STABILITY PROGRAMME UPDATE

SPAIN

2007 - 2010

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1. INTRODUCTION

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

This Update is consistent with 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. Additionally, since the last Update, Spain's fiscal policy has been governed by the new Budgetary Stability Acts, which were enacted in May 2006 and came into force in January 2007. This Update coincides with the first Budget to be drawn up under that new legislation.

The fiscal strategy based on the commitment to budgetary stability throughout the economic cycle, establishing priorities for public expenditure and policies aimed at improving the quality of public finances and ensuring their long-term stability, is maintained. Consequently, the fiscal objectives established here amply fulfil the commitments contained in the Growth and Stability Pact as well as continuing to provide scope to implement policies that enable growth and productivity to be improved.

The content and format of this Update conforms to the new Code of Conduct approved in 2005, including the technical adjustments approved by the Economic and Financial Committee on 25 September 2007.

The remittal of the Stability Programme Update to the EU authorities is a matter to be decided upon by the Cabinet. The European Council's opinion is also taken into consideration when setting multi-year objectives for budgetary stability; these are set in the first half of each year and must be approved by both houses of Parliament. The Budgets drafted subsequently must conform to those multi-year budgetary objectives.

2. OVERALL POLICY FRAMEWORK AND OBJECTIVES

The priority goal of Spain's economic policy is to improve citizens' well-being by increasing their wealth and job opportunities. In particular, the "National Reform Programme[1]: Convergence and Employment" (NRP) presented by Spain in October 2005 establishes the goal for 2010 of attaining full convergence in per capita income with the European Union (EU-25) and an employment rate of 66% of the population of working age. To attain those objectives, economic policy strategy is aimed at favouring a model of economic growth that is sustained, balanced, and productive while also providing solidarity, and to this end it is necessary to increase productivity and the stock of productive capital while maintaining high rates of job creation.

[1] www.la-moncloa.es

This Stability Programme Update is part of that strategy, whose fundamental components are as follows:

- Macroeconomic and budgetary stability: this is one of the seven pillars of the National Reform Programme. This Update extends, for another three years, the government surplus first attained in 2005 and makes further progress in reducing the debt as a percentage of GDP, thus consolidating a very sound position in public finance. This is possible due to the reform of the Budgetary Stability laws, which also include detailed regulations on the composition of expenditure. In fact, the definition of fiscal objectives takes account of the need to priorities expenditure that will stimulate productive investment. The sound financial position has also made it possible to amend the direct taxation system by not only reducing the tax burden but also making the system more efficient, equitable and neutral. The Social Security surplus envisaged in this Update make it possible to continue increasing the Reserve Fund for pensions; coupled with the steady decline in debt as a percentage of GDP, the reforms to the Social Security System and the measures to control healthcare expenditure, the result is to increase the public accounts' long-term sustainability.

- Fostering productivity: it is necessary to promote a change in Spain's growth model, which to date has been based almost exclusively on job creation, and to sustain the process of real convergence. To that end, it is necessary to undertake reforms that improve the markets in goods, services and factors and to enhance the economy's infrastructure and human and technological capital stock. These were the goals underlying the March 2005 Plan to Vitalise the Economy and Enhance Productivity, whose measures were subsequently incorporated into the NRP. Two updates of the NRP have been published to date; they describe very positive progress in the measures and the attainment of the quantitative goals that were established.

- Transparent and efficient regulation: the goal is that the government's regulatory action should contribute to market efficiency while also offering more and better information about the economic effects of the measures that are approved. In the context of the Programme to Improve Regulation and Reduce Red Tape, a commitment has been made to reduce the burden imposed by domestic legislation on companies by 25% by the year 2012. The Action Plan to attain that goal is expected to be ready in January 2008. Additionally, the State Agency for the Assessment of Public Policy and Service Quality, established in December 2006, is tasked with promoting a culture of assessment in addition to performing the assessments within its brief, and it may cooperate with other administrations to this end. Transparency is being enhanced by means of Government decisions to improve economic and statistical information. Those decisions establish publication schedules and have also led to the publication of adjustments to the National Accounting to make it possible to match the approved stability goals with the budgeted figures, and the investments by government-owned companies and their breakdown by region.

Accordingly, this Update provides full continuity with the economic policy strategy that commenced in this legislature and is also fully consistent with the commitments made under the Stability and Growth Pact.

3. CURRENT ECONOMIC SITUATION AND OUTLOOK

3.1 External assumptions

In the first half of 2007, the world economy continued expanding at a 5% annual rate, prolonging the positive tendency of the last few years. The vigour of the emerging economies continued, with an increasing leading role of the big three, China, India and Russia, which represented half of total world growth last year and compensated for the more moderate growth in developed countries. Since August, financial market turbulence, initially triggered by problems in financial institutions caused by US subprime mortgages, has added uncertainty to the international panorama, affecting the general economic climate and provoking major stock market volatility.

After this episode, the world monetary authorities acted decisively, injecting liquidity when necessary and, in the case of the Federal Reserve and the Bank of England, reducing interest rates. As a result, interest rate expectations changed: the markets are discounting rate cuts in the USA and, as long as market tension lasts, a central scenario of no rate movements by the European Central Bank.

Oil prices have increased once again in the last few months due to new tensions in the Middle East and the OPEC's decision to maintain current production levels, while a combination of both demand and supply factors have pushed international cereal prices upwards.

The US growth rate remained firm in the third quarter, boosted by strong consumer spending and exports, favoured by the falling dollar (which offset the sharp setback in residential construction). Nevertheless, recent indicators point to a slowing in the fourth quarter due to the ongoing real estate crisis, and the effect of rising oil and food prices on consumer spending and production costs.

In the euro area, GDP growth slowed substantially in the second quarter, after having intensified in the first, although the deceleration may have been caused by the mild weather conditions at the beginning of the year, which favoured construction work. In the third quarter, expansion gained pace and the latest indicators show continued growth at a moderate rate. Unemployment rates continue sliding while exports remain dynamic despite the appreciation of the euro. This appreciation will contribute to correcting the world's financial disequilibria, but the adjustment will mainly fall on the euro area.

Outside the euro area, the UK economy has shown signs of slowing in recent months as a result of the impact of the subprime mortgage crisis, but the Bank of England was quick to react by cutting interest rates. In Japan, growth continues at a more moderate pace. The emerging economies are expanding rapidly, providing crucial support for world growth.

Despite the credit market turbulence, high oil prices and the increase in agricultural commodity prices, world economic prospects for the rest of this year and 2008 continue on the favourable side according to the European Commission, as economic fundamentals remain solid. With respect to its April 2007 estimate, the Commission increased its estimate for 2007 by 0.3 points to 5.1% and lowered its prediction for world GDP growth in 2008 by 0.1 points to 4.7%. For 2009, growth is expected to be 0.1 points more than the 2008 figure.

Table 1 reflects the main international assumptions on which this Update of Spain's Stability Programme for 2007-2010 is based. This table shows a slight slowdown of the European economy after 2007, to 2.4% in 2008-2009, after which the economy will once again pick up speed. World GDP, excluding the European Union, will experience growth of some tenths of a point less than in 2008, due to adjustments in the US housing market, but will later regain strength insofar as the US economy returns to its potential rate; at the same time the emerging economies will continue to expand rapidly.

Table 1

EXTERNAL ASSUMPTIONS

	2006 (A)	2007 (F)	2008 (F)	2009 (F)	2010 (F)
Euro area interest rates (annual average)					
Short-term rates	3.1	4.3	4.4	4.3	4.3
Long-term rates	3.8	4.3	4.4	4.5	4.5
Euro exchange rate (dollars per euro) (annual average)	1.26	1.36	1.42	1.42	1.42
Nominal effective exchange rate in the euro area (% change)	0.8	2.2	1.0	0.0	0.0
World excluding EU-27, GDP growth (*)	6.0	5.6	5.3	5.4	5.5
EU-27 GDP growth (*)	3.0	2.9	2.4	2.4	2.5
Growth of foreign markets (**)	9.1	6.9	6.3	6.3	6.5
World goods import volume, excluding the EU-27	8.5	8.1	7.4	7.9	8.0
Oil prices (Brent, USD/barrel)	66.2	70.6	78.8	76.0	76.0

(*) Real percentage change

(**) Real percentage change Intra- and extra-EU trade

(A) Advance

(F) Forecast

Source: European Commission and Ministry of Economy and Finance.

In accordance with the scenario described above, world trade will increase at a more moderate annual rate, accelerating towards the end of the projection period, which will be reflected in the performance of Spain's export markets.

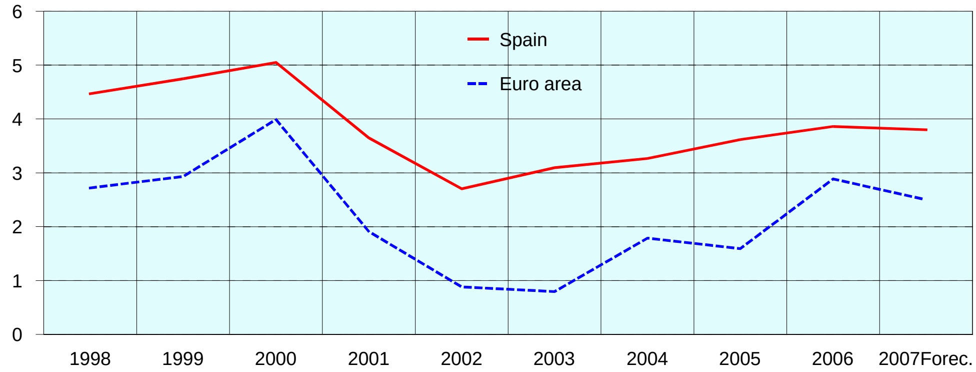
Brent, the European benchmark oil price, is expected to peak in 2008. It is expected to decline slightly after 2008, while remaining high. The dollar/euro exchange rate is assumed to remain at 1.42 in the coming three years.

3.2 Cyclical developments and outlook

In 2006, Spain's economy maintained the rapid pace of growth observed in previous years. According to National Accounts figures, GDP accelerated gently in 2006 to an annual average of 3.9%. It attained 4% growth in the first nine months of 2007 compared with the same period of 2006. Progress has been made in 2007 in rebalancing the composition of GDP in terms of expenditure, since domestic demand has maintained the gentle deceleration that commenced in 2006, while external demand has detracted -0.8 percentage points from growth, contrasting with -1.2 points in 2006.

Figure 1

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



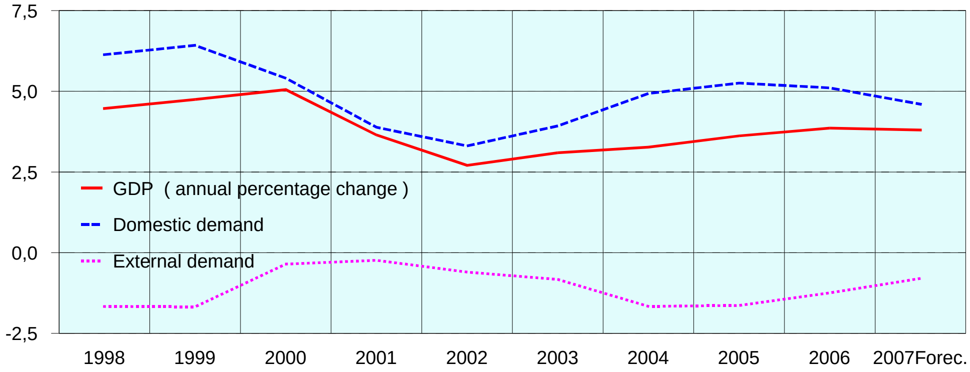
Source: National Statistics Institute (INE), European Commission and Ministry of Economy and Finance.

The composition of domestic demand has also changed in recent quarters, characterised by a deceleration in consumer spending and in construction investment while productive investment (particularly capital goods) gained in importance. Consumer spending is continuing the slowdown that started months ago as a result of trends in its main determinants and, fundamentally of the effects of the increase in interest rates since December 2005.

As for investment, capital goods was the most dynamic component in the first three quarters of 2007, growing at record rates of around 12.5% year-on-year in a context of high corporate earnings profitability and a good outlook for business, favoured by the lower Corporate Income Tax rate. In contrast, investment in construction in the same period grew by 4.5% year-on-year, 1.5 points less than last year, due to the weakening of the home-building subsector. The ongoing slowdown in residential investment has intensified in recent months as tighter lending conditions have affected housing demand. Nevertheless, sustained growth in civil engineering has partially compensated for the deceleration in construction investment.

Figure 2

Composition of GDP growth
Contribution in percentage points



Source: National Statistics Institute (INE) and Ministry of Economy and Finance.

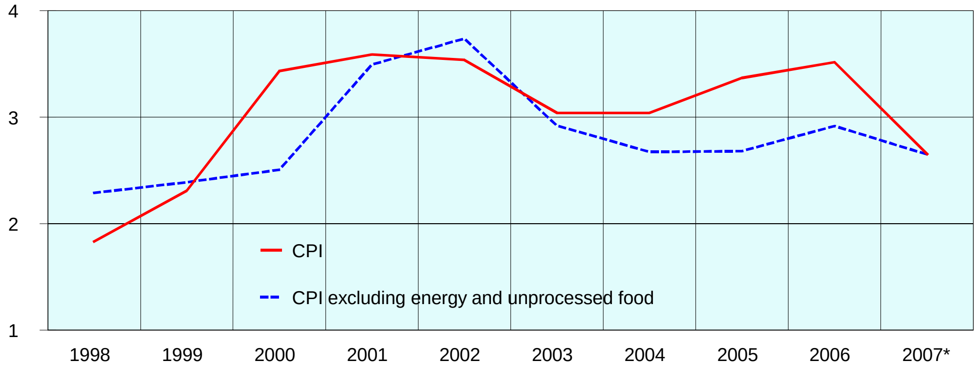
Exports of goods and services accelerated slightly in January-September 2007, while imports slowed, leading to the aforementioned improvement in the foreign sector's contribution to growth. In that period, exports increased by 5.5% year-on-year in real terms, while imports increased by 7%.

These changes in the composition of growth on the expenditure side are reflected in the various sectors of the economy, which jointly expanded strongly in the first three quarters; while the services sector and industry remained strong, the pace of construction activity slowed.

In 2007, the labour market maintained the robust performance observed in recent years. Employment continues to expand at a rapid pace, although slightly slower than the exceptional growth registered in 2005-2006. The work force has also grown at a significant rate (though more slowly than in previous years), driven by rising immigration and the growing female participation rate. Consequently, unemployment has fallen steadily, reaching 8% in the second and third quarters of 2007. Wages are remaining moderate, although compensation of employees is estimated to have accelerated slightly in 2007, in annual average terms, offset by a recovery (though less intense) in productivity. As a result, Unit Labour Costs (ULC) may accelerate in 2007 to nearly 3% nominal year-on-year growth.

Figure 3

Headline inflation and core inflation
Annual percentage change



(*) Latest available Nov.

Source: National Statistics Institute (INE).

In the first eight months of 2007, prices continued the deceleration that had commenced in autumn 2006, when the upward trend of the previous two years (driven mainly by sharp increases in oil prices) was truncated. However, starting in September, the CPI accelerated in parallel with the upswing in world oil prices and the prices of several foodstuffs. The result was that inflation reached 4.1% in November. This recent adverse trend also affected core inflation (i.e. CPI excluding energy and unprocessed foods), which was 3.2% in November, boosted primarily by processed foods. From the second quarter of 2008, inflation will foreseeably begin to decline as a result of sharp increase in the same period of 2007. Nevertheless, the average increase in CPI will be approximately 2.8% in 2007, compared with 3.5% in 2006.

3.3 Projections for 2007-2010: baseline scenario

The central scenario (Table 2) is for a slight deceleration by the Spanish economy, with annual growth averaging approximately 3% in the next three years, and a prolongation of the process of re-balancing in the pattern of growth. Domestic demand will steadily reduce its contribution to GDP growth and external demand's negative contribution will decline to stabilise around -0.3% from 2009 onwards.

After an estimated 3.8% growth by the Spanish economy in 2007, a deceleration of 0.7 points to 3.1% is projected for 2008. This projected slowdown will be due, among other factors, to deceleration by house prices, tighter monetary and financial conditions and, to a lesser extent, lower projected growth by the world economy and the European Union. In 2009, Spain's GDP growth rate may fall by another 0.1 point to 3.0%, accelerating to 3.2% in 2010.

Table 2 MACROECONOMIC PROSPECTS Chained volume indices: 2000=100, unless otherwise indicated							
	ESA Code	2006(A)		2007 (F)	2008 (F)	2009 (F)	2010 (F)
		Level	Rate of change (%)				
1. Real GDP	B1*g	122.0	3.9	3.8	3.1	3.0	3.2
2. Nominal GDP. Billion euro	B1*g	981.0	8.0	7.1	6.7	6.2	6.6
	Components of real GDP						
3. Domestic private final consumption expenditure (*)	P.3	123.3	3.8	3.2	2.8	2.7	2.9
4. Public administrations final consumption expenditure	P.3	133.8	4.8	5.3	5.2	4.6	4.0
5. Gross fixed-capital formation	P.51	137.6	6.8	5.9	3.1	2.7	3.7
6. Changes in inventories (% of GDP)	P.52+P.53	52.9	0.2	0.2	0.2	0.2	0.2
7. Exports of goods and services	P.6	123.7	5.1	5.7	5.4	5.4	5.7
8. Imports of goods and services	P.7	147.2	8.3	7.2	5.5	5.2	5.5
	Contributions to real GDP growth						
9. Final domestic demand		128.6	5.0	4.6	3.5	3.3	3.5
10. Changes in inventories	P.52+P.53	52.9	0.1	0.0	0.0	0.0	0.0
11. External balance	B.11	549.1	-1.2	-0.8	-0.4	-0.3	-0.3

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

The expected deceleration in domestic demand in the projection period will come through an adjustment in residential investment and household consumption expenditure.

The current process of adjustment in the real estate market is expected to be lengthy. Residential demand will continue to suffer from the effect of high interest rates and lower returns on this asset, which, coupled with the expected deceleration in household incomes, will gradually weaken the demand for housing. On the supply side, the slowdown observed in construction in the last few months will be maintained in the remainder of the year and during 2008. Consequently, residential investment will decelerate in 2007, 2008 and 2009, with an impact on construction investment. The number of housing starts is expected to stabilise in 2010 at its equilibrium level, which is determined basically by demographics, leading to a recovery in investment in housing which will boost construction investment overall.

The deceleration in household consumption expenditure that started last year will continue in the fourth quarter of 2007, easing slightly in 2008 and 2009 in response to changes in financial and monetary conditions, a deceleration in disposable income, and a lower wealth effect, and will recover starting in 2010. In this context, it should be noted that Spanish households have notable sources of support, such as the solid labour market and their sound wealth situation (the ratio of bank debt to wealth is among the lowest among our partners).

Major public and private investment in recent years, following a period of intense job creation, should enhance the possibilities of growth in the long term. Although investment in capital goods and non-residential construction is expected to grow more slowly than in the first half of 2007, it will foreseeably continue to expand in the medium term.

After accelerating gently in 2007, goods exports will slow slightly in 2008 as a result of deceleration in Spain's exports markets. That fact, coupled with stabilisation of tourism revenues (and despite growth in non-tourism services), will reduce the growth in exports of good and services by a few tenths of a point in 2008, and the growth rate will be stable in 2009. In 2010, the gentle recovery expected in Spain's export markets will allow goods and services exports to recover slightly.

All components of imports are expected to decelerate steadily until 2009, in line with the progressive slowdown in final demand. However, in 2010, a rebound by consumption expenditure and gross fixed-capital formation will again boost import growth.

Consequently, the foreign sector's net contribution will improve in the projection period with respect to 2007, though it will remain negative throughout.

Although more moderate than in 2005-2006, job creation (Table 3) will remain high in 2007, then decelerate in 2008 and 2009 in parallel with GDP, and recover in 2010. Also, growth in the labour force will ease off due partly to lower immigration of active workers. Slower growth in the work force will limit the effect on unemployment of the slower (though still high) pace of job creation, with the result that unemployment will not exceed 8.2% in 2008 and 2009 and will fall to 7.9% in 2010.

The various measures adopted in the National Reform Programme plus the gradual decline in the importance of the more labour-intensive sectors, such as construction, will favour a recovery in productivity per worker, continuing the trend already observed in 2006-2007 and reaching 1.1% growth in 2010.

As a result of the upswing in inflation in late 2007 and much of 2008, employee compensation will accelerate in 2008, decelerating thereafter. However, this phenomenon will be partly offset by greater gains in productivity, with the result that ULCs will rise by about 3% in 2007-2008 and slow thereafter.

Table 3 LABOUR MARKET DEVELOPMENTS (*)							
	ESA Code	2006 (A)		2007 (F)	2008 (F)	2009 (F)	2010 (F)
		Level	Rate of change (%)				
1. Employment, persons (million)		20.0	3.7	3.4	2.9	2.7	2.9
2. Employment, FTEQ (million people)		18.5	3.2	3.0	2.2	2.0	2.2
3. Labour productivity per employee (GDP/1) (million euro)		38.5	0.1	0.4	0.2	0.3	0.4
4. Labour productivity, FTEQ (GDP/2) (million euro)		41.5	0.7	0.8	0.9	1.0	1.1
5. Compensation of employees (**) (million euro)	D1	28.5	3.0	3.7	4.0	3.5	3.4
6. Unemployment rate (% of labour force)		8.5		8.2	8.2	8.1	7.9

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

As for prices, following the deceleration in 2007 in annual average terms (Table 4), prices will accelerate slightly in 2008 and then decelerate in the following year, in line with the assumption of stable oil prices, lower pressure from domestic demand, and slower growth by ULCs. In particular, the private consumption expenditure deflator will slow by around 0.6 percentage points between 2006 and 2010, reaching 2.8% in 2010, i.e. 0.5 points lower than the GDP deflator. Export and import prices are also expected to accelerate, after easing in 2007. Imports are expected to perform more favourably, in line with the projected trend in commodity prices.

The international financial turbulence has increased the uncertainty surrounding economic projections by accentuating the downside risks for performance by real variables.

External risks lie mainly in the uncertainties about tensions in the financial markets and their impact on lending and confidence, which may lead to a sharper-than-expected deceleration worldwide. Additionally, the recent increase in the price of oil and other commodities may increase inflationary pressure, but the impact on growth is expected to be lower than in previous decades because of the greater credibility of economic policies and the fact that many countries are less dependent on oil.

The internal risks are basically of a larger and more persistent increase in international interest rates than is currently expected, which might deteriorate the economic players' financial position and would have a larger negative wealth effect on real expenditure than is considered in the baseline scenario. The more persistent this phenomenon and the greater the possible credit restrictions on the economic players, the greater the potential deterioration in consumer expenditure and investment.

Table 4
PRICE DEVELOPMENTS
Chained volume indices: 2000=100

	ESA Code	2006 (A)		2007 (F)	2008 (F)	2009 (F)	2010 (F)
		Index	Rate of change (%)				
1. GDP deflator		127.6	4.0	3.2	3.4	3.1	3.3
2. Private consumption deflator (*)		121.5	3.4	2.7	3.3	2.7	2.8
3. Public consumption deflator		122.8	3.7	2.3	3.4	2.5	2.6
4. Gross fixed-capital formation deflator		133.1	4.7	3.5	3.2	3.2	3.4
5. Export price deflator (goods and services)		112.8	4.0	2.3	2.7	2.6	2.7
6. Import price deflator (goods and services)		105.7	3.5	1.3	2.3	1.7	1.6

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

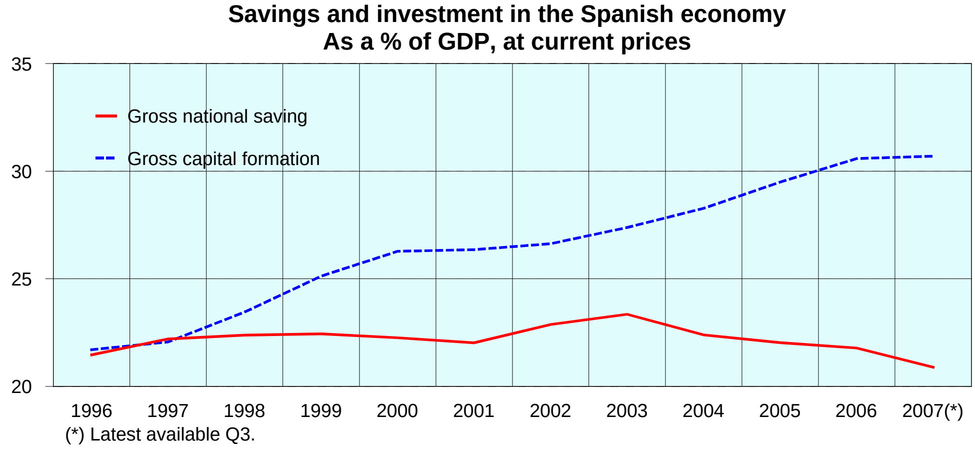
3.4 Sectoral balances

The Spanish economy's external borrowing has increased steadily over the last few years to 9.5% of GDP in the first three quarters of 2007. Among the causes of this increasing imbalance, it is important to note the Spanish economy's positive growth differential with respect to the euro area, the market for most of Spain's exports, which has varied between 1 and 2 percentage points since 2000, thereby creating a permanent stimulus for imports, whereas exports have necessarily been driven by the economic performance of our export markets.

Another crucial factor has been the rising price of Brent oil, the European benchmark, which has gone from 29 dollars per barrel in 2003 to 92.5 dollars in November, noticeably increasing the energy bill and contributing significantly to the increase in the trade deficit.

An analysis of the foreign deficit from an investment and savings point of view reveals that, although domestic saving is high, it is insufficient to finance the high level of investment, which has increased continuously to 30.7% of GDP in the first nine months of 2007, much higher than the average among the main countries in the European Union.

Figure 4



Source: National Statistics Institute (INE).

As regards the recent evolution of the components of the foreign deficit, the trade deficit has essentially stabilised in terms of GDP, but the primary net income and current transfer deficits have continued to deteriorate due to the increase in interest rates and in immigrant remittances as well as the depreciation of the US dollar against the euro, and the reduction in financial flows from the European Union.

The Spanish economy's external borrowing requirement will stabilise around 9% of GDP in 2008-2009 and decline towards the end of the projection period (Table 5).

Table 5

SECTORAL BALANCES (National Accounts)

	ESA Code	2006 (A)		2007 (F)	2008 (F)	2009 (F)	2010 (F)
		Level (*)	% of GDP				
1. Net lending (+)/borrowing (-) vis-à-vis the rest of the world	B.9	-79.9	-8.1	-9.0	-8.9	-8.8	-8.7
- Balance of foreign trade in goods and services		-60.3	-6.1	-6.3	-6.3	-6.1	-5.8
- Balance of primary incomes and current transfers		-26.1	-2.7	-3.4	-3.3	-3.4	-3.3
- Capital account		6.5	0.7	0.7	0.7	0.5	0.4
2. Net lending (+)/borrowing (-) of the private sector	B.9	-97.9	-10.0	-10.8	-10.1	-10.0	-9.9
3. Net lending (+)/borrowing (-) of general government	EDP B.9	18.0	1.8	1.8	1.2	1.2	1.2
4. Statistical discrepancy		-	-	-	-	-	-

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

The Public Administrations are expected to have a surplus until 2010, although it will decline by half a percentage point between 2007 and 2008, to 1.2% of GDP, and remain constant for the remainder of the projection period. Consequently, the public sector will again play a role of moderating the external deficit, while the private sector's borrowing will decline gradually to 9.9% of GDP in 2010. Companies will continue to borrow abroad, mainly to finance investment in capital goods and other products (which remains strong) and in non-residential construction. Borrowing by households and NPISH will ease as a result of the higher saving rate and the slowdown in residential investment.

4. GENERAL GOVERNMENT BALANCE AND DEBT

4.1 Policy strategy

This Update maintains the fiscal strategy that commenced with the 2005 Budget, the main goal being to contribute to the sustainability of the growth model through budgetary stability and to enhance productivity, improve public services and foster growth with solidarity.

Commitment to budgetary stability over the full economic cycle

The entry into force of the new Budgetary Stability Acts in 2007 strengthened the commitment to sound public finances and laid the foundations for them to be maintained over the period covered by this Update. Last year, some principles of this new budgetary framework were applied in advance of the new Act, particularly those referring to the Central Government. Nevertheless, this Update is the first to be drafted under a definition of the stability goals for the next three years that is coherent with the new law. In particular, the definition of objectives was adapted to the economy's cyclical position and the Autonomous Communities' involvement and support in defining this objective were enhanced, which offers greater assurance that it will be attained. Consequently, this reform affords more realistic application of the stability principle as it strengthens the stabilising role of fiscal policy and fosters greater consensus and participation by all administrations (for details of the new features in this system, see section 8.1).

The stability goals envisaged for 2008-2010 entail maintaining a budget surplus for 6 years, which is unprecedented in the history of Spain's public accounts. For the first time, the burden is also shared more equitably since the objective of an overall and individual surplus has been accepted not only by Central Government and the Social Security but also by the Autonomous Communities.

The budgetary stability commitment is also evident in the decline in government debt as a percentage of GDP, since it will reach 34% in 2008, two years earlier than envisaged in the NRP. Additionally, the commitment to align

Central Government expenditure growth with nominal GDP growth has been maintained.

These fiscal objectives are more ambitious than would arise from strict compliance with the Growth and Stability Pact. They are also coherent with the macroeconomic projections and they are prudent since they have scope to accommodate a less favourable outcome. In fact, the combination of a surplus, the low indebtedness ratio and the accumulation of assets by the Social Security put the public finances in a solid position to face longer-term pressures on expenditure as a result of population ageing.

Prioritising productive public expenditure and policies aimed at improving the quality of public finances

Future economic growth and increasing well-being will require not just sound finances but also attention to the qualitative aspects of fiscal policy. As in previous years, the composition and efficiency of public expenditure and revenues are a central pillar of this Update. On the expenditure side, priority is given to increasing the economy's growth capacity and productivity: expenditure on research and development, infrastructure and education.

On the revenue side, further progress is made with reforms to make direct taxation more efficient, thus continuing with the 2006 reform. The tax system is also being made more equitable, by enhancing measures to prevent and combat fraud and providing a more efficient tax collection system so as to facilitate tax compliance.

The assessment of public policies and services, together with modernisation of the public administration, constitute the third pillar underpinning quality public finances.

Guaranteeing the long-term sustainability of finance to ensure the sufficiency and sustainability of social spending.

The social dimension of fiscal strategy is essential to ensure that everyone shares in the benefits of economic growth. To this end, it is necessary to extend welfare coverage to address new social realities while also ensuring that the public finances are sufficient and sustainable. Consequently, this Update continues to take a long-term view of the underlying pressures on expenditure, particularly those stemming from ageing.

To attend to new realities, the new long-term care system is being phased in gradually with the cooperation of all the administrations. And a first set of measures has been implemented in the area of pensions and healthcare spending that should have a positive impact on the Social Security system's sustainability.

In addition to strengthening the pension system's contributory nature, the reform includes measures to encourage delayed retirement. The financial viability of the healthcare system is already being enhanced with the measures adopted in pharmaceutical policy and those implemented by the Autonomous Communities to rationalise healthcare spending.

In addition to these reforms, the Social Security surplus envisaged within the period covered by this Update will make it possible to further expand the Pension Reserve Fund, which in November 2007 amounted to 4.7% of GDP. Additionally, the reduction in debt to 30% of GDP by 2010 will release funding for items that can increase potential growth, thus reducing the burden on future generations.

4.2 Medium-term budgetary targets

In compliance with the General Budgetary Stability Act, on 25 May 2007 the Cabinet approved the stability objective for 2008-2010. That objective, which was approved by the lower house of Parliament on 19 June, envisages a budget surplus for the public administrations as a whole amounting to 1.15% of GDP in each year of that three-year period. This multi-year objective is aimed at achieving compatibility between budgetary stability, growth in productivity, social spending and improved public services, the aim being to contribute to citizens' well-being and economic and social progress.

The Medium-Term Objective for the public finances is still a "cycle-adjusted budgetary balance", a goal adopted two years ago in compliance with the requirements of the Growth and Stability Pact. It is a more demanding objective than mere compliance with the Pact, which allows a cycle-adjusted deficit of up to 1% of GDP. It is consistent with the current fiscal policy strategy as it makes a determined contribution to the long-term sustainability of the public finances. Moreover, none of the conditions for a revision as envisaged in the Pact (every four years, in principle) apply. And it is a prudent objective, considering that estimates of the structural or cycle-adjusted balance must be taken with due caution.

4.3 Actual budgetary balances and implications for the next year

The budgetary outcome of 2007 (Table 6) will again be better than initially expected, not just because of the prudence with which the budgetary projections were made but also because of the Spanish economy's rapid growth rate this year (similar to last year, in average terms). This dynamic performance was reflected mainly in the growth of public revenues, which amounted to 40.8% of GDP, while expenditure may increase slightly to reach 39.0% of GDP, leading to a surplus of 1.8% of GDP, i.e. notably higher than the 1% estimated in the previous Stability Programme Update.

The main boost to public revenues in 2007 came from direct taxes and property income. Regarding the former, Personal Income Tax and Corporate

Income Tax both performed positively despite the reform that came into force in January, which reduced the average tax rate on earned income. These taxes performed well in a context of rapid growth in employment, capital income, capital gains and corporate earnings. Additionally, the sharp increase in capital income in 2007 was due to the increase in interest rates and the Bank of Spain's income.

Basically as a result of more moderate performance by VAT revenues, indirect taxation grew by less than GDP, declining as a share of the total by some tenths of a point. The moderate performance by VAT revenues can be attributed firstly to the sharp increase in VAT refunds this year, but it may also be reflecting a degree of containment in nominal aggregate expenditure, particularly expenditure on housing. In parallel with wages and social security contribution bases and rates, it is estimated that social security contributions grew in line with nominal GDP, continuing to account for 13% of that aggregate.

That performance by public revenue in 2007 made it possible to fulfil the goals of continuing to improve basic public services, increasing the stock of infrastructure and strengthening solidarity through social spending without jeopardising the equally important goal of budgetary stability. Accordingly, most of the expenditure items in Table 6 increased slightly as a percentage of GDP, with the exception of the interest burden on public debt, which will be approximately the same as in 2006.

The improvement in basic public services means an increase in public consumption expenditure. In particular, the number of employees as well as wages have been strengthened in some areas, namely the armed forces, police forces and justice administration. The gradual growth in public gross fixed-capital formation in recent years, to 3.9% of GDP in 2007 (well above the EU average), reflects efforts being made to equip the Spanish economy with a volume of public productive capital that will contribute to productivity growth. Also, because of the notable increase in the consumer price index in November, adjustments to maintain pensions’ purchasing power will contribute to increasing social spending. The increase in interest rates since late 2005 led to a slight increase in 2007 in the effective yield on government debt, after a prolonged period of steady decline. That increase is expected to offset much of the reduction in the debt ratio, meaning that the interest burden will be similar to 2006 in GDP terms (1.6%).

The 2008-2010 budgetary projections maintain the basic lines and objectives of the 2007 budget policy. As for 2008, public expenditure may increase slightly as a percentage of GDP to approximately 39.2%, while revenues will decline some tenths of a point to 40.4% of GDP as a result of the economic deceleration expected in 2008 and the tax reform.

Table 6
BUDGETARY PROJECTIONS
(excessive deficit procedure)

	SEC code	2006	2006	2007	2008	2009	2010
		Level (million euro)	% of GDP				
Net lending (+)/borrowing (-)(EDP. B9)							
1. General government	**S. 13**	**17,942**	**1.8**	**1.8**	**1.2**	**1.2**	**1.2**
2. Central Government	S. 1311	6,200	0.6	0.8	0.4	0.4	0.4
3. Autonomous Communities	S. 1312	-17	0.0	-0.1	0.0	0.0	0.0
4. Local Government	S. 1313	-927	-0.1	0.0	0.0	0.0	0.0
5. Social Security Administrations	S. 1314	12,686	1.3	1.1	0.8	0.8	0.8
General government (S. 13)							
6. Total revenues	TR	396,280	40.4	40.8	40.4	40.4	40.3
7. Total expenditure	TE	378,338	38.6	39.0	39.2	39.2	39.1
8. Lending/Borrowing	EDP.B9	17,942	1.8	1.8	1.2	1.2	1.2
9. Interest expenditure	EDP. D41	16,126	1.6	1.6	1.5	1.4	1.4
10. Primary balance		34,068	3.4	3.4	2.7	2.6	2.6
Selected components of revenue							
11. Total taxes		240,382	24.5	24.8	24.6	24.7	24.7
11a. Indirect taxes	D.2	121,273	12.4	12.1	12.1	12.1	12.1
11b. Direct taxes	D.5	114,417	11.7	12.2	12.0	12.1	12.1
11c. Capital taxes	D.91	4,692	0.5	0.5	0.5	0.5	0.5
12. Social contributions	D.61	127,076	13.0	13.0	13.0	13.0	13.0
13. Property income	D.4	7,636	0.8	0.9	0.9	0.9	0.9
14. Other		21,186	2.2	2.1	1.9	1.8	1.7
15. Total revenue	**TR**	**396,280**	**40.4**	**40.8**	**40.4**	**40.4**	**40.3**
p.m.: Tax burden		357,981	36.5	36.8	36.7	36.8	36.7
Selected components of expenditure							
16. Compensation of employees + intermediate consumption (16a + 16b)	D.1+P.2	147,805	15.1	15.2	15.4	15.4	15.4
16a. Compensation of employees	D.1	98,475	10.0	10.1	10.2	10.2	10.2
16b. Intermediate consumption	P.2	49,330	5.0	5.1	5.2	5.2	5.2
17. Social transfers (17a+17b)	D. 62+D. 63	138,523	14.1	14.2	14.3	14.3	14.2
17a. Social transfers in kind via market	D.63 (1)	25,805	2.6	2.6	2.7	2.7	2.6
17b. Social benefits (not in kind)	ED62	112,718	11.5	11.6	11.6	11.6	11.6
18. Interest expenditure	EDP. D.41	16,126	1.6	1.6	1.5	1.4	1.4
19. Subsidies	D.3	9,796	1.0	1.0	1.0	1.0	1.0
20. Gross fixed-capital formation	P.51	36,874	3.8	3.9	3.9	4.0	4.1
21. Other		29,214	3.0	3.1	3.1	3.1	3.0
22. Total expenditure	**TE**	**378,338**	**38.6**	**39.0**	**39.2**	**39.2**	**39.1**
p.m.: Public consumption	P.3	177,978	18.1	18.2	18.6	18.8	18.8

(1) D.63 = D.6311 +D.63121 + D.63131
Source: Ministry of Economy and Finance.

The tax reform will have a greater impact on the 2008 Corporate Income Tax than on Personal Income Tax because of the change in net settlements and the reduction in the rate applicable to prepayments. Nevertheless, households' tax bill will be reduced again in 2008 as a result of the deflation of the tax rates and, for the first time, of the increase in the tax thresholds for individuals and households to compensate for inflation.

Finally, after the impact of the tax reform, public revenues should increase approximately in line with GDP, staying at 40.4% in 2009 and falling slightly at the end of the period as a result of a marginal reduction in capital income. In 2009 and 2010, expenditure will grow at a similar pace to GDP, reaching 39.1% by the end of the period. Consequently, the Public Administration surplus will stabilise around 1.2% of GDP in 2009 and 2010.

4.4 Structural balance and fiscal stance

In order to analyse the orientation of fiscal policy, this Update estimates the Spanish economy's potential product with the production function methodology used by the European Commission and agreed by its Working Group on Output Gaps[2], although certain methodological and statistical changes have been made (including updated population projections that reflect the recent increase in immigration) so as to obtain more accurate estimates that are more coherent with the Spanish economy's point in the cycle in recent years. Those changes, which were presented to the European Commission in the context of the ongoing work to improve the estimate of the EU countries' output gap, are reflected in the results shown in Table 7.

That table shows that the gap between real and potential product peaks in 2007 and starts decreasing in 2008, practically closing by the end of the period. This reflects the Spanish economy growing above its potential rate in 2006 and 2007, and slightly below in 2008 and 2009, regaining dynamism in 2010 so that it grows around its potential.

The changes in the primary structural balance, as an approximate indicator of the fiscal stance, show that fiscal stance will be practically neutral or slightly expansive in 2007 and 2008, basically as a result of the tax reform. In 2009 and 2010, the primary structural balance will remain constant at 2.6 points of GDP, which will also contribute to the long-term stability of the public finances.

Despite the caution that should be taken when using the various methodologies for estimating the output gap in order to assess the fiscal policy stance, the conclusions from methods other than the one used here (e.g. using the trend GDP with a Hodrick-Prescott filter) do not differ significantly among them, since any differences that may exist in the potential product (and, therefore, in the calculation of the output gap) practically disappear in

[2] *"Calculating potential growth rates and output gaps. A revised production function approach"*. Cécile Denis, Daniel Grenouilleau, Kieran Mc Morrow and Werner Röger. European Commission. Economic Papers number 247. March 2006.

most cases when annual variations are taken as the indicator of fiscal policy stance.

Table 7
CYCLICAL DEVELOPMENTS [1]
% of GDP, unless otherwise stated

	2006	2007	2008	2009	2010
1. Real GDP growth (%)	3.9	3.8	3.1	3.0	3.2
2. Net lending(+)/borrowing(-)	1.8	1.8	1.2	1.2	1.2
3. Interest expenditure	1.6	1.6	1.5	1.4	1.4
4. Potential GDP growth (%)	3.6	3.5	3.4	3.3	3.2
Contributions:					
- labour	*1.74*	*1.70*	*1.63*	*1.53*	*1.41*
- capital	*1.65*	*1.69*	*1.65*	*1.58*	*1.56*
- total factor productivity	*0.16*	*0.16*	*0.16*	*0.19*	*0.25*
5. Output gap	0.3	0.5	0.2	-0.1	-0.1
6. Cyclical budgetary component	0.1	0.3	0.1	0.0	0.0
7. Cyclically-adjusted balance (2-6)	1.7	1.5	1.1	1.2	1.2
8. Cyclically-adjusted primary balance (7+3)	3.3	3.1	2.6	2.6	2.6

(1) Using Potential GDP (production function).
Source: Ministry of Economy and Finance.

4.5 Public debt developments

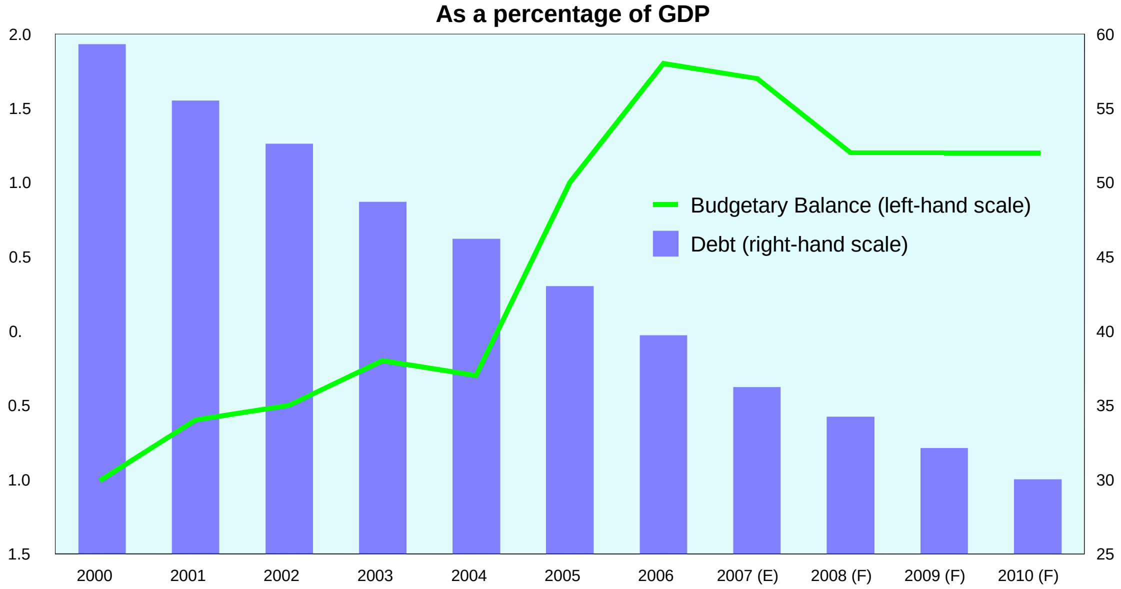
The budgetary outcomes projected in this Update will enable the public debt to decline steadily during the period as a percentage of GDP, thus strengthening the public finances vis-à-vis future challenges, especially those associated with population ageing. Between 2008 and 2010, the debt is projected to decline by 6.2 points of GDP to 30% at the end of the period (Table 8). The projection assumes that the stock-flow adjustments will remain relatively high, i.e. above the historical average of 0.8% of GDP, due mainly to increases in the State's deposits at the Bank of Spain and the foreign debt held by the Social Security Reserve Fund portfolio.

The primary surpluses envisaged for 2008-2010 will reduce the debt ratio by 7.9 percentage points in that period, while nominal GDP growth will contribute an additional 6.3-point reduction. Conversely, interest payments and the stock-flow adjustment will increase the debt ratio by 4.3 and 3.7 points, respectively. The net outcome of those four factors will be a reduction in debt by 6.2 points of GDP with respect to 2007.

Table 8 **GENERAL GOVERNMENT DEBT DEVELOPMENTS** **% of GDP**						
	2006	**2007**	**2008**	**2009**	**2010**	**Change 2008-2010**
1. Gross debt	39.7	36.2	34.0	32.0	30.0	-6.2
2. Change in gross debt	-3.4	-3.5	-2.2	-2.0	-2.01	-6.2
Contributions to change in gross debt						
3. Primary budget balance	-3.4	-3.4	-2.7	-2.6	-2.6	-7.9
4. Interest expenditure	1.6	1.6	1.5	1.4	1.4	4.3
5. Effect of nominal GDP growth	-3.2	-2.6	-2.3	-2.0	-2.0	-6.3
6. Other factors (debt-deficit adjustment)	1.6	0.9	1.3	1.2	1.2	3.7
p.m.: implicit interest rate on debt	4.13	4.22	4.41	4.47	4.52	
Source. Ministry of Economy and Finance.						

Figure 5

PUBLIC FINANCES
As a percentage of GDP



Source: Ministry of Finances and Bank of Spain.

5. SENSITIVITY ANALYSIS AND COMPARISON WITH PREVIOUS UPDATE

5.1 Sensitivity analysis: alternative growth scenarios

In order to estimate the sensitivity of Spain's public finances to changes in the macroeconomic scenario, it is assumed that real GDP growth is the only variable that changes. Accordingly, an alternative moderate growth scenario is posited in which real GDP growth is 0.5 points less than in the baseline or central growth scenario in each year of the projection period.

The results are shown in Table 9, which reveals that slower economic growth would give rise to a steady decline in the surplus in 2008-2010 with respect to the baseline scenario, the surplus reaching 0.4% of GDP at the end of the projection period, contrasting with 1.2% in 2010 in the baseline scenario.

In the lower growth scenario, the public debt would rise by 0.4, 1.1 and 1.9 percentage points of GDP in 2008, 2009 and 2010, respectively, to represent 31.9% of GDP in 2010. That is to say, whereas the baseline scenario projects a 6.2–percentage point decline in debt as a percentage of GDP over the three-year period, the moderate growth scenario would provide a 4.3-point decline.

Table 9
SENSITIVITY ANALYSIS
Alternative economic growth scenarios

	2006	2007	2008	2009	2010
Baseline growth scenario					
Real GDP growth (%)	3.9	3.8	3.1	3.0	3.2
Budgetary balance (% of GDP)	1.8	1.8	1.2	1.2	1.2
Gross debt (% of GDP)	39.7	36.2	34.0	32.0	30.0
Moderate growth scenario					
Real GDP growth (%)	3.9	3.8	2.6	2.5	2.7
Budgetary balance (% of GDP)	1.8	1.8	0.9	0.7	0.4
Gross debt (% of GDP)	39.7	36.2	34.4	33.1	31.9

Source: Ministry of Economy and Finance.

5.2 Sensitivity analysis: interest rates

The analysis of sensitivity to interest rates is performed, as usual, by assuming the yield curve implicit in the calculations of the baseline scenario is shifted upward (high rate scenario) and downward (low rate scenario) by 1 percentage point.

Also, it is assumed that the variation in interest rates affects the public accounts alone, with no impact on the other macroeconomic variables, and that the fiscal authorities do not react to the rate change by modifying other public revenue and expense items. Finally, the new rates are assumed to apply only to new debt issued to cover borrowing needs and maturities in the period.

The result of the interest rate sensitivity analysis in these conditions is shown in Table 10. The fiscal variables' response to the change in interest rates is relatively slow because the average term of Spain's public debt is close to 7 years. At the end of the period, shifting the yield curve by 1 percentage point leads to variations in the budget balance between 0.1 to 0.2 percentage points with respect to the baseline scenario, while the deviation of the debt ratio would be 0.3 points of GDP.

Table 10
SENSITIVITY ANALYSIS: Interest rates
% of GDP

	2006	2007	2008	2009	2010
High rate scenario					
Budget balance	1.8	1.8	1.1	1.0	1.0
Gross debt	39.7	36.2	34.0	32.2	30.3
Baseline scenario					
Budget balance	1.8	1.8	1.2	1.2	1.2
Gross debt	39.7	36.2	34.0	32.0	30.0
Low rate scenario					
Budget balance	1.8	1.8	1.2	1.3	1.3
Gross debt	39.7	36.2	33.9	31.9	29.7

Source: Ministry of Economy and Finance.

5.3 Comparison with the previous Stability Programme Update

The most notable differences between this year's and last year's Stability Programme Update are basically due to the change in the international economic situation due to the subprime mortgage difficulties in the US since last summer. This has made it necessary to rectify the pre-existing growth forecasts in the majority of the OECD countries.

In the case of Spain, Table 11 shows that, contrasting with the relatively high growth rates envisaged in the previous update, the current one projects a slight slowdown in 2008 and 2009, followed by a rebound in 2010. Nevertheless, the growth rates projected in this Update do not deviate significantly from the Spanish economy's potential growth rate, as mentioned before. The result is a slight divergence in the growth rates envisaged for 2008 and 2009 by the two Updates. However, the strong average growth registered by the Spanish economy in 2007, as a continuation of the expansion in the last few years, was underestimated in the previous Stability Programme Update to a certain extent.

As regards fiscal variables, the differences in prediction are due mainly to the differences in economic growth rates (for the reasons described above), and are negligible beyond 2008.

The greatest differences are observed in the surpluses envisaged for 2007 as a result of the increase in public revenue this year, in a context of faster–than-expected economic growth, which has led to review upwards the surplus to 1.8% of GDP against the 1% estimated in the previous Update. Finally, the differences in the debt ratios throughout the projection period are negligible.

Table 11
DIVERGENCE FROM PREVIOUS STABILITY PROGRAMME UPDATE

	2006	2007	2008	2009	2010
GDP growth (%)					
Previous update	3.8	3.4	3.3	3.3	
Current update	3.9	3.8	3.1	3.0	3.2
Difference	0.1	0.4	-0.2	-0.3	
Budgetary balance (% of GDP)					
Previous update	1.4	1.0	0.9	0.9	
Current update	1.8	1.8	1.2	1.2	1.2
Difference	0.4	0.8	0.3	0.3	
Gross debt (% of GDP)					
Previous update	39.7	36.6	34.3	32.2	
Current update	39.7	36.2	34.0	32.0	30.0
Difference	0.0	-0.4	-0.3	-0.2	

Source: Ministry of Economy and Finance.

6. QUALITY OF PUBLIC FINANCES

6.1 Policy strategy

In addition to pursuing sound public finances that contribute to nominal stability in the economy and thereby lay the foundations for economic growth, Spain's current fiscal strategy also focuses on quality. The sound fiscal position, attained after three years of surplus and a substantial reduction in government debt as a percentage of GDP, has not impaired interest in the qualitative aspects of the public finances. On the contrary, in a context where resources must attend to the growing needs stemming from long-term challenges, such as population ageing, it is vital to address qualitative aspects of the budget and use it more efficiently and effectively to lay the foundation for sustained and balanced growth.

Accordingly, in line with the 2005 Integrated Guidelines and the Growth and Stability Pact, and in coherence with the conclusions of the ECOFIN Council of the EU, the quality of public finances occupies a central role in the design of Spain's fiscal policy. This is a comprehensive strategy that addresses the structure and efficiency of expenditure and revenues and the configuration of an appropriate institutional fiscal framework.

Given the challenge of increasing productivity, the goal for public expenditure is to change its composition so as to prioritise policies that have the greatest capacity to enhance productivity. This will enable progress to be made towards changing the pattern of economic growth and, consequently, improving the long-term sustainability of the public finances. Consequently, this Update continues to prioritise expenditure so as to improve the economy's capitalisation by enhancing its technological, physical and human capital. And it also continues to pursue the reforms required to increase the efficiency of those specific policies and of public expenditure in general. In this context, a culture of assessment is being promoted, and this task has been entrusted to the State Agency for the Assessment of Public Policy and Service Quality. Work is also being done to enhance the efficiency and quality of public service delivery by modernising the public administration, in terms of both organisation and human resources management and by extending the use of new technologies.

As for revenues, the goal is to have a system, which is efficient, equitable and neutral while also ensuring sufficient revenues. In the area of efficiency, the goal is to minimise the distortions that the various taxes may produce in the decisions by the economy's agents, particularly with regard to the labour supply and saving decisions. Therefore, in coherence with the reform of direct taxation, which came into force in January 2007, this Update takes account of the additional measures proposed to maintain the effects of that reform. Some taxes have also been reformed for environmental purposes, although the changes are revenue-neutral. Additionally, the need for equity and the growing complexity of financial transactions mean that efforts to prevent and combat fraud are a priority on the revenue side, along with the efforts to achieve a more efficient tax compliance management.

It is also necessary to have a quality institutional budgetary framework. Accordingly, the 2008 Budget was the first one to be drafted under the new budgetary framework introduced in the reform of the Budgetary Stability Acts. Additionally, the system of territorial finance, which is a key feature of budget policy, as discussed in section 8.2, is undergoing reform.

6.2 Developments on the expenditure side

Since the 2005 Budget, public expenditure has given priority to the items that have the greatest capacity to enhance the economy's growth potential through productivity: expenditure on research, development and innovation (R&D&I), infrastructure and education. In 2004-2007, the Central Government budget increased expenditure on civilian R&D&I, education and infrastructure by 125%, 63% and 36%, respectively, i.e. much faster than overall expenditure.

The ongoing multi-year programmes (Ingenio 2010, Strategic Infrastructure and Transport Plan 2005-2020, and the AGUA Programme), the legislative reforms (Education Organic Act and Universities Act) and other agreements (e.g. to develop the new professional training system) are reflected in this Update. In particular, the draft Central Government Budget for 2008 envisages increases in these areas that are far higher than overall spending growth.

The Ingenio 2010 programme[3] defines the medium-term strategy for promoting R&D&I and converging with Europe, the goal being for R&D&I expenditure to amount to 2% of GDP by 2010 (55% contributed by the private sector) and increase the information society's share of the economy to 7%. As a result of the good response to the three sub-programmes[4] launched in 2006 to articulate this strategy, the government's commitment to double R&D&I funding in this legislature was fulfilled in 2007, one year ahead of schedule. In 2006, R&D spending amounted to 1.20% of GDP (1.13% in 2005), and 47.1% was funded by the private sector (46.3% in 2005). The Draft 2008 Central Government Budget increases the allocation for civilian research by 17.4% with respect to 2007, 2.6 times the 2004 level of funding.

Also, a new programme (Euroingenio) was implemented in 2007 with the fundamental goal of increasing Spain's share in the Seventh Framework Programme for R&D (FP7). Also, the new National R&D&I Plan 2008-2011 introduces significant new features that will simplify and improve management of R&D& actions and increase the system's efficiency. They include multi-year

[3] www.ingenio2010.es

[4] CENIT, to promote public-private cooperation in major industrial research projects; CONSOLIDER, to increase cooperation between researchers in leading consortia and unique facilities; and AVANZ@, to promote the development of the Information Society among citizens, companies, and the public administration.

programming (with a proposal for a 16% annual increase in funding), as well as simplifying and reducing paperwork.

Budgetary efforts are being accompanied by regulatory reforms and measures to create an environment that is more conducive to innovation. The new Universities Organic Act[5] favours knowledge transfer and cooperation between the private sector and universities by introducing the possibility of a 5-year leave of absence for teaching staff; since February[6] the new rebate on employer social security contributions for research staff is in force. Additionally, the Public Sector Procurement Act was enacted and the Government has approved a Draft Act for Propagating the Information Society, which will establish citizens' entitlement to engage in commercial transactions via the internet and introduces measures to facilitate on-line formation of companies, is in the process of approval.

Human capital is a key variable for attaining sustained growth in productivity and for promoting equal opportunities and social cohesion. The Draft Central Government Budget for 2008 maintains the policy of allocating significant amounts to education, a 13.9% increase with respect to 2007, and professional training for employment.

Education funding is channelled basically through study grants and aid, which will increase by 4.6% in 2008 with respect to 2007, increasing both the monetary amount of grants and the number of beneficiaries. And the new Education Organic Act[7] has increased the funding to ensure free schooling in the second stage of nursery school and for programmes to support and reinforce primary and secondary education. The Universities Organic Act pursues a more open and flexible university structure.

And a new training model was created under the Agreement on Professional Training for Employment 2006, signed with the social partners. Occupational Training and Continuous Training have been integrated into a single system, thus favouring life-long learning while maintaining the possibility of adapting the offering to the different needs of the unemployed and the employed. The new model was set in motion as a result of the approval in March 2007 of legislation, which regulates the subsystem of professional training for employment. The new system increases the management capabilities of the Autonomous Communities and enhances cooperation between all Administrations.

The reorientation of public spending towards infrastructure policy is articulated through the 2005-2020 Strategic Infrastructure and Transport Plan[8] (PEIT) and the AGUA Water Programme[9]. The PEIT sets out the medium- and long-

[5] Act 4/2007, of 12 April.
[6] Royal Decree 278/2007, of 23 February.
[7] Act 2/2006, of 3 May.
[8] www.fomento.es
[9] www.mma.es

term guidelines for action to achieve a quality transport system that is more integrated, safer and more efficient. Its financial solvency is warranted by the budgetary resources, and also through new financing instruments and mechanisms such as the creation of the State Company for Terrestrial Transport Infrastructure (*Sociedad Estatal de Infraestructuras de Transporte Terrestre—SEITT*), the concession system used to finance the plan to upgrade the first generation of motorways, the framework agreement signed in 2006 with the European Investment Bank, and the Programme-Contracts for railways signed with RENFE-Operadora and the Rail Infrastructure Management Company (*Administrador de Infraestructuras Ferroviarias–ADIF*).

The AGUA programme was reoriented in 2004 in pursuit of more efficient and effective management, improved water quality and preservation of water resources. Additionally, the new National Water Quality Plan (2007-2015) was implemented in 2006 as the last component required to fulfil the demands of the EU Directive on waste water, with the goal of contributing to the attainment of the Water Framework Directive's environmental requirements by 2015.

The Draft Central Government Budget for 2008 increased infrastructure policy funding by 5.9% with respect to 2007 or by 9.4%, if Government Agencies and State-owned companies are included. Infrastructure investment represents a major part of this policy. In this sense, the Central Government will invest 16.4% more in this area than in 2007, including the investment by government agencies and companies owned by the Infrastructure and Environment Ministries.

The new State Agency for the Assessment of Public Policy and Service Quality has been operational since January 2007, after its governing statute was approved in December 2006. Its goal is to promote a culture of evaluation and to assess Central Government policies and public programmes so as to foster rational use of public resources and promote quality in government services. On 30 March, the Cabinet approved the programmes and public policies to be included in the Agency's work programme: administrative requirements for starting up a business; register of greenhouse gas emissions; national museums; and some of the policies contained in the NRP. The Agency can also assess public policies and programmes managed by the Autonomous Communities, subject to prior agreement with them. The Draft Central Government Budget for 2008 assigns 5.15 million euro to the Agency, 5.1% more than in 2007.

That Agency, as well as the Agency for International Development Aid and the Official Gazette Agency (both created in November), are the ones that have been created to date under the State Agencies Act[10], approved in July 2006, with the goal of providing the administration with a model of organisation that facilitates more flexible and autonomous management. The Draft 2008 Budget

[10] Act 28/2006, of 18 July, on State Agencies for the Improvement of Public Services.

Act contains the mechanisms for allocating a budget to any agencies that are created in 2008.

Additionally, in order to improve the quality of public services, progress is being made to modernise the public administration in the area of organisation, procedure management, and relations with citizens. The use of new technologies is being encouraged by the Citizens' Electronic Access to the Administration Act, which offers legal certainty for the rapid deployment of this technology by regulating citizens' rights and the administration's obligations. The Act guarantees that citizens and companies will be able to process paperwork with the administration on-line by 2010.

And the Basic Statute for Civil Servants[11], which must be implemented in detail by each administration, seeks to improve the quality of public services by establishing the basic principles that must inspire the management of human resources throughout the public administrations. The Statute takes account of the process of decentralisation and the greater flexibility required in personnel management. Performance evaluation is one of the key variables determining remuneration and promotion. And the Government Procurement Act is a determined effort to manage the procurement process on-line and to eliminate barriers to bidding for government contracts.

6.3 Developments on the revenue side

The direct taxation reform came into force in January 2007[12], amending the Personal Income Tax Act and partly amending the Corporate Income Tax, Non-Residents' Income and Wealth Tax Acts. These reforms, which were discussed in detail in the previous Update, will impact revenues in 2008 also; the impact on Corporate Income Tax revenues will be partly due to the second reduction in the general rate, to 30% in January. Also, in July 2007, the reform and adaptation of accounting law to harmonise with EU regulations was approved[13]. The changes pursue three goals: adapt to the new accounting principles, increase internationalisation, and make the tax credit for reinvestment of extraordinary gains more flexible.

The 2008 Budget envisages further changes in the rules on Personal Income Tax that are coherent with the 2006 reform and will increase taxpayers' disposable income by more than 900 million euro in 2008. These measures include:

- Deflation of the tax rate to correct the impact of inflation on the tax's progressive structure, saving taxpayers close to 260 million euro.
- Updating the personal, household and earned income tax thresholds, ensuring that the effects of last year's reform, in which these

[11] Act 7/2007, of 12 April.
[12] Act 35/2006, of 28 November.
[13] Act 16/2007, of 4 July.

parameters were increased substantially, will be maintained. These measures will save taxpayers around 600 million euro.

And two new personal income tax credits have been introduced to favour the birth rate, protect the family, and make it easier for women to enter the labour market, on the one hand, and to foster rented accommodation, on the other hand:

- New births or adoptions qualify for a new one-off payment of 2,500 euro. This new benefit has two facets. For about 80% of beneficiaries, it will take the form of a tax credit (a reduction in net tax payable), costing approximately 1 billion euro per year. For beneficiaries that do not qualify for the tax credit, the payment will be made in the form of a non-contributory Social Security payment; the estimated cost will be 250 million euro.
- A deduction[14] in the Central Government portion of personal income tax for persons living in rented accommodation, the goal being to apply comparable tax treatment to home purchase and rental. This new tax credit is means-tested in order to favour lower income brackets. It will benefit all citizens, regardless of age, whose taxable income is less than 24,020 euro per year. The measure represents a transfer of 350 million euro to tenants in its first year of application (and its effects on government tax revenues will be felt for the first time in 2009).

Also, as part of the package of urgent measures approved by the Government in July in the context of the Spanish Strategy on Climate Change and Clean Energy, the Air Quality and Protection of the Atmosphere Act was approved in November; it amends the vehicle registration tax in accordance with environmental criteria. As a result of this initiative, from 1 January 2008, the tax will be based on the level of emission of pollutant gases rather than on engine capacity and type. This change will be neutral in terms of tax revenue but will favour less-polluting vehicles.

In parallel with the tax reform, a quality, fair tax system requires supplementary measures to improve compliance by combating tax fraud and improving tax management so as to reduce the burden of compliance and provide citizens with more information and support. In order to optimize control activities, the implementation of the Tax Fraud Prevention Programme, endorsed by the Government in February 2006, was strengthened. In particular, the Tax Fraud Prevention Act[15] was approved in November 2006; it contains a number of measures aimed at enhancing the powers of action of the oversight bodies while also establishing measures to improve the quality and immediacy of obtaining the information available to the tax administration. It also contains measures to guarantee that tax debts are actually collected.

[14] As an additional benefit for young people aged 22-30 earning at most 22,000 euro gross per year, there is a 210 euro monthly rent benefit plus a 600 euro loan for the deposit and a six-month guarantee.
[15] Act 36/2006, of 29 November.

The Act seeks to prevent the various types of fraud. It establishes subsidiary liability for parties that purchase merchandise from organised VAT fraud rings. As for the Vehicle Tax, used vehicles must be inspected prior to registration. Also, it is now possible for the charges to be brought for tax crimes without prior consultation. As for real estate fraud, the measures are aimed at improving information gathering so as to make it possible to follow the chain of title and monitor how the property is actually used; among other measures, all parties' tax ID numbers and the means of payment must be entered in the deeds of sale. And the property's cadastral reference number is required in contracts for electricity supply. Technical solutions have been adopted to combat operations conducted from tax havens and zero-tax territories more effectively. Additionally, to combat fraud in the tax collection phase, the principle has been established of piercing the corporate veil in the administrative phase of proceedings. A key feature of this law is the new treatment given to related-party transactions, to provide a connection with the accounting principles and to adapt Spanish law to the international context, particularly the OECD guidelines on transfer prices.

The incorporation of new technologies into the tax administration has made it possible to configure a more agile and innovative administration that is being used by a growing number of taxpayers. In particular, the increased number of services offered via the internet is making a decisive contribution to facilitating compliance with tax obligations. Furthermore, the web site has become a veritable on-line office at which taxpayers can perform a large number of processes.

7. SUSTAINABILITY OF PUBLIC FINANCES

In accordance with the "Guidelines on the format and content of Stability and Convergence Programmes", this Update includes projections for Spain’s public expenditure related to population ageing drawn up for EU-25 by the Working Group on Population Ageing attached to the Economic Policy Committee (EPC) and by the European Commission and supported by ECOFIN. The projections address five categories of spending: pensions, healthcare, long-term care, education and unemployment. They use the demographic and macroeconomic assumptions agreed upon by the Member States, and they assume no changes in economic policy.

7.1 Long-term budgetary projections

This Update includes the latest projections drafted in 2005 within the mentioned common framework, as backed by the Ministers in February 2006 and included in Spain’s 2006 Update.

The projections for Spain by the EPC, using 2004 as the baseline, predict that total expenditure on the aforementioned five categories will reach 28.6% of

GDP in 2050, compared with 20% of GDP in 2005 (Table 12). In line with these projections, pensions will be the item contributing most to the increase in expenditure, followed by healthcare. The most recent information available indicates a ratio of contributory pension expenditure[16] to GDP which is slightly lower than the projections.

Table 12
PROJECTIONS FOR EXPENDITURE ON AGEING BY THE EU'S ECONOMIC POLICY COMMITTEE
(% of GDP)

	2005	2010	2020	2030	2040	2050
Total contributory pension expenditure (1+2)	**8.7**	**8.9**	**9.3**	**11.8**	**15.2**	**15.7**
Social Security contributory pension expenditure* (1)	**7.8**	**8.1**	**8.5**	**11.0**	**14.4**	**15.2**
Old-age and early retirement pensions	5.2	5.2	5.5	7.7	10.9	11.8
Disability benefits	0.9	1.0	1.1	1.2	1.2	1.1
Survivors' pensions	1.7	1.8	1.9	2.1	2.3	2.3
Non-social-security benefits (2)	**0.8**	**0.8**	**0.8**	**0.8**	**0.7**	**0.5**
Healthcare expenditure	6.1	6.3	6.7	7.3	7.9	8.3
Long-term care expenditure	0.5	0.5	0.5	0.5	0.6	0.8
Education expenditure	3.6	3.2	3.2	3.0	2.9	3.1
Unemployment expenditure	1.1	0.9	0.7	0.7	0.7	0.7
Total expenditure on ageing	**20.0**	**19.7**	**20.4**	**23.4**	**27.3**	**28.6**
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
Participation rate males (aged 20-64)	85.6	86.9	87.9	87.0	86.1	87.8
Participation rate females (aged 20-64)	61.5	66.4	72.2	73.5	73.4	74.9
Total participation rates (aged 20-64)	73.6	76.7	80.2	80.3	79.9	81.5
Unemployment rate	10.4	8.7	7.0	7.0	7.0	7.0
Population aged 65+ as % of total population of working age	24.5	25.3	29.8	38.2	52.5	65.6

* Includes minimum pensions
Source: Baseline scenario of the Report by the Economic Policy Committee and the European Commission on the impact of ageing populations on public spending. EPC and Commission, 2006.

In accordance with the Ministers' mandate, these common projections should be drafted every three years, the next update being due in 2009.

[16] Ratios of 8.4% and 8.3% in 2005 and 2006, respectively.

Based on these projections, the annual sustainability assessment based on the Stability and Convergence Programmes, led the Council to consider Spain as having a medium-risk level and recommend that it maintain a high primary surplus in the medium-term and implement more measures to stem the growth of expenditure. Moreover, the Commission's 2006 Report on Sustainability, which used the "Report on Projections of Public Expenditure Related to Population Ageing" as the benchmark, indicated the need to implement the Social Security reform that had been agreed upon in 2006; that reform was, in fact, approved in November 2007.

7.2 Policy strategy

The strategy to address the expected increase in expenditure for ageing is fully consistent with the aforementioned recommendations, and is based on three fundamental pillars:

- Budgetary stability, which allows for reducing the public debt to GDP ratio and increasing allocations to the Reserve Fund.
- Greater employment, a longer working life and higher productivity.
- Reviews of the pension, healthcare and long-term care systems.

Social Security Reserve Fund

The Social Security surplus has led to an increase in allocations to the Social Security Reserve Fund (FRSS), which was created in 2000 to meet future needs in the area of contributory benefits and has grown significantly since then. In fact, in November 2007, the Reserve Fund reached 45.704 billion euro, i.e. more than 8 months' pension payments, or 4.7% of GDP. As of 31 December 2006, the portfolio consisted of 54.1% Spanish government bonds and 45.9% foreign government bonds, in nominal value terms. In 2007, the Committee responsible for managing the Social Security Reserve Fund maintained the investment approach of the preceding year, which caps the share of foreign debt at 50% of the nominal value. In 2008, according to the Draft Budget Act, the fund will be allocated an additional 6.814 billion euro, bringing the total at year's end to over 52.500 billion euro.

The Reserve Fund's volume and the growth prospects in the coming years make it advisable to reform its management model to give it greater flexibility and efficiency in pursuit of its goals. The reform proposed includes the following new features:

- It includes social, economic and environmental responsibility criteria among its investment policy principles.
- It extends the possibilities for investment in different types of assets, while at the same time setting limitations to ensure that the principles of security and risk diversification are complied with.
- It allows for outsourcing the management of part of the Fund's assets.

Pensions reform

The new law on Social Security measures was approved by the Congress on 22 November 2007, as a result of an Agreement reached between the Government and social partners in June 2006, in line with recommendations in the original and renewed Toledo Pact. It will enter into force in January 2008. The Act's principal objectives are:

- To make progress in solidarity and ensure funding sufficiency through gradual improvement and extension of benefits and coverage and maintaining a single funding account. This must be achieved while ensuring the financial sustainability of the pension system, whose future stability will be strengthened by the new Act.
- To enhance the contributory nature of the system by moving toward greater proportionality between contributions and benefits while also avoiding unfairness in recognition of entitlement. In particular, the effective contribution period for entitlement to a retirement pension has been increased from 12.6 years to 15 years.
- To strengthen the measures aimed at delaying retirement beyond the age of 65 through increases in the retirement pension (between 2% and 3% per year worked)[17]. And through reductions in the social contributions for workers over the age of 65[18], which provides an incentive by increasing their net salary, complementing the current regulations, which reduce employer contributions for workers over 59[19].
- Rationalisation of early retirement categories: The age of 61 has been established as the threshold for qualifying for any form of early retirement, including partial retirement. Moreover, partial retirement has been rationalised: to qualify, workers must have at least 6 years' service with the same employer and 30 years' contributions; the reduction in the working day has been modified: the maximum is 75% (formerly 85%) and the minimum is 25% (formerly 15%); the worker's contribution base may not be less than 65% of the pre-retirement base. These requirements will be phased in over 4 years.
- To modernise the system so as to respond to new household situations, widow's pension entitlement has been extended to include civil unions.
- To introduce contributory elements into the permanent disability pension, which will now be proportional to the contributions.

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[17] An additional 2% for each year workers delay their retirement beyond the age of 65 if, upon reaching the age of 65, the worker has fulfilled the minimum period of contributions for entitlement to a 15-year retirement pension (previously 35). This increases to 3% (previously 2%) if, upon turning 65, the worker has contributed for 40 years.

[18] Workers aged 65 and over are only required to pay the common contingencies component, provided that they have 35 years of contributions and an indefinite contract and have been working for the same employer for at least 5 years.

[19] A 40% reduction for workers aged over 59 and who have been working for the same employer for at least 4 years, paid for out of the Social Security Budget. A 50% rebate for workers aged over 60, covered by the State Employment Service, which increases by 10 percentage points annually until reaching 100% for workers aged 65.

Aside from the new Act, the recently created Unit to control the costs of temporary disability, coupled with the legal changes on the control of processes in 2006, has greatly curtailed the increase in expenditure (6.1% in 2007, compared to 7.6% in 2006 and 9.9% in 2005).

Control of health spending

New measures are successfully being developed to rationalise healthcare expenditure:

- The measures by the different Administrations under the price policies contained in the Act for Guarantees and Rational Use of Medicines and Health Products, the regional plans for the use of generic medicines, the programmes to promote the rational use of medicines and the new system of benchmark prices, in force since March 2007, are allowing for a slowdown in pharmaceutical costs, making it possible for Autonomous Communities to dedicate their economic resources to other health priorities.
- Many of the actions in the Strategic Plan of Pharmaceutical Policy aimed at improving healthcare professionals' access to information have been implemented, such as the Ongoing Training Programme in the rational use of medicines for physicians through agreements with all the Autonomous Communities. Also, the Draft Royal Decree on medical prescriptions and hospital dispensary orders contributes to the rational use of medicines, encouraging the exchange of information between healthcare professionals and patients and adapting prescription to actual needs.
- The second report from the Working Group on Healthcare Expenditure Analysis shows that all Autonomous Communities have implemented measures, including most notably programmes related to rational pharmaceutical consumption and to improve the efficiency of healthcare services management.
- Finally, it should be noted that significant progress has been made in 2006 and 2007 in drawing up and approving health strategies in the Quality Plan. These actions aim to improve the system's quality and cohesion, and they foster healthy lifestyles, reduce inequality in health, particularly between men and women, support planning and development of the healthcare system's human resources, foster clinical excellence through assessment, and exploit information technology to improve healthcare through the Online Healthcare programme in the framework of the AVANZA Plan.

8. INSTITUTIONAL FEATURES OF PUBLIC FINANCES

8.1 Implementation of national budgetary rules

In line with the conclusions from the Council of Ministers for Economic and Financial Affairs[20] of the EU on the introduction of information regarding fiscal rules in the Stability Programmes, the previous Update contained a detailed description of the rules on budgetary balances that entered into force in January 2007 as well as the regulations that limit regional administration indebtedness. Both normative frameworks remain unchanged and fully in force.

This Update highlights the main novelties produced by the new budgetary stability framework during its first year of implementation. This new regulation, which entered into force in January 2007, was fully applied for the first time in defining the budgetary stability targets for the 2008-2010 period and, therefore, for drafting 2008 budget.

To achieve a more realistic application of the fiscal regulation, the definition of 2008-2010 budget targets was based on the report on the economy's cyclical position drafted by the Ministry of Economy and Finance. That report was presented on 28 March, after consulting the National Statistics Institute and the Bank of Spain and taking into account the European Central Bank and the European Commission's forecasts[21]. On that basis, economic growth in the Spanish economy in the 2008-2010 period[22] was forecast to be higher than the transitory threshold (3%) set out in the fiscal regulation for administrations subject to the budgetary stability principle to be required to budget a surplus for the entire period. As a result, in June the Parliament approved the Government's proposal that sets out the budgetary targets for the government overall and each of its component groups, targeting a general government surplus of 1.15% of GDP for each of the three years.

With the objective of strengthening consensus, commitment and participation in fiscal discipline by all of the administrations, a new mechanism has been applied to determine the budgetary stability targets of the Autonomous Communities based on dialogue and negotiation. Accordingly, the report on the cyclical position was sent to all Autonomous Communities during the consultation process before the Government formulated its budgetary stability target proposal. On 24 April, the Council for Fiscal and Financial Policy (CPFF) approved the proposal for the Autonomous Communities. Subsequently, the Cabinet Decision was approved by Parliament. The Ministry of Economy and Finance and the Autonomous Communities then began the bilateral negotiation process to determine each Community's individual target;

[20] ECOFIN on 10 October 2006: conclusions regarding the quality of public finances and ECOFIN on 9 October 2007 on improving the effectiveness of the preventive arm of the Stability and Growth Pact.
[21] The Commission's interim forecasts of February 2007 were used.
[22] 3.3% in 2008 and 2009 and 3.1% in 2010.

following the CPFF's favourable report, this led to the agreement on the individual budgetary targets adopted by the Cabinet on 27 July.

With the aim of continuing to increase transparency regarding budget stability among the Autonomous Communities, an inventory of Local Government entities in each Autonomous Community as of 1 January 2007 was compiled in 2007 and published on the internet; it refers to the situation as of 1 January 2007 and it is updated on a half-yearly basis. Another major effort to enhance transparency is the shortening of the deadlines for Autonomous Communities to publish their budgets and settlements as well as the release of the 2002–2005 figures for the Autonomous Communities.

As in the previous Update, the targets for the Central Government and the Social Security were established separately in order to make each administration's budget targets more transparent.

The new regulatory framework for budget stability in Local Governments was approved by the Government on 2 November, in the form of the Regulation for Applying the General Law on Budget Stability to Local Governments. New features of the Regulation, which will be first applied to the 2008 budgets, include individual stability targets for each Local Government, the creation of a supervisory and early warning mechanism to take action in the event of risk of non-compliance with the stability target, and the introduction of stricter criteria set out in the Budgetary Stability Law to authorise debt transactions and promote the principle of transparency regarding the composition, budgetary procedures and indebtedness of local government.

8.2 Reform of the territorial financing systems

Discussions are underway with a view to reforming the Autonomous Communities' financing system; meanwhile the system approved in 2001 remains in force. The working group made of representatives of the Government and the Autonomous Communities is currently seeking the best possible consensus so as to ensure the reform’s success.

The diagnosis by the Ministry of Economy and Finance was circulated to the Autonomous Communities in December 2006. According to that report, the discussion should not focus exclusively on the contribution of new funding by the Central Government, whose margin for manoeuvre has been substantially reduced after the previous budget reform and devolution to the Autonomous Communities. The resulting system should not be considered permanent but, rather, as subject to regular revision. That report evidenced that the available funds under the present system increased faster than GDP in the three years in which it was fully applied. This increase was greater in the Autonomous Communities where population growth was highest; indicating it is necessary to improve the mechanisms to adapt the system's funding to the expenditure needs arising from demographic changes. There is also scope for improving the transparency of solidarity and levelling mechanisms and of the settlement and advance payments systems.

Apart from the funds derived from the finance system itself, the Autonomous Communities are receiving supplementary transfers to improve healthcare funding pending the approval of the new system.

The reform of the local government financing model will be addressed at the same time as the reform of the Autonomous Community financing system. Partial measures include:

- The regulation of an additional compensation derived from the Tax on Economic Activities.
- The establishment of a fund to finance municipalities with up to 20,000 inhabitants.
- Cash advances to local governments on account of the final settlement of their share in the Central Government tax revenues for 2005 and 2006.

8.3 Other reforms with an impact on the budget scenario

Since its approval[23] in 2006, the new system of long-term care is being implemented gradually and is expected to be completed by 2015; it requires the cooperation of all administrations to ensure coverage throughout the national territory. The new law establishes a minimum degree of care which will be guaranteed financially by the Central Government, and a second level to be implemented through cooperation and financing between the Central Government and the Autonomous Communities. Furthermore, the Autonomous Communities may develop a third level of additional care for citizens.

In 2007 major implementing regulations were finalised: a number of Royal Decrees were approved to regulate the assessment of long-term care needs, define the system's baseline level of care, address social security coverage for caregivers, and define the criteria for setting the level of care and the amount of monetary benefits. The Autonomous Communities are drafting regional regulations to enable the law to be fully implemented throughout the national territory.

The Budget for 2008 allocates 871 million euro for financing the minimum amount guaranteed by the Central Government, covering certain expenses within the system and the social security contributions of non-professional caregivers. That is a significant increase on allocations in the budgets for 2007 (400 million euro) and 2006 (200 million euro).

[23] Law 39/2006, of 14 December, for the Promotion of Personal Autonomy and Care for Dependent Persons.

9. CONCLUSION

Public finances have gained in strength in the last few years to become an important asset of the Spanish economy. The staunch commitment to budgetary stability has led to a budget surplus, which is to last for the next three years. These fiscal prospects contribute towards the building of a stable economic environment, which affords economic players the certainty they need to develop entrepreneurial initiatives and make appropriate decisions as regards production, consumption and investment.

This combination of a surplus and the resulting low debt-to-GDP ratio offers fiscal policy the opportunity to provide important support in achieving the Lisbon objectives and stimulate growth, productivity and employment. Fiscal policy is prioritising expenditure items, which have the capacity to boost the economy's productivity. The various taxes and the tax administration are also being reformed under criteria of efficiency, equality and neutrality.

Stability and efficiency together provide an adequate foundation to prolong the significant economic growth exhibited by the Spanish economy, thus contributing to the sustainability of public finances in the long-term. However, in view of the challenges posed by ageing, measures are already being adopted to combat its impact on the public administrations' accounts through direct reforms of those benefits which are most affected, such as Social Security pensions and healthcare expenditure. This is important given that this challenge will not only tend to increase existing benefits but will also create new long-term care needs and situations to which a developed society must respond.

As a result, Spanish fiscal policy in the last few years and the guidelines established in the Update for 2008-2010 will allow progress to be made in increasing well-being.