



STABILITY PROGRAMME UPDATE

SPAIN

2005 - 2008

CONTENTS	Page
1. INTRODUCTION	4
2. OVERALL POLICY FRAMEWORK AND OBJECTIVES	4
3. CURRENT ECONOMIC SITUATION AND OUTLOOK	6
3.1. External assumptions	6
3.2. Cyclical developments and outlook	8
3.3. Projections for 2006–2008: baseline scenario	10
3.4. Sectoral balances	13
4. GENERAL GOVERNMENT BALANCE AND DEBT	16
4.1. Policy strategy	16
4.2. Medium-term budgetary targets (2006-2008)	18
4.3. Actual budgetary balances and implications for next year	20
4.4. Structural balance and fiscal stance	22
4.5. Debt levels and developments	23
5. SENSITIVITY ANALYSIS AND COMPARISON WITH PREVIOUS UPDATE	24
5.1. Sensitivity analysis: alternative growth scenarios and risks	24
5.2. Sensitivity analysis: interest rates	25
5.3. Comparison with the previous Stability Programme Update.	25
6. QUALITY OF PUBLIC FINANCES	26
6.1. Policy strategy	26
6.2. Developments on the expenditure side	27
6.3. Developments on the revenue side	30
7. SUSTAINABILITY OF PUBLIC FINANCES	31
7.1. Long-term budgetary projections	31
7.2. Policy strategy	33
8. INSTITUTIONAL FEATURES OF PUBLIC FINANCES	35
8.1. Reform of the Budgetary Stability Law	35
8.2. Reform of the Autonomous Communities Financing System	37
8.3. Agency Law	37
8.4. Other reforms with an impact on the budget scenario	38
9. CONCLUSION	39

INDEX OF TABLES AND FIGURES

TABLES

1. External assumptions	7
2. Macroeconomic prospects	11
3. Price developments	12
4. Labour market developments	13
5. Sectoral balances	14
6. Budgetary objectives approved by the Spanish Parliament	18
7. Budgetary projections	19
8. Cyclical developments	23
9. General government debt developments	24
10. Sensitivity analysis: alternative growth scenarios	24
11. Sensitivity analysis: interest rates	25
12. Divergence from previous Update	26
13. Long-term pension expenditure projections	32
14. Social Security Reserve Fund	33

FIGURES

1. Real growth and convergence	8
2. Composition of growth	9
3. Inflation and core inflation	9
4. Savings and investment in the Spanish economy	15
5. Expenditure policies in the budgets for 2005 and 2006	29

1. INTRODUCTION

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

This Update is based on the new fiscal policy framework adopted by the Member States in the context of the reform of the Stability and Growth Pact adopted in March 2005. The economic and budgetary projections are, accordingly, fully consistent with that reform and actually envisage more ambitious goals than those derived from the strict application of the reformed Stability and Growth Pact.

This Update also takes account of the key elements of the reform of Spain's Budgetary Stability laws, which is in the process of parliamentary approval at the time this Update is being drafted. The reform's basic principles are fully aligned with the new Community regulations and they introduce new mechanisms to make the budgetary stability principle more effective and more in tune with the cyclical and structural requirements of the Spanish economy. The budgetary projections in this Update thus take account of the economy's cyclical position but this does not diminish its capacity to contribute to attaining the Lisbon objectives, as reflected in National Reform Programme for Convergence and Employment adopted in October 2005.

The content and format of the Update conform to the new Code of Conduct approved this year 2005 to replace the one that had been in force since 2001. In particular, considering the provisions of the Code and the fact that the planned reform of the Stability Laws envisages three-year cycles for the adoption of budgetary objectives, like the process of definition and multilateral supervision of the European Union's Broad Economic Policy Guidelines, this Update extends until 2008.

This Update is presented slightly late with respect to the schedule established in the Code of Conduct for reasons related to Spain's budgetary cycle.

2. OVERALL POLICY FRAMEWORK AND OBJECTIVES

The priority goal of Spain's economic policy is to improve citizens' wellbeing by increasing their wealth and job opportunities. This goal is fully consistent with the European Council's March 2005 decision to relaunch the Lisbon Strategy, focusing its priorities on economic growth and employment, as reflected explicitly in Spain's National Reform Programme for Convergence and Employment. In particular, this Programme quantifies for 2010 both the commitment to attain full convergence in per capita income with the European Union (EU-25) and to attain an employment rate of 66% (age 15-65).

Attainment of these goals requires the implementation of an economic policy that is capable not only of stimulating high growth that generates employment but also of ensuring its sustainability over time. Spain's recent economic growth has been supported partly by temporary factors, such as low interest rates and immigration flows, which have boosted private consumption expenditure and construction, but which will be difficult to sustain at the same pace in the future. Moreover, the rapid pace of growth has been accompanied by imbalances in prices and the foreign sector. Consequently, the current economic policy strategy is oriented towards favouring a change in the growth model to foster evolution towards a lasting and more balanced pattern than the one in place at present, thereby increasing productive capital stock and productivity while maintaining high rates of job creation.

Accordingly, this is a continuation of the economic policy strategy that was initiated in 2004 and set out in the previous Stability Programme Update, and is based on the following principles:

- Strengthening budgetary stability, by reiterating the political commitment to this principle but modifying it to adapt it to the economy's cyclical situation (in accordance with the revision of the Stability and Growth Pact). Additionally, the necessary reforms are proposed in order to strengthen the application of the budgetary stability principle in all levels of the public administrations and to preserve priority expenditure policies in coherence with a productivity-oriented strategy. This commitment to budgetary stability will be materialised in a steady reduction in public debt as a percentage of GDP, which will contribute to enhancing the sustainability of public finances in the long term as well as inter-generational equity.
- Improving the competitive environment and enhancing productivity, through the "Plan to Dynamise the Economy and Enhance Productivity" (Dynamisation Plan), which was presented by the government in March 2005, and the "National Reform Programme for Convergence and Employment" adopted in October, which complements the former:
 - The "Dynamisation Plan"¹ set out a large number of specific actions in the area of competition, goods and services markets, financial markets, R&D and innovation, and quality and efficiency in expenditure. A first package of 100 measures in the Plan was embodied in four laws containing specific actions. Moreover, this Plan introduced a new form of instrumenting economic policy as it was the result of a broad consensus and attributed specific responsibilities for implementing it to the various Ministerial departments, with schedules for the next three years, thereby enhancing the Spanish economy's transparency and predictability.

¹ www.meh.es

- The National Reform Programme (NRP)², which runs for five years, defines objectives and measures based on seven pillars for complying with the Integrated Guidelines endorsed by the European Council in July 2005. The PNR is another step forward in defining Spain's economic policy as it sets out, with specific plans, the actions envisaged in the Dynamisation Plan, particularly in the field of infrastructure (Strategic Infrastructure and Transport Plan) and R&D and innovation (INGENIO 2010), and it expands on them by addressing major new initiatives in the area of human capital, the labour market and fostering entrepreneurship.

With these measures to boost productivity, the aim is to move away from a model in which real convergence hinged largely on increasing the employment rate and in which productivity played a much less important role. Moreover, productivity contributes to containing macroeconomic imbalances in prices and the foreign sector. Reforms of the factor markets aimed at fostering innovation, investment in infrastructure and enhancing the skills of human capital, together with those aimed at increasing efficiency and competition in the markets of goods and services, play a fundamental role in boosting productivity.

- Greater transparency and quality in the regulatory framework, as essential elements in the application of the above-mentioned reforms. Efforts focus primarily on perfecting the competition system, improving the supply of economic information to citizens, and adopting measures aimed at enhancing the assessment of the overall impact of proposed regulations, particularly in the economic field.

These priorities of economic policy are reflected in the budgetary scenario set out in this Stability Programme Update where, based on a firm commitment to budgetary stability, the items relating to R&D and innovation, the information society, education and infrastructure are greatly increased in order to enhance the Spanish economy's long-term growth potential. Therefore, the budget projections in this Update are fully consistent with the Stability and Growth Pact.

3. CURRENT ECONOMIC SITUATION AND OUTLOOK

3.1. External assumptions

In line with the Code of Conduct on the format and content of Stability Programmes, this Update is based on the Commission's common external assumptions (Table 1).

² www.la-moncloa.es

Table 1 EXTERNAL ASSUMPTIONS					
	2004 (A)	2005 (F)	2006 (F)	2007 (F)	2008 (F)
Dollars per euro	1.24	1.25	1.21	1.22	1.22
Nominal effective exchange rate in the euro area (% change)	2.9	-1.0	-0.8	0.7	0.0
Nominal effective exchange rate in the EU-25 (% change)	3.9	-0.8	-1.5	0.5	0.0
World excluding EU-25, GDP growth (*)	5.9	5.1	4.9	4.6	4.0
EU-25 GDP growth (*)	2.4	1.5	2.1	2.4	2.7
Growth of foreign markets of the EU-25 (**)	-	5.7	6.6	6.5	7.0
World import volumes, excluding the EU-25	13.9	8.8	8.7	8.4	8.0
Oil prices, (Brent, USD/barrel)	37.8	55.0	61.4	60.3	60.0
(*) Real percentage change					
(**) Intra- and extra-EU trade					
(A) Advance					
(F) Forecast					
Source: European Commission and Ministry of Economy and Finance.					

In 2005, the world economy has continued to grow at a high rate while inflationary pressure has been relatively contained, despite an increase of around 60% in oil prices during the year. Greater energy efficiency in the advanced economies, higher competition and flexibility in the markets plus credible economic policies, among other factors, have contributed to limiting the impact of rising energy prices.

The Commission's outlook suggests that world economic activity will continue to perform well. In particular, the world economy excluding the EU will continue the expansion trend that initiated after the 2001 crisis, although the pace of growth will slow slightly, from 5.1% in 2005 to 4% in 2008. As in previous years, the main boost will come from the US and the continuing strength of Asian emerging countries. The dynamism of large developing economies, such as China and India, will be a major driver of activity and trade in the coming years, even though their growth is expected to slow slightly. The rise in oil exporters' revenues will also help to increase their imports. World import volumes, excluding the EU, will decelerate slightly, although the growth rate will still be around 8%, which will provide major support to European economies, whose intra- and extra-EU markets will recover gradually.

Europe's economy will rebound significantly, bringing growth near its potential. The conditions now exist for an acceleration in activity in the euro countries: low interest rates, strong growth in world demand, the euro's depreciation since the start of 2005 and a better business climate will help to boost economic activity, which will be driven initially by exports and subsequently by consumer spending and investment.

The Commission expects inflation to remain moderate despite oil prices will remain high. Oil price projections have been upgraded with respect to those in the spring, to around USD60/barrel, as a result of growing demand in large emerging economies and scant idle capacity on the supply side. Nevertheless, government actions to modulate inflation expectations and, therefore, limit second-round effects, combined with a possible scenario of slightly higher interest rates, will help to maintain price stability.

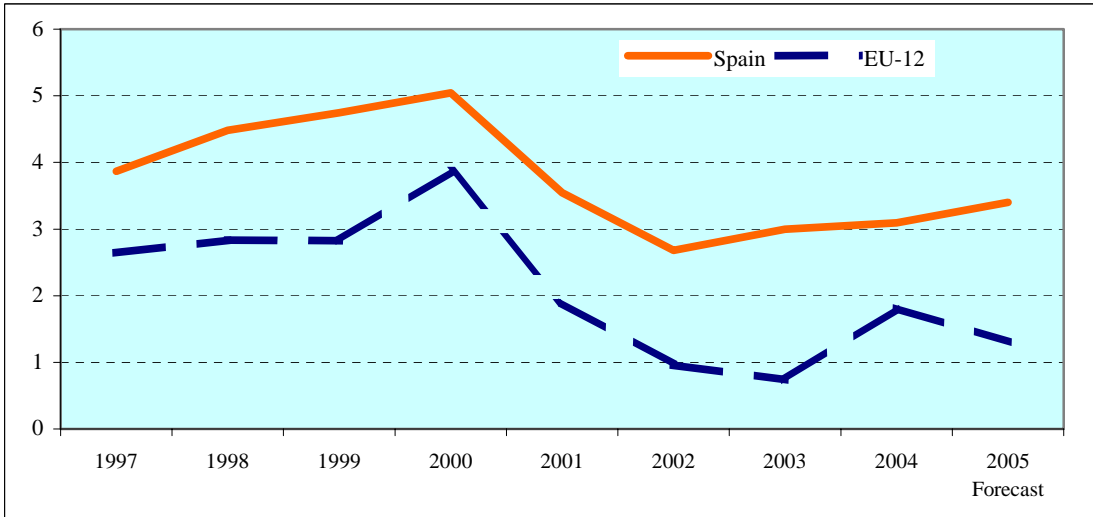
The euro is expected to depreciate slightly against the dollar in 2006 and then stabilise at USD1.22.

3.2. Cyclical developments and outlook

In 2004, Spain's economy registered 3.1% real growth, according to the new National Accounts baseline 2000 (NA 2000), which considerably upgraded GDP and its growth rates compared with previous estimates.

That revision of real economic growth was due to the use of a new method to obtain estimates of volumes and to the changes, mainly statistical, introduced in the estimates of GDP at current prices. The main changes were the introduction of the population estimates based on the 2001 census and the use of employment estimates based on the new Labour Force Survey. As a result, employment in the NA 2000 series was revised upwards significantly due mainly to the large increase in the number of immigrants.

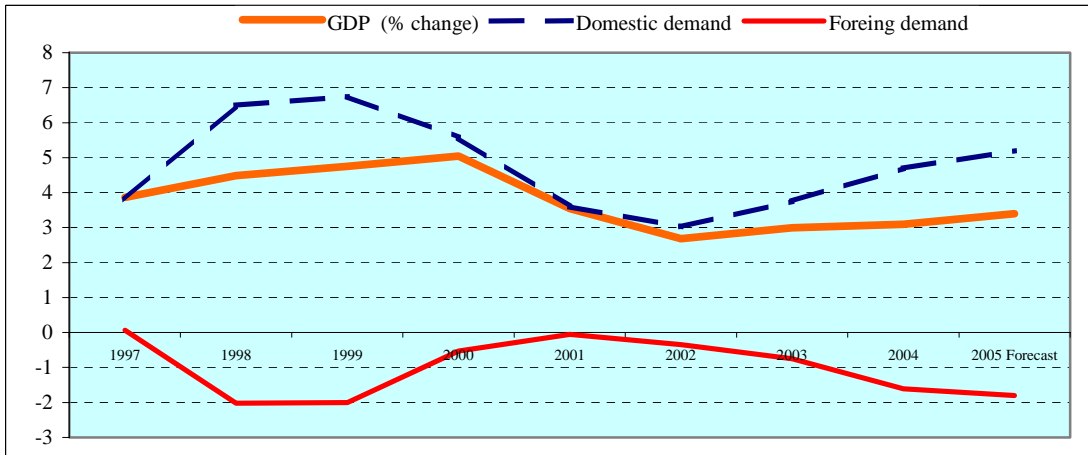
Figure 1
Real growth and convergence of the Spanish economy
Change in GDP (%)



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

Since mid-2003, quarterly GDP growth has accelerated, reaching 3.5% year-on-year growth in the third quarter of 2005, so the annual average growth for 2005 is estimated to be 3.4%.

Figure 2
Composition of GDP growth
Contribution as a %

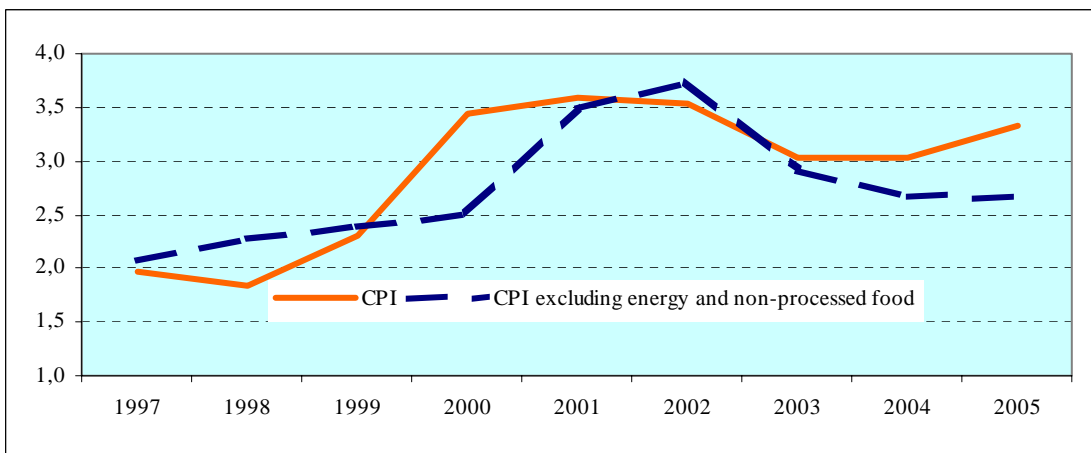


Source: INE and Ministry of Economy and Finance.

In 2005, the growth driver continues to be domestic demand, which is estimated will contribute just over five percentage points to GDP growth due to dynamism in all its components, especially the acceleration in capital goods investment. Low interest rates and rising employment have boosted this domestic demand performance.

However, foreign demand has cut nearly two points off economic growth in 2005 since export growth has been curbed by, among other factors, the very slow recovery of the large European economies that receive most of Spain's exports. Imports have decelerated although they continue to grow at a fast rate driven by domestic demand, especially for capital goods. As a result of the external sector's real performance, combined with a deterioration in the terms of trade caused by rising oil and commodity prices, Spain's net borrowing has increased to 6,6% of GDP in 2005.

Figure 3
Inflation and core inflation
Change in CPI (%)



Source: INE.

Inflation has been impacted by the sharp increase in energy prices, reaching a 3.4% in November. The exogenous nature of that increase is reflected in core inflation i.e. excluding energy and non-processed foods, which has performed much better, standing at 2.7% in that month, i.e. 0.2 percentage points lower than December 2004.

Employment continues to advance at a strong pace, consistent with the considerable increase in the working population as a result of immigration and higher female participation, with a substantial reduction in the unemployment rate, to 8.4% in the third quarter of 2005, i.e. two percentage points lower than a year before. Wages have performed moderately, although nominal unit labour costs, contrary to their real performance, continue to grow faster than the euro area average due to scant growth in aggregate apparent productivity as a result of a sharp increase in employment in labour-intensive sectors such as construction and some service industries.

The 2006 growth outlook is positive: an average 3.3% GDP growth rate is projected. Nevertheless, a more balanced composition is expected: a deceleration in consumer spending and in investment in construction will offset the contribution from domestic demand, while exports will gain momentum, in line with the Commission's external assumptions of an economic recovery in Europe and with the effects expected as a result of the euro's depreciation against the dollar during 2005. That lower pressure from domestic demand, combined with less negative performance by energy prices, should enable inflation to perform better in 2006.

3.3. Projections for 2006–2008: baseline scenario

According to the 2006-08 baseline scenario (table 2), economic growth will remain high, helping Spain to progress in towards real convergence with the European Union. That economic growth will be characterised by a more balanced contribution from the various components of aggregate demand, a moderation in inflationary pressures, and a continuing downward trend in the unemployment rate.

Economic growth is expected to be over 3% in the 2006-08 period. Specifically, GDP will grow by 3.3% in 2006 and by 3.2% in 2007 and 2008, i.e. higher than the estimates stated in the previous Stability Programme Update: in particular, GDP is expected to grow 0.5 percentage points faster in 2005, 0.3 percentage points faster in 2006 and 0.2 percentage points faster in 2007 and 2008. As stated before, the change in the National Accounts baseline has led to an increase of the economic growth rates of the last few years.

That scenario assumes that domestic demand remains strong, boosted by interest rates that will remain low in Spain during the projected period, even though they will tend to rise, and by employment performance partly linked to immigration, whose growth pace will tend to slow. Nevertheless, domestic

demand will decelerate gradually and this is expected to be mostly offset by a more favourable external sector contribution, which will help restore the balance in the growth pattern.

The deceleration in domestic demand will be due foreseeable to more moderate performance by government and private consumption expenditure and by home-building. Private consumption expenditure will decelerate gradually to converge upon the GDP growth pace in 2008. The household savings rate may start to recover in 2007 and account for approximately 10% of gross disposable income in 2008. Government consumption expenditure is also expected to decelerate, as next section details, since some of the factors that have boosted its growth in recent years will disappear; therefore, in 2008, its growth rate will be 0.1 percentage points lower than GDP growth.

Table 2 MACROECONOMIC PROSPECTS							
Chained volume indices: 2000=100, unless otherwise indicated							
	2004 (A)	2005	2006	2007	2008		
		(F)	(F)	(F)	(F)		
	Level	Rate of change (%)					
1. Real GDP growth	112.9	3.1	3.4	3.3	3.2	3.2	
2. Nominal GDP (million euro)	837.3	7.3	7.5	6.7	6.4	6.1	
Components of real GDP:							
3. Private consumption expenditure (*)	113.7	4.4	4.2	3.5	3.3	3.2	
4. Public administrations final consumption expenditure	120.7	6.0	4.5	4.1	3.6	3.1	
5. Gross fixed capital formation	119.6	4.9	7.1	5.9	5.2	5.1	
6. Changes in inventories (% of GDP)	96.2	0.4	0.4	0.4	0.3	0.3	
7. Exports of goods and services	113.4	3.3	1.1	2.6	3.3	3.8	
8. Imports of goods and services	125.3	9.3	7.0	5.8	5.5	5.5	
		Contributions to real GDP growth					
9. Final domestic demand	116.3	4.7	5.2	4.5	4.1	4.0	
10. Changes in inventories	96.2	0.0	0.0	0.0	0.0	0.0	
11. External balance of goods and services	334.6	-1.6	-1.8	-1.1	-0.9	-0.8	
(*) Includes households and NPISH (non-profit institutions serving households)							
(A) Advance							
(F) Forecast							
Source: INE and Ministry of Economy and Finance.							

Sustained loose financing conditions, a recovery in exports, and companies' efforts to improve productivity and their capacity to successfully face growing competition will support the momentum of capital goods investment. Conversely, investment in construction will gradually decelerate due to the maturity of the expansion cycle in home-building, the gradual increase in interest rates, and the expected effects of the measures to boost the rented accommodation market.

The external sector will benefit from the recovery expected in the European economies and an improvement in competitiveness through costs and prices, which will lead to a gentle acceleration in exports. In turn, imports will slow, in line with lower pressure from final demand. Both factors will gradually reduce the negative contribution of the external sector by one percentage point and it will thus cut 0.8 percentage points off economic growth in 2008, compared with nearly two percentage points in 2005.

Prices will perform better in terms of both the GDP deflator and the private consumption deflator. Nevertheless, the private consumption deflator is expected to decelerate faster due to better performance by oil and commodities prices and to wage moderation, compatible with a mild recovery in aggregate productivity. A deceleration in import prices to negative rates in 2007 will improve the real terms of trade that year, after poorer performance expected in 2005 and 2006 (Table 3).

	2004 (A)		2005 (F)	2006 (F)	2007 (F)	2008 (F)
	Index	Rate of change (%)				
1. GDP deflator	117.7	4.1	3.9	3.2	3.1	2.8
2. Private consumption deflator (*)	113.1	3.4	3.4	2.8	2.5	2.2
4. Public consumption deflator	113.9	3.3	3.4	3.2	2.5	2.3
5. Investment deflator	120.0	5.4	5.9	4.5	3.1	2.7
6. Export price deflator (goods and services)	104.5	2.0	3.8	2.2	0.5	0.5
7. Import price deflator (goods and services)	97.8	1.8	4.5	2.6	-0.2	-0.5

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

In accordance with the GDP growth forecasts, the labour market will continue to perform very positively, with employment growth reducing the unemployment rate to under 8% by 2008 in a context of a growing working population. Employment will continue to grow rapidly although a slight deceleration is expected once the effects of the methodology changes in the Labour Force Survey and National Accounts peter out. As a result of that employment performance and the lower expected immigration growth, the working population will foreseeable decelerate (table 4).

The measures adopted in the Dynamisation Plan and those envisaged in the National Reform Programme, combined with a slowdown in the labour-intensive construction sector, will gradually improve labour productivity, which will accelerate from 0.4% in 2005 to 1% in 2008. The recovery in productivity, plus a steady advance in personal earnings, will lead to a deceleration in nominal unit labour cost, while they will continue to fall in real terms.

Table 4						
LABOUR MARKET DEVELOPMENTS (*)						
	2004 (A)	2005 (F)	2006 (F)	2007 (F)	2008 (F)	
	Level	Rate of change (%)				
1. Employment, persons (million)	18.3	2.6	3.1	2.9	2.6	2.3
2. Employment, FTEQ (million people)	17.4	2.6	3.0	2.8	2.5	2.2
3. Labour productivity, persons (GDP/1) (million euro)	39.0	0.5	0.3	0.4	0.6	0.9
4. Labour productivity, FTEQ (GDP/2) (million euro)	40.8	0.5	0.4	0.5	0.7	1.0
5. Compensation of employees (**) (million euro)	26.9	3.3	2.8	2.8	2.7	2.7
6. Unemployment (% of labour force)	11.0		9.0	8.4	8.1	7.8

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

The main downside risks to the scenario described above are primarily external and are related to the uncertainties arising from oil price developments and United States economic imbalances and to the intensity of the recovery by the European economy.

In Spain, the scenario hinges on wage moderation and the consequent absence of any second-round effects associated with high oil prices, and on higher productivity gains. The combined effect of those variables will help to moderate the inflationary pressure and the external imbalance, reinforcing the bases for ensuring a longer-lasting and more balanced growth pattern than the current one. Finally, the adjustment arising from a sudden spike in interest rates does not seem a very likely internal risk.

3.4. Sectoral balances

Since Spain joined the euro area, net lending has been negative; it has increased considerably in recent times and is expected to reach 6.6% of GDP in 2005. That deterioration (table 5) is due to trade in goods and services, which has not been offset by the other components. The balance of primary incomes and current transfers is expected to register a deficit amounting to 2% of GDP, while capital transfers will maintain a surplus of around 1% of GDP.

Although the positive balance of tourism has deteriorated somewhat, the main feature has been a widening of the trade deficit. This is due partly to the greater dynamism and growth differential of the Spanish economy. Imports of goods are very sensitive to final demand, as evidenced by their growing contribution to GDP. Import elasticity has averaged over 2 in the last ten years.

Table 5 SECTORAL BALANCES (National Accounts)						
	2004 (A)	2005 (F)	2006 (F)	2007 (F)	2008 (F)	
	Level (*)	% of GDP				
1. Net lending/borrowing vis-à-vis the rest of the world	-40.1	-4.8	-6.6	-7.7	-8.0	-8.2
- Balance of goods and services	-31.6	-3.8	-5.6	-6.6	-6.8	-6.9
- Balance of primary incomes and current transfers	-17.3	-2.1	-2.1	-2.0	-1.9	-1.8
- Capital account	8.8	1.1	1.1	0.9	0.7	0.5
2. Net lending/borrowing of the private sector	-38.8	-4.6	-7.6	-8.6	-8.7	-8.8
3. Net lending/borrowing of general government	-1.3	-0.2	1.0	0.9	0.7	0.6
4. Statistical discrepancy	-	-	-	-	-	-

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

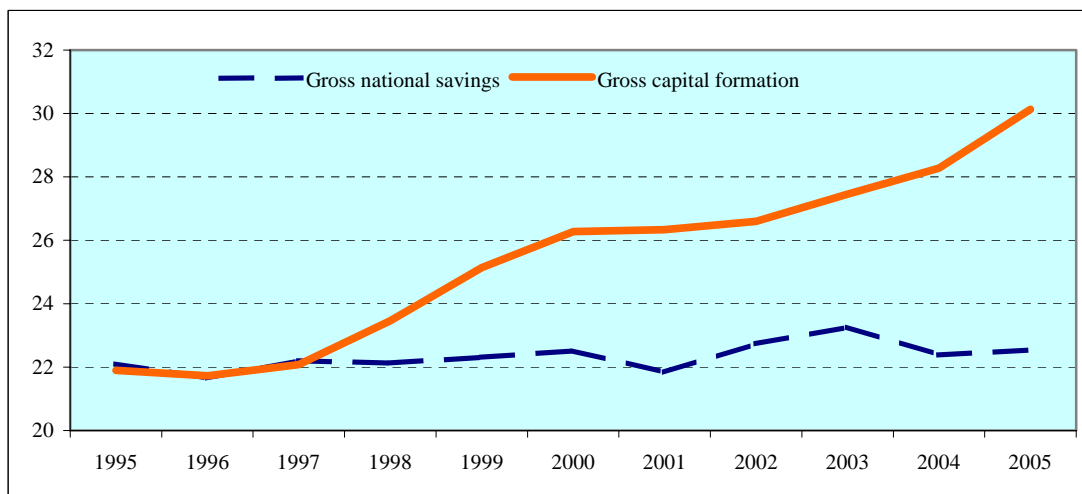
Exports have outperformed the euro area average in real terms and Spain even increased its market share, but this decreased slightly recently. Spain's exports increased their share of the world market from 1.7% in 1995 to 1.9% in 2004 after reaching 2% in 2003. This gain in market share has been compatible with a deterioration in the price-competitiveness indicators, measured in terms of producer prices or unit labour costs, compared with the steady relative competitiveness measured via export prices, as evidenced by narrower export margins.

Despite this positive relative performance by exports of goods, rising international competition due, among other factors, to the entry of Asia's large emerging economies (China and India) in international trade and to the European Union's enlargement means that Spain must adopt measures to reinforce the competitiveness of its external sector. Spain must strengthen its price-competitiveness through productivity gains and overcome the structural weakness of its exports, which are characterised by high geographical concentration (70% of exports concentrate in the EU) and low specialisation in high-tech products (low- and mid-tech products account for half of Spain's exports).

From a macroeconomic standpoint, if net capital transfers received from the rest of the world are deducted from net borrowing, the external imbalance reflects insufficient domestic saving to finance investment in Spain. In Spain's case, this mismatch is due to an increase in investments and not to a decrease in the savings rate. Gross fixed capital formation at current prices has increased its contribution to GDP by over one percentage point in 2005, evidencing a significant positive gap with the euro area average due not only to investment in construction but also to dynamic capital goods investment. The savings rate has

been practically constant and exceeds that of the large euro-area countries as a percentage of GDP (figure 4).

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



Source: INE (*quarterly national accounts*).

From a sectorial standpoint, and even though the data using the new 2000 accounts baseline are not yet available, the expansion in net borrowing in 2005 is apparently due to private sector performance. The public sector has ceased to be a borrower and is now a net lender to the private sector's investment process. In the private sector, companies have always been borrowers, although in 2005 households are also contributing to the increase in the country's net borrowing since they have reduced net lending due to higher investment in homes.

Based on the foregoing, the investment process should contribute to reducing the external deficit insofar as it leads to improved competitiveness and productivity. Moreover, although part of that investment is not in the capital goods sector, the external imbalance reflects how business and consumers adapt their intertemporal decisions to a new interest rate scenario, so a sudden intense adjustment is not expected in the short term. Based on the budget projections envisaged in this Update, the public sector will continue to curb the external imbalance by maintaining net lending during the entire period. Since Spain is part of the euro area, the capacity to lend and borrow is greater in the longer term since it does not depend on currency adjustments and, therefore, this becomes a less significant constraint on growth.

In that context, business investment is expected to continue rising in the medium term, which should increase companies' net borrowing. At the same time, households will be net borrowers between 2005 and 2007, and in 2008 they will once again provide financing for the other sectors. As is detailed in the next section, the public sector is expected to continue having a surplus during the Programme period.

4. GENERAL GOVERNMENT BALANCE AND DEBT

4.1. Policy strategy

Fiscal strategy responds to the general orientation of economic policy, which is aimed at fostering a model of economic growth which, within the framework of budgetary stability, contributes to increasing the Spanish economy's productivity while ensuring the sufficiency and stability of public finances. Accordingly, the Stability Programme Update 2005-2008 is a continuation of the strategy first defined in the Budget for 2005 and is based on the following principles:

- A firm commitment to budgetary stability over the full economic cycle.
- Prioritising productive public expenditure and policies aimed at improving the quality of public finances.
- Ensuring the long-term sustainability of finances as a necessary means of guaranteeing the sufficiency and sustainability of social spending.

Budgetary stability is a necessary condition for ensuring a sustainable model of economic growth and improving social welfare. The commitment to this principle is evident, on the one hand, in the fiscal policy objectives adopted by the Public Administrations, which entails maintaining a high surplus in the administrations as a whole throughout the entire period of the Programme, as well as steadily decreasing public debt as a percentage of GDP. Accordingly, this budgetary approach is fully consistent with the economic growth scenario envisaged for the coming years, enabling fiscal policy to play a stabilising role. Moreover, these objectives place Spain's public accounts in a very favourable position from which to face a weaker-than-expected economic situation within the Programme's time-scale and to face the longer-term challenges posed by population ageing and globalisation.

The commitment to sound finances is further reinforced by the ongoing reform of the Budgetary Stability Laws that is fully aligned with the principles contained in the reform of the European Union's Stability and Growth Pact. The amendment to Spain's legislation was approved by the Cabinet in July 2005 and is being discussed by the Economy and Finance Committee of the Congress at the time of drafting this Update. Although the ongoing reform is detailed in section 8 of this Update, the proposed changes aim at increasing the credibility of the budgetary objectives themselves by enabling the application of the stability principle in coherence with the economy's cyclical position, enhancing the stabilising function of fiscal policy. Additionally, the Spanish reform imposes, for the first time, the obligation to budget for a surplus in periods of fast economic growth while taking account of the efforts required to close the R&D and innovation gap with the European Union. Greater fiscal discipline is also pursued at all levels of government through fostering greater consensus and participation of all the public administrations in setting the budget targets.

The reorientation of budgetary policy towards programmes that boost productivity implies granting priority to expenditure programmes that contribute to expanding technological, physical and human capital. The budget devotes particular attention to R&D and innovation and to developing the Information Society, public investment in infrastructure, and actions in the area of education, while reinforcing the transition towards a more lasting model of growth. Apart from its indubitable contribution to real convergence, productive expenditure also enhances the economy's potential growth capacity and, consequently, improves the future revenue-raising capacity and, in short, the very sustainability of public finances in the long term.

This determined focus on productive expenditure is complemented by additional reforms to improve the quality of public finances by enhancing the efficiency of the tax system and the institutional framework in which the State's financing activity is conducted. The tax system is to be reformed so as to make it more efficient by improving incentives to job creation, saving and business investment; this process is described in detail in section 6.3, which discusses public revenues in the context of the quality of public finances. Public sector management is also being modernised so as to attach more importance to efficiency in public policy. This objective is pursued by measures to reorganise the administration and modernise its technology as section 6.2 details.

Finally, fiscal strategy takes account of the importance of ensuring the sufficiency and sustainability of social spending as a means of enhancing wellbeing and social cohesion and ensuring that benefits from economic growth flow to all citizens and that inter-generational equity is maintained. In particular, during the time horizon of this Stability Programme Update, the effects of the measures adopted to control healthcare expenditure should be felt; they include the development of a Strategic Plan for Pharmaceutical Policy and the adoption of a Plan to improve the quality and cohesion of the National Health System as section 7 details. Additionally, during the years of the Programme, reforms will be designed and implemented as a result of the current process of Social Dialogue so as to improve the Social Security benefits system and strengthen its sustainability.

In addition to these reforms, the long-term sustainability of Spain's finances will benefit from ample room for manoeuvre and a relatively privileged position in the European context due to the low level of public debt as a percentage of GDP and the existence of a Social Security Reserve Fund which, following the allocations envisaged in 2006, will amount to 3.4% of GDP. More importantly, the commitment to budgetary stability is a clear guarantee that this room for manoeuvre will continue to expand during the period covered by this Programme.

4.2. Medium-term budgetary targets (2006-2008)

In accordance with the provisions of the Stability Laws still in force, on 20 May 2005 the Spanish Cabinet approved the 2006-2008 budgetary stability objective for the entire public sector and its agents, plus a cap on the State's non-financial expenditure that was compatible with its 2006 budgetary stability. Both were approved by the Spanish Parliament³ in June 2005. Those objectives, which are detailed in Table 6, were established when the information about the 2005 public accounts was still scant and, consequently, the projection was that, based on the previous Stability Programme Update, the public administrations would end 2005 with a surplus of 0.1% of GDP.

Table 6 BUDGETARY OBJECTIVES APPROVED BY THE SPANISH PARLIAMENT (June 2005) (% of GDP) 2006-2008			
	2006	2007	2008
CENTRAL GOVERNMENT	0.3	0.4	0.4
State	-0.4	-0.3	-0.3
Social security	0.7	0.7	0.7
AUTONOMOUS COMMUNITIES	-0.1	-0.1	0.0
LOCAL GOVERNMENTS	0.0	0.0	0.0
GOVERNMENT TOTAL	0.2	0.3	0.4

Source: Ministry of Economy and Finance.

Nevertheless, the information available when drafting this Stability Programme Update suggests that the surplus may reach 1% of GDP as a result of strong dynamism of the Spanish economy. As detailed further below, this increase will be due to better-than-expected results by the State, Social Security administrations and Autonomous Communities, while the local administrations maintain the expected budgetary balance.

As a result of better-than-expected 2005 results, the budgetary objectives established in May have been updated. Consequently, this Stability Programme Update envisages budgetary objectives with larger surpluses: 0.9% of GDP in 2006, 0.7% in 2007 and 0.6% in 2008. The breakdown by public administrations is detailed in Table 7.

³ Plenary session of the Congress on 23 June.

Table 7
BUDGETARY PROSPECTS
(excessive deficit procedure)

	2004		2005	2006	2007	2008
	Level (million euro)	% of GDP				
Net lending/borrowing						
1. General government	-1,173	-0.1	1.0	0.9	0.7	0.6
2. Central government	-9,600	-1.1	0.1	0.1	0.1	0.0
3. Autonomous Communities	-185	0.0	0.0	-0.1	-0.1	0.0
4. Local government	-23	0.0	0.0	0.0	0.0	0.0
5. Social security funds	8,635	1.0	0.9	0.9	0.7	0.6
General government						
6. Total revenue	323,799	38.7	39.4	39.3	39.1	38.9
7. Total expenditure	324,972	38.8	38.4	38.4	38.4	38.3
8. Net lending/borrowing	-1,173	-0.1	1.0	0.9	0.7	0.6
9. Interest expenditure (incl. FISIM)	17,125	2.0	1.8	1.7	1.5	1.4
p.m.: FISIM (1)	181					
10. Primary balance	15,952	1.9	2.8	2.6	2.2	2.0
Selected components of revenue						
11. Total taxes	188,945	22.6	23.3	23.3	23.1	23.0
11a. Taxes on production and imports	99,632	11.9	12.0	11.9	11.9	11.9
11b. Current taxes on income, wealth, etc.	85,642	10.2	10.9	10.9	10.8	10.7
11c. Capital taxes	3,671	0.4	0.4	0.4	0.4	0.4
12. Social contributions	109,037	13.0	13.1	13.1	13.1	13.1
13. Property income	5,970	0.7	0.7	0.7	0.7	0.7
14. Other	19,847	2.4	2.3	2.3	2.2	2.2
15. Total revenue	323,799	38.7	39.4	39.3	39.1	38.9
p.m.: Tax burden	290,257	34.7	35.5	35.5	35.3	35.2
Selected components of expenditure						
16. Collective consumption	148,898	17.8	17.9	18.0	18.0	17.9
17. Total social transfers	98,379	11.7	11.8	11.8	11.8	11.9
18. Interest expenditure	17,125	2.0	1.8	1.7	1.5	1.4
19. Subsidies	8,278	1.0	1.0	1.0	1.0	1.0
20. Gross fixed capital formation	28,708	3.4	3.5	3.5	3.6	3.7
21. Other	23,584	2.8	2.4	2.4	2.4	2.4
22. Total expenditure	324,972	38.8	38.4	38.4	38.4	38.3
p.m.: compensation of employees	84,302	10.1	10.0	10.1	10.1	10.1

(i) Financial intermediation services indirectly measured.
Source: Ministry of Economy and Finance.

The trends expected for the public sector, both by the Spanish Parliament and by this Stability Programme Update, amply respect the principle of medium-term budgetary stability set out in article 2.a of Regulation 1466/97 as amended in the framework of the new Stability and Growth Pact. That article limits the medium-term deficit in euro area countries to 1% of GDP, measured in structural terms, net of one-off and temporary measures.

Within that budgetary framework and considering the content of the reform of the Spanish Budgetary Stability Laws that redefine the concept of budgetary stability to take account of the economy's cyclical situation, the Medium-Term Objective (MTO) assumed in this Stability Programme Update is a cyclically-adjusted "budgetary balance". This objective strongly reinforces the long-term sustainability of public finances and is prudent given the cautious approach that must be taken with structural or cyclically-adjusted balance estimates.

The very concept of the MTO envisaged in the Reform of the Stability and Growth Pact may be affected due to the March 2005 Ecofin report, which states that implicit liabilities may be taken into account when defining it.

Consequently, as a result of the reforms under way in Spain and the provisional nature of the EU reference framework, the Medium-Term Budgetary Objective envisaged in this Update must be viewed with due caution and a revision in forthcoming Stability Programme Updates can not be ruled out depending on advances in the Spanish and/or EU regulations.

Budgetary stability is closely linked to a gradual reduction in public debt as a percentage of GDP, which is expected to reach 36% by 2008 year-end, i.e. 7 percentage points less than the estimate for 2005, putting public finances on the right path to attaining the 2010 target of 34% envisaged in the National Reform Programme approved in October 2005.

4.3. Actual budgetary balances and implications for next year

As stated earlier, Spain's public accounts may end 2005 with a surplus of 1% of GDP, after registering a 0.1% deficit in 2004. Nevertheless, it should be noted that in 2004 the State assumed RENFE's debt of 5.459 billion euro (0.65% of GDP). This one-off measure, , was aimed at improving RENFE's finances as part of the restructuring of the railway sector. Excluding that operation, government overall registered a surplus of 0.5% of GDP, which is a much better reflection of the trend in public accounts.

In 2005, in a context of dynamic performance by the Spanish economy, public revenues will grow substantially more than estimated GDP, while, because of the aforementioned debt assumption which resulted in extraordinarily high expenditure in 2004, expenditure will grow by considerably less than GDP, giving rise to the aforementioned 1% surplus.

Once again, the most dynamic revenue component in 2005 will be taxes, especially current taxes on income and wealth, evidencing favourable

performance by gross household income (wages, pensions and capital income, plus realised capital gains) and corporate profits. Continued high growth rates in nominal aggregate household expenditure (consumption expenditure and home-buying) will considerably boost indirect tax revenues in 2005.

The significant rise in employment in 2005 has considerably increased the number of social security contributors and, consequently, contributions. The impact on supply of the significant rise in immigration in Spain in recent years and the impact on the fiscal variables (especially social security contributions and, to a lesser extent, personal income tax) increased considerably faster this year after foreign workers were regularised in 2005.

Regarding public expenditure, the public administrations' final demand (consumption expenditure and investment) and social benefits have slightly increased as a percentage of GDP in 2005. Conversely, because of the downward trend in the debt ratio and effective interest rates, the interest on public debt and, above all, capital transfers (the heading under which RENFE's debt was assumed by the State in 2004) will both decrease as a percentage of GDP. As a result, total public expenditure will decrease its GDP contribution by 0.4 percentage points in 2005.

In 2006, in the absence of additional regulatory changes that increase tax rates, tax revenues will continue to contribute the same percentage to GDP. The increase in some excise duties (alcohol, beer, intermediate products and tobacco) approved in September 2005, in the framework of the Healthcare Funding Improvement Agreement, will have a moderate effect on 2006 revenues. Expenditure will continue to account for the same percentage of GDP since its increase as a result of certain measures aimed at improving basic public services (defence, public safety and justice) and the funding of Autonomous Communities, as well as the decisive commitment to maintaining public investment high as a percentage of GDP will be offset by a further decrease in the interest/GDP ratio.

As a result of the aforementioned revenue and expenditure trends, general government will have a budgetary surplus equivalent to 0.9% of GDP in 2006.

In 2007 and 2008, public revenues will decrease as a percentage of GDP, in line with the direct taxation reform under consideration detailed in section 6.3, while indirect taxation will increase approximately at the same pace as GDP, so its proportion of GDP will remain constant in the period, just like social security contributions, in a context of a slight deceleration in employment.

Public consumption expenditure growth will slow in 2007-2008 although, because of the sharp increase in previous years, it will not decline as a percentage of GDP until 2008. As a result of fewer unemployed people and a more favourable performance by consumer prices, social benefits will continue to grow in line with GDP and they will remain constant as a percentage of GDP during most of that period and may increase marginally at the end of the period, in line with the projections for pension expenditure.

The interest rate rises in the projection period are assumed to be gradual and small so, given the average term of Spanish public debt, their impact on the financial burden will not be very high in the period. As a result of this assumption as well as of the primary budget surpluses' path foreseen, interest expenditure as a percentage of GDP will continue to fall in 2007 and decrease marginally in 2008. The decrease in interest expenditure and public consumption will enable the public investment rate to continue to increase as a percentage of GDP, while total public expenditure will slightly diminish as a percentage of this variable.

A public surplus will be maintained during the entire 2006-2008 period because the Central Government will maintain a balance or a slight surplus in its accounts during that period, while the Autonomous Communities will reduce their respective deficits by 0.1 percentage points of GDP to attain a budgetary balance by 2008. As the positive effects of job creation and immigration start to ease off, the Social Security administrations may reduce their surpluses gradually, to 0.6% by 2008. Local governments will maintain a balanced budget during the 2006-2008 period.

4.4. Structural balance and fiscal stance

The structural balance estimates contained in this section are based on the trend GDP obtained by applying the Hodrick-Prescott (HP) filter⁴. The use of the HP filter instead of the production function method is based on the 11 May 2004 Ecofin Council's Conclusions, which stated that "for Spain, both methods will be used in parallel until results have become more stable". In the subsequent work performed by the Economic Policy Committee, it was endorsed in June 2005 that "Spain could in principle agree to use the production function method as long as the Commission's macroeconomic database was updated with the revised Spanish datasets, (National Accounting and employment series) and the HP filter could continue to be used as a back-up method⁵.

The work performed by the Commission and in Spain in the last few months shows that there are still some major problems in applying the production function method to calculate Spain's potential growth. The problems are due mainly, but not exclusively, to the series that are used; the potential growth estimates for Spain provide results that are inconsistent with the economic reality and with economic analysts' general perception⁶.

As a result, and because of the economic policy implications that an inappropriate estimate potential GDP might have, the introduction of the

⁴ The HP filter is applied to the series of real GDP in the 1960-2011 period with lambda equal to 100. Structural revenues and expenditure were calculated with an elasticity of 1.09 and 0.16, respectively, as estimated in the European Commission's document entitled "New and Updated Budgetary Sensitivities for EU Budgetary Surveillance" dated 30 September 2005.

⁵ The Guidelines envisage that, until an agreement on the Production Function Method is reached, Member States can use their own figures.

⁶ The Ministry of Economy and Finance is working with the Commission's technical services to resolve persisting problems in the application of the production function method to Spain.

production function method has been postponed; instead the Hodrick-Prescott filter continues to be used to calculate potential GDP. The structural balance estimate based on the HP filter is shown in Table 8.

Applying the HP filter means that GDP will grow just slightly below potential GDP, while the output gap is practically zero throughout the period. Therefore, the bulk of the budgetary balance observed is of a structural nature and both the cyclically-adjusted balance and the cyclically-adjusted primary balance barely change.

Table 8					
CYCLICAL DEVELOPMENTS⁽¹⁾					
% of GDP, unless otherwise stated					
	2004	2005	2006	2007	2008
1. Real GDP growth (%)	3,1	3.4	3.3	3.2	3.2
2. Net lending/borrowing	-0.1	1.0	0.9	0.7	0.6
3. Interest expenditure (incl. FISIM)	2.0	1.8	1.7	1.5	1.4
4. Potential GDP growth (%)	3.4	3.4	3.4	3.3	3.3
5. Output gap	0.1	0.2	0.2	0.1	0.0
6. Cyclical budgetary component	0.1	0.1	0.1	0.0	0.0
7. Cyclically-adjusted balance (2-6)	-0.2	1.0	0.9	0.7	0.6
8. Cyclically-adjusted primary balance (7+3)	1.8	2.8	2.6	2.2	2.0

(1) Potential GDP calculated using the Hodrick-Prescott filter for the 1960-2011 period ($\lambda= 100$).

Source: Ministry of Economy and Finance.

4.5. Debt levels and developments.

The fiscal objectives envisaged in this Update will contribute very positively to the long-term sustainability of public finances since they will continue to substantially reduce public debt as a percentage of GDP, from 43.1% in 2005 to 36.3% in 2008.

As shown in Table 9, the expected primary surpluses will contribute 6.8 percentage points to reducing the debt ratio. Nominal economic growth will contribute 7.3 percentage points of GDP to that reduction. Interest expenditure will increase the ratio by 4.6 percentage points. The increase due to acquisition of financial assets and other adjustments (stock-flow adjustment) is expected to be the same as in 2004 it is to say 0.8 percentage points of GDP, so its contribution to increasing the debt ratio in the three projected years will be 2.4 percentage points.

Table 9						
GENERAL GOVERNMENT DEBT DEVELOPEMENTS						
% of GDP						
	2004	2005	2006	2007	2008	2008/2005 Increase
1. Gross debt	46.6	43.1	40.3	38.0	36.0	-7.1
2. Change in gross debt	-2.4	-3.5	-2.8	-2.3	-2,0	
Contributions to changes in gross debt						
3. Primary balance	-1.9	-2.8	-2.6	-2.2	-2,0	-6.8
4. Interest expenditure	2,0	1.8	1.7	1.5	1.4	4.6
5. Effect of nominal GDP growth	-3.3	-3.3	-2.7	-2.4	-2.2	-7.3
6. Other factors	0.8	0.8	0.8	0.8	0.8	2.4
p.m.: implicit interest rate on debt	4.47	4.23	4.12	4.05	4.02	

Source: Ministry of Economy and Finance.

5. SENSITIVITY ANALYSIS AND COMPARISON WITH PREVIOUS UPDATE

5.1. Sensitivity analysis: alternative growth scenarios and risks

To analyse the sensitivity of public finances to economic growth, real GDP growth is assumed to be the only variable that changes. Specifically, an alternative scenario was considered in which real GDP growth is 0.5 percentage points lower than the baseline scenario as from 2006. The results are shown in Table 10, which shows that this slower growth scenario reduces the budget surplus until it becomes a 0.1% deficit in 2008. Moreover, instead of decreasing by 7 percentage points of GDP as envisaged in the baseline scenario, the debt ratio would decline by 5 percentage points to 37.9% at the end of the period.

Table 10					
SENSITIVITY ANALYSIS					
Alternative growth scenarios					
	2004	2005	2006	2007	2008
Baseline growth scenario					
Real GDP growth (%)	3.1	3.4	3.3	3.2	3.2
Budgetary balance (% of GDP)	-0.1	1.0	0.9	0.7	0.6
Gross debt (% of GDP)	46.6	43.1	40.3	38.0	36.0
Lower growth scenario					
Real GDP growth (%)	3.1	3.4	2.8	2.7	2.7
Budget balance (% of GDP)	-0.1	1.0	0.7	0.2	-0.1
Gross debt (% of GDP)	46.6	43.1	40.8	39.1	37.9

Source: Ministry of Economy and Finance.

5.2. Sensitivity analysis: interest rates

To analyse the effect of interest rate fluctuations on the deficit and public debt envisaged in the baseline scenario, the interest rate curve is assumed to shift 1 percentage point up (high interest rate scenario) and down (low interest rate scenario) with respect to the baseline scenario.

It is also assumed that the interest rate changes do not affect other macroeconomic variables, the fiscal authorities do not react to those changes by altering other revenues and expenditure, and the new interest rates are applied only to the new debt that is issued to cover repayments and net borrowing in the period.

Table 11				
SENSITIVITY ANALYSIS: Interest rates				
% of GDP				
	2005	2006	2007	2008
	High interest rate scenario			
Budgetary balance	1.0	0.9	0.6	0.4
Gross debt	43.1	40.4	38.2	36.4
	Baseline scenario			
Budgetary balance	1.0	0.9	0.7	0.6
Gross debt	43.1	40.3	38.0	36.0
	Low interest rate scenario			
Budgetary balance	1.0	1.0	0.8	0.8
Gross debt	43.1	40.3	37.8	35.7
Source: Ministry of Economy and Finance.				

In those conditions, the 1 percentage point deviation in the interest curve with respect to the baseline scenario starts to have a noticeable (though moderate) effect as from 2007 since the average term of Spanish public debt is around six years. At the end of the time horizon (2008), the deviations with respect to the baseline scenario are around 0.2 percentage points of GDP in the budgetary balance and around 0.4 percentage points in the debt/GDP ratio (see Table 11).

5.3. Comparison with the previous Stability Programme Update.

As shown in Table 12, the differences between this and the previous Update in terms of economic growth are significant, especially in the next few years.

Those differences are due partly to the fact that the previous Update used the National Accounting baseline 1995 while this Update uses the data relating to the new GDP estimates made by the National Statistical Institute in the framework of the new National Accounting baseline 2000 (NA2000).

The new GDP estimates, which are based on major conceptual and statistical changes with respect to the previous 1995 baseline accounts series (including new population and employment series), have increased the level and growth rates of GDP; this explains why the largest differences are in the most recent years and these differences will be attenuated steadily during the projected period.

Table 12					
DIVERGENCE FROM PREVIOUS UPDATE					
	2004	2005	2006	2007	2008
	Real GDP growth (%)				
Previous update	2.6	2.9	3.0	3.0	3.0
Current update	3.1	3.4	3.3	3.2	3.2
Difference	0.5	0.5	0.3	0.2	0.2
	Budgetary balance (% of GDP)				
Previous update	-0.8	0.1	0.2	0.4	0.4
Current update	-0.1	1.0	0.9	0.7	0.6
Difference	0.7	0.9	0.7	0.3	0.2
	Gross debt (% of GDP)				
Previous update	49.1	46.7	44.3	42.0	40.0
Current update	46.6	43.1	40.3	38.0	36.0
Difference	-2.5	-3.6	-4.0	-4.0	-4.0

Source: Ministry of Economy and Finance.

As a result of publishing a 2004 budget deficit (using the 2000 baseline) that was lower than the previous estimate (using the 1995 baseline), and because of the information available on 2005, the surplus for the 2005-2008 period has increased, especially since the 0.1% deficit in 2004, adjusted for the State's assumption of RENFE's debt (see previous section), represents a 0.5% surplus.

The deviations in the debt ratio between this and the previous Update are due to a more favourable budgetary balance performance envisaged in this Update and, above all, to the increase in nominal GDP as a result of using the new 2000 baseline. That effect was insignificant in terms of the percentage of budgetary balance since this accounts for a very small percentage of GDP.

6. QUALITY OF PUBLIC FINANCES

6.1. Policy strategy

The 2005-08 fiscal strategy not only refers to attaining the budgetary stability objectives but also focuses specifically on the quality of the public revenue and expenditure policies. Nevertheless, improving the quality of public finances also requires measures to strengthen the institutional framework in which the public sector operates. This is very important in Spain, where budget decisions are increasingly being decentralised and, therefore, effort and commitment are

required at all levels of government. This aim will be met by the reforms envisaged in the Budgetary Stability Laws and in the Autonomous Communities Financing System, further developed in the last section of this document.

The priority in public expenditure is to continue the policy that commenced in the 2005 Budget of focusing on the items with the greatest capacity to boost productivity and contribute to the goal of convergence in per capita income with the European Union. The goal is also to ensure that the main government policies are effective and efficient by creating a Public Policies and Service Quality Assessment Agency, which is envisaged in the Draft Agency Law that is currently being discussed by Parliament. This focus on the quality of public expenditure, particularly on the so called growth enhancing expenditure, is due not only to the objective of real convergence but also to its positive effects on potential growth that will reinforce the long-term sustainability of public finances.

Regarding revenues, a tax reform is currently being studied which, while maintaining the revenue neutrality principle, is aimed at increasing the tax system's efficiency and equity as well as promoting the respect to the environment. This reform will not be effective in 2006, when the only changes in the tax regulations will be technical modifications under the commitment to limit the distortion effects of inflation on taxation. Thus, for the second year running: the personal income tax rates will be deflated, the coefficients applicable to real estate assets will be inflation-adjusted and certain levies will also be inflation-adjusted. Excise rates on alcohol, beer, intermediate products and cigarettes will be maintained, after the increase in September 2005.

In addition to this reform, if GDP performance leads to higher revenues than the projections contained in this Update, the possibility of using those additional revenues to foster productivity or to relieve the impact of a reduction in European funding will be analysed.

6.2. Developments on the expenditure side

The priority given by economic policy to productivity entails an expenditure strategy which prioritises policies that most directly affect growth. Consequently, spending on R&D and innovation and on the development of the Information Society, investing in infrastructure and strengthening education policy are a priority in budget policy. This means not only increasing their share of overall expenditure policies but also having a medium-term strategy to support those policies and ensure their continuity. The effort devoted to budgetary stability is of utmost importance since policies take time to have an effect and there is relatively little room for manoeuvre in expenditure policies.

Civilian investment in R&D and innovation is a key factor in maintaining and increasing growth, productivity and welfare. As a result of Spain's R&D and innovation gap with respect to the EU, convergence in this field is a priority in economic and budgetary strategy. The Ingenio 2010 Programme is aimed at encouraging the State, companies, universities and other research centres to

increase R&D and innovation spending to 1.6% of GDP by 2008 and 2% by 2010, with the private sector contributing 52.5% by 2010. The goal is also to increase the Information Society's participation in the economy to 6.4% of GDP by 2008 and 7% by 2010 (vs. 4.8% in 2004).

To mobilise the funds required to attain those goals, it has been undertaken to increase civilian investment in R&D and innovation by no less than 25% per year during this legislature. To comply with that commitment, expenditure on those items in 2006 is projected to increase by 30.9%, or by nearly 28% considering only non-financial expenditure (figure 5).

In addition to increasing the allocation to the projects under way, the Ingenio 2010 Programme will provide new strategic actions: the CENIT Programme, to foster public-private partnership; the CONSOLIDER Programme, to increase cooperation among researchers in leading consortiums and special facilities; and the AVANZ@ Plan, to foster the development of the Information Society among citizens, businesses and the public administration, and to narrow the gap with the EU.

The physical capital deficit in the Spanish economy and its close relation to productivity and growth explain the priority given to public investment in infrastructure. The effort in this field is essential for modernising the economy and integrating it into Europe and it also contributes to territorial cohesion and market efficiency. Specifically, the 2006-08 period continues to concentrate investments in two areas: transport infrastructure and water resources. In 2006, projected investments will grow by 12.4%, i.e. over 4 percentage points more than the increase in the consolidated non-financial spending budgeted for that year.

To provide a coherent, stable framework for those actions, the 2005-2020 Strategic Infrastructure and Transport Plan⁷, which focuses on investments in transport infrastructure, was approved. Although there are actions to increase the capacity of ports and airports, the top priorities are railway infrastructure and, secondly, road transport.

The water investment policy is based on the AGUA Programme⁸, which includes a policy change in accordance with the EU Directives and whose purpose is to foster rational, efficient use of water resources and increase the effectiveness of the public funds allocated to water infrastructure and management.

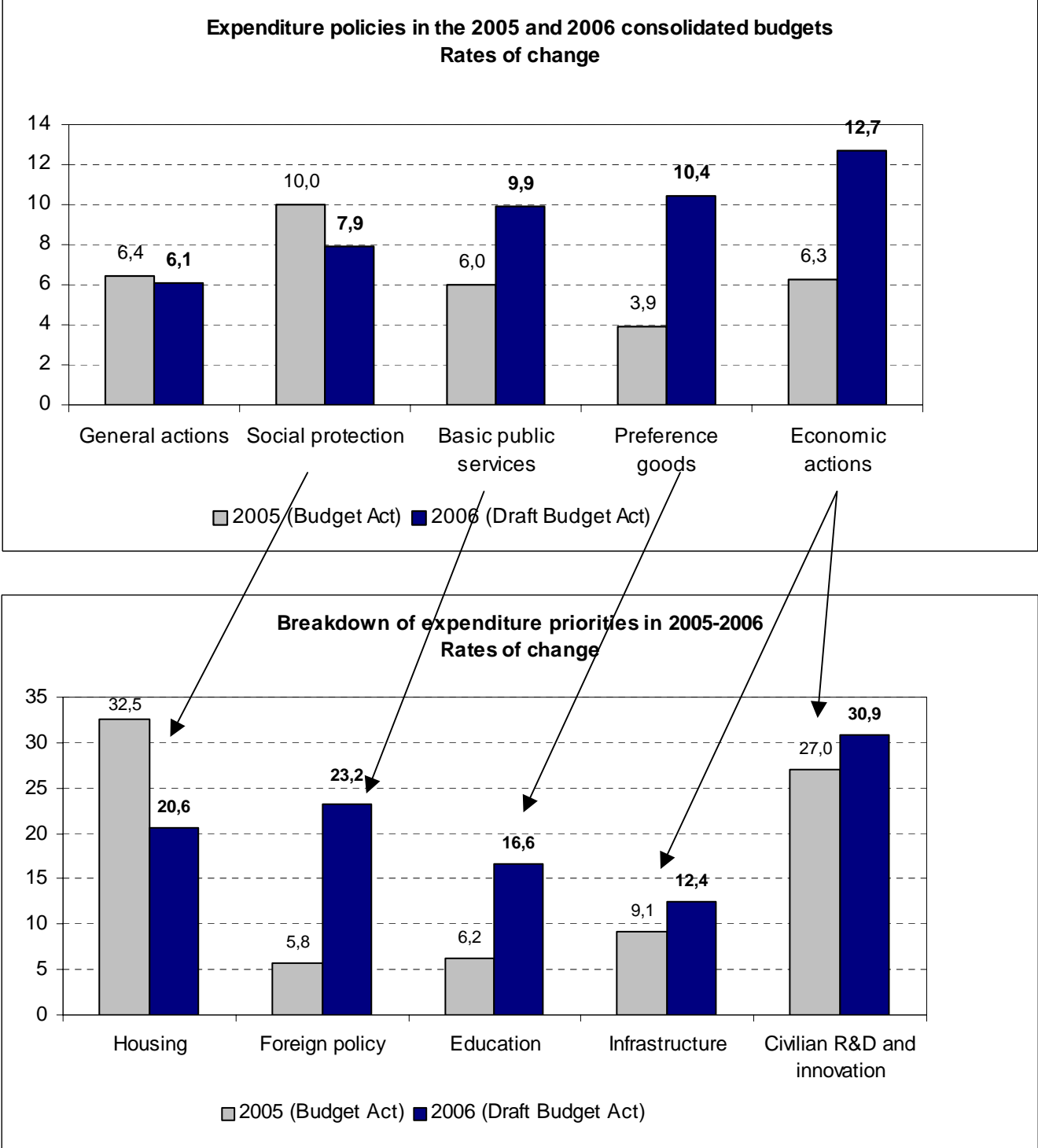
Even though most education policies are decentralised, their clear impact on the productivity of human capital and the State's role as guarantor of quality education and equal opportunities explain the efforts envisaged in this field. The State assumes part of the costs of the education reform under way (reform of the Organic Law on Education) which, among other actions, will foster language-learning, introduce information and communications technology (ICT) and

⁷ www.fomento.es

⁸ www.mma.es

maintain the commitment to the grants policy. In 2006, education spending will rise by 16.6%, with a 9.6% increase in study grants and aids.

Figure 5



Professional training for the employed and unemployed will also receive attention, and collective bargaining and collaboration between the State and the Autonomous Communities in this field will be reinforced. The 2006 budget includes a 6.3% increase in total spending on professional training for the employed and unemployed.

The Public Policies and Service Quality Assessment Agency, envisaged in the draft Agency Law, will also play a fundamental role in improving the quality of public finances. This draft law is currently being discussed by the Public Administration Commission of Congress. Under that law, the Agency will promote and assess public policies and programmes in order to foster rational use of resources and quality management of public services. For those purposes, the programmes and policies that are to be assessed will be approved each year. Congress must also receive an annual activity report on the state agencies' activities and their commitments to improving the quality of public services. Besides, the National Reform Programme envisages that the Agency will draft an additional annual report on its implementation.

This new Agency is part of the wider context of actions envisaged to modernise public management. The Draft Agency Law provides for a partial reorganisation of the administration, introducing institutional changes to facilitate a more flexible, autonomous management model that should enhance the quality of public finances, as it is further developed in section 8.3.. Technology is to be modernised via the CONECTA Plan, which provides for investments to bring the administration closer to citizens (ciudadano.es), rationalise and simplify management procedures ([simplifica](http://simplifica.es)) and foster data exchange, electronic certificates ([certifica](http://certifica.es)) and electronic signatures ([eDNI](http://eDNI.es)).

6.3. Developments on the revenue side

The tax reform currently being studied is aimed at increasing equity, boosting efficiency and improving the environment. Consequently, the reform focuses on direct taxation by amending personal and corporate income taxation. In the framework of the recently-approved AVANZ@ Plan, the Ministry of Economy and Finance will consider extending the tax incentives for R&D and innovation investments to cover the use of ICT and training of ICT personnel and to introduce incentives to foster teleworking.

The reform of personal income taxation is aimed at ensuring a more equitable treatment depending on the taxpayer's personal and family circumstances, reducing the tax burden on salary income, simplifying taxes, and increasing efficiency by reducing the number of tax brackets and the maximum marginal rate. The reform also considers reorienting the tax incentives for private pension plans, ensuring that they complement the public system and mitigating the problem of long-term care via tax benefits.

The reform of corporate income tax seeks to have a major effect on economic and employment growth. Therefore, the changes are aimed at reducing the tax rate in order to enhance companies' competitiveness and at simplifying and rationalising the tax deduction scheme by eliminating deductions that have not met the targets and distort business decisions.

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

In addition to the tax reform, a fraud prevention law is also expected to be drafted to ensure equity in taxation, without which the results of any reform would be undermined.

7. SUSTAINABILITY OF PUBLIC FINANCES

7.1. Long-term budgetary projections

In accordance with the Code of conduct on the format and content of Stability and Convergence Programmes, this Update includes the pension expenditure projections based on the common demographic and macroeconomic assumptions by the Ageing Working Group of the Economic Policy Committee.

The common demographic assumptions suggest that the overall population of Europe in 2050 will be considerably older than in 2003. In Spain, the total labour force will decrease significantly while the population aged 65+ will double and the population aged 80+ will triple.

Regarding the common long-term labour market assumptions, Spain will be the EU country where the labour force will increase most in the 2004-50 period, apart from Cyprus, due to a large increase in participation by women and workers aged between 55 and 64. In any case, the methodology assumes that there are no changes in labour market policies. The unemployment rate is expected to converge upon the EU-15 NAIRU average (7%) in 2012 and remain constant until 2050. As a result of the expected participation and unemployment rates, the employment rate of the population aged between 15 and 64 will grow considerably, to 71.4% by 2050. Nevertheless, because of demographics, the number of people employed in 2050 will be 3.8% lower than in 2003.

Regarding labour productivity, an approach was adopted based on the production function in which employee productivity is determined by the projected

employment rate based on the assumptions for the total factor productivity (TFP), which in Spain will converge to 1.1% by 2012,⁹ and on investment, which is expected to remain constant as a percentage of GDP until 2010, while the capital/labour ratio will be constant between 2030 and 2050, so labour productivity growth will be the same as total factor productivity growth. Other significant macroeconomic assumptions are that real interest rates will be 3%, the inflation rate will be constant at 2%, and growth in real wages will be the same as labour productivity growth.

As a result of these assumptions, the potential growth rate will decrease considerably throughout the EU by 2050.

Based on these scenarios, the main features of the projections for pension expenditure made by Spain in the framework of Ecofin are shown in Table 13. Pension expenditure will increase from 8.7% of GDP expected in 2005 to 15.7% in 2050 due mainly to a rise in the dependency rate (population aged 65+ as a percentage of the labour force) from 24.6% in 2004 to 65.6% in 2050.

Table 13							
LONG-TERM PENSION EXPENDITURE PROJECTIONS							
% of GDP							
	2000	2005	2010	2020	2030	2040	2050
Total pension expenditure	9.1	8.7	8.9	9.3	11.8	15.1	15.7
Social security pensions	8.1	7.8	8.1	8.5	11.0	14.4	15.2
Old-age and early retirement pensions	6.0	5.7	5.8	6.1	8.4	11.5	12.2
Other pensions	3.1	3.0	3.1	3.2	3.4	3.6	3.5
Assumptions							
Labour productivity growth		0.8	1.6	2.0	1.7	1.7	1.7
Real GDP growth		3.1	2.8	2.0	1.0	0.4	1.0
Male participation rate (aged 20-64)		85.6	86.9	87.9	87.0	86.1	87.8
Female participation rate (aged 20-64)		61.5	66.4	72.2	73.5	73.4	74.9
Total participation rates (aged 20-64)		73.6	76.7	80.2	80.3	79.9	81.5
Unemployment rate		10.4	8.7	7.0	7.0	7.0	7.0
Population aged 65+ as % of total population		16.8	17.2	19.6	24.4	30.5	35.0
Source: Ministry of Economy and Finance.							

⁹ The general assumption for the EU-15 is that the TFP growth rates will converge to 1.1% by 2030. Since this assumption produces strange results in some cases, including Spain, individual solutions have been adopted.

7.2 Policy strategy

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

- Budgetary stability, which helps to reduce the public debt/GDP ratio and increase the reserve fund assets.
- Greater employment and a longer working life.
- Revising social security systems and controlling other age-related expenditure.

Social Security Reserve Fund

The Social Security surplus has raised the allocations to the Social Security Reserve Fund (SSRF), which was created in 2000 to meet future needs in the area of contributory benefits and has grown significantly since then. Under the Budget Law, 6,266.75 million euro will be provisioned to the Reserve Fund in 2006, so the Fund balance will exceed 32.9 billion euro, i.e. 3.4% of GDP.

Table 14 SOCIAL SECURITY RESERVE FUND	
	%
Bank of Spain current account balance	4.0
Spanish short-term government bonds	7.4
Spanish long-term government bonds	71.1
Foreign government bonds	17.5
Source: Ministry of Economy and Finance.	

In November 2005, the SSRF, valued at market prices, amounted to 27.424 billion euro. The breakdown of the fund by asset class at market prices is shown in Table 14.

Social welfare reform

In the framework of the Social Dialogue Declaration signed in July 2004, it was agreed to create a Forum for Dialogue with the social partners to reform the Social Security. In that context, on 10 November 2005 the Ministry of Employment & Social Affairs submitted to that Platform a proposal with a broad package of reforms that affect not only retirement benefits but also the system's entire benefits in order to allow for an orderly increase in expenditure on all items and correct current loopholes in the social welfare system.

The reforms proposed to the social partners include a longer working life, a closer link between contributions and benefits, and adjustments to correct injustices in the system.

In line with international institutions recommendations, the reforms aimed at lengthening the working life are as follows:

- Create effective incentives for workers to voluntarily lengthen their working lives by improving their benefits.
- Provide more incentives to businesses to retain older workers.
- Discourage early retirements.

The objective of achieving a closer link between contributions and benefits is a mandate of the Toledo Pact, for which the government proposes the following:

- Increase the possibilities of improving the tax base and generate more incentives to lengthen the working life.
- Reduce the possibilities of evading or lowering the legal requirements to obtain benefits (qualifying periods, short-term or long-term disability, the combination of various cases).
- Simplify the system's structure and eliminate obstacles to a better classification.
- Simplify and unify the requirements for receiving benefits.

The proposals to correct the lacunae in the current social welfare system are as follows:

- Improve minimum pensions.
- Improve the severe disability benefits of workers with lower pensions.
- Expand widows'/widowers' pensions to encompass new family situations of economic dependency while adapting benefits to Spain's future social and economic reality.
- Correct the current situation in which people who retire early voluntarily receive a larger pension than those who retire due to a lay-off.
- Establish greater contributions from those who work for less time.

Control of healthcare expenditure

The fundamental objective is to guarantee the financial viability of the National Health System by moderating expenditure growth and seeking maximum efficiency in resource utilisation in order to maintain a quality universal public health system and face the major challenge of population ageing and technological innovation.

- a) Development of a Strategic Plan on Pharmaceutical Policy: The Plan, implemented mainly in the Law on the Guarantee and Rational Use of Medicaments and Healthcare Products, envisages, among other items, actions in the following spheres: establishment of objectivity and transparency criteria in funding drugs and healthcare products by increasing the effectiveness of drug prescriptions funded by the public sector; improvement in the pricing mechanisms by attaching greater importance to scientific evidence and fostering rational and efficient use of resources; reform of the reference pricing system, which establishes maximum funding prices for

certain drugs, to ensure that it is objective, transparency, gradual and predictable for the pharmaceutical industry; implementation of a selective drug-funding mechanism based on criteria of therapeutic effectiveness and pharmaco-economics; actions to ensure ongoing training and the quality and objectivity of drug information provided to professionals; and fostering rational and informed use of medicines by citizens. The Plan also contains measures to increase the availability of generic drugs in the National Health System as a means of rationalising and containing expenses by expediting the registration and marketing authorisation procedures and providing information and promotional campaigns, among other measures.

- b) A Quality Plan will be adopted to improve the quality and cohesion of the National Health System, with the following action guidelines: reinforcing health and safety policies via Healthcare Strategies; drafting and promoting guidelines on evidence-based clinical practices in order to rationalise the use of all the diagnostic and therapeutic technologies; reinforcing the Healthcare Technology Assessment Agency and the National Health System assessment network in order to foster prior assessment of technologies that are introduced into the system; providing support for the ongoing training of professionals; developing programmes to accredit and assess healthcare centres and services; and developing information systems.

8. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

8.1. Reform of the Budgetary Stability Law

On 29 July 2005, the Spanish Cabinet approved the submission to Parliament of the amendment to the General Budgetary Stability Law and the Organic Law Complementing the General Budgetary Stability Law, in which budgetary stability is reinforced and more transparent criteria and procedures are introduced in order to ensure application by all the administrations.

The budgetary objectives take account of the peculiar features of the various public administrations, so the Social Security objectives are established separately from those of the other administrations. This enhances transparency in defining the budgetary stability objective. The Social Security objective is to attain a balance between long-term revenues and expenditure, i.e. to ensure the system's financial sustainability. Accordingly, the Social Security's stability objective will be determined based on the medium- and long-term projections for demographic and economic performance.

For the other administrations, the budgetary stability principle is modified in order to adapt it to the economy's cyclical situation, so a budget deficit is allowed in exceptional circumstances. The budgetary objectives will be defined for a 3-year period based on the economy's cyclical position expected in those years, thus reinforcing fiscal policy's stabilising function and preventing a possible pro-cyclical bias. The stability objective will be established each year using a Spanish GDP growth threshold below which governments may register a deficit and

another threshold over which governments must budget a surplus. Between the two thresholds, governments must balance the budget. Initially, the minimum threshold will be 2% of GDP growth and the maximum 3%.

Therefore, deficits may be incurred in periods of slow growth but they cannot exceed the maximum threshold of 1% of GDP for the State, Autonomous Communities and Local Administrations as a whole, broken down as follows: State: 0.20% of GDP; Autonomous Communities: 0.75% of GDP and Local Administrations: 0.05% of GDP.

The new regulation also imposes the obligation to attain surpluses in periods of fast growth, which is more demanding than the European Stability and Growth Pact. Nevertheless, the obligation to budget a surplus takes account of the degree of convergence in R&D and innovation and in the development of the Information Society.

The cyclical position needed to establish the multiyear stability objectives is determined by the Ministry of Economy and Finance. Nevertheless, before drafting the report, the Ministry must consult with the National Statistics Institute and the Bank of Spain, and take account of the projections by the European Central Bank and European Commission.

Regardless of the foregoing and in addition to the deficit that is determined, the State, the Autonomous Communities and certain Local Administrations that have tax-raising powers may register a deficit when it is used to increase investment in programmes to address productive actions, including R&D and innovation. Nevertheless, the deficit arising from those programmes is capped at 0.5% of GDP for governments as a whole, which continues to provide a wide margin to meet the SGP even if the cyclical position of the economy allowed an additional deficit of up to 1% of GDP. Besides, the requirements for acceptance of those programmes have been clearly defined. Specifically, it must be accredited that the programmes increase public investment, that at least 30% of the programmes are funded with the gross savings of the proposing administration, and that the investments contribute to improving economic productivity and competitiveness. Moreover, the decision to accept an investment programme must take account of the proposing administration's public indebtedness t.

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

To improve the application of the stability principle, the reform toughens the indebtedness requirements of all the public administrations that fail to comply with the deficit objective and it highlights that the State will not assume or be liable for the commitments arranged by the Autonomous Communities or the bodies associated with them. If there is a risk of any administration failing to comply with the stability objective, the Government may issue a warning. If the objective is breached and there is a larger deficit, an economic and financial adjustment plan must be drafted.

Furthermore, the reform focuses especially on increasing the transparency of public accounts. Accordingly, the budgets for the State, Autonomous Communities and Local Administrations and their settlements must enable them to comply with the stability objective and with the EU regulations on national accounts. Moreover, the administrations' information requirements will be increased and the information will be entered into a public database.

8.2. Reform of the Regional Financing System

The reform's objective is to increase the symmetry of the Autonomous Communities' powers in terms of revenues and expenditure in order to correct the current pressures on expenditure that are due to the limited joint fiscal responsibility. The reform will reinforce the principles of neutrality, autonomy and equity by enhancing the system's transparency and stability. The reform's main guidelines are as follows:

- Devolve new legislative power to Autonomous Communities in order to increase joint fiscal responsibility and reinforce their presence in the tax institutions in order to favour both the financial autonomy of the various administrations and the efficient management of the state's tax resources.
- Establish an explicit levelling mechanism to ensure that the Autonomous Communities can provide a minimum level of services independently of their fiscal capacity.
- Ensure that the regions' additional fiscal efforts are aimed at funding services in the corresponding region.
- Ensure that funding is linked more closely to demographics.
- Reduce the dispersal of funding per capita.

8.3. Agency Law

The Draft Law on Agencies for Improving Public Services is currently being processed and it will regulate and introduce a new general form of organisation into the General State Administration: State Agencies. The aim is to ensure that public management is more in line with the Administration's current dimensions in the 21st century and in line with the most advanced countries in terms of the public function.

Those new bodies will have greater autonomy and flexibility than those envisaged in current legislation, while the efficiency control mechanisms will be reinforced by fostering a performance-based culture. Their management model will be based on the following basic features:

- Management by objectives, set out in a management contract that establishes commitments, performance indicators and certain efficiency and quality levels.
- Greater autonomy in the areas of personnel, budget and control.
- Greater capacity to generate revenues, with the possibility of obtaining sponsorship revenues.

The creation of those agencies does not automatically entail the creation of a new type of public body. On the contrary, the current public bodies whose activity and functions conform to the concept of State Agency will be gradually switched to this new formula. Specifically, the Draft Law proposes the creation of the following eight agencies, in addition to the Public Policies and Services Quality Assessment Agency referred to earlier:

- BOE
- Scientific Research
- Immigration & Emigration
- Safety in Transport & Air Navigation
- Performing & Musical Arts
- Meteorology
- International Cooperation
- Research in Biomedicine & Health Sciences

8.4. Other reforms with an impact on the budget scenario

One of the main recent budgetary reforms is the agreement in September 2005 to improve healthcare funding. That agreement includes measures that affect the 2006 budget; based on the Government's commitment, the State will contribute 1.677 billion euro (excluding advances on account) to the Autonomous Communities to fund healthcare expenditure.

Furthermore, Royal Decree-Law 12/2005 authorises the Ministry of Economy and Finance to grant cash advance facilities to the Autonomous Communities under the common system and to the Autonomous Cities on account of the funding system's final settlement. Those advances may affect the expenditure cap.

That Royal Decree-Law also increases taxation on alcohol and tobacco, with the double effect of raising revenues and discouraging its consumption. The tax rate on alcohol and alcoholic beverages has increased by 10%. The specific tax rate on cigarettes has increased by 5.3% while the *ad valorem* tax has increased by nearly 1 percentage point. The *ad valorem* tax rate on other tobacco products has increased by a similar proportion to the overall increase in tobacco taxation

as a result of applying the new rates. The conditions set out in the EU regulations are respected in all cases.

9 CONCLUSION

This Stability Programme Update shows that public finances are clearly a major asset of the Spanish economy. Healthy public finances enable the development of a strategy in which economic growth and productivity are the main focuses and challenges of Spain's economic policy. Far from restricting the policies that boost economic growth, Spain's fiscal policy is a fundamental tool in enabling it to meet the Lisbon objectives by providing quality finances.

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

This favourable starting point does not prevent the government from considering other reforms required to address any challenges that may arise outside this programme's horizon or other reforms that reinforce fiscal policy efficiency and effectiveness. Therefore, in addition to the budgetary objectives themselves, this update details the reforms being processed or under consideration, covering the reform of the budgetary stability laws, the tax reform, the social security reform and the new Agency Law.