would already be reached in 2013 which would continue widening slightly in subsequent years.

3.6. The Effect of Structural Reforms on the Budget

The positive impact of the reforms introduced in this program on activity and employment have already been discussed. The most important reforms are financed by the expenditure programmes' ordinary allocation, so there are not budget costs linked to their implementation. The fiscal measures have been already quantified and their impact on the economic and budget forecasts has been reflected in the Program.

However, the positive effects on the budget go beyond the period of the Program and so some reforms will continue to have a positive impact well after. As for the reform which is expected to have the greatest effect on activity, the Labour reform, the same simulation that allows to calculate its impact shows a positive effect on tax revenues of 4.7% in the long term. This effect, slightly higher than the one obtained for activity, is compatible with other estimates which show an elasticity for total tax revenues a little higher than one.

By adding the impact of all the structural reforms, the effect of broadening the tax base will, in the long run, increase tax revenues in 2020 by 9.5% to what otherwise would be collected in a scenario without reforms.

3.7. Regional Governments and Local Corporations

3.7.1. Regional Governments

In recent years, the Regional Governments have run up deficits that are greater than the targets agreed upon. More specifically, in 2011, the aggregate deficit of the Regional Governments was 2.94% of GDP (having eliminated the effect arising from the negative settlement of 2009), more than twice the objective of 1.3%. This deviation explains most of the total deviation of the Public Administrations as a whole and has created doubts about the capacity to contain the regional deficit. On the other hand, it has highlighted the lack of transparency in their accounts. So this is one of the essential problems to be solved in order to comply with the new consolidation track committed.

The obstacles that make it difficult to control the deficit and which are being addressed are:

1. Transparency and the Central Government's capability of control and correction.

2. The important downward rigidity in Regional Governments' spending.

3. Revenues have fallen substantially.

The key role of the **recently adopted Organic Budget Stability and Financial Sustainability Act** in the framework of transparency and control has already been mentioned**.** This law modifies the previous budget stability law in the sense that it forces all the public administrations to meet the deficit and debt objectives (structural balance and a maximum of 60% debt for the Public Administrations as a whole).

The new law reinforces fiscal discipline and includes as its main novelty a system of early warnings and compulsory compliance and sanction procedures. By establishing a monthly reporting system, apart from the previous quarterly one, whereby the Regional Governments have to report to the Central Government and they even have to send the outlines of their budgets before they are adopted, all of which makes it easier to monitor and correct any deviations from the deficit objectives if necessary.

The introduction of coercive measures such as deposits and fines, of 0.2% of GDP, and compulsory compliance by applying Article 155 of the Constitution, which implies the intervention of a Region by the Central Government, undoubtedly eliminates the uncertainty about the Central Government's capacity to guarantee Regional Government compliance. If the risk of intervention is obvious and there is an early warning system in place to verify in advance whether objectives will be met or not, then non-compliance is unlikely.

In particular, the Central Government procedure of control over the targets of deficit, debt and the expenditure rule, starts very early on. Before the Regional Budgets are adopted, in October of the previous year, the Regional Governments have to send the broad outlines of their budgets to the Central Government for the Central Government to assess whether they will feasibly meet their targets. If the Central Government were to consider they were not going to, either before the Regional Parliaments adopt their budgets or because of the trend in its execution, it would warn the Region concerned to apply sufficient corrective measures to offset the deviation from the objectives. Should these be considered insufficient by the Central Government, all the borrowing operations of the Regional Government concerned and the agreements and subsidies to be received from the Central Government would be conditional to the adoption of such measures.

In the event of non-compliance with the objectives, the Regional Government concerned would have to present a re-balancing and/or economic-financial plan, depending on the objectives that were not met. If the objectives of the plan/s were not met, or no plan were presented or were such a plan inadequate, the Regional Government in breach would have to adopt an agreement of non-availability of budget credits on the expenditure side and establish a remunerated deposit for the amount of 0.2% of GDP. If the Regional Government were to continue to fail to adopt corrective measures, the deposit would not be remunerated and finally it would be considered a coercive fine.

Moreover, the Regional Government could not borrow money, as it would not be authorised to do so by the Central Government. The Central Government would also send a committee of experts to the Region to assess and present a proposal for compulsory measures. If in the end, the Regional Government did not adopt the measures proposed by the committee of experts, the Central Government would apply Article 155 of the Spanish Constitution, which allows the Central Government to adopt the necessary measures to force the

Regional Government to apply the measures by giving instructions to all the Authorities of the Region.

The law also introduces new, far more restrictive fiscal rules that promote fiscal consolidation, prevention and the sustainability of the public finances in the Regions. These rules establish an expenditure ceiling, a maximum debt/GDP limit for each Region of 13% of GDP, the elimination of structural deficit, except in the exceptional circumstances established, and even make it compulsory to use any surplus to reduce net debt. Moreover, it makes it impossible to engage in debt transactions that could increase the stock when the threshold of 95% of the debt/GDP limit is reached.

In short, this law prevents potential non-compliance with the public finance stability and sustainability objectives and it can coercively force a Regional Government to comply, which in the last resort, could include the intervention of the Regional Government concerned, pursuant to article 155 of the Spanish Constitution.

Apart from the Organic Budget Stability and Financial Sustainability Act, control will also be facilitated by the measures established in the **draft transparency bill.**

This draft seeks, on the one hand, as "**active publicity",** to provide the people with as much information as possible on contracts awarded, with modifications, extensions, prices; subsidies and public grants given with amounts and beneficiaries; or remuneration received by directors.

It also contains **a code of good governance**, which establishes ethical principles, which for the first time will be binding by law on all the public administrations. If these are not respected, it will give rise to the corresponding sanctions. Some examples of very serious infractions are non-compliance with the provisions regulating settlement, collection and payment to the Treasury; the authorisation of spending commitments without having sufficient credit or against the applicable legislation; the lack of justification for investing funds pursuant to the Subsidies Act or deliberate non-compliance with the obligation to reduce the level of public debt in the terms established in law.

Not drawing up adjustment plans or economic-financial plans in the circumstances provided for in the Organic Budget Stability and Financial Sustainability Act is also considered a serious infraction.

Any public officer who commits a very serious infraction may be relieved of his/her post and will not be eligible for certain posts for a period of between five and ten years.

The transparency act enhances the sustainability of the public finances of the Regional Governments by increasing transparency for the people and by individually punishing public sector employees and senior officials that do not adequately manage public resources or who do not comply with the rules.

On the other hand, the **Suppliers Payment Mechanism** designed by the Central Government by creating a fund, means that Local Corporations and Regional

Governments can now pay off 100% of the commercial debts they have incurred before the end of 2011 that meet the requisites established in the regulatory frameworks of the mechanism locally and regionally. This funding will represent a major injection of liquidity into the productive economy of up to € 35 bn, which will directly benefit 177,000 suppliers. This funding mechanism is based on a strict economic conditionality, which guarantees compliance with the objectives of budget stability. This conditionality is also applicable to the ICO (Official Credit Institute) lines of credit for the Regions to cover the maturity of financial transactions during the first semester of 2012.

The second field of action concerning the Regional Governments is to remove the obstacles to spending control and the need to re-dimension the size of the Public Administration to make it, in turn, more efficient. In this sense, the Central Government has also taken measures to help the Regions to reduce their deficits in the area of education and health, which required changes in the central legislation. By virtue of the decision taken by the Fiscal and Financial Policy Council meeting of the 17th of January 2012, the Central Government will also assess and monitor the regional public sector Re-structuring Plans adopted by the Regional Governments by formulating recommendations about their size and composition and by presenting a quarterly report to the Fiscal and Financial Policy Council on the progress being made.

a) Adjustment measures adopted by the Central Government that affect the Regional Governments:

In the **area of non-university education**, a series of measures have been established aiming at cost-saving and rationalisation, such as increasing the number of teaching hours for teachers, reducing the number of teacher replacements, only allowing a substitute to be taken on if the absence is longer than ten teaching days, raising the number of pupils per class, eliminating the possibility of designing new remuneration bonuses or variable remunerations, eliminating the obligation of schools to provide at least two modules of sixth form, or postponing the implementation of the 2,000 hour modules established in the LOE (Organic Education Act) for middle and advanced Grade training cycles.

In addition, there is also a plan to reduce absenteeism among public sector employees, which has a direct impact on the Spanish education sector. This is an important initiative if we bear in mind that the MUFACE personnel in the education sector, working in the Regional Education Ministries and Universities, amounts to approximately 480,000 people, of a total of 1,540,000 people covered by MUFACE.

In the **area of university education**, measures have been established that will have an impact on rationalising and reducing university spending, and others that will increase revenues. On the spending side, eliminating the number of courses that do not reach a minimum number of students, limiting the number of new teachers hired, revising the teaching regimen so that they have to teach more credits, suspending the development of the regulations concerning increasing retirement age to 75 and the universities taking on board the principles of budget stability, empowering Regional Governments to intervene if a university deviates from the stability objectives; and the funding of grants. On the income side, the increase in the price of university tuition fees to bring them more in line to a certain extent, with their real cost, increasing the enrolment fee for students having to repeat a subject/year and making non-EU students pay the total cost of fees.

The financial impact of these measures in the area of education is estimated at € 3.9875 bn.

Table 3.7.1.1
ESTIMATED SAVINGS IN EDUCATION
Yearly, in millions of euros

Measures	Estimated savings
Increase in teaching hours	840
Increase in student-classroom ratios	615
Teacher regime	280
Bring pricing in Universities closer to the costs of the service	1,760
Rationalise number of universities, number of degrees and minimum student numbers	71
Introducing the principle of budget stability in universities	150
Limiting the number of teachers hired	72
Other measures affecting education and university	200
TOTAL	**3,988**

In the **area of health**, the Central Government has also taken certain measures recently that impact the sustainability of the public health system managed by the Regional Governments, **which could generate savings of up to € 7.267 bn per year.**

These include rationalising the demand for pharmaceutical products by a general increase in the percentage of the cost that is met directly by consumers when they buy pharmaceutical products, depending on income, monitoring the number of prescriptions per patient and by introducing co-payment for pensioners for the first time, also dependent on income and with a given monthly ceiling on how much they pay, excluding the long-term unemployed and those that receive a non-contributory pensions. A centralised procurement platform has also been established, which means that the Central Government makes all purchases directly from the Regional Government suppliers, with the consequent saving for prompt payment. These measures also include energy efficiency plans and the application of new information and communication technologies; limiting access to certain services for non-residents and measures to prevent people from fraudulently obtaining a health service card in order to prevent what is known as "health tourism"; creating a single health card throughout Spain. Finally, the planning of the service portfolio, establishing a common and free basic portfolio, together with a common portfolio of supplementary accessory services for which users would pay part of the cost, and a portfolio of complementary services to be decided upon by the Regional Governments, which would be paid for by said Regional Governments.

Table 3.7.1.2 **ESTIMATED SAVINGS IN HEALTH CARE** per year, in millions of euros	
Measures	**Estimated savings**
National Insurance Reform, foreigners	917
Restructure the portfolio of NHS services	700
Improved efficiency of NHS services	1,500
Rationalise the demand for pharma products: prescription of generics, change benchmark prices	3,550
Restructure NHS human resources	500
Other measures	100
TOTAL	**7,267**

Moreover, a Health Care Guarantee Fund is created as a clearing house for Regions that spend more than they budget for on providing care for foreigners away from home entitled to care in their country of origin, for patients referred from one Region to another and for patients during their travels around the area covered by the National Health Service. These are mechanisms that ensure that the Health and Social Services work in a fashion as coordinated as possible.

Other measures in the area of health include a rationalisation of the pharmaceutical services, such as the application of reference prices to equivalent therapeutic groups, fostering the use of generic pharmaceutical specialities even further, and the elimination of public funding for medication with very low therapeutic value or medication with a very low market value, except for very low income groups, revising the planning of human resources in the area of health by improving mobility and establishing a catalogue of equivalencies in professional categories.

In the **area of Social Services**, the 2012 National Programme of Reforms contemplates reforming the dependency system to guarantee its long term sustainability by means of a system in which users make a financial contribution, delaying the process of inclusion in the system and reviewing the National Insurance registration for non-professionals carers (relatives). **Savings are estimated at € 283 m in 2012.**

In the **area of Justice**, efficiency is enhanced by reforming the basic procedural legislation, desincentivising the undue use of the judicial system by reforming the system of legal dues and the promotion of out-of-court conflict resolution with new legislation on mediation and a voluntary jurisdiction law.

Concerning re-sizing the size of the public sector, the 2012 National Programme of Reforms includes measures aimed at this that affect both the Regional Governments and the Local Corporations and which will be implemented progressively.

One key element in this re-dimensioning process is the commitment to rationalising the regional public sector, as was approved by the Central Government for its public sector in January. The number of agencies is reduced, reversing the trend towards a flight from Administrative Law that limited control of the budget, spending, the property and procurement regime and especially, control over the civil servant remuneration regime. The remuneration system for senior civil servants and directors in the public business sector is now regulated, with a significant reduction in remuneration and compensation.

This plan has been spread to cover the Regional Governments and Local Corporations. In this sense, there is a Decision of the Fiscal and Financial Policy Council meeting of the 17th of January to improve the efficiency of public services by reducing the number of agencies, simplifying their structure and operations and by seeking to re-organise and rationalise the regional public sector and taking actions that prevent duplicities.

According to the information provided by the Regional Governments, the plans are to reduce the number of agencies by 514 and the actual reduction up to the end of February is 126.

Table 3.7.1.3 PLANS FOR RESTRUCTURING THE PUBLIC AUTONOMIC SECTOR

	Forecasted cutbacks (number of local/regional entities)	Cutbacks to end of February (number of local/regional entities)
Andalusia	111	8
Aragon	16	-2
Principality of Asturias	1	0
Balearic Islands	93	7
Canary Islands	6	-1
Cantabria	-1	-1
Castile and León	2	-2
Castile-La Mancha	48	33
Catalonia	67	7
Extremadura	12	7
Galicia	46	8
Community de Madrid	25	12
Region of Murcia	49	14
Chartered Community of Navarre	26	25
La Rioja	0	0
Valencian Community	13	11
TOTAL	**514**	**126**

As part of this rationalisation and elimination of duplicities, the programme aims **to eliminate the duplicities that exist between the Central Government and the Regional Governments**, such as the Court of Auditors, the Competition Tribunal, the Ombudsman and the Council of State, as well as the Statistics Bureaus, Audiovisual Councils and Data Protection Agencies, all of which generate unnecessary duplicity and costs. **The elimination of these duplicities provides an overall saving of € 250 m.**

In order to **offer greater flexibility to the Regional Governments in the way they manage their public television services**, the Central Government has also adopted a Bill to modify the General Audiovisual Communication Act. In this sense, the Regional Governments will be able to decide whether or not they provide the public television service in their respective regions. They can put the audiovisual licenses out to tender if they wish. They can also provide this service by direct management or choose other, indirect management formulae, such as a public-private partnership. This latter solution would allow Regions with their own television service to change from direct to indirect management by selling the ownership of the agency that provides the service. In any event, they will have to comply with the principles of budget stability**. The estimated saving is € 130 m.**

A summary of the estimated annual savings attained by these measures once they are fully operational is shown in the table below.

Table 3.7.1.4
SUMMARYOF ESTIMATED SAVINGS PER SECTOR
per year, in millions of euro

Areas	Estimated Savings
Health care	7,67
Education	3,988
Justice	128
Social services	613
Elimination of duplicities in bodies of Autonomous Communities	245
Ellimination of offices for promotion of Autonomous Communities abroad	150
Rationalisation of number of local entities and some competences assumed by local entities*	10,500
TOTAL	**22,891**
* Ranging from 8,900 to 12,000	

Finally, given the current difficulties faced by the Regional Governments in accessing capital markets, alternatives for funding them will have to be analysed. Whatever alternative is finally implemented, if it wants the Central Government guarantee, it will have to be accompanied by strict economic conditionality, in the same way as has been done with the ICO-Regional Government lines of credit.

b) Adjustment measures decided upon by the Regional Governments:

The Regional Governments have also taken their own mid-term fiscal consolidation measures both in the 2012 Budget and in the economic-financial balancing plans they have presented. All the regional government budgets for 2012 have been approved, except for Asturias, Castile La Mancha and Castil e and Leon.

All the Regional Governments have also presented their economic-financial balancing plans to the FFPC, summarising their income and expenditure plans for the period 2012-2014.

The plans presented to the FFPC at the beginning of this year, in general show a reduction in spending of some €5.7 bn just in 2012, and they will act as a foundation for reductions in later years. They also contain measures aimed at increasing income by some € 4.050 bn, most of which will be permanent increases.

Table 3.7.1.5 MEASURES OF THE ECONOMIC-FINANCIAL REBALANCING PLANS FOR THE PERIOD 2012-2014
in millions of euro

EFPs 2012-2014: QUANTIFICATION OF MEASURES FOR REDUCING EXPENDITURES IN 2012

	AST	ARA	CTB	CAN	CLM	BAL	VAL	PV	AND	CAT	MAD	LRJ	EXT	CYL	MUR	NAV	GAL	
CHAP 1		44	26	97	657		247	103			123	11		65	122	25	100	
CHAP 2	8		5	29	251		102				53	8	81	35	31		17	
CHAP 3																		
CHAP 4	32	87	57	13	440		114	46			31	20	76	24	167		99	
CHAP 5																		
Non financial EXP.	**40**	**130**	**88**	**139**	**1,348**	**-**	**463**	**148**	**-**	**729**	**207**	**39**	**157**	**124**	**320**	**25**	**216**	
CHAP 6	224	133	10		206		50	25			24		138		48		40	
CHAP7	85	52	36		243		50	97			7			1	29		30	
Cap exp	**309**	**185**	**46**	**-**	**449**	**-**	**100**	**122**	**-**	**-**	**31**	**-**	**138**	**1**	**77**		**70**	
TOTAL	**349**	**315**	**134**	**139**	**1,797**	**-**	**563**	**271**	**-**	**729**	**238**	**39**	**295**	**125**	**397**	**25**	**286**	**5,701**

EFPs 2012-2014: QUANTIFICATION OF MEASURES FOR INCREASING REVENUES IN 2012

	AST	ARA	CTB	CAN	CLM	BAL	VAL	PV	AND	CAT	MAD	LRJ	EXT	CYL	MUR	NAV	GAL	
CHAP 1		30								314			9		37	95	45	
CHAP 2			20	140	17		160			303		1		159	33		15	
CHAP 3			3		5		30			104		1	1	19	6		8	
CHAP 4					1				32			69						
CHAP 5					89										91			
Non financial Rev.		**30**	**23**	**140**	**112**	**-**	**190**	**-**	**32**	**720**	**-**	**71**	**10**	**178**	**167**	**95**	**68**	
CHAP 6					21				350	888	8				60			
CHAP7					44				845									
CAP Rev.			**-**	**-**	**65**	**-**	**-**	**-**	**1,195**	**888**	**8**	**-**	**-**	**-**	**60**			
TOTAL		**30**	**23**	**140**	**177**	**-**	**190**	**-**	**1,227**	**1,609**	**8**	**71**	**10**	**178**	**227**	**95**	**68**	**4,052**

b1) Expenditure measures

Expenditure measures include cutting **personnel costs**, which, de facto, represent a very large percentage of the regional budgets – over 50% including operational expenses. The most common measures included are freezing or reducing the salaries of public sector workers and senior officials; the introduction of measures to make working hours more flexible, (accompanied by a proportional reduction in salary); the amortisation of job vacancies and not hiring any new staff by establishing a replacement rate of between zero and ten per cent, plus posts covered by temporary or supply staff, or by reducing the number of public agencies and companies in the regional public sector; the reduction in the number of senior officials and temporary staff by reducing the number of Regional Ministries and Directorates; the cut in extra holiday days or extra days for seniority; the increase in working hours to the maximum permitted; public employment control measures; reducing the number of union representatives benefitting from extended leaves of absence; control of absenteeism at work; the reduction of social benefits and contributions to pension plans for public employees; a prohibition on compensation clauses and a reduction in complementary benefits for temporary incapacity.

Specific control measures in the area of health personnel: reduction of the portfolio of services provided, paralysation of professional career promotions, reduction of substitutions, increase in the working day of supply staff, elimination of additional rest periods, reorganisation of the staff on continual care duty in primary care, elimination of bonuses for working permanently in the afternoon in primary care and for special tasks, reduction of medical duty shifts, modification of the conditions of the health agreements, partial closure of hospitals, reduction of child dental plans, more stringent application in prescripting dietary products.

Specific control measures in the field of education staff: eliminating supplements, extending the working day and continuous care, reducing substitutions, increasing working hours for temporary staff, increasing class sizes, eliminating extracurricular activities, optimizing school savings, splitting up units in teaching institutions, reducing the workforce, eliminating seniority bonuses and suppressing retreat programmes and groups.

Regarding operating expenses, this includes savings from the implementation of centralised procurement systems, renegotiating prices or reducing the number of contracts and agreements, travel expenses; reducing consumables through the use of new technologies or by extension of eGovernment; rationalization of energy consumption, telephone use and building use, seeking energy efficiency, reduced opening hours for public buildings, and reduction in costs of office supplies; adjustments in the price of hospital pharmacy supplies, centralizing equipment maintenance services, especially high-tech equipment; adjustments to the transport fleet, limiting the maintenance of buildings and equipment; integrated public information systems; administrative simplification, reduced costs for printing and publications; reductions in consulting work for outside companies and reduced protocol and representation expenses.

Furthermore, there will be savings on drugs consumption due to the prescription of the active ingredient, reducing the number and volume of public subsidies, such as on housing, transportation or textbooks, the reduction of subsidies to the respective public sector and universities, or modification of public television management system.

Also included are **reductions in investment spending,** and the drop in real investment and capital transfers due to reprogramming in investment and the reduction of the provision for technical assistance.

b2) Revenue measures

On the revenue side, of particular relevance is the increased tax rates on personal income tax by reducing or eliminating various deductions on that tax, bringing back the wealth tax, increasing the tax rate on wealth and property transfer and legal proceedings, or elimination of the reduced rate; implementation of the regional share of the tax on retail sales on certain hydrocarbons, the increase in sanitation levies, the rise in special tax rates for certain means of transportation, or the increase in some cases of the inheritance and donations tax in certain cases.

In addition, capitalising on their tax collection powers, the Spanish Autonomous Communities have created new taxes and modified some which had been applied in the past: taxes on bank deposits, plastic bags, radioactive waste, facilities that affect the environment, tourist accommodation and on transport and energy production.

The Autonomous Communities have also increased fees and charges to the public in general by 1% although some communities have been higher, as is the case in Catalonia, 14%, 2.5% Murcia, Andalusia 1.8% or Aragon 3%. The increase in Catalonia is due to the creation of the fee for issuance of prescription pharmaceuticals. The fees and charges are intended for public services in the field of social policy, the treatment of municipal solid waste, water supply, environmental and nature conservation, the regulation and inspection of commercial and industrial activities and on agricultural projects co-financed with the European Union, etc. There is also an increase in the amount of fines and penalties.

Additionally and exceptionally, some communities are planning the sale of real estate assets, whether buildings, land or housing, and the sale of shares in private companies. The franchise agreements on ports belonging to autonomous communities are also considered.

In short, the Government has taken steps to ensure that there are effective mechanisms for monitoring and control of the autonomous communities and to remove rigidities that hinder regional deficit reduction. Communities, meanwhile, have been taking measures on both income and expenditure to ensure compliance with their deficit target.

3.7.2. Local corporations

Out of the more than 8,000 local corporations in Spain, around 2,700 have submitted adjustment plans for a span of 10 years in order to join the Supplier Payment Plan promoted by the Central Government.

The 2,700 savings plans, taken together, produce **an overall saving** for the period 2012-2020 of **39.245 bn Euros**, thanks to increased revenues of €22.915 bn and a decrease in expenditure of €16.331 bn. **For 2012 the projected savings are €3.059 bn and €3.361 bn in 2013.** Savings in 2012 come from an increase of 1.584 bn in revenue through augmented taxes and decreased spending to the sum of 1.474 bn. The path mapped out for savings over the period 2012-2022 in the 2,700 different adjustment plans is detailed in the following table:

The increase in revenues from local corporations comes from increased tax rates and levies, and from removing tax breaks on local taxes, amounting to €12.314bn, and from fees and public charges for funding public services to the sum of €4.449bn.

Considering only the 15 largest municipalities in population, which, according to budget results for 2010, had global revenues of €10.748bn and €11.032bn of expenditure, the 2012-2022 adjustment plans will adopt measures to produce savings of €7.452bn, thanks to increased revenues of €3.809bn and a decrease in expenditure of €3.643bn. In annual terms, income will rise by 3.2% and spending will fall by 3.0%, taking into account the data mentioned above on budget results. During 2012, these municipalities are expected to increase income by €254mn (2.4%), by increasing taxes, and decreasing costs by €376mn (3.4%), by reducing personnel costs, non-realization of investments and a reduction in smaller contracts. **There is a commitment to generate savings of €630mn.**

In the adjustment plans submitted by local authorities from the 15 largest populations, the increase in income is due to increases in tax levies and rates, and the removal of tax breaks from local taxes, totalling **an increased income of €1.937bn** for the period.

In addition, there will be an increase in rates and public charges in these local corporations for financing public services to the sum of €1.118bn. The other measures focus primarily on strengthening efficient collection and bolstering the local tax inspectorate in order to discover new taxable areas.

On the expenditure side, the table below provides detailed information on the origin of total savings for the period 2012-2022, for both the 2,700 adjustment plans setting and the particular case of the 15 largest municipalities by population size:

Regarding expenditure, local authorities will also obtain savings from cutbacks in their vehicle fleet, reduced spending on IT and telecommunications services, a reduction in rental costs and energy and water supplies, the review of recruitment procedures and reducing expenditure on subsidies.

In addition to measures included in the plans above, the plan **to remove assumed competences at the local level** will result in savings of €3.5bn by reducing competences and grouping municipalities.

Finally, increased revenues and reduced costs set by the Central Government, through the augmented share in central government tax revenues or the increase in the Real Estate Property Tax (IBI), together with the extension of the repayment period on negative settlements corresponding to the financing system and the freeze of non-financial expenditure of Local Corporations will have an additional impact on savings for the years 2012 and 2013, as seen in the following table:

4. COMPARISON WITH THE PREVIOUS UPDATE. SENSITIVITY TESTS

4.1. Comparison with the previous Update

4.1.1. Comparison of the fiscal path

The correction of the excessive deficit in the 2011 Stability Programme was based on a path of Public Administration net borrowing that reached 3% of GDP in 2013. Its intermediate milestones were the achievement of 6% of GDP in 2011 and 4.4% in 2012. In terms of structural deficit, this implied an adjustment between 2011 and 2013 (both years inclusive) of 5.4 percentage points and, measured by the primary structural deficit reduction, the consolidation was estimated in the same period as in 5.6 pp.

The current 2012 Stability Programme starts from a budget deviation of 2.5 points of GDP in 2011, which considerably extends the structural effort to achieve the goal of 3% of net borrowing in 2013. Thus, the contraction of the structural deficit between 2011 and 2013 reaches 5.8 pp. More specifically, the structural effort to develop only in 2012 will increase to about 3.8 percentage points, which, together with the 0.7 percentage points that were made in 2011, is already a stronger effort than the one committed for the same two years in the 2011 Stability Programme (4.5 pp versus 4.3 pp). The average structural effort between 2012 and 2013 would, in the present case, be well above the 1.5 pp minimum required by the Stability Pact (about 2 percentage points), whereas the one developed over the years 2012-2015 would amount to approximately 2.4 percentage points, also clearly above the 0.8 percentage required by the Transitional Provision of the LOEP.

Regarding the path of the public debt, this update reflects a greater accumulation in all years. The most significant difference is specified in the first two and, in particular, in 2012, when the stock increment will be 11.3 pp. This increase is explained by several factors: higher than expected net borrowing, lower nominal GDP growth, downward rigidity of the interest rate applied to the debt and a large stock-flow adjustment. The inflection point is expected to take place in 2014, as was also expected in last year's update.

Let us take these reflections as a preamble to put forward the intense effort to develop over the next few years, compared to what was foreseen in the 2011 Stability Programme, and its impact on growth.

4.1.2. Comparison of the macroeconomic scenario

While the previous Update presented an average growth rate in the years 2012-2014 of 2.4%, in the current Stability Programme average growth projections for the same years have been reviewed downwards to 0%. The difference is patent and is not only a result of higher tax effort.

The difference between the expected (1.3%) and the observed (0.7%) GDP growth in 2011 has not been too remarkable and has been mainly due to the cyclical inflexion that took place in the last semester of the year. However, the diagnosis of the major economic events of 2011 leads to conclusions that go beyond these quantitative differences. The process to correct the major imbalances accumulated by the Spanish economy is longer than was felt in the early stages of the crisis, largely by insufficient recognition of the magnitude of the economic imbalances that had to be faced. All this, despite the low injection of net credit flows to the private sector, the on-going substantial adjustment in real and nominal housing prices -higher than in other episodes of excess supply in the real estate market- and the remarkably better performance of the exporting sector compared to that of previous crises.

Underlying reasons for this slowness have been the rapid deterioration in public finances and the questions raised regarding its sustainability; the persistent institutional weakness of the labour market, reflected in the strong job destruction even in periods of relative recovery as in 2011; the unfinished financial sector restructuring, with its consequent inefficiencies in the allocation of resources, and finally the insufficient domestic and international credibility of the reform process undertaken in Spain, with the resulting crisis of confidence at all levels.

On the other hand, the interplay of adverse factors in the current international environment has been added to the previous facts. This has been particularly so in regard to the Euro zone and future developments, even with good prospects of recovery in the baseline scenario, are still uncertain.

Therefore, the inertial behaviour of agents, generated by the confluence of all these factors, must be internalized, along with the typical delays in the effects of gains in credibility and economic dynamism that an ambitious structural reform sequence such as the one launched by the Government involve. The result is a macroeconomic scenario that presents a continuing recessive trend during 2012, exacerbated by the need to implement a bigger fiscal adjustment, that gradually returns to the positive zone of growth.

As for the composition of growth, the difference is particularly evident in the contribution of domestic demand, which in the 2011 Stability Programme was consistently positive in 2012-14, while now it is strongly negative until 2013 inclusive. However, at the same time, this Update foresees a greater positive contribution to growth by the external sector than in the previous update, based on the positive development of external demand in 2011, largely due to higher gains in competitiveness provided by the structural reforms. Thus, while the previous Programme established an average growth in nominal unit labour costs between 2012 and 2014 close to one percentage point., this Update assumes a fall above one percentage point This phenomenon is also reflected in a more intense correction of the trade and current account balances, even in the presence of a more negative income balance.

The net financing capacity of the private sector is also higher in this Stability Programme, as a consequence of the sector's deleveraging pace since 2010. Thus, if in the 2011 Stability Programme, the years 2013 and 2014 marked the virtual end of this process, this stage is now delayed at least 2 or 3 years, thereby generating higher net financing capacity throughout the forecast period. Although this difference implies flatter paths in consumer spending and investment, at the same time it entails a deeper correction in the external net borrowing of the economy, which in 2014 reaches a financing capacity of 1.4% of GDP, compared to a net borrowing position of 2% of GDP in the 2011 Stability Programme.

Finally, the differences between both Stability Programmes are particularly remarkable with regards to the unemployment rate. The previous update expected this rate to decline in 2011, while reality has been very different, bringing last year's average rate to 21.6%, 1.5 pp above 2010. In addition, considering the employment trend observed during the first quarter of 2012, the increase in the average unemployment rate this year to 24.3% seems unavoidable, starting from a seasonally adjusted 23% in the fourth quarter of 2011. Reversing the upward trend in unemployment will not be achieved until 2013, two years later than forecasted in the 2011 Stability Programme. Even with the effects of the labour reform already palpable from 2013, at the end of 2015 the rate will still be around 22%. The reduction from the 2012 peak will be largely due to the reform itself, unlike in the 2011 Stability Programme, where the reduction in the last two years was mainly due to an expected growth rate above 2%.

4.2. Risk scenarios and sensitivity analysis

Uncertainty about the international environment is currently causing a strong dispersion of forecasts by international organisations and research departments. Perhaps the main sources of this uncertainty come from the behaviour of financial markets, which could react to unforeseen events through varying risk premiums -even temporary- and from oil prices, which could be affected by geo-strategic considerations.

However, considering the former for the purpose of conducting sensitivity analysis should not be interpreted as a downplaying of the risks in the macroeconomic scenario. Interest rates in international markets have been affected by considerable volatility over the last year and favourable news about the performance of the most significant systemic economies could produce the opposite effect.

On the other hand, oil prices are currently at a level higher than expected by the International Energy Agency and OPEC at the beginning of the year. Therefore, a downward slide should not be ruled out at all, especially considering the commitment by countries like Saudi Arabia to offset possible oil supply shortages arising from the situation in Iran.

From a domestic perspective, a more favourable reaction of the demand to the current reforms is a likely scenario, especially considering that the baseline scenario does not include the quantification of all of them, and that for some of them the scenario considers the lower bound, especially with regard to the financial reform.

Here the analysis focuses on the consequences of transitory changes in interest rates of 1 percentage point with respect to the baseline scenario and a progressive increase in oil prices until 2015.

4.2.1. Change in interest rates

Firstly, the sensitivity analysis looks into the impact on the main macroeconomic aggregates of an interest rate perturbation resulting in + / - 1 percentage point changes in the interest rate. In particular, the shock is introduced in a way that the 1 pp difference remains for four years (2012-2015), and then gradually returns to its reference value in the next two years (2016 and 2017). Agents know in advance, within a framework of rational expectations, the evolution of this path. Therefore, due to the forward-looking nature of the model used for the simulation, most of the expected effects accumulate in the first quarters.

These effects are simulated in the REMS2 model, a general equilibrium model of the Spanish economy that tries to reflect the current situation of the Spanish economy characterised by financial constraints, considering three different types of consumers: debtors, creditors and those affected by liquidity constraints, who cannot consume beyond their current income.

The increase in interest rates causes a sharp drop in investment and employment, which also induces a reduction in household consumption, which exerts a downward pressure on prices. The effect on GDP growth rate, smoothed over a four year forecast, stood at about 0.25 points annually and an average annual inflation of 0.15 points. In regard to debt, its impact would be progressive, accumulating the debt / GDP ratio a deterioration of 3 points in the Programme's period. The current account balance would improve by 0.3 points of GDP. In the event of a drop in interest rates of equal magnitude, the effects are quasi-symmetric.

4.2.2. Changes in economic growth

Another analysis focuses on the sensitivity to changes in the growth path, particularly in a scenario in which growth is half a point lower each year, cumulative. To perform this exercise with the same general equilibrium model, it is necessary to characterise the exogenous shock that results in this scenario of lower growth and in for that purpose a strong and sustained impact of oil prices has been simulated. To generate a negative impact on GDP of the abovementioned magnitude, a progressive increase in oil prices has been simulated, which will reach in 2015 a value twice the current.

The increase in oil prices raises the marginal cost of production, while at the same time reduces the demand for energy inputs through a substitution effect, owing to its relatively higher cost. This leads to an increase in the energy input productivity and a reduction in other factors' productivity, now relatively more abundant. Since the price shock is permanent and there is some complementarity between inputs, the marginal cost increase causes a decrease in their demand: in the capital stock given the reduction in investment, Tobin's q descends and hence its relative profitability; and in employment, due to its falling productivity. In short, factors of production are shifted from the Spanish economy to the rest of the world, thereby reducing the economy's productive capacity.

The initial rise in inflation resulting from rising energy prices would be mitigated gradually amid falling demand. Falling tax revenues would be somewhat lower than the GDP, but nevertheless the deterioration of the debt to GDP ratio in the Programme's period would be significant, amounting to almost 4 points. The current account balance would suffer an initial deterioration resulting from the increase of the energy bill, which would be a tenth in the first year. However, these effects would be more than compensated by the fall in imports due to the drop in demand, so in the next three years there would be average improvements of a tenth in the balance.

5. SUSTAINABILITY OF PUBLIC FINANCES

5.1. Long-term budgetary projections

Responding to the mandate of the ECOFIN Council every three years, the Economic Policy Committee Aging Working Group and the European Commission make public expenditure projections associated with aging population. The starting point of these exercises is the Eurostat's updated population projections and a macroeconomic scenario developed with a common methodology.

A key feature of this methodology is the hypothesis that there are no changes in economic policy, beyond those which already have legal validity when the projection exercise is done. In these projections, five categories of public spending are analysed: pensions, health care, long-term care, education and unemployment. The last projections were published in 2009 and the next ones are scheduled for May this year.

Table 5.1.1. sets out the national projections, based on the European year ending in the month of May, taking as reference the new Eurostat population projections, published in May 2011.

These projections have two significant changes from those recorded in the previous Programme. On the one hand, the macroeconomic scenario has variations due to the depth of the economic crisis. The new macroeconomic forecasts assume that the rate of labour productivity converges to 1.5% compared to a growth assumption of 1.7% in the previous exercise, more than offsetting the weak employment growth over the period. The 2010-2060 average annual potential growth is now 1.6% versus 1.8% projected in 2009.

On the other hand, we incorporate the effect of pension reform. The baseline projection does not take into account the savings that would produce the sustainability factor whose effects, however, are considered separately as a sensitivity scenario. The main elements of the pension reform are discussed in the next section.

As seen in Table 5.1.1, between 2010 and 2060, the total increase of the five expenditure items is 4 percentage points of GDP. This is a significant reduction from the projected increase in the previous update, which was 8.2 percentage points of GDP. Thus, despite lower estimated growth in the projection period, the expenditure / GDP ratio at the end of the period is lower than the one projected in the previous exercise of 2009.

Table 5.1.1. 2010-2060 PROJECTONS OF AGEING-RELATED EXPENDITURE (% OF GDP)									
	Incr. 2010-2060	**2007**	**2009 or latest available data[(b)]**	**2010**	**2020**	**2030**	**2040**	**2050**	**2060**
TOTAL EXPENDITURE *(1-2+3+4+5):*	**4.0**	**19.3**	**22.3**	**23.6**	**24.5**	**23.6**	**25.3**	**27.0**	**27.6**
1. Pension expenditure	3.6	8.5	9.5	10.1	10.6	10.6	12.3	14.0	13.7
Retirement and early retirement pensions[a]	4.1	5.6	6.4	6.8	7.5	7.8	9.5	11.1	10.9
Disability pensions	-0.1	1.0	1.1	1.2	1.1	1.1	1.2	1.0	1.1
Other pensions (survivor's pension & family)	-0.3	1.8	2.0	2.1	1.9	1.7	1.7	1.8	1.8
2. Healthcare expenditure	1.3	5.5	6.4	6.5	6.5	7.0	7.4	7.7	7.8
3 Long-term care expenditure	0.7	0.5	0.8	0.8	0.9	0.9	1.0	1.3	1.5
4. Expenditure on education	-0.5	3.5	3.9	4.2	4.0	3.4	3.4	3.6	3.7
5. Expenditure on unemployment	-1.1	1.3	1.6	2.0	2.5	1.7	1.2	1.0	0.9
Pro memoria: Impact of pension reform									
Pre-reform pension expenditure	6.6	8.5	9.5	10.1	10.9	11.8	14.5	16.8	16.7
Pension expenditure with sustainability factor	2.9	8.5	9.5	10.1	10.6	10.6	12.1	13.4	13.0
Pro memoria: Assumptions for the exercise									
Potential GDP real growth	*1.6**			*-0.1*	*2.4*	*2.2*	*1.1*	*1.2*	*1.6*
Labour productivity growth	*1.4**			*1.6*	*0.7*	*1.6*	*1.6*	*1.6*	*1.5*
Participation rate for men (20-64)	*-0.9*			*85.5*	*85.2*	*84.7*	*84.2*	*84.8*	*84.6*
Participation rate for women (20-64)	*11.8*			*69.7*	*77.4*	*80.3*	*81.2*	*81.5*	*81.5*
Total participation rate (20-64)	*5.3*			*77.7*	*81.4*	*82.6*	*82.7*	*83.2*	*83.0*
Unemployment rate (20-64)	*-12.5*			*19.5*	*16.5*	*8.5*	*7.4*	*7.1*	*7.0*
Population over 65/working-age population	*34.6*			*26.8*	*31.5*	*39.1*	*50.8*	*62.0*	*61.5*

*Source: Ministry of Economy and Competitiveness, OECD, UOE, ESSPROSS. * Average for 2010-2060 period.*

[a] Includes minimum pensions and non-contributory pensions
[b] For expenditure on education, average for 2007-08; for expenditure on unemployment, average for 2007-09

For items of expenditure, this increase responds mainly to the dynamics of pension expenditure, which increased 3.6 points of GDP in the period. The second item of expenditure that increases the most is the health expenditure, whose projected rise is 1.3 points of GDP, significantly lower than the 1.6 points projected in 2009, thanks to cost control measures recently approved. Progress is more moderate in long-term care, 0.7 points. In contrast, education and unemployment expenditure will experience a reduction over the period, of 0.5 and 1.1 points of GDP respectively.

Delving more in pension expenditure, as shown in Table 5.1.1, the increase between 2010 and 2060 is reduced by half compared to that obtained with the same demographic and macroeconomic scenarios but without reform. Pension expenditure increases 3.6 points of GDP, compared to 6.6 points in a scenario without reform, so the estimated reform savings, excluding the sustainability factor, rises to 3 points of GDP.

This saving is mainly due to the lengthening of working life. The increase of the legal retirement age results in an increase in the average exit age from the labour market compared to the 2009 projections, between 1.5 and 2 years, being over 65 years in 2027. This delay allows to compensate, in part, the aging of the population behind the demographic scenario in which the dependency ratio is doubled in the period to stand at 56% in 2060. This greater reliance on its own, and keeping all other assumptions constant, would generate an increase labour market compared to the 2009 projections, between 1.5 and 2 years, being over 65 years in 2027. This delay allows to compensate, in part, the aging of the population behind the demographic scenario in which the dependency ratio is doubled in the period to stand at 56% in 2060. This greater reliance on its own, and keeping all other assumptions constant, would generate an increase in GDP spending of 9.5 points. Extending the retirement age has a double positive effect. It reduces the ratio of pensioners to the population over 65 years and it increases the employment rate of older workers.

As mentioned, the baseline scenario projections do not explicitly incorporate the impact of the sustainability factor, which, however, is an additional element contributing to the system sustainability in the long term. Under conservative assumptions, the sustainability factor would be an additional saving of about 0.7 points of GDP in 2060, so the total savings would amount to 3.7 points of GDP compared to the 3 mentioned above.

This estimate assumes that only two parameters would be updated in the system, based on life expectancy: retirement age and number of years required to qualify for a full pension. It is assumed that every 10 years life expectancy increases somewhat less than a year from 2027. As a result, the exit age from the labour market increases 1.3 years from 2032 to 2060.

Moreover, the role of the sustainability factor has been confirmed by the Organic Law of Budgetary Stability and Financial Sustainability which provides that, in case of projecting a long-term deficit in the pension system, the system will be reviewed by automatically applying the sustainability factor in the terms and conditions established by the Law 27/2011 of August 1.

5.2. Strategy

The pension system reform

The public pension system reform approved last August 1[3], following the adoption of the Report on the Assessment and Reform of the Pact of Toledo[4] , along with other measures taken recently, is another step in strengthening the sustainability of the Welfare State. The reform will be introduced gradually from 2013, with transition periods until 2027, to allow citizens to adapt gradually to the new regulation. Thus, its effects are achieved when the increase in ageing-related spending shows greater intensity.

The reform aims to ensure the system sustainability and intergenerational equity, acting on the side of expenditure and income, trying to keep more senior workers in employment, improving contributions throughout the working life and the proportionality between contribution and benefit. All this will result in an increase in labour supply and in system revenues. At the same time, reinforces a

[3] Law 27/2011 of 1 August on updating, improvement and modernisation of the Social Security system.

[4] Report on the Assessment and Reform of the Toledo Pact, adopted by the Parliament on January 25 2011.

cohesive system that takes into account special situations, long careers and working women.

Among the measures, the rise in two years of the statutory retirement age to 67 is highlighted. The increase is achieved gradually between 2013 and 2027. It also recognizes the long contribution careers, so that retirement at 65 is possible with 100% of the pension, when a contribution period of 38 years and a half is proved. The age for early retirement increases immediately in two years, to 63, and subject to prove a minimum contribution of 33 years and that the resulting pension exceeds the minimum pension. There is an increase in the incentives for voluntary extension of working life beyond retirement age and in the calculation of the regulatory base to include the contribution of the last 25 years prior to retirement, compared with the 15 years before the reform.

The key objective of the reform is to safeguard the system from future increases in life expectancy and achieve an intergenerational distribution of the cost. For this, a new element in the pension legislation in Spain is the introduction of a sustainability factor linked to life expectancy. From 2027, with revisions every 5 years, the system parameters will be updated with the increase of life expectancy at 67 years between the year of the review and 2027.

Finally, we must remember that in the context of comprehensive reform of pensions, since January 2011, all newly recruited civil servants of the Spanish Public Administration are integrated in the General Social Security System, so that the passive class system governing the pensions of an important part of public sector employees will be progressively phased out.

Consolidation of Public Finance and Social Security Reserve Fund

The long-term sustainability of public finance is reinforced both by the adjustment of pension expenditure, and by the fiscal consolidation strategy. Consequently, the two basic elements of the sustainability indicator will be reduced, limiting the risks from the public finance.

In the evaluation of the 2011 Programme, the S2 sustainability indicator reached a value of 12% of GDP, due to the deterioration of the primary structural balance estimated for Spain in 2010 and the rise of the aging-related expenditure projected at that time. This result meant that for the Public Administrations cumulative revenues to equal cumulative expenditure in the long-term, it would be required to undertake, on a permanent basis, an increase in the tax burden, a reduction in other public expenditures, or a combination of both in the required magnitude. However, by reducing the public spending increase in the long-term, the pension reform will reduce the S2 sustainability indicator by more than 2 points, according to preliminary calculations.

We should also take into account the reserve assets that are already in the pension system, obtained with the cumulative surpluses of the Social Security. Since its inception in 2000, successive allocations to the Social Security Reserve Fund, along with financial returns obtained from these endowments, have helped to achieve, in December 2011, a fund of EUR 66.815 million (6.22% of

GDP) to meet future requirements related to contributory benefits. The investment policy, maintained in 2011, is based on the principles of safety, profitability, risk diversification and adaptation to the temporal horizon of the Fund.

Control of health care and pharmaceutical costs

The fiscal consolidation measures adopted in 2010 and 2011 have had and will go on having a lasting impact on public health spending, primarily due to lower personnel costs and reforms introduced in pharmaceutical expenditure. Both accounted for 62.4% of public health spending in the 2009 fiscal year.

The reduction in personnel costs was due to the average 5% cut in wages of public employees in the second half of 2010, and its freezing in 2011. Furthermore, the published data from the EPA for the fourth quarter of 2011 shows a fall in employment of health personnel. For 2012, we add the effect of the wage freeze for civil servants and the limitation on replacements in the health workforce to situations of strict necessity. Finally, the Royal Decree-Law 20/2011 increased the public servants working hours to 37.5 hours per week, effective from 1 January 2012.

Meanwhile, pharmaceutical expenditure made through the national health system official prescription has experienced a major slowdown in recent years; from 6.9% growth in 2008 to a reduction of 8.8% in 2011. Two factors explain this adjustment. On the one hand, the increased use of generic drugs. The incorporation of generic drugs in consumption has been growing every year. In 2010, the consumption of generic drugs in percentage of total drugs has tripled since 2003, from 9 to 27%. The billed amount has gone from 6% in 2003 to 11% in 2010.

On the other hand, there has been a reduction in prices and margins of drug distribution, following the reform of reference prices. In particular, Royal Decree 4/2010 established a 30% reduction in prices of generic drugs, and Royal Decree 8/2010 laid out the reduction in expenditure for the rest of the drugs by 7.5%. From March 1, 2011, the effect of reducing the reference prices which affects more than 7,000 products (SPI Order 3052/2010 of 26 November) must be added.

Finally, Royal Decree 9/2011 of 19 August, with measures to improve the quality and consistency of the national health system, with contribution to fiscal consolidation and with a rise in the maximum amount of State guarantees for 2011, provides new measures in the field of pharmaceutical services. Among others, the prescription of the active ingredient, that implies dispensing the cheapest drug or medical device.

The measures envisaged in this section should be added to those discussed in section 3.3. on rationalisation of expenditure on health and pharmaceutical prescriptions. Once approved and exactly quantified, they will be included in future evaluation exercises of age-related expenditure.

In line with the reduction in pharmaceutical expenditure, there is a downturn in the number of prescriptions dispensed, with a growth rate of 1.6% in 2011, compared to 4.9% in 2009. Similarly, the average cost per prescription falls by 10.23% in 2011 and expenditure per person is reduced by 9% (in its second consecutive decline, after falling for the first time in 2010 around 3%).

5.3. Contingent liabilities

This section details information on guarantees issued by the State, with the latest information available from December 31 2011, according to the following categories:

i) Guarantees of a regulated amount within Article 49 of Law 39/2010, of December 22, on the General State Budget for 2011. Within this, we should distinguish guarantees to non-classified entities, with a balance of 740.40 million euros. Guarantees to issuance by the Electricity Tariff Deficit Asset Securitisation Fund, granted by Royal Decree Law 6/2010 of April 9, on measures to boost economic recovery and employment, with an amount of 9,906 million euros Finally, the issuance of guarantees by the European Financial Stability Facility, Royal Decree Law 9/2010 of May 28, with an outstanding balance of 2,992.89 million euros.

ii) Guarantees of regulated amount within Article 50 of Act 39/2010, on Asset Securitization Funds for SMEs (FTPYME): outstanding balance amounts to 7,502.13 million euros.

iii) Guarantees following Royal Decree Law 7/2008, on Urgent Measures in Economic-Financial Matters, related to the Concerted Action Plan of Countries of the Eurozone. In Article 1, the above provision authorised the granting of state guarantees to new financing operations by lending institutions, as of the date of the enforcement of this Royal Decree-Law. The outstanding balance under this heading in euros reaches 62,736.05 million euros, and, in yen, it amounts to 523.33 million euros.

iv) Guarantees relating to the Fund for Orderly Bank Restructuring (FROB), established by Royal Decree Law 9/2009, on banking restructuring and increase of capital reserves of lending institutions, show an outstanding balance of 13,945 million euros.

As of 31 December 2011, Government total risk to principal loss was 98,345.80 million euros and 523.33 million euros in yen-denominated bond issues.

6. QUALITY OF PUBLIC FINANCES

Ensuring the quality of a country's public finances requires keeping the sustainability of its fiscal position. Mid- and long-run sustained growth demands sound and predictable public finances. This prevents unsustainable debt levels from developing. Such debt levels pose a serious threat to a country's solvency and are responsible for crowding-out effects on the private sector.

The urgent need to regain a sustainable balanced budgetary path has constrained the drawing up of the Spanish budget as well as the measures put forth in this Program. It contains a very ambitious consolidation process based on expenditure reductions and expenditure rationalization. The desired effects of these exceptionally-hard measures are to regain the confidence in the Spanish economy and to lay the foundations upon which a new period of balanced growth is to be developed. A framework of severe austerity always acts as a restraint upon our political action. Our measures and policies are guided by the principles of expenditure control, equitable distribution of the adjustment burden and resource allocation efficiency maximization.

Notwithstanding the burdensome consolidation process, aspects regarding the quality of finances have not been neglected. The consolidation is achieved by reducing the weight of public expenditure over GDP, a feature characteristic of the most successful and growth-promoting consolidation processes around the world.

These efforts are made:

i) In expenditure rationalization, always ruled by efficiency standards,
ii) by enlarging the tax base and removing tax system distortions, and
iii) in fiscal governance reform

6.1. Expenditure rationalization

In January 2012 the Government passed a Plan to the restructuration and to the rationalization of the public business and foundational sector. This plan is intended to preserve rationality and efficiency. The number of public entities will be reduced, reversing the lack of application of the Administrative Law and its inherent controls and limits. The non-application of Administrative Law in public business, created under private law, had been used as a way of getting round budgetary controls of expenditure, , governance contracting employment regulations, and, especially, the public employees remuneration system. The state-business managers pay system has undergone drastic reform, with a substantial reduction of payments and compensations.

This plan has been instituted at every level of government by seeking and reaching specific agreements intended to reduce the public-business sector at every level.

Regulatory bodies will be reformed and reduced in number in an attempt to clarify their competences and avoid overlapping situations as well as competition conflicts. The seven bodies now responsible for supervising a number of sectors will be integrated into just one, The National Commission of Markets and Competition, responsible for preserving competition in markets and network sectors.

As we have mentioned above in presenting our fiscal policy strategy, we will endeavour to introduce a growing number of measures intended to promote efficiency in the distribution of tasks and responsibilities among and within every level of government. We are determined to avoid overlapping by assigning every agent only those tasks it is best suited for, and by allocating resources to the most important tasks. In this same policy direction, human resources optimization has now become a priority in every level of government. The public employees work schedule will be revised, and changed accordingly, they will need to undertake tasks formerly-outsourced and the salary elements in the wage structure linked to performance will be given a greater weight

The draft law on Transparency, Public Information Access and Good Governance seeks further efficiency gains and, considerably strengthens citizens' rights and the duties of public managers. Every aspect of the administrative activity will be subjected to citizens´ scrutiny. Public managers legal responsibilities are considerably increased by giving legal status to certain general ethical requirements and to certain principles of action that all government officials must meet. . "A transparency web site" providing information about public funds will be created, a Good Governance Code, penalizing its violation by state officials will be drafted, and the General State Budget will set out the maximum payments that members of the Local Corporations can legally receive. Public officials will be legally responsible for misuse of public funds.

As to expenditure composition, public investment continues to be priority, due to its important effects on growth through a number of channels (productive capital, human capital, factor efficiency…). In the present restrictive budgetary conditions, the efficiency of every policy is evaluated, and changes are introduced accordingly.

- It is true that the biggest cuts will be in public investment along the fiscal adjustment path foreseen by the government. But this could not be otherwise, in a mix of actions aimed at substantially reducing expenditure in a very short period of time. Two reasons explain why cuts are so big in public investment, especially for 2012 and 2013: i) public investment expenditure reached quite high levels. during the years before the crisis Public capital stock in terms of GDP grew significantly, placing Spain above many European countries' average. Given the relatively low depreciation rate affecting this stock, political actions are intended to preserve existing capital, rather than to create new capital; ii) this may change in the future, for it is expected that after 2015 public investment expenditure may be selectively increased to some extent; public expenditures not the only relevant public investment policy. Supply-side, mainly regulatory, policies are being implemented to achieve infrastructure optimization and financial viability of certain exploitation models for these infrastructures. This policies may produce outstanding results and that view underlies our policy.

- The public infrastructures policy has been reprogrammed within this transitory outlook on cut backs in public investment. Public works with an advanced stage of execution and high traffic volume corridors have been prioritized:, and the use of rail transport: (high speed rail lines, conventional rail lines and commuter rail lines), has been fostered. Based on a rigorous evaluation of societal needs, the Strategic Plan of Infrastructure, Transport and Housing (PITH) will establish the priorities and programmes through 2024. The most relevant new infrastructure considerations focus primarily on High Capacity Transportation Networks, Conventional Highway Networks and urban environments in which the primary focus is the establishment of efficient connections with ports and airports, key considerations in the facilitation of both industry and tourism.

When considering the actions that are to be carried out on the supply side, one must highlight the completion (around the end of June) of the new regulations regarding airport management. The objective of the new model is to improve the quality and accessibility of airports, as well as the use of air traffic capacity. It includes improved punctuality, the optimization of commercial activities, the streamlining of investments and the economic and financial restructuring of functioning airports. It will also be based on the internationalization of AENA services and the sale of its sectorial know-how.
Within this approach, efforts will be also made to modify the prevailing legislation in order to ensure financial viability in the tolled motorways system, regulating the cases where it is necessary to financially rebalance concessions, the expropriation of land or the recovery of concessions. This action will form part of the aforementioned Strategic Plan for Infrastructures, Transport and Housing.

- The State continues to provide considerable resources to education. Initial professional training programs are promoted and developed so that all students achieve the professional skills equivalent to a Level One qualification within the current National Qualifications and Vocational Training Catalogue. The aim is to ensure satisfactory social and labour-market integration and increase basic skills that enable to continue studying in different areas. Within the budget, priority is given to the compensatory education program which works to reduce inequalities.

- In the healthcare sector, whilst taking into account the implementation of streamlining strategies with a budgetary impact (such as those affecting the demand for health services, pharmaceutical spending or the Dependence System), new actions are also being undertaken to improve quality using the resources which are already available. Within this context the Draft Bill on Basic Services whose main objectives include the creation of a viable financing system and to guarantee territorial cohesion within the National Healthcare System. In turn, the National Strategic Plan for Childhood and Adolescence 2012-2015, to be developed in collaboration with the Ministry of Education, will pursue the triple objective of achieving quality education, a vocational training which facilitates the integration into the labour-market and the offer of

- With regards the policy on Research, Development and Innovation (R&D&I), in 2012 the integration of innovation and internationalization will be promoted. This will be easier to achieve with the incorporation of the State Secretariats for Commerce and Research, Development and Innovation within the Ministry of Economy and Competitiveness, encouraging the presence of researchers and companies in international programs. Within the current budgetary framework, the system's resources are channelled towards two areas: firstly, to maintain (as far as possible) the levels of scientific excellence achieved in recent years. Secondly, to ensure that the resources and capacity currently available to Spanish science contribute more efficiently to the economic recovery and social development of our country, by means of the innovation and technology-transfer policies which have lacking in Spain in the past.

  To this end, the new Law on Science, Technology and Innovation is of particular interest and will serve to streamline and reorganize the resources available to promote R&D&I, eliminating overlapping. Transparent, objective and excellence-based criteria will be used for granting subsidies, reducing nominative grants and promoting competitive awards. Likewise, and given that the consolidation of a globally-minded, professional and competitive scientific and technical community is a priority, the conditions of pre-doctoral contracts will be improved this year and a 'distinguished researcher's contract' will be introduced for scientists of renowned prestige.

  Similarly, regarding this matter and within the scope of future actions, it is expected that the Statutes of the Spanish Innovation Agency will be approved by June. The latter are intended to improve the organizational model for the evaluation and funding of scientific projects, to provide the agency with greater independence, diligence and flexibility and to guarantee a tighter control over the use of public funds. At a later date, in September, the Spanish Science and Technology Strategy and the Spanish Innovation Strategy are expected to be approved. These two instruments will provide greater stability and coherence to the R&D&I plans of the different administrative bodies.

6.2. Tax base enlargement and tax system's distortions reduction

As mentioned earlier, the magnitude and urgency of the fiscal adjustment in Spain has made it necessary to adopt revenue measures . These have been aimed at increasing tax bases (by eliminating distortions), perfecting tax structures, introducing progressive complementary mechanisms and fighting tax fraud.

Direct personal income taxation was increased at the start of 2012, although this was done by means of a temporary, progressive and complementary adjustment. Since the increase is temporary, it is expected to have limited impact on growth as households feel that it only affects income temporarily. Furthermore, progressiveness has been strengthened, so the impact will be greater among taxpayers with higher incomes who have a lower propensity to consume. Similarly, Tax on property has been increased for the years 2012 and 2013. This increase has been introduced in a progressive way, taking into account when property values were last reviewed.

In order to correct distortions in Corporate Tax, the Royal Decree-Law 12/2012, enacted 30th March, introduced modifications to increase the tax base of large companies by means of a simplified and transparent structure, without increasing the tax rate, as recommended by consensus in the economic theory on the quality of public finances. To be precise, limitations on tax base adjustments and on the application of deduction are placed, as well as changes in the system for calculating instalment payments.

By means of the above, an annual limit is set on goodwill deductions, there is a reduction in the limit for deductions applicable during the tax year, a minimum payable amount for instalments is established for entities with a net turnover of more than 20 million Euros, the deductibility of financial expenses is eliminated, for the year 2012 a special duty is established on income from foreign sources and free amortization unrelated to job creation is eliminated and limits are placed on the deductibility of the outstanding amounts.

Additionally, indirect taxation has been increased, although just on products with more inelastic demand, as recommended by the theory of optimal taxation. In compliance with the EU regulations, in force since the first of January, taxation on professional diesel has been increased, reducing the amount for partial refunds. The structure of the Tax on Tobacco has been modified, increasing the specific rate, linked to the number of units, whilst also reducing the proportional rate (which depends on the sale price) by two points.

These decisions, taken in very specific circumstances, do not represent a value judgment regarding the most appropriate tax structure in the medium term. In fact, from 2013 onwards, the Government will propose changes in the composition of the tax structure, giving priority to certain indirect taxes to benefit labour taxation. In this way, the tax-raising potential of certain indirect taxes is combined with a reduction in the cost of labour, thereby neutralizing (at least partially) the contractive effects of the former on job creation.

6.3. Fiscal governance reform

To this regard, the Organic Law on Budget Stability and Financial Sustainability, as detailed in the previous chapter, will consolidate trust on the stability of the Spanish economy. As mentioned earlier, this improvement in fiscal governance must have a positive effect on the potential for growth of the Spanish economy as a result of its positive impact on the credibility of public finances.

On the other hand, in the last few years, there was a progressive worsening of problems regarding the failure of Territorial Administrations to pay their suppliers of goods and services, especially affecting small and medium enterprises. This situation affects both, local and regional administrations, and required a comprehensive solution thorough instruments that return credibility to the administrations, stimulating economic activity and furthering job creation. Royal Decree-Law 4/2012 of 24 February, which imposed information obligations and defined the processes to establish a financing mechanism to pay the suppliers of Local Institutions, is a starting point action. So is Royal Decree-Law 7/2012 of 9 March, which creates and regulates a Fund to Finance the Payment to Suppliers. These payments are conditioned to the strict compliance of Territorial Administrations with the consolidation plans.

This operation, for the regularization of supplier payments, most of them SMEs and self-employed workers, is the greatest re-financing operation carried out in Spain, , , and will allow Local Corporations and Regions to refinance their trade debts. This will also entail a cash injection of approximately 30,000 million euros to the productive economy. A total of 177,000 suppliers, two thirds of which are SMEs and self-employed workers, will benefit from the payment of outstanding invoices across Spain. The estimated macroeconomic effect of this cash injection is that between 80 and 110 thousand jobs will be kept or created and GDP will increase between 0.4 and 0.6 percentage points compared to the baseline scenario. Finally, this will strengthen the budgetary discipline of Territorial Administrations as financing is conditioned to submitting and approval of adjustment plans. The return of this financing is guaranteed through their participation in State revenues.

7. INSTITUTIONAL FRAMEWORK OF FISCAL POLICY

7.1. Fiscal rules and credibility

Fiscal governance is often defined as the set of rules and procedures that shape the planning, implementation and monitoring of budgetary policies. In the EU, Spain holds a prominent place in this area, judging by its high score on the European Commission's Fiscal Rules Index. Even so, one of the country's on-going objectives is to strengthen its fiscal governance, as attested to by improvements in this regard introduced by the recent Organic Law on Budgetary Stability and Financial Sustainability, which is an improvement on previously existing tax rules.

A growing corpus of evidence from empirical research on the effects of improvements in fiscal governance shows that when well designed, it reduces the likelihood of budget deficits and unsustainable debt, further boosting the credibility of policy targets. A solid framework for fiscal governance also directly reduces the estimated probability of default, lowering the risk premium and improving the growth potential of the economy.

In Lara and Wolff's (2011)[5] structural model to calculate sovereign risk premiums in the presence of different levels/ attitudes toward risk aversion, for instance, the fiscal framework proves to be one of the explanatory variables of interest rate spreads. Specifically, that analysis shows that the effect of rule improvements in fiscal governance on the premium is comparable to the effect of a more balanced budget. A one-point improvement in the governance quality index would lower the risk premium by about 22%.

The IMF (2009)[6] also reported that fiscal rules reduce the spread on sovereign debt. The key to such a beneficial impact is that the rules must take cyclical considerations into account and set objectives in terms of cycle-adjusted budget balances.

To date, Spain has applied the fiscal rule laid down in the General Budget Stability Law enacted under Royal Legislative Decree 2/2007 of 28 December, which amended the former rules to adapt to the changes in the European Stability and Growth Pact introduced in 2006. This basic rule was complemented by the provisions on spending contained in Article 8 bis of Royal Decree Law 8/2011 of 1 July. The main premise on which this rule was based was the nominal public sector borrowing requirement, with a ceiling adjusted in accordance with the economic cycle. The primary shortcoming to such a rule is that as it fails to set structural targets, it greatly increases the sensitivity of deficit to variations in the cycle, thus rendering the ex-post reversal of the deviation difficult and scarcely credible. A clear example can be found in the Spanish economy itself since 2007, when it reached a budget surplus based

[5] Reproduced in the publication of Public Finances in EMU-2011 (European Commission, 2011)

[6] Fiscal Rules-Anchoring Expectations for Sustainable Public Finances (IMF, 2009)

primarily on cyclical conditions. The abrupt appearance of demand and supply shocks in late 2007, coupled with an adjustment in the housing sector that has accelerated in the interim, led to a deterioration in public accounts of more than 13 points of GDP in just 2 years.

The obvious inadequacy of that rule contributed to triggering international financial markets´ lack of confidence in the country's ability to reverse the steep upward trend of its public debt in a reasonable time. In that awareness, on 27 September 2011, the main Spanish political parties agreed to amend Article 135 of the Constitution, under which all levels of government are obliged to adhere to the principle of budgetary stability and refrain from incurring structural deficits. The sole additional provision in that constitutional amendment, established that the Organic Law regulating this principle must be adopted by 30 June 2012.

The fiscal rule laid down in the LOEP is geared to implementing a genuinely countercyclical fiscal policy without the interferences that attempts to correct structural imbalances may induce during cyclical contractions Consequently, according to the new rule, by the end of the transitional period, the budget must be balanced (or show a surplus). This will allow budgetary balances for cyclical fluctuations and prevent increasing debt tendencies. Such a rule can gain greater market credibility by efficiently and transparently combining two objectives: economic stabilization and fiscal solvency. Full effectiveness, however, calls for compliance with two conditions.

- A transition period must be established until budgets are balanced at all levels of Government, in the light of the large structural imbalance prevailing at the time of the approval. This period should be long enough to make consolidation feasible and at the same time entail the minimum annual effort required to ensure achievement of the budget target by the deadline set.

- Sufficiently extensive and systematic control mechanisms must likewise be instituted to monitor compliance with the objectives, promptly correcting possible deviations regardless of the level of Government involved, and imposing sanctions to penalise not tackled unjustified deviations. Such a system entails the establishment of incentives to encourage those in charge of budgetary planning and management in all areas of the Administration to steer their efforts in the direction specified in the law.

At the same time, on the European scale, the severe economic and financial situation prompted the adoption of a package of measures, called the "Six pack", to strengthen economic governance. These measures include, among others, the reform of the Stability and Growth Pact and the adoption of Directive 2011/85 on the requirements for national budgetary frameworks. The latter culminated in the Treaty on the Stability, Coordination and Governance in the EMU signed on 2 March of this year. Therefore, the Organic Law on Budgetary Stability and Financial Sustainability necessarily embraces some of the requirements laid down in the new European Union regulation, while the constant reference in the Law to Community legislation translates into on-going and automatic adaptation to the provisions of the latter.

7.2. Organic Law on Budgetary Stability and Financial Sustainability

This Law, approved on 27 April 2012, came into effect immediately. Its main features are set out below.

- The Public Administration must maintain a budgetary balance or structural surplus. Exceptionally, the Autonomous Regions and the Central Government may record a deficit in the event of natural disasters, severe economic recession or force majeure/extraordinary emergency situations beyond their control that significantly impair the State's financial, economic or social sustainability. These exceptional circumstances must be so regarded by an absolute majority of members of Congress of Deputies. Local Corporations must keep balanced budgets or book surpluses, while the Social Security Administration may show a deficit only in the cases referred to and under the conditions governing the application of the Pension Reserve Fund.

  Economic recessions that may justify a structural deficit must be severe and their underlying circumstances, together with, natural disasters or emergency situations, must be beyond governmental control in order to justify a structural deficit. Even in such cases, the resulting deviation may be temporary only and may not jeopardise medium-term fiscal sustainability in any way. The severity of recessions is measured with the European Stability and Growth Pact yardstick.

- A structural deficit of up to 0.4% of GDP is allowed when structural reforms with a short-term cost but a positive medium-term impact on the budget are implemented.

- Sovereign debt is limited to 60% of GDP or the amount established in future by Community regulations. That figure is divided among the levels of Government as follows: 44% for the Central Government, 13% for all the Autonomous Regions and 3% for Local Corporations. Net debt issuance is banned for any administration exceeding those ceilings.

- The Community expenditure rule is adopted, whereby variations in Government spending may not exceed the reference rate, namely the Spanish economy's medium-term GDP growth. Such spending excludes interest, non-discretionary spending for unemployment benefits and spending financed by earmarked transfers from the EU. The GDP growth rate must be calculated using the European Commission methodology and published in the Report on the State of the Spanish Economy.

- In the first half of each year, the Government must set the budget stability and debt target for the General Government and for each of its administration levels for the following three financial years. These proposals must be submitted by 1 April to the Fiscal and Financial Policy Council for the Autonomous Regions (Spanish initials, CPFF) and to the National Commission for Local Administration (Spanish initials, CNAL), whose respective reports must be forthcoming in no more than fifteen days.

The Agreement adopted by the Council of Ministers must also limit non-financial spending under the Central Government Budget, based on the expenditure rule, and must be submitted to Parliament, together with the recommendations made by the European institutions and a report assessing the state of the economy.

- The State, the Autonomous Regions and the Local Corporations must adopt, in their fields of competence, a non-financial expenditure ceiling coherent with the budget stability target and the expenditure rule, which will define the allocation of their budgetary resources. By 1 August of each year, the Ministry of Finance and Public Administration will inform the Fiscal and Financial Policy Council of the non-financial expenditure limit set for the Central Government Budget. Similarly, each Autonomous Region must submit information on its non-financial expenditure limit to the Fiscal and Financial Policy Council.

- Monitoring compliance with the objectives and the expenditure rule will begin already a priori. Specifically, both the Autonomous Regions and the Local Corporations must submit their budgets headlines to the Ministry of Finance and Public Administration by 1 October. By 15 October the Ministry of Finance and Public Administration must verify the consistency and compliance of the draft budgets submitted with the stability and debt targets and the expenditure rule, and is empowered to establish recommendations, which must be published. All budgets must be approved between October and December.

- Before 1 April, the Ministry of Finance and Public Administration must re-check that the budgets for the current financial year meet the objectives defined and the expenditure rule. By 1 October, the Ministry must submit a report to the CPFF and CNAL on compliance with the stability and public debt targets and the expenditure rule during the previous year.

- The Organic Law on Budgetary Stability and Financial Sustainability includes automatic preventive measures, absent in previous legislation. The most important of these measures is that any Administration whose public debt climbs up to 95% of the set ceiling will only be able to undertake treasury borrowing operations. If risk of non-compliance is observed, the Central Government will issue and publish a pre-warning, after which the Administration warned will have one month to take action. Failure to do so or if the action taken is deemed to be insufficient, corrective measures will be adopted (including the withdrawal of authorisation to issue debt, grant subsidies or conclude agreements, in addition to the unavailability of credit and possible revenue-side measures to ensure the target is met).

- Notwithstanding the above automatic action in the event of breach of the deficit or debt targets or the expenditure rule, an economic and financial plan must be submitted with a detailed description of the measures to be taken within one year to meet the objectives. Non-compliance attributable to the exceptional circumstances provided for by law and endorsed by an absolute majority of Congress is treated differently. In such cases, a plan to restore budget balance must be submitted, whose duration will depend on the severity and intensity of the underlying causes. In order to expedite the correction of imbalances, economic-financial and budget balancing plans must be adopted within two months to ensure no more than a three months lapse between the non-compliance is detected and the plan is implemented. One of these three months from detection of the deviation is reserved for the submission of the plan and the other two, at most, for its implementation.

Plan monitoring is also more intense, as it is conducted quarterly and coercive measures will be adopted if deviations are detected in two consecutive reviews. Local Corporations, however, will be subject to six monthly reviews as at present. If the first quarterly review reveals deviations, the Ministry of Finance and Public Administration will call upon the respective administration to amend the plan. Coercive action will be taken if the second quarterly review shows that the stability target is not met as a result of non-implementation of the corrective measure.

- Coercive measures entail the adoption of a decision on credit non-availability to ensure that the target is met and the constitution of a deposit with the *Banco de España* for 0.2% of nominal GDP in the area for which the Administration in question is responsible. Such deposit may only be cancelled after the necessary corrective measures are applied. If the appropriate measures have not been implemented within 3 months of the statutory deposit, it will accrue interest and 3 months later it will become a fine. Failure to adopt these measures will require the Central Government to send a delegation of experts to assess the economic and financial situation of the Administration concerned. This delegation will propose a series of mandatory measures. No debt may be issued until such measures have been implemented.

- These coercive measures may also be applied where Autonomous Regions or Local Corporations requesting extraordinary access to liquidity fail to submit or comply with adjustment plans or where such plans are unfavourably assessed.

- If the aforementioned measures are not taken and/or no resolution on credit non-availability is adopted and/or the statutory deposit with the *Banco de España* is not established, the Central Government, pursuant to Article 155 of the Constitution, may enforce their implementation on the Autonomous Regions or Local Corporation concerned. If a Local Corporation commits a further breach of such compulsory enforcement, the Government may order its dissolution under Article 61 of the Regulation of the Basis of Local Regimes. These coercive measures are one of the most distinctive features with respect to the former legislation.

The consequences of non-compliance are now much more severe and the possibility of Central Government to exert much greater control.

- Notwithstanding the foregoing, the principle of accountability enshrined in Article 8.1 stipulates that in case of non-compliance by Spain of its fiscal obligations towards the European Union, each Administration responsible for deviations will assume the resulting penalties in proportion to the amount of the deviation attributable thereto. Moreover, the no bail-out principle laid down in Article 8.2, which implies that “higher ranking” bodies may not assume the commitments of "lower ranking" bodies (for example, an Autonomous Community cannot assume a Local Corporation’s debt) constitutes an additional incentive to comply with the obligations under the LOEP.

- Finally, the Organic Law on Budgetary Stability and Financial Sustainability intensifies the reporting requirements incumbent upon all levels of Government. Some of the most prominent of these requirements include the obligation to submit monthly statements for the Autonomous Regions and quarterly statements for the Local Corporations, as well as the information required on the initial budget in terms of National Accounts.

- A transitional period is regulated, as envisaged in the Constitution for the entry into force of the deficit and debt ceilings, i.e., until 2020. During this period, each Administration’s non-financial expenditure may not rise faster than the rate of the Spanish economy's real GDP growth.

However, even during the transitional period, when annual real growth is at least 2% or net annual job creation is positive, public debt must be lowered by at least two points of GDP per year.

Also during this period, Public Administrations must reduce their structural deficit by a yearly average of at least 0.8 percentage points, to be distributed among Autonomous Regions and the Central Government on the grounds of their contribution to the structural deficit at 1 January 2012. In 2015 and 2018 deficit and debt reduction pathways will be reviewed to ensure that the general scheme of a structurally balanced budget is in place by 2020.

Lastly, to ensure consistency among all the current fiscal plans and macroeconomic and fiscal forecasts, the legislation explicitly states that the budgets of the different levels of Government as well as the rebalancing plans must be taken into consideration in the annual Stability and Growth Programme updates.

To ensure the implementation of the Law in 2012, it contains a provision whereby the economic-financial and rebalancing plans submitted in 2012 and the targets set for 2012 under the former Law are governed pursuant to the provisions of the current Law on monitoring and enforcement. This precludes the existence of a one-year gap in the effectiveness of the Law, which might lead to further fiscal budget deviations. After enactment, the application of the LOEP will be reinforced through the following measures.

- From the entry into force of the Law, the Autonomous Regions will be required to submit monthly information on budget implementation.

- The Autonomous Regions' economic-financial and budget balancing plans will be made public as soon as they are approved by the Fiscal and Financial Policy Council in mid-May. As a result of that, a full inventory of discretionary measures to be adopted by the Autonomous Regions can be drawn up, in turn providing for thorough monitoring of compliance with budgetary targets.

7.3. Methodological considerations on the implementation of the Organic Law on Budgetary Stability and Financial Sustainability.

In general, the new fiscal rules assign an essential role to indirectly observable variables, such as the economy's potential output or structural balance. This renders their design and implementation more complex, technically speaking, especially in a State as highly decentralised as Spain.

The Organic Law on Budgetary Stability and Financial Sustainability vests the Ministry of Economy and Competitiveness with the competence to calculate the potential output, and on that basis, the reference growth rate to be used to limit the increase in public spending by the different levels of Government. This growth rate will be computed pursuant to the technical specifications laid down in the European legislation (as provided in the Law). The resulting national rate will be applied to the Central Government, Autonomous Regions and Local Corporation budgets.

The use of a single potential growth rate and a single cyclical gap for all levels of Government is based on empirical evidence of a close and narrowing cyclical correlation between all the Autonomous Regions and the national economy. It also makes the implementation of the LOEP more operational, for otherwise the production function method used by the EC to estimate potential growth would call for detailed forecasts for each Autonomous Region, as well as detailed and reliable estimates of the variables that define their capital stock and labour input level.

The new rules also provide that no Public Administration may incur a structural deficit, except where duly appraised, which involves having a method to measure this unobservable variable for different types of Administrations. The usual practice, which will be also applied to the implementation of these rules, is to calculate the cyclical component of the balance and subsequently subtract it from the actual balance to obtain the structural component. Since the potential growth benchmark is one single specific reference, and thus so it is the measurement of the economic cycle, its breakdown by sub-sectors will depend on the adopted sensitivity to the cycle. The calculation of this latter will depend on the plausible assumption that the sensitivity of any item of income or expense depends on the nature of the operation and not on the Administration posting the income or expense. Consequently, the range of sensitivity for the different levels of Government will depend on the differences in the structures of their income and expenses.

The procedure for determining the structural component of the deficit for a given Administration will therefore be as follows: i) on the basis of the macroeconomic scenario, the potential growth and cyclical gap for the national economy is estimated, ii) that figure is applied to the cyclical gap estimated for the level of Government concerned, iii) this is used to calculate the cyclical balance and the cyclically adjusted balance components.

ANNEX 1

TFP filtered estimates for potential growth and structural deficit using the Kalman filter approach

Table 3.5.1. (bis) CYCLICAL EVOLUCION (1) % GDP, unless otherwise indicated					
	2011	**2012**	**2013**	**2014**	**2015**
1. Real GDP growth (% change)	0,7	-1,7	0,2	1,4	1,8
2. Net lending (+) / borrowing (-).Public sector	-8,5	-5,3	-3,0	-2,2	-1,1
3. Interest	2,4	3,1	3,3	3,2	3,1
4. Temporary measures	0,0	1,0	0,8	0,0	0,0
5. Potencial GDP growth (% change)	0,6	-0,3	-0,5	-0,4	-0,4
Contributions:					
- *Labour*	-0,4	-0,9	-1,1	-1,0	-1,1
- *Capitall*	0,5	0,3	0,2	0,3	0,3
- *Total Factor Productivity*	0,6	0,4	0,3	0,3	0,4
6. Output gap	-6,9	-8,3	-7,6	-5,9	-3,8
7. Cyclical balance	-3,0	-3,6	-3,3	-2,5	-1,6
8. Structural balance (2-7)	-5,6	-1,8	0,2	0,3	0,6
9. Structural primary balance (8+3)	-3,2	1,4	3,5	3,5	3,7

(1) Using potential GDP (production function). Potential TFP estimated using Kalman filter method.
Source: Spanish Ministry of Finance and Competitiveness