STABILITY PROGRAMME

UPDATE

KINGDOM OF SPAIN

2002-2006

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I. INTRODUCTION: ECONOMIC POLICY GOALS AND INSTRUMENTS

This Stability Programme Update sets forth the information needed for the multilateral supervision conducted annually by the European Union (EU). The ultimate aim of the exercise is to facilitate economic policy co-ordination, now more vital than ever in the framework of Economic and Monetary Union (EMU). Its pages provide an updated account of the performance of the Spanish economy alongside medium-term forecasts, and discuss the direction given to economic policy in general, and fiscal policy in particular.

After four years growing at rates of 4%, the Spanish economy entered a slowdown phase in 2001–2002 resulting from a generally adverse external context and a loss of domestic demand momentum. But even over these two years, Spain has continued the process of **real convergence** with Europe's most developed countries, on the upkeep of a positive growth differential over the EMU average. This marks a break with the performance pattern of the Spanish economy in past cycles, when it would outgrow the European average at times of expansion only to sink further in the contraction phase, thereby losing ground in its drive to converge with the income and social welfare standards of the European Union.

Medium-term **forecasts for the economy** state that growth will recover in main world zones. In a more favourable economic context, Spain could be expected to recoup growth rates of near 3% in the coming years.

Against this backdrop, Spanish **economic policy** will continue bent on its central goal, namely, continued real convergence with the most developed EU economies. The economic policy strategy that flows from this has two main pillars: the upkeep of macroeconomic stability and an increase in the economy's potential growth rate. Membership of EMU means Spain has basically two economic policy instruments at its command: fiscal policy and structural reforms in product and factor markets.

Fiscal policy has its mid-term sights on supporting long – term growth while contributing to macroeconomic stability through a firm commitment to budgetary discipline. Within this framework, the fiscal stance will retain its sensitivity to changes in the overall level of economic activity, but without imperilling the medium-term goal of fiscal stability. Hence the budgetary projections set out in this Update are for a near-zero deficit in the next few years turning to a slight surplus at the end of the reference period. Fiscal stability will also be consistent with a comprehensive reform of personal income tax, to come into force on 1 January 2003, and reckoned to save taxpayers some €3,600 million.

Structural reform efforts will again prioritise liberalisation and increased competition in product and factor markets. In the labour market, work will proceed on rolling out the latest reforms. In product markets, the focus will be kept on building competition in network industries, as the providers of basic inputs to the economy as a whole and development drivers for the Information Society. Also, more support will be forthcoming for entrepreneurship, research and development and technological innovation and the protection of the environment.

This document has been drawn up in accordance with the Code of Conduct on Stability and Convergence Programme content and format approved by the ECOFIN Council in July 2001.

The Stability Programme Update stands alongside the Progress Report on the Reform of Goods, Services and Capital Markets, the National Action Plan on Employment and the National Strategy Report on the Future of Pension Systems as the cornerstones of the Spanish government's economic policy design.

In closing this introduction, we must refer to the economic, social and environmental repercussions of the ecological catastrophe caused by the sinking of the oil tanker "Prestige" off the coast of Galicia, which is affecting a number of Autonomous Communities. The contents of the present Update make no allowance for the budgetary actions and allocations now being designed and implemented to deal with the aftermath of the disaster.

II. ECONOMIC POLICY, CURRENT ECONOMIC SITUATION AND OUTLOOK

1. Economic policy

The Spanish Government's economic policy has pursued one **fundamental objective**: to advance further in real convergence with the EU's most developed countries. This objective has inspired all economic policy actions and decisions throughout the past seven years.

The strategy employed seeks, firstly, to boost the **growth potential** of the Spanish economy and, secondly, to continue laying the groundwork for the upkeep of a **positive growth differential** with respect to the EU's most developed countries.

The aim, in essence, is for the Spanish economy to grow faster than its main European partners through both expansion and contraction phases. This means breaking with the structural pattern of the past, whereby Spain would pull ahead of the European average in periods of upswing, but fall harder during slowdowns or recessions, thus losing the ground gained in convergence with the income and employment levels of the European Union.

If these ambitious goals are to be met, economic policy must work to provide **a stable macroeconomic framework** supportive of production, investment, work and saving decisions, which serves to raise the economy's growth capacity over time.

Economic policy in 2001 and 2002

In the EMU context, there are basically two **instruments** available to the above ends: fiscal policy and the policy of structural reform in product and factor markets.

Fiscal policy has again been guided by an unwavering commitment to budgetary rigour. The ambitious fiscal consolidation drive of recent years has pulled public finances into near balance in 2001 and 2002, despite the slower pace of growth dictated by a sharper-than-suspected international downturn.

This fiscal orientation has allowed for tax reforms to improve the efficiency and fairness of taxation, and a higher allocation to the budget lines with most bearing on the economy's potential growth, that is, capital expenditure on physical, human, technological and organisational capital.

The credibility of this zero-deficit commitment, even through phases of economic weakness, was reinforced by the January 2002 enactment of the General Law of Budgetary Stability. This legislative text enshrines the principle of stability, understood as a balanced or a surplus budget, across all general government sub-sectors. The National Budget for 2003 was the first drawn to be up under its provisions.

Structural reform has remained very much in the foreground. In **goods and services markets** work continued on implementing and supplementing the reform package of June 2000, which set ambitious timetables for liberalisation. **Competition policy** was also strengthened in recognition of its key role in guaranteeing the efficient allocation of resources in freed-up markets. Antitrust procedures have been tightened up, while the competition authorities have been assigned greater material, human and institutional resources for carrying out their work. The measures taken in both these areas are described more fully in Annexe 4.

In the **labour market**, Spain has persevered in its reform process with a three-pronged effort to raise participation, stimulate demand and improve the supply-demand match. Royal Decree–Law 5/2002, of 24 May, on Urgent Measures to Reform the Unemployment Protection System and Improve Employability, set out to modernise social protection systems so they provide more incentives to active job search. Then Law 35/2002, of 12 July, on Measures to Establish a Phased, Flexible Retirement System put a battery of support measures behind active ageing (see Annexe 3).

Law 46/2002 of 18 December on the Partial Reform of Personal Income Tax also includes measures to mobilise the supply side of the labour market, among them an improved tax treatment of earned income and targeted incentives to raise the participation of women and older workers (see Annexe 1).

Finally, the recently enacted Law of Financial System Reform Measures reworks certain rules governing **capital markets** to adapt their operation to fast-changing agent needs and help them efficiently perform their key function of channelling savings to investment (see Annexe 4).

Future economic policy guidelines

The goals of **fiscal policy** are to maintain a stable macroeconomic framework and expand the economy's mid-term growth potential. As such, all decisions in this area are subject to the strictures of the General Law of Budgetary Stability and the objectives set in this Stability Programme Update.

Meeting these objectives means getting the right mix of revenues and expenditures for each given moment. On the revenue side, the aim will again be to improve taxation efficiency so the system is properly supportive to saving, investment and work decisions. Hence the major reform of personal income tax to come into force on 1 January 2003 (see section III.1. and Annexe 1), and the recently approved reform of the tax on economic activities which will exempt around 90% of present payers.

On the expenditure side, the priority for investment will again be those areas conducive to supply-side and productivity growth, as a means to prime the Spanish economy for future challenges. This translates as priority attention to enlarging physical, technological, organisational and human capital, as reflected in the 2003 National Budget.

Structural reforms in product and factor markets seek pre-eminently to further the openness and liberalisation of the Spanish economy, favour a correct allocation of productive resources and open up new investment and business opportunities.

More specifically, future measures in goods and services markets will seek to safeguard and deepen the advances made in liberalisation. This is particularly the case in network industries after the recent liberalisation packages and the ambitious calendars set for market opening.

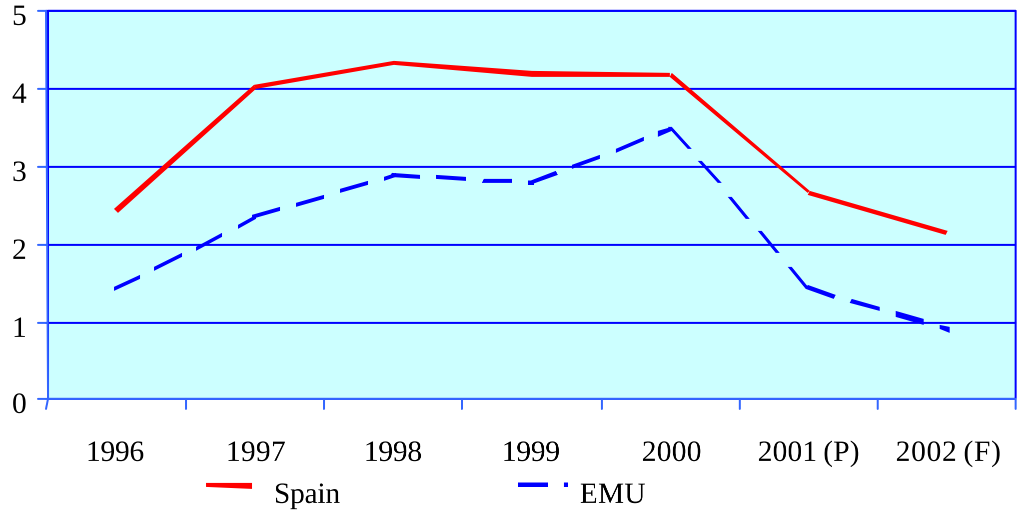
Further steps will be taken to strengthen **competition policy** instruments, to ensure the benefits of liberalisation find their way to all economic agents through the medium of effective market competition.

In the **labour market**, work will centre on the management side of active employment policies and the latest reforms on unemployment protection. The involvement of the public employment services is critical to ensure their practical implementation and effectiveness.

2. Performance of the Spanish economy 2001-2002

The growth of the Spanish economy cooled to 2.7% in 2001 after four years expanding at rates of 4% or more. And the outlook is for deceleration to persist through 2002 as far as a year-end growth rate of 2.2% under pressure of a generally adverse external context and weakening domestic demand. Spain, however, will continue real convergence with the most developed European countries, on the strength of a **positive growth differential** of around 1 percentage point vs the EMU average.

Figure 1
REAL CONVERGENCE OF THE SPANISH ECONOMY
Real annual growth of GDP



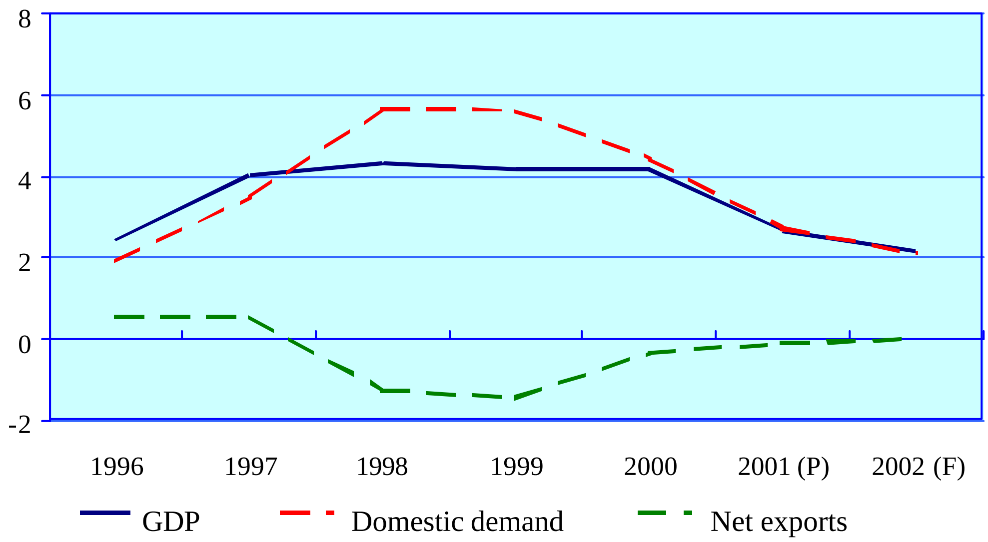
Source: INE, European Commission and Ministry of
(P) Provisional (F) Forecast

Domestic demand weakness has been the main downside factor for Spanish output growth. Net exports, in contrast, deducted just one decimal point from 2001 growth and are poised to contribute neutrally in 2002, compared to the more deeply negative contributions of prior years.

Domestic consumption expenditure slowed notably between 2000 and 2001 due to adverse factors like a slackening pace of job creation or the decline in expectations caused by stock market losses. Both these trends have persisted through 2002, prolonging the downturn in household consumption. Government consumption, meantime, has grown more moderately as part of the drive to attain a zero deficit.

Investment growth too has begun to flag in the past two years, albeit with a differentiated conduct of its two main components. **Construction spending** has lost a little of its vigour, and is likely to close this year up by 4.7% after the 5.8% advance of 2001, the cause being the slower pace of new housing investment due to more pressured household income and the progressive exhaustion of the whole subsector after the strong run-up of past years. This evolution has been partly offset by rising investment on the civil works side.

Figure 2
COMPOSITION OF GROWTH
Contribution to GDP growth



Source: INE and Ministry of Economy
(P) Provisional (F) Forecast

Equipment investment is projected to close 2002 with a fall of 1.8% after the 1% advance of 2001. Although the corporate sector is in good financial health, it may be that the heavy investment of previous years plus more muted GDP growth and the unsettled international outlook have led companies to postpone some of their investment decisions.

Net exports began to come up a little in 2000, and closed 2001 with a deduction from growth of just 0.1 percentage points. The contribution of the external sector is expected to be neutral in 2002.

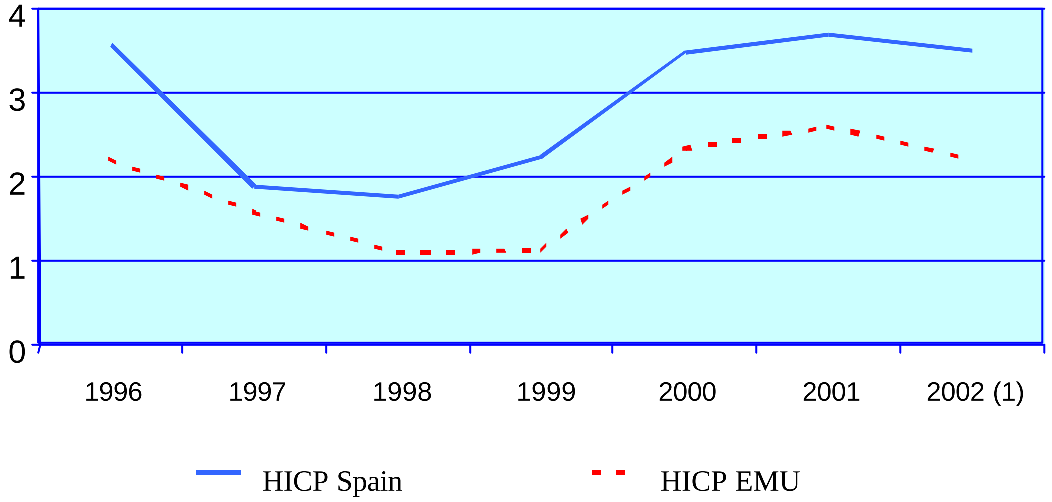
The after effects of the crude price spiral, from $9/barrel at the 1998 close to between $20 and over $30/barrel in the 2000–2002 interval, added to the stock market slide begun in early 2000 and the United States' recession of 2001, have caused a gradual slowdown in world economic activity, which has braked the growth of Spanish exports. However, the less buoyant tone of domestic demand has also kept a lid on imports. Both variables have recorded only a small advance after two years' steady inroads into Spain's commercial exchanges with the rest of the world.

A number of transitory factors have conspired to drive **inflation** higher over 2001 and 2002: the animal health crises of end 2000, which pushed up the price of meat, then the adverse weather of early 2002, with the same effect on fresh vegetables. The introduction of the euro also favoured price rises in certain sectors, partly because of a rather cumbersome peseta-euro conversion rate. Another inflationary factor was the increase at the year's outset of indirect taxes on certain products. The outlook, finally, is that price tensions will persist through the closing months of 2002 as oil prices harden above end-2001 levels.

Figure 3

PRICE DIFFERENTIAL SPAIN - EMU

Annual % change



Source: INE and Eurostat

(1) Data to October

However, the transitory nature of these factors suggests inflation should ease in 2003, providing the present spike does not harden into permanence by way of wage claims and the collective bargaining process. The GDP deflator, finally, is projected to close 2002 with an increase of around 3.5%.

The **wage** acceleration of 2001 owed presumably to the higher-than-forecast inflation of end-2000 and its trigger effect on safeguard clauses. Although the available data point up some moderation in 2002, thanks to the collective wage agreement between employers and unions, fears are that the rollover of safeguard clauses, which extend to more than 75% of workers covered by collective agreements, could mean the inflation spike of these last few months feeds through to early 2003 settlements.

The economic slowdown has kept **employment** creation below the levels of last year. Even so, 359,400 new posts were created in 2001 and over 175,000 in 2002, by the National Accounts measure of full-time equivalent jobs. As to **unemployment**, 2002 is likely to end with a slight increase. This, however, may be partly due to a methodological change in the Labour Force Survey, which redefines the jobless concept as of 2001 and rules out direct comparison with 2000 figures.

Finally, the **net borrowing requirement of the Spanish economy** will drop from 2% of GDP in 2001 to a likely 1.6% in 2002.

3. Short- and medium-term forecasts 2003–2006: baseline scenario

International assumptions

In accordance with the Code of Conduct for the drawing up of Stability Programme Updates, the following section runs through the common assumptions drawn up by the Commission for the conduct of key international variables.

The **growth slowdown** which maintained its grip through 2001 y 2002 will give way in 2003 and 2004 to renewed **recovery** in the world's leading economies. Japan will progressively emerge from its recession, the United States will consolidate the growth rates recorded in 2002 then accelerate afresh in 2004, and growth in the EU will pick up steadily over 2003 and 2004 to close the latter year at 2.7%, possibly ahead of its potential rate.

The upswing in main world economies will exert a pull effect on **world trade**, appreciable in the more rapid advance expected for non EU imports.

On these projections for the world economy, the effective exchange rates of the **European Union** should appreciate slightly in 2003, then retrace their steps in 2004. As to interest rates, the Commission's view is that the transitory factors that have pushed up inflation in many EMU countries will wear off over 2003, suggesting rates may be lowered in the near term then raised again slightly once recovery firms.

Table 1 BASELINE ASSUMPTIONS			
	2002	2003	2004
Growth			
World GDP growth ex. EU (a)	3.0	3.9	4.2
- US	2.4	2.4	2.8
- Japan	-0.6	1.2	1.5
- EU	1.0	2.1	2.7
World import volumes excluding EU-15	3.2	6.8	7.4
Change in effective euro exchange rate (%)	3.9	3.5	1.0
Average annual $US/€ exchange rate	0.94	0.98	0.97
Interest rates			
Short-term rates	3.3	2.8	3.2
Long-term rates	4.8	4.4	4.7
Commodity prices			
Crude oil price ($US/barrel)	25.5	24.1	22.5
Commodity prices in $US (% increase)	0.3	4.3	4.5
(a) real % change SOURCE: European Commission.			

Oil prices are expected to sink below $25/barrel in 2003 and 2004 as Middle East tensions cool. This would help towards the inflation reduction augured for the zone. However, reviving activity in most world economies could put mild upward pressure on the price of commodities other than oil.

Macroeconomic forecasts: baseline scenario

The baseline macroeconomic scenario starts from **3% growth in 2003**, with a positive 3.2% input from domestic demand countered by a negative 0.2% from the net exports side. The domestic demand upturn this implies owes mainly to quickening growth in consumer spending and equipment investment.

In this scenario, **private consumption** works back to 2.9% growth. Personal income tax reductions will boost households' disposable income and join with the advance in employment to help consumer spending out of its 2002 trough. Consumption growth, however, will lag GDP for the fourth year running, which should consolidate the improvement in households' financial position first apparent in 2001. Meantime, the projected 3% advance in government consumption is on a par with the average of the past few years.

Investment should gain strength in 2003 led by an **equipment** component back to average growth of 3.2%. The subdued growth rates of the past two years, the world recovery and the equipment variable's keen sensitivity to any change in the economic climate point the way of a gradual acceleration. Further support will come from the solid corporate earnings of the past few years, the low cost of finance and an abundance of available credit.

Table 2
MACROECONOMIC SCENARIO

	2001	2002	2003	2004	2005	2006
GDP by demand component (real % change)						
Final domestic consumption expenditure	2.6	2.2	2.9	2.9	2.9	2.9
- Households (a)	2.5	1.9	2.9	2.9	2.9	2.9
- General government	3.1	3.0	3.0	3.0	3.0	3.0
Gross capital formation	3.0	1.8	3.8	3.5	3.5	3.5
- Gross fixed capital formation	3.2	1.7	3.8	3.6	3.6	3.6
- Equipment	1.0	-1.8	3.2	3.8	3.8	3.8
- Construction	5.8	4.7	4.3	3.4	3.4	3.4
Change in stocks (b)	0.0	0.0	0.0	0.0	0.0	0.0
Domestic demand	**2.7**	**2.1**	**3.1**	**3.1**	**3.1**	**3.1**
Domestic demand (b)	2.8	2.1	3.2	3.1	3.1	3.1
Exports of goods and services	3.4	1.8	4.0	7.3	7.3	7.3
Imports of goods and services	3.5	1.7	4.4	7.3	7.3	7.3
Net exports (b)	-0.1	0.0	-0.2	-0.2	-0.2	-0.2
GDP	**2.7**	**2.2**	**3.0**	**3.0**	**3.0**	**3.0**
- GDP at current prices (€ bn)	651.6	689.0	729.2	771.5	816.1	863.3
- GDP at current prices (% change)	6.9	5.7	5.8	5.8	5.8	5.8
PRICES AND COSTS (% change)						
GDP deflator	4.2	3.5	2.8	2.8	2.8	2.8
Final household consumption deflator	3.3	3.5	3.1	2.5	2.5	2.5
Payments (labour cost) per employee in terms of FTEJ (c)	4.1	3.4	3.5	2.7	2.7	2.7
Unit labour costs (in FTEJ) (c)	3.7	2.4	2.3	1.5	1.5	1.5
LABOUR MARKET (FTEJ) (c)						
Employment: change in %	2.4	1.1	1.8	1.8	1.8	1.8
Employment: change in thousands	359.4	175.5	282.4	283.4	288.4	293.5
OTHER VARIABLES						
Net lending (+) or borrowing (-) vs rest of world	-2.0	-1.6	-1.7	-1.7	-1.7	-1.8
Unemployment as % of labour force (LFS)	10.5	11.3	11.0	10.7	10.3	10.0

(a) Includes Non Profit Institutions Serving Households
(b) Contribution to GDP growth
(c) Full-time equivalent jobs
SOURCE: Ministry of Economy

Construction investment will decelerate slightly from 2002 rates due to the flagging pace of residential building, after the strong run-up of previous years, and non residential building. Some offset will be provided by expanding civil works activity. The outcome should be a construction growth rate of 4.3% in 2003 against the 4.7% projected for 2002.

The slowdown of **foreign trade** in 2002 should give way to a 2003 pick-up in goods and services imports and exports. On the export side, the 4% advance projected rests on quickening economic growth in the rest of the world and the EU countries in particular. Meantime, the final demand boost provided by domestic demand and strengthening exports should return imports to 4.4% growth, supported by a general upswing in activity and an appreciating euro. The result will be a slight growth drain from the external sector in 2003 (-0.2%).

The above conduct of goods and services exchanges and, in particular, the widening of the trade deficit, will lift the **net borrowing position** of the Spanish economy to an estimated 1.7% of next year's GDP.

Employment creation will pick up speed in 2003 in line with the year's stronger output growth. The employed population (full-time equivalent jobs) will increase by 1.8%, accompanied by a modest recovery in productivity, to the benefit of unit labour costs and the external competitiveness of the Spanish economy.

Inflation is expected to moderate in 2003 thanks to the fading influence of some of the present year's most inflationary items, the likely stabilisation of crude oil prices at or around their current levels and a mild appreciation in euro exchange rates. The GDP deflator is forecast to ease back to 2.8% in 2003, drawing, inter alia, on the moderation of the private consumption deflator from 3.5% in 2002 to 3.1% at the 2003 close.

Looking **beyond 2003**, the assumption is that Spain's economy will grow at close to its potential rate, in the neighbourhood of 3%. Both private and government consumption will likely repeat the growth rates of 2003: in the first case, because families will continue to consolidate their financial position, and, in the second, because the general government sector will maintain a tight rein on expenditures.

In the case of investment, the prospect is for a recovery in equipment spending supported on the better international context and a dispelling of some of the uncertainties that have dominated 2001 and 2002. On the construction side, the deceleration of residential building will be partly offset by the greater buoyancy of civil works. The outcome projected is a 3.6% increase in gross fixed capital formation.

The improved international outlook in general and, particularly, in Spain's main client markets, will ramp up the growth of Spanish exports and imports to 7.3% as of 2004. The gathering strength of domestic demand will propel import growth to the same 7.3%, translating as an external contribution to GDP growth reckoned at –0.2 percentage points.

Output growth near 3% in the 2004-2006 interval should deliver a **job creation** rate (full-time equivalent jobs) of approximately 1.8%. The result will be further inroads into the unemployment rate, projected to close the reference period at 10% despite a likely increase in labour force strength.

On **inflation**, finally, the more moderate growth of factor remuneration should steer the private consumption deflator to a stable 2.5% approximately. The GDP deflator will hold at a somewhat higher 2.8%.

III. BUDGETARY PERFORMANCE AND PROJECTIONS

1. Fiscal policy guidelines

Fiscal policy is the anchor of any coherent economic policy design. Especially, as in Spain's case, when the goals pursued are to promote economic growth and the process of real convergence with the EU's most developed economies. Fiscal policy decisions, as such, sit within a far broader framework bent on medium-term objectives, with the following implications:

- Fiscal policy must **contribute to macroeconomic stability**. The emergence of recurring deficits imperils the sustainability of public finances which can, in turn, threaten macroeconomic stability, especially in a Monetary Union. The medium-term objective must therefore be to secure and maintain budgetary equilibrium.

- The public sector has the duty to **provide an economic framework which is known, predictable and stable**, and to adhere to clear, stringent rules of conduct. The commitment to fiscal rigour must be **credible** if it is to guarantee a settled macroeconomic climate supportive of investment and saving decisions. In Spain's case, this credibility has been won by an ambitious fiscal consolidation drive, and by the commitment to budgetary balance. This determination is evident in Spain's reiterated support for the Stability and Growth Pact and its enactment of the General Law of Budgetary Stability.

- Establishing clear, predictable, stable and credible ground rules for public sector conduct, also means that, in general, it must **refrain from the discretionary use of fiscal policy**. Firstly, because the discretionary, that is to say, unpredictable action of fiscal policy has a destabilising influence on the expectations of economic agents, who immediately have to rethink their consumption, saving, investment, work or hiring decisions. And secondly, because discretionary fiscal policy actions are not an effective response to the problems of economic growth, especially when they are structural in origin.

- But this fiscal orientation towards medium-term stability **does not mean the public sector should forego all action in cases of slowdown.** The government revenues and expenditure mix should be so designed making possible the reaction of those concepts sensitive to the level of the level of economic activity (automatic stabilisers), supporting it in deceleration phases in a manner both predictable and non disturbing. The only constraint is that this activity must not undermine budgetary discipline.

- Finally, this approach says that public finances should be geared to **supporting long-term growth** through the revenue and expenditure mix. The composition of revenues and the design of taxes should pursue greater tax efficiency and an environment supportive of saving, investment and work decisions. Expenditures, meantime, should continue prizing budget lines which enlarge the capital stock of the economy, that is, infrastructure, physical capital, human capital and technological development.

These fiscal policy guidelines find their expression in two **new legislative texts**:

— First, the **General Law of Budgetary Stability**. The 2003 National Budget is the first to be drawn up under this law, which obliges the public sector and its different agencies (Central Government, Autonomous Communities, Local Authorities, Social Security and publicly owned companies) to close their books in balance. Deficits are only contemplated in exceptional circumstances, and when they do arise, the agent responsible must present a game plan for restoring budgetary equilibrium within three years at most. This law gives legal expression to the balanced budget principle underpinning Spanish fiscal policy action in recent years.

The General Law of Budgetary Stability allows the netting of Social Security and Central Government balances for compliance scoring purposes, until such time as financing sources have been fully separated. In the interim, Central Government deficits will be offset by Social Security surpluses, as the practice had been in previous years.

— Second, the **personal income tax reform** (see also Annexe 1). A partial reform of personal income tax will be brought into force in 2003. Its aims are to lower the tax burden weighing on citizens, as a means to favour economic activity, to promote saving in general and retirement saving in particular, as a means to mitigate the future pressure of pension liabilities on public finances, and to encourage more people into the labour market.

The main lines of the tax reform are:

a) **an across-the-board reduction in taxes** especially benefiting the lowest income groups.

b) **lighter taxation of salary income** via larger reductions for earned income.

c) **incentives to labour market participation** in the shape of new targeted reductions for women with children under three and workers prolonging their active lives.

d) **a better tax treatment for families** via new and larger reductions in taxable income which take more accurate account of the taxpayer's family circumstances.

e) **incentives to the geographical mobility of labour** and its better allocation via change-of-residence tax relief and incentives to housing lets.

f) **greater neutrality in the tax treatment of saving** and the instruments through which it is channelled.

g) **encouragement of private pension schemes**, by raising the amounts deductible for pension plan contributions and the corresponding reduction in taxable income. A new kind of voluntary instrument is also legislated for, the insured retirement plan.

h) greater **neutrality** in the taxation of economic activities, and tightening up the **fight against fraud.**

The personal income tax reform should save taxpayers around €3.60 billion in its first year of application (€3 billion in 2003, mainly via withholding tax reductions and €600 million more in 2004 tax returns), on an initial reckoning which takes no account of the dynamic effects of the reform. To go by the experience of the last reform, however, and the forecasting models constructed by Banco de España, tax receipts will be largely recouped through the knock-on effects of component measures. The projection, specifically, is that the reform will add 0.5 decimal points to GDP growth and help create 65,000 new jobs. The clawing-back of revenues by way of the boost given to economic activity will leave the final saving in household direct taxation at an estimated two decimal points of GDP in 2003 and one decimal point in 2004. These estimates are factored into the accompanying projection tables.

2. Budgetary performance

Despite economic deceleration, 2001-2002 saw a continuation of the **fiscal consolidation** process begun midway through the 1990s. The general government deficit narrowed half a GDP point in 2001, which closed with a near-to-balance situation. And although 2002 growth threatens to be lower than envisaged when the National Budget was presented, the budget outcome should be broadly similar.

The slight worsening of this year's fiscal balance owes in part to the budgetary implementation of the Autonomous Communities, since Central Government sectors are projected to close with a small surplus.

Tax revenues have increased at a slower pace, while tight control of current expenditures has kept their growth in line with GDP, and their percentage weight at a similar level to last year's. Meantime, the upkeep of investment efforts has lifted gross fixed capital formation more than 10% higher.

The budget impact of measures to cope with the aftermath of the "Prestige" disaster is initially estimated at around €250 million.

2002 developments in revenues and current expenditures will hold **gross government saving** at 3.9% of GDP, providing margin to spare for financing the year's intense **public investment** programme. This means the capital stock is being enlarged without recourse to higher borrowings, and signals an important structural change in Spain's public finances.

The **primary balance** will foreseeably stand at 2.7% of GDP, thanks to the slightly falling GDP weight of interest payments.

On a breakdown **by agency**, the State and autonomous agencies subsector is expected to record a deficit of approximately 0.6% of GDP, cancelled out by a slightly larger Social Security surplus. The surpluses of past years have allowed allocation to the Reserve Fund of more than €6 billion, and its assets now stand around the 1% of GDP targeted for the year 2004.

Autonomous Communities will close this debut year for the new regional financing system with a negative balance bordering on 0.5% of GDP, on a par with last year's outcome. Local Authorities, finally, will return a slight surplus.

3. Budgetary projections

The weakening economic activity of 2001 and 2002 should give way to a moderate recovery in 2003, according to forecasts, which will persist through the following years. These projections accordingly reflect a steady improvement in budget balances. Remember also that National Budgets from 2003 on will be subject to the General Law of Budgetary Stability. It is reasonable to project, then, that general government accounts will **close 2003 in balance**. The parallel increase in capital stock makes this commensurate with an increase in the potential growth of the Spanish economy.

Table 3
GOVERNMENT REVENUES AND EXPENDITURES
(National Accounts basis, ESA-95. Annual % change)

Item	2001 (P)	2002 (F)	2003 (F)	2004 (F)	2005 (F)	2006 (F)	Average 03 – 06
Total revenues	7.3	5.9	5.9	5.6	5.8	5.8	5.8
- Tax receipts	6.7	5.8	5.7	6.0	6.2	6.2	6.0
Total expenditures	6.0	6.2	5.2	5.5	5.6	5.6	5.5
- Current	5.2	5.8	5.2	5.2	5.2	5.2	5.2
- Capital	11.1	8.7	5.3	7.7	7.8	8.0	7.2
Gross fixed capital formation	11.3	10.5	5.5	8.8	8.8	9.2	8.1

(P) Provisional.
(F) Forecast
SOURCE: IGAE and Ministry of Economy

Government revenues will rise an average 5.8% annually in 2003-2006, cleaving close to nominal output growth in the same period. As a result, their GDP weight will hold throughout in the neighbourhood of 35.5%.

In 2003, direct tax receipts will increase less than the nominal GDP rate due to the personal income tax reform. However, the economic recovery foreseen will provide an offsetting advance in social security contributions and indirect taxes. General government tax revenues will accordingly hold at 35.4% of GDP, edging up thereafter to 35.7% at the period’s end.

Table 4
GENERAL GOVERNMENT ACCOUNTS
(National Accounts basis, ESA-95. As % of GDP)

Item	2001 (P)	2002 (F)	2003 (F)	2004 (F)	2005 (F)	2006 (F)
Total revenues	39.8	39.8	39.8	39.8	39.8	39.8
- Tax receipts	35.4	35.4	35.4	35.5	35.6	35.7
Direct taxes	10.5	10.7	10.5	10.5	10.7	10.8
Households	7.4	7.4	7.2	7.1	7.1	7.1
Companies	3.0	3.3	3.3	3.4	3.6	3.8
Indirect taxes	11.4	11.2	11.2	11.2	11.2	11.2
Social contributions	13.6	13.6	13.7	13.7	13.7	13.7
Total expenditures	39.9	40.1	39.8	39.7	39.7	39.6
- Current	34.7	34.7	34.5	34.3	34.1	33.9
Financial charges	3.1	2.9	2.8	2.7	2.6	2.5
- Capital	5.2	5.4	5.4	5.5	5.6	5.7
Gross fixed capital formation	3.3	3.5	3.5	3.6	3.7	3.8
General government surplus (+) or deficit	-0.1	-0.2	0.0	0.0	0.1	0.2
Central government	0.4	0.2	0.0	0.0	0.1	0.2
State and autonomous agencies	-0.5	-0.6	-0.5	-0.4	-0.3	-0.2
Social Security	0.8	0.8	0.5	0.4	0.4	0.4
Territorial governments	-0.5	-0.4	0.0	0.0	0.0	0.0
Autonomous Communities	-0.5	-0.5	0.0	0.0	0.0	0.0
Local governments	0.1	0.1	0.0	0.0	0.0	0.0
Gross debt	57.1	55.2	53.1	51.0	49.0	46.9
Primary surplus	3.0	2.7	2.8	2.7	2.7	2.7
Gross saving	3.9	3.9	4.0	4.2	4.4	4.6

(P) Provisional
(F) Forecast
SOURCE: IGAE and Ministry of Economy

Growth of **government expenditure** will lag a little behind that of GDP, so its weight will recede slightly in the period. Current expenditure restraint will assure growth of this item (5.2%) runs lower than the GDP rate, taking its weight down by eight decimal points vs 2002 to 33.9% at the period's end. Contention efforts will be assisted by a drop in interest charges, flowing from the public debt reduction brought by the fiscal consolidation process. These current expenditure projections factor the budgetary implications of the agreement between the Ministry of Public Administration and government employees' representatives. The said agreement includes wage increases linked to performance, the introduction of a new staff replacement rate which includes both civil service and contract personnel and the creation of a pension fund for government workers.

Enlarging the growth capacity of the Spanish economy is, as stated, one of the prized goals of Spanish economic policy. Hence the annual average growth of over 8% projected for general government gross fixed capital formation, sizeably ahead of the GDP rate. This item will accordingly raise its weight by three decimal points to 3.8% in the terminal year. The relatively high real growth of capital spending is justified by its power to hasten real convergence with the EU.

The above expenditure and revenue movements will set **gross government saving** rising steadily from the 3.9% of 2001 to around 4.6% in 2006, providing ample coverage of the capital expenditure referred to above. These projections confirm and consolidate a structural change in public accounts: tight control of current expenditures giving rise to a gross government saving which allows public investment to be funded without recourse to borrowings.

The conduct projected for revenues and expenditures implies general government accounts will start from a position of **balance** in 2003 then work up to a budget **surplus** of 0.2% in 2006.

A breakdown **by agency** reveals that all government subsectors will return balanced budgets in the terms envisaged by the General Law of Budgetary Stability.

A breakdown of the budget balance into its cyclical and structural components shows that fiscal discipline has been resolutely kept up. Between 2001 and 2002, the **structural deficit**, worked out using a Hodrick-Prescott filter with a parameter $\lambda = 100$, reduced by 0.4 points of GDP. Fiscal policy, moreover, will persevere in its consolidation efforts such that the cyclically adjusted balance will improve by 0.6 points of GDP between 2002 and 2006.

Lastly, this progression of balanced budgets and output growth will prolong the **reduction of the public debt/GDP ratio**, from 57.1% in 2001 to a projected 46.9% in 2006.

Table 5
CHANGES IN THE DEBT STOCK

	2001 (P)	2002 (F)	2003 (F)	2004 (F)	2005 (F)	2006 (F)
Debt stock	57.1	55.2	53.1	51.0	49.0	46.9
Change in the debt stock	-3.4	-1.9	-2.1	-2.1	-2.1	-2.1
Contributions to change in the debt stock						
Primary balance	-3.0	-2.7	-2.8	-2.7	-2.7	-2.7
Interest payments	3.1	2.9	2.8	2.7	2.6	2.5
Nominal GDP growth	-3.9	-3.1	-3.0	-2.9	-2.8	-2.7
Other factors	0.4	1.0	0.9	0.9	0.8	0.8
Pro memoria nominal GDP growth	6.9	5.7	5.8	5.8	5.8	5.8

(P) Provisional
(F) Forecast
SOURCE: IGAE and Ministry of Economy

IV. THE QUALITY AND SUSTAINABILITY OF PUBLIC FINANCES

The **quality of public finances** is about the attainment of a revenue and expenditure mix conducive to the fiscal policy goal of raising the economy's potential growth. This means ensuring that taxation and spending programmes are correctly structured and designed.

On the **revenue** side, the goal, as stated, is to improve the efficiency of taxation and mobilise the supply side of the economy, facilitating work, saving, investment and hiring decisions. Of relevance here are the Government's reforms of personal income tax (the first in force since January 1999 and the second as of January 2003), which have substantially lightened the taxation of salary income and brought greater neutrality to the tax treatment of saving, while encouraging take-up of private pension schemes. Also, reform measures in corporate taxation seek to promote investment in R&D and training and the reinvestment of capital gains. Finally, changes to the economic activity tax will reduce the tax burden on entrepreneurs.

Expenditure policy, meantime, will continue geared to raising the economy's stock of physical, human and technological capital as the best lever for output growth. Among the priorities set for 2003 is the committing of more public investment to infrastructure and research:

- In infrastructure, work is progressing on basic projects like the High-Capacity Motorway Plan, the modernisation of rail communications, support to port and airport infrastructure, hydraulic works and water quality projects. Environmental investment is also being stepped up.

- Research policy will continue working to the goals of the National Plan for Scientific Research and Development and Technological Innovation 2000–2003. Support will be targeted on quality basic research in every subject area, competitive research and the development of the Information Society. Financing will also go to selected programmes in human capital formation, the development of technical-industrial projects, support structures for hi-tech companies and research projects within the National Space Programme.

The **sustainability of public finances** needs to be secured as a means to maintain budgetary stability over time and prevent fiscal imbalances emerging which could undermine the bases for sustained economic growth and, thereby, for potential growth.

On the question of sustainability, it is necessary to draw a line between **fiscal policy strategy**, whose mid-term goal is to procure fiscal accounts in balance and avoid a deficit-induced run-up in the public debt, and the problems surrounding **population ageing** and the pressure it exerts on different budget heads (pensions, health, dependent care).

In consequence, Spain's strategy for the long-term sustainability of public finances rests on the following **two pillars**:

- A **commitment to budgetary stability**, to be met by compliance with the Stability and Growth Pact and the tenets of the General Law of Budgetary Stability which inspire the Autonomous Community Financing Law and the reform underway of Local Authority financing (see Annexe 2).

  Support to public finance sustainability also comes from the policy of public debt reduction. The GDP weight of Spain's national debt began heading steadily lower in 1997. Factors behind this trend were, firstly, the deficit reduction process and fulfilment of Stability and Growth Pact milestones, which have allowed issuance volumes to be steered downwards and, secondly, the robust growth of the Spanish economy.

- A lasting response to the **challenge of population ageing** through a **multi-way strategy** which acts simultaneously on various fronts. Consolidating the pension system is a vital step; one which involves assuring a level of pensions adequate for the country's needs while guaranteeing the financial viability of the system itself, backed by the broadest possible social consensus. Another issue to be addressed is the control of healthcare and dependence spending, while broader actions will be targeted on raising labour market participation and deepening the structural reform of product and capital markets, as a means to gear up the economy's potential growth.

The main points of this strategy are detailed below:

1. Pensions

Reforming the pension system is seen as a gradual but ongoing process. One which dates back to Parliament's setting-up of the Toledo Pact Commission to analyse the pension system and put forward proposals for its sustainability. The Commission has a mandate to meet every five years, as warranted by the dynamic approach this kind of issue requires. It can thus take on board intervening changes in the country's demographic, economic and social landscape. The reform process, furthermore, has been based from the start on political consensus and social dialogue given the sensitive nature of any change in the state pension system.

Among **recent measures** to support the sustainability of the pension system, we can highlight:

- Those designed to raise the effective retirement age. A keynote text here is the Law on Measures to Establish a Phased and Flexible Retirement System, approved in 2002. Its provisions, pacted with the social agents, include incentives to employers and workers in support of active ageing:

  — reform of the regulations on partial retirement so people reaching the standard retirement age can opt to continue working part time while receiving a (smaller) retirement pension.

  — in the case of workers reaching 65 who want to go on working and can accredit 35 years paying into the system, they and their employers will be exempted from social contributions for standard contingencies.

  — those staying in work beyond 65 can continue building up their pension entitlement. Workers accrediting 35 years of contributions, i.e. who are up to 100% of the regulatory base, can now go over it by 2% for each additional year worked.

  — deduction in the employer's contribution for standard contingencies in respect of workers over 60 under indefinite contract. This deduction may vary depending on the worker´s age from 50% to 100%.

  — companies filing redundancy plans will be obliged to finance a special agreement with the Social Security in respect of employees aged over 55, to be paid into by both employer and worker.

- Those which seek a **closer relationship between contributions and benefits**, by lengthening the pay-in period which counts towards the calculation base for pension entitlement. The Agreement for the Improvement and Development of the Social Protection System of 2001 states that discussion should start in 2003 on a more proportional way of calculating pensions.

- Those seeking the **gradual approximation of special Social Security regimes** and the General Regime. The law on Fiscal, Administrative and Social Measures due for approval at end-2002 makes a number of provisions in this regard, building in Toledo Pact conclusions on pensions.

- Those behind the establishment and funding of a **Reserve Fund** for the public pensions system. By 2002 this fund's assets had already reached the

1% of GDP target originally set for 2004. And they will be added to in future out of surpluses returned by the Social Security subsector.

- Those to foster the **second and third pillars of the pension system**: the supplementary pension schemes of companies and individuals. Reforms have sought to speed the development of employment pension plans, to which employers pay in for their workers, by improving their regulatory and tax treatment. The recent Agreement between the Ministry of Public Administration and government employees' representatives envisages a designated pension fund for public sector workers. Meantime, the personal income tax reform enlarges both the limits for deductions and deductions themselves in respect of individual pension fund contributions and legislates a new modality covering the same contingencies; insured pension plans.

- Those to fight **fraud** within the system.

2. Health spending

The structural policy of **pharmaceutical cost contention** provides the central axis around which recent measures have revolved, and should receive further development going forward.

The adoption of a reference price and generic medicines system is now showing its first effects. A Ministerial Order of December 2001 reworked the reference prices in force and created new standard groups of medicines to which such prices are to be applied. The above Order came into force on 1 May 2002. And the plan is to issue a further Order in December 2002, putting this review function on an annual basis.

The result of these policies is that generic medicines raised their turnover from €10.73 million in 1998 to €353.12 million in 2001. Considering their price difference vs the original branded products (25% to 30% in most cases), the higher consumption of generics will have brought a total saving of some €195.81 million in the 1998-2001 interval. And the progression is clearly in the right direction: from €3.3 million in 1998 to €109.38 million in 2001.

Pharmaceutical cost contention and rationalisation are seen as central to ensuring the long-term sustainability of the healthcare system. And work must continue to tap savings potential to the fullest possible extent. Measures will target both the number of prescriptions and their average prices, and will seek the collaboration of all sector professionals. Important in this last respect is the end-2001 Agreement between the Administration and interested parties (Integrated Plan for Pharmaceutical Spending Control) which sets the goal of moderate growth in pharmaceutical spending without too great a strain on the National Budget.

3. Dependents

Economic policy has also, as in previous years, addressed the issue of the situations of dependency derived from population ageing and their repercussions on the sustainability of public finances and the economy as a whole. The line taken has been to defray part of the expense of those caring for dependent relatives. The 1998 tax reform increased the minimum allowance for families with an elderly dependent in their care. The new **personal income tax reform** goes further in its support, as follows:

— an increase to €800 in the age allowance for over 65s.

— a new, targeted allowance of €1,000 for the care of those aged over 75, whether taxpayers or older dependents sharing their homes.

— higher allowances for disabled persons, as far as an upper limit of €5,000.

— creation of a targeted reduction of €2,000 for the care of persons suffering over 65% disablement or impaired mobility, whether taxpayers or relatives sharing their homes.

Note, finally, that responsibility for social services delivery now lies with the Autonomous Communities, so direct action on situations of dependence calls for coordination between all layers of government.

4. Other targeted areas

Spain's strategy to secure the sustainability of public finances acts on two more areas: the labour market and product and capital markets.

The goal of **raising labour market participation** as a prop to sustainability in general and that of the pension system in particular, was addressed by the Law on Measures to Establish a Phased, Flexible Retirement System, dealt with earlier, and by the following initiatives:

— tax incentives for workers over 65 opting to stay in work, and for women with children aged under three.

— measures to get the unemployed back into work: receipt of unemployment benefit is made subject to the signing of an activity agreement, active job search and participation in the insertion actions which the public employment services consider suited to the claimant's profile.

- reform of regional farmworker benefit schemes and the introduction of a new contributory Social Security regime for casual farmworkers of nationwide application, thus removing a major hurdle to geographical mobility.

- launch of a geographical mobility programme, plus tax incentives for unemployed workers who move to another municipality to take up a job offer.

- larger deductions in employers' social security contributions for hiring women returning to work after childbirth under indefinite contract.

- wider incentives for the hiring of unemployed persons, in particular women and older workers, under indefinite contract, by self-employed professionals and co-operatives and worker-owned companies.

- compatibility between the receipt of a salary and unemployment benefit for those over 52 years of age.

- support to self-employment initiatives, by allowing unemployed persons setting up as self-employed or as partners in a co-operative or worker-owned company to receive part of their benefit entitlement as a lump sum.

- access to the Active Integration Income Scheme 2002 is made more flexible, and its benefits extended to certain collectives prone to unemployment.

- support to the hiring of physically and mentally disabled persons.

Finally, structural reforms in **goods, services and capital markets** contribute to the sustainability of public finances by way of raising the economy's potential growth. The main measures taken in this sphere are detailed in Annexe 4.

5. Long-term public finance projections

On submission last September of the National Strategy Report on the Future of Pension Systems, the European Commission was sent a series of pension expenditure projections which are now elaborated on in this Stability Programme Update.

The Code of Conduct on the content and format of Stability Programmes calls on EU Member States to furnish details of their strategies for coping with the budgetary impact of population ageing including, on a voluntary basis, any long-term projections made. The Economic Policy Committee (EPC) of the EU drew up its own country projections in 2001, which can be used in this section if desired. However, the interpretation rules for the Code of Conduct indicate that

Member States may submit projections of their own which differ from the EPC's findings, providing they offer sufficient background to justify the discrepancies, especially as regards the demographic and macroeconomic premises used.

Table 6
LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES

	2000	2005	2010	2015	2020	2030	2040	2050
Pension expenditure (%GDP)	8.4	7.9	8.0	8.2	8.5	9.9	12.0	13.0
SOURCE: Ministry of Employment and Social Affairs								

Spain has made use of this possibility, with the result that the projections contained in this Stability Programme Update are based on its National Strategy Report on the Future of Pension Systems. The central forecast, as shown in Table 6, is that pension expenditure will trend steadily higher in GDP terms to 13.04% in 2050. This is sizeably less than the 17.3% the EPC is forecasting for the same year.

The divergences between these figures and the EPC's trace back to the baseline assumptions used. The key parameters for projecting pension expenditure are the macroeconomic scenario, the labour market scenario and the demographic scenario. Macroeconomic and labour market scenarios are approximately the same in both cases. The small discrepancies existing are mainly due to the moment they were drawn up, and have no significant bearing on the end results.

Conversely, **the demographic scenarios used are radically different**, and the main cause of results divergence. The key points they differ on are:

a) **Total population in the baseline year (2000):** the EPC based its projections on a Eurostat model constructed with data from the 1995 survey of the Spanish National Statistics Office (INE), giving a 2000, that is, baseline population of 39.4 million. The projections used in this Stability Programme Update draw on the INE's latest demographic study, which puts the 2000 population at 40.1 million. The difference between baseline inhabitants is accordingly 700,000 persons.

   Both figures are in any case based on the 1991 census now being updated. In the new, 2001 census, whose full results will come out in mid-2003, the INE estimates Spain's 2000 population at 40.5 million. In other words, the real population in 2000 was 1,100,000 higher than the EPC's estimates.

b) **Projections of population growth**: the EPC, using Eurostat data, assumed a dramatic fall in the total population from 2020 on, with particular incidence in the population of working age. In contrast the projections presented here assume a stable population the whole length of the reference period, though likewise with a sharp fall-off in the working-age population. The Eurostat model, as such, assumes a far steeper ageing curve, with the differences mainly down to net migration flows. The EPC (Eurostat) assumes 31,000 immigrants in 2000, building up to 60,000 in 2010 and constant from that point on. The projections of the Stability Programme Update use more recent data and start from 360,000 immigrants in 2000, dropping to 160,000 in 2005 and holding flat thereafter.

The differences between the two demographic scenarios are set out in Table 7.

The new INE-2001 Census, whose full results, as stated, will be published in mid-2003, will offer **new population projections up to 2050**. The figures advanced suggest these new projections will put the future population even higher, so the pension expenditure forecasts of the EPC and the present Update may both be inaccurate in the speed, if not the consequences, of the population ageing process.

Table 7
DEMOGRAPHIC SCENARIOS

	Total population (million)		**Population aged 16-64** (million)		**Dependence rate** (% retired/ working age population)	
	2000	**2050**	**2000**	**2050**	**2000**	**2050**
Stability Programme	40.1	41.2	27.0	22.8	25.0	56.0
EPC	39.4	35.1	26.4	18.9	25.0	61.0
New INE census	40.5	n/a	n/a	n/a	n/a	n/a

n/a = not available
SOURCE: Ministry of Employment and Social Affairs, Ministry of Economy and EPC

It should be pointed out here that these projections include all contributory public pensions (retirement, disablement, widow's, orphan's) plus minimum pension supplements. Not included, however, are the pensioned staff of the central government administration.

Current estimates suggest that Spain will have a surplus in hand for the next fifteen years. This can be taken as the timeframe for action to assure the sustainability of its pension system (system revenues by this point will sum around 8.5% of GDP).

Finally, to remark that the projections contained in this Stability Programme Update **are not official forecasts of the Spanish Government**. They respond, simply, to a predictive exercise and are subject to a large margin of error, like any projection on a long-term horizon. They also presuppose no changes in the strategy line on population ageing. However, the Government's multi-way approach to the ageing issue, anchored on its core commitment to fiscal stability, involves not only structural reforms in the labour market (increased participation) and product and capital markets (higher productivity to boost potential growth), but also supplementary changes to the public pension system and the strengthening of the second and third pillars of retirement saving, corresponding to company and individual schemes.

V. SENSITIVITY ANALYSES

This Stability Programme Update describes a scenario of general government accounts closing with a small deficit in 2002, in balance over 2003 and 2004 and with a slight surplus in the last two years of the projection period. The sensitivity analysis we go on to describe shows how these budgetary outcomes stand up to a lower-than-baseline growth scenario.

1. Alternative growth scenario

The **lower growth scenario** modelled posits a later and less vigorous world recovery than baseline assumptions. In this framework, the Spanish economy would expand a more muted 2% in 2002 and 2003 then work back to 2.5% growth from 2004 to 2006.

Table 8
SENSITIVITY ANALYSIS: macroeconomic variables
(% change unless otherwise stated)

	2001	2002	2003	2004	2005	2006
Baseline scenario						
GDP	2.7	2.2	3.0	3.0	3.0	3.0
GDP deflator	4.2	3.5	2.8	2.8	2.8	2.8
Employment: change in %	2.4	1.1	1.8	1.8	1.8	1.8
Net lending (+)/borrowing (-) vs rest of world [a]	-2.0	-1.6	-1.7	-1.7	-1.7	-1.8
Low growth scenario						
GDP	2.7	2.0	2.0	2.5	2.5	2.5
GDP deflator	4.2	3.5	2.6	2.5	2.5	2.5
Employment: change in %	2.4	1.1	0.8	1.3	1.3	1.3
Net lending (+)/borrowing (-) vs rest of world [a]	-2.0	-1.6	-1.7	-1.6	-1.6	-1.6

(a) % of GDP
SOURCE: Ministry of Economy

Domestic demand and employment have a less expansive tone than in our baseline scenario, while the net external contribution turns rather less negative. The reasoning is that cooler external demand would constrain the advance of Spanish goods and services exports, while weaker domestic demand would depress import growth below the baseline assumption. The result, as stated, is a negative contribution from the net exports side, but less so than in the baseline scenario. This outcome would lead, in turn, to a narrowing of the trade deficit and a lower net borrowing position of the Spanish economy.

These differing scenarios give rise to different **budgetary outcomes**. For our lower growth scenario, we have calculated what the budget balance would be allowing automatic stabilisers their full play and without corrective measures in 2003. The result is the emergence of a general government deficit bordering on 0.4% of GDP. However, with all subsectors of general government bound by the General Law of Budgetary Stability, balance would be restored within three budget years, in a sequence close to that shown in Table 9.

The deficit appearing in the lower growth scenario would be accompanied by an appreciably slower pace of **public debt/GDP** reduction by the dual route of higher borrowing requirements and a lower rate of nominal GDP growth.

Table 9
SENSITIVITY ANALYSIS: budgetary performance

	2001	2002	2003	2004	2005	2006
Baseline growth scenario						
Gen govt. surplus (+)/deficit (-)	-0.1	-0.2	0.0	0.0	0.1	0.2
Public debt	57.1	55.2	53.1	51.0	49.0	46.9
Low growth scenario						
Gen govt. surplus (+)/deficit (-)	-0.1	-0.2	-0.4	-0.3	-0.2	0.0
Public debt	57.1	55.2	54.1	52.6	51.1	49.5
SOURCE: IGAE and Ministry of Economy						

2. Interest rate sensitivity analysis

Two alternative scenarios have been modelled to gauge the sensitivity of baseline budget objectives to variations in interest rates. Both assume a parallel shift of one percentage point in the interest rate curve factored in the baseline scenario, upwards in one case and downwards in the other.

As the average life of Spain's public debt exceeds 6 years at the 2002 close, the rates stated only apply to new issued debt, whether in place of maturing references or as part of the Treasury's new issuance programme. Logically, with the year now practically over, the effects are barely perceptible in 2002 and only show through from 2003 onwards.

Assuming that these changes pass through in full to the budget balance, their effects on the public deficit and public debt ratio will be as set out in Table 10.

Table 10 SENSITIVITY ANALYSIS: interest rates (National Accounts basis, ESA-95. % of GDP)						
Scenario	**2001 (P)**	**2002 (F)**	**2003 (F)**	**2004 (F)**	**2005 (F)**	**2006 (F)**
Higher rates						
Budget balance [a]	-0.1	-0.2	-0.2	-0.2	-0.2	0.0
Public debt	57.1	55.2	53.2	51.2	49.2	47.2
Baseline						
Budget balance [a]	-0.1	-0.2	0.0	0.0	0.1	0.2
Public debt	57.1	55.2	53.1	51.0	49.0	46.9
Lower rates						
Budget balance [a]	-0.1	-0.2	0.1	0.2	0.3	0.5
Public debt	57.1	55.2	53.0	50.8	48.7	46.6

(P) Provisional
(F) Forecast
SOURCE: IGAE and Ministry of Economy

We can see from the above table that the changes implied are approximately two decimal points of GDP on or off the public debt ratio and on or off the budget balance. The relatively long average life of Spain's public debt means changes in the interest rate curve take time to work through completely to interest payments. In any event, even in the worst-case scenario, higher interest charges are no impediment to either an improved fiscal position or reduction of the public debt/GDP ratio.

3. Comparison with projections contained in the previous Stability Programme Update

The headline change with respect to the previous edition is that economic deceleration has skimmed some points off 2001 and 2002 growth, which in both cases will be slightly below the rates presented in the Stability Programme Update 2001-2005. However, GDP growth forecasts for the years 2003 to 2005 have been left unaltered at 3%.

The lower-than-envisaged growth of 2001, by 3 decimal points, left the year-end deficit at 0.1% of GDP against the zero deficit prognosticated. For 2002, the combined effect of annual growth below the forecast level and transition to the new financing system for Autonomous Communities will be a deficit in general government accounts. Moving onto 2003, as the GDP growth forecast is left unchanged vs the last Update, so too is the general government fiscal outcome.

Table 11
DIFFERENCES VS PREVIOUS STABILITY PROGRAMME UPDATE

	2001	2002	2003	2004	2005
GDP growth					
Update 2002-2006	2.7	2.2	3.0	3.0	3.0
Update 2001-2005	3.0	2.4	3.0	3.0	3.0
Difference	-0.3	-0.2	0.0	0.0	0.0
Budget balance					
Update 2002-2006	-0.1	-0.2	0.0	0.0	0.1
Update 2001-2005	0.0	0.0	0.0	0.1	0.2
Difference	-0.1	-0.2	0.0	-0.1	-0.1
Gross debt					
Update 2002-2006	57.1	55.2	53.1	51.0	49.0
Update 2001-2005	57.5	55.7	53.8	51.9	50.0
Difference	0.4	0.5	0.7	0.9	1.0

SOURCE: Ministry of Economy

Finally, the present Update is more sanguine about public debt/GDP ratios across the whole projection period. This is partly because the 2001 baseline was better than initially projected, and 2002 too looks set to close with some improvement on the forecast level.

VI. HORIZONTAL ISSUES IN PUBLIC FINANCES

A horizontal reform with direct impact on the governmental environment, and thereby fiscal policymaking, will be the **new local authority financing system** brought into force in 2003 (see Annexe 2).

The reworked scheme will give local authorities more power to decide the tax levels they wish to apply, which will aid their compliance with the General Law of Budgetary Stability.

The draft law in amendment of Law 39/1988, of 28 December, Regulating Local Authority Treasuries is still before Parliament. In broad terms, however, article 142 of the Spanish Constitution stipulates that local authorities should have sufficient funds to perform the functions ascribed to them by law. The main sources they draw on will be the taxes they raise and their allotment of Autonomous Community and Central Government taxes.

The reform will reaffirm and extend the principle of fiscal coresponsibility at local government level, by strengthening councils' powers of decision with respect to local taxes. The reform, as it stands, will affect two of their financing sources:

- municipal taxes (tax stream).
- allotment of central government taxes (financing stream).

A point to note is that the new local taxation system brings with it a reform of the tax on economic activities. Once the new financing scheme is in operation, this tax will cease to be levied on natural persons (the self-employed) and a large proportion of companies. This will encourage more SMEs into existence and contribute to job creation.

VII. CONCLUSIONS

This Stability Programme Update has been prepared on the basis of cautious economic assumptions, with the international climate still unsettled though, it is hoped, heading for calmer times in 2003.

The Spanish Government's economic policy has retained its supply-side orientation, while the effective application of the General Law of Budgetary Stability in the 2003 National Budget ensures the continuation of fiscal discipline and provides economic agents with a known, predictable short-term framework in which to operate.

Economic policy guidelines are bent on the mid-term goals of instituting budget surpluses and maintaining a low level of public debt. This does not signify a hands-off stance by the public sector at times of economic deceleration. It implies rather a judicious use of automatic stabilisers, should they be needed, to steer Spain back toward fiscal surpluses within the term covered by this Stability Programme Update.

An optimal revenue and expenditure mix is seen as critical to get public finances lined up behind long-term growth. On the revenue side, the aim is to raise the efficiency of the tax system and make it more supportive of saving, investment and work decisions. The main vehicle here will be next year's tax package, primarily affecting personal income tax, which will lighten the burden on taxpayers across the length of the projection period, while stimulating economic activity and long-term retirement saving.

On the expenditure side, 2003 projections are shaped by three central elements: the implementation of the General Law of Budgetary Stability, which puts a ceiling on non financial outlays; the new financing scheme for the Autonomous Communities, which will raise the efficiency of public spending, and, finally, the priority conceded to productive investment.

All this, as stated, ignores the still incalculable effects of the sinking of the tanker "Prestige" off the coast of Galicia, with damages extending to several Autonomous Communities. The budgetary impact of this ecological disaster is not accounted for in the coming-year projections of the present Stability Programme Update.

Meantime, the economic reform of product and service markets remained at the forefront of the Government's concerns. The ambitious liberalisation package of 2002 has been followed up by implementing measures aimed at maximising its effectiveness. Attention, as before, has centred on network industries and improvements to the regulatory environment, as well as competition policy.

Improving the performance of the labour market has long been a central aim of Spanish economic policymaking. The modernisation process begun in 1997 has been expanded on in 2002 by new measures targeting active job search and a phased, flexible retirement system.

Short- and medium-term fiscal stability, structural reforms at the service of growth and labour market modernisation constitute the nucleus of the Government's multi-way strategy to secure the long-term sustainability of public finances in the light of population ageing. The surplus currently run by the state pension system gives the leeway to attack the problem from a global standpoint, that is to say, acting on all the factors, beyond the pension system itself, which determine the make-up of public finances and the long-term performance of the economy.

In sum, the ultimate aim of the Government's economic policy— supported on the twin pillars of budgetary stability and structural reform—is to raise the economy's productivity and potential growth. This is seen as the surest way to advance in real convergence with the European Union, as well as towards full employment and the greater well-being of Spanish society at large.

ANNEXE 1

THE PERSONAL INCOME TAX REFORM

The personal income tax reform (Law 46/2002 of 18 December) which will come into force in 2003, builds on the previous reform of 1998 to improve the efficiency, equity, simplicity and neutrality of the taxation system.

The goal of improving **tax efficiency** and stimulating output and employment growth is addressed by a reduction in tax brackets and rates. The result will be an across-the-board rise in taxpayers' disposable income:

- The number of tax brackets is reduced from 6 to 5 (compared to 16 in 1996).

- The top rate drops from 48% to 45% while the lowest drops from 18% to 15%.

- To encourage work and support active labour market policies:

  - A 7% increase in the tax base reduction for earned income, rising to 17% for salaries under €8,200.

  - The reduction coefficient for irregular salary income is raised from 30% to 40%.

  - Working mothers get an annual €1,200 deduction in the tax charge for each child under three, as a means to encourage women back to work after childbirth.

  - As a means to promote active ageing, over 65s who opt to continue working get double the reduction in the tax base for salary income.

  - This double reduction is also granted, for a two-year period, to unemployed workers accepting a job offer which means changing their residence to another municipality, as a means to encourage active job search and geographical mobility.

  - Housing lets get a more advantaged tax treatment to assist geographical labour mobility.

  - Incentives are also given for employee share ownership schemes.

- To promote saving and its greater tax neutrality:

— The reduction for savings income generated over more than two years is raised from 30% to 40%.

— Capital gains on savings raised after more than one year are taxed at a rate of 15%.

- To boost the efficiency of the financial market:

  — Savings can be transferred between mutual funds without incurring a tax charge.

  — Insurance policies are given a better tax treatment by raising and simplifying reduction coefficients, which will be 40% for premiums with over two years' life and 75% for those with more than 5 years' life.

  — Withholding tax is aligned with the lowest tax rate, i.e. 15%.

  — The policy of stimulating retirement saving is advanced by raising the pension fund contribution ceiling for tax purposes to €8,000, increased by €1,250 per year when the scheme member is aged over 52. A higher ceiling is also allowed for contributions on behalf of disabled persons (from €22,838 to €24,250) or spouses (from €1,803 to €2,000).

  — Insured pension plans are legislated for as a new insurance product, with the condition that they replicate the features of individual pension plans as regards the contingencies covered and early redemption options. Premiums paid into such pension plans, which will offer a guaranteed interest rate and use actuarial techniques, may be deducted from taxable income within the limits established for individual pension plans.

To enhance the **equity of taxation**:

- The progressive nature of the tax is reinforced, such that the average reduction in net tax payable will be larger in the case of lower incomes. So while taxpayers as a whole will get an average cut of 11.1%, those whose taxable income is less than €12,020 will save 38.14%.

- The tax gets closer to the personal and family circumstances which have a decisive influence on the disposable income and therefore the paying capacity of each taxpayer. Measures towards this end are:

  — The minimum personal allowance is raised to €3,400 for Spain's 17 million tax payers.

- The minimum family allowance per child is raised between €200 and €500, with larger increases as of the second. Reductions will stand at €1,400 for the first child, €1,500 for the second, €2,200 for the third and €2,300 from the fourth onwards. 4.7 million families with children will benefit.

- Other, targeted improvements raise the non taxable income of priority groups like families with young children, elderly people and the disabled.

  - Families with young children get a new reduction of €1,200 for each child in their care aged under three. This is accumulable with the minimum family allowance and will benefit 1 million households.

  - For the elderly:

    a) A 33% increase in reductions for families living with older relatives aged over 65 and for taxpayers above this same age. The new reduction will stand at €800 and benefit 3.25 million households.

    b) A new €1,000 reduction, accumulable with the above, for the care of relatives aged over 75. This reduction, which is not contingent on accrediting care expenses, will benefit 1.2 million households.

  - For the disabled:

    a) Disability reductions are raised by €200 to €2,000 when the degree of disablement is between 33% and 65%. For disablement of 65% or more, the reduction is set €1,400 higher at €5,000 (there are 650,000 families in Spain with a disabled member).

    b) Disabled people can also apply a higher reduction for earned income—of €2,800 (up €1,100) when their degree of disablement is under 65%, and €6,200 (more than double) when it is 65% or greater.

    c) A new, accumulable reduction of €2,000 is established for the care expenses of all those with 65% or more disability, to which those less than 65% disabled will also be entitled if their mobility is impaired.

To **make tax easier** and help taxpayers fulfil their obligations:

- The tax agency *Agencia Tributaria* will send 5.5 million taxpayers a draft tax return which will help out on the formal side of the process. If the taxpayer deems it to be correct, they simply indicate their consent by one of the means provided, and their obligations have been met.

- The income threshold below which taxpayers are exempt from declaring is raised to €22,000 in the case of earned income from a single payer, to €8,000 for earned income from two payers, and to €1,600 for capital income. Taxpayers in these situations can also claim a fast-track rebate, as can pensioners whose income does not exceed €22,000, even if they draw it from more than one payer.

- The settlement system is modified to make it simpler and give citizens a clearer idea of the effective tax rate they are paying.

As to **entrepreneurial activities**, the reform bill takes steps to improve the neutrality of their tax treatment and tighten compliance:

- The catchment population of the objective assessment regime is more clearly delimited by establishing a €300,000 ceiling on purchases, not including fixed assets.

- The fiscal transparency system is abolished to restore neutrality to the tax treatment of business and professional activities carried out by individuals.

- A new tax regime is established for limited partnerships, which will now pay corporate income tax at a higher-than-standard rate of 40%, but work out their taxable income under personal income tax rules.

- Information must be furnished on all accounts open with financial institutions, whether or not they have generated income, specifying the account holder and any authorised signatories.

The personal income tax reform will bring taxpayers a total saving of €3,000 million in 2003 and €600 million in 2004.

ANNEXE 2

THE NEW SYSTEM OF LOCAL AUTHORITY FINANCING

Spain's local authorities will start working to a new financing system in 2003, as part of a broader reform of the territorial government sector which includes the Autonomous Community financing system and economic agreement with the Basque Country instituted in 2002. The new local authority scheme and the updated economic agreement with the region of Navarra, shortly to be enacted, mark the concluding stages of the process.

The text of the law reforming local authority financing is based on the findings of a commission of academics and representatives of the government administration and the *Federación Española de Municipios y Provincias*. The agreement over its contents signed on 21 November last between members of the Government and the Federation's Executive Committee had the support of all parliamentary groups.

The law's passage puts a more modern, efficient, coresponsible and sufficient system behind Spain's local governments:

- Modern, because it adapts local financing to the new economic and social reality.

- Efficient, because it improves the allocation of resources and supports employment creation.

- Coresponsible, because councils are assigned greater regulatory power.

- Sufficient, because they are assured the funds they need to meet budget expenditures.

The system will be implemented in two phases. The first, a reform of local taxes, starting 1 January 2003 and the second, concerning the allotment of central government revenues, one year later.

Specifically, local authorities as of 1 January 2003 will be able to tailor tax policy more closely to their needs and objectives, and introduce new tax benefits in support of the family, employment and the protection of the environment.

The reform will mean an overhaul of the five local taxes, though its biggest novelty is that the Government will exempt over 2,200,000 self-employed professionals and small businesses from payment of the tax on economic activities (more precisely, all individual payers plus firms turning over less than one million euros). Other aspects of this tax are also modified in order to facilitate new enterprise and employment creation. For instance, new-start companies of whatever size are exempt from payment in their first two years of operation, and may be eligible for deductions in the following five years. The tax charge will no longer be worked out with reference to “number of employees”, while councils are empowered to establish deductions for companies creating jobs or not in profit. Among other novelties are the targeted allowances for activities favouring the environment and community welfare.

Property tax suffers two major modifications. Firstly, councils are empowered to set differentiated tax rates according to whether the use of a property is residential, commercial or industrial, and can impose heavier taxation on housing properties which are left unoccupied. Such differential rates, however, may only be applied to 10% of non residential properties with the highest rateable value. Secondly, councils are given discretionary powers to offer “large families” (those with three or more children, totalling over 500,000) a reduction of up to 90% in their property tax bill.

The big change vis à vis remaining taxes, and applicable likewise to economic activity and property tax, is that all local authorities will use the same tax rate range regardless of their population size. Other novelties serve a basically social purpose, such as higher exemptions and deductions for disabled drivers (in motor tax), for works to facilitate disabled access (in construction tax) or for environmental improvement measures.

The second phase, to be rolled out starting 2004, concerns local authorities’ allotment of central government revenues. A two-level system has been devised, the first applying to municipalities with over 75,000 inhabitants, provincial capitals and the capitals of Autonomous Communities, and the second to all other local authorities. The first group will be assigned a share of personal income tax, value added tax and excise taxes, topped up by transfers channelled through a Supplementary Financing Scheme. The second group, comprising smaller municipalities, will be financed through transfers on the basis of population, ability to pay tax and tax effort.

A special regime is instituted for municipalities classed as tourist centres. Eligibility is confined to towns of between 20,000 and 75,000 inhabitants where second homes outnumber first homes according to the official Building and Housing Census. Councils meeting these conditions will be assigned 2.04% of fuel tax and tobacco tax receipts, chosen for the localised nature of the corresponding sales outlets.

The transfers received will vary in line with central government tax receipts, regardless of each council’s size or category.

The system, finally, confers greater stability on local authority financing. This plus the consensus behind it, the greater coresponsibility entailed and the diversification of financing sources should contribute to the permanence of the new arrangement.

ANNEXE 3

THE LABOUR MARKET REFORM

Labour market reform and modernisation is a prized goal of Spanish economic policy. The reform process begun in 1997 has engendered numerous actions with three main aims in view: raising participation, stimulating demand and improving the supply-demand match. The following measures were taken in 2002:

- Enlargement of the 2002 **Employment Promotion Plan**, which will be rolled over to 2003. The Programme includes targeted deductions in employer's social security contributions for hiring workers from the collectives facing most obstacles to labour-market entry or permanence (women, young people, older workers and specifically disadvantaged groups).

- **Royal Decree-Law 5/2002 of 24 May**, now being enacted, on Urgent Measures to Reform the Unemployment Protection System and Improve Employability. This is a broad-ranging modernisation package centred on reforming the unemployment protection system to make it more supportive of active job search, the phased reform of regional farmworker benefit schemes and the removal of incentives to challenging dismissal through the courts. Main measures are as detailed below:

  — greater individual responsibility is urged on unemployment benefit recipients by obliging them to make a written activity undertaking and to actively seek work, to participate in actions to increase their employability and to accept suitable jobs when offered.

  — incentives to court action against dismissal are reduced by new regulations on interim wages.

  — the reform of regional farmworker benefits and launch of a new, contributory Social Security regime of nationwide application for casual workers in the agriculture sector, removing a major hurdle to labour mobility.

  — a programme to encourage geographical mobility including subsidies to employers and workers when hirings involve a change of residence.

  — new deductions under the aforementioned Employment Promotion Programme for hiring disabled persons or women returning to work in the two years after childbirth, and for staff hirings by co-operatives.

— compatibility of paid work and receipt of unemployment benefit for collectives prone to labour-market exclusion.

— support to self-employment initiatives, by allowing unemployed persons setting up as self-employed or as partners in a co-operative of worker-owned company to receive part of their benefit entitlement as a lump sum.

— access to the active integration income scheme is made broader and more flexible.

— penalties are tightened against the fraudulent or abusive use of serial fixed-term contracts.

- **Law 35/2002, of 12 July, on Measures to Establish a Phased, Flexible Retirement System**, pursuant to Royal Decree–Law 16/2001, sets out to promote active ageing and discourage early retirement. Component measures, which act on both the employer's and the worker's side, include:

— the first-time possibility of **flexible retirement**, so a person reaching retirement age can receive a (smaller) retirement pension while holding down a part-time job.

— extension of the **early retirement** option to workers not enrolled in the social security system before 1 January 1967, subject to new conditions and pension reduction coefficients. Conditions and coefficients are also standardised.

— measures to favour **active ageing** i.e. continuing paid work beyond sixty-five, in particular:

1) An increase in retirement pensions. Those staying in work beyond 65 can continue building up their pension entitlement. Workers accrediting 35 years of contributions, i.e. who are up to 100% of the regulatory base, can now go over it by 2% for each additional year worked.

2) Salaried and self-employed workers aged 65 and over are exempted from paying Social Security contributions. This exemption extends to both employee and employer contributions in respect of standard contingencies (excluding temporary disablement) whenever the worker is aged 65 or more, accredits 35 years paying into the system and has decided to continue or resume work of his/her own volition.

3) The possibility that workers aged 65 or over may be granted a pension for permanent disability arising from their professional activity.

— incentives to retain the services of older workers: employers will get a 50% deduction in their social security payments for standard contingencies (excepting temporary disability) in respect of workers over 60, under indefinite contract, who have been with the firm for 5 or more years. These deductions are increased 10% a year to a limit of 100%, and are compatible, subject to the same limitation, with those envisaged in the Employment Promotion Programme.

— regarding preretirement, the law takes special measures to assure contribution periods are completed in the case of companies filing redundancy plans. Specifically, it states that the quotas financing the special agreement with the Social Security must continue to be paid, in the case of workers aged 55 or more (not enrolled in the system before 1 January 1967) from the time their unemployment benefit expires to their regulatory retirement age. The employer will be liable for such payments until the worker reaches 61, and the worker him or herself from this point onwards.

- The **personal income tax reform** effective as of 1 January 2003 will support labour supply and mobility and labour market participation, particularly of women and of older workers, by lightening the taxation of earned income and through targeted reductions and deductions. Its measures are detailed in Annexe 1.

ANNEXE 4

STRUCTURAL REFORM

Increasing the openness and competitiveness of product and factor markets is a top priority for Spain. The ambitious liberalisation package of June 2000 has accordingly been built on and supplemented through the implementation of component measures and the development of follow-up reforms.

The Progress Report on the Reform of Goods, Services and Capital Markets gives a detailed description of the past year's developments. Its main points are summarised in the following pages.

I. GOODS AND SERVICES MARKETS

The liberalisation focus was again very much on network industries, in recognition of their determining role in the competitiveness of the Spanish economy as providers of basic inputs to the rest of the economy and development drivers for the information society.

1. Energy

1.1. *Electricity*

Efforts in 2002 centred on preparing the ground for the full liberalisation of electricity consumption starting 1 January 2003, pursuant to Royal Decree-Law 6/2000, of 23 June, and on the regulatory development of other measures to promote effective competition. For instance, an explicit methodology has been laid down for the setting of average or reference tariffs.

Special-regime producers have been encouraged to raise their involvement in the production market and international interconnectivity has been enlarged with France, Morocco and, particularly, Portugal through the nascent Iberian Electricity Market.

A 3% ceiling has been placed on ownership interests in the Grid Operator as a means to guarantee its arm's length management.

Liberalisation has shown its competitive fruits in generation via the entry of new operators and a reduction of five percentage points (to 61%) in the combined market share of the two largest operators since January 2002. In supply, the extension of consumer choice is serving to draw in new competitors. Finally the year has brought a steady rise in the volume of retail sales transacted at non tariff prices.

1.2. *Natural gas*

Liberalisation proceeded through 2002 with the adoption of implementing measures to Royal Decree 6/2000, of 23 June, aimed at completing the regulatory framework by the main route of improving third-party access to gas transmission networks. The groundwork has thus been laid for the full liberalisation of supply on 1 January 2003.

Work concluded on developing an integrated economic system for the gas sector, with the design of a calculation mechanism for network access tolls and a remunerative system based on costs. The aim in all cases was to incentivise the entry of new competitors, increase competition and foster infrastructure development.

ENAGAS's Action Plan, approved 2001 and targeting the enlargement of its shareholder base, was rolled out practically in its entirety, and the auctioning to suppliers of 25% of the gas from the Algerian contract went ahead as planned.

Taking stock of the market; a large number of operators have entered the supply business since liberalisation commenced in 1999, while the proportion of demand met from the liberalised market climbed from 9% in 2000 to 38.4% in 2001.

1.3. *Liquid hydrocarbons*

As prescribed by Royal Decree 6/2000, of 23 June, work proceeded on the action plan to open up the shareholder base of CLH. By midway through 2002, the joint shareholding of refining companies was down to 50% of the logistics operator's capital.

A further measure is the compulsory publication of the conditions governing access contracts to logistical installations, the aim being to ensure all agents receive an equitable and neutral treatment. Transparency will also be enhanced by the posting on the National Energy Commission website of the access prices and terms applying at each storage and transport facility.

An encouraging development in oil product retailing was the 2001 increase in service station numbers, most notably in shopping centre areas, as a consequence of the Government's liberalising moves. Also, the difference between top and bottom prices for each type of fuel continued to widen through the year; a good pointer to growing market competition.

2. Telecommunications

A start has been made to transposing the new EU regulatory framework for the telecommunications industry. Draft implementing legislation sets out to simplify the rules for market entry and operation as a means to strengthen competition and safeguard consumers' basic rights.

Law 34/2002, of 11 July, on Information Society and e-Commerce Services, inter alia, broadens the concept of universal services and lays down implementing criteria for the technological upgrade programme on the access network to the public fixed telephony network.

The provisions of the liberalising decrees of 1999 and 2000 were rolled out further to strengthen basic competition instruments.

Work continued on the effective implementation of the new capacity-based interconnection model. This pioneering move aims to level the playing field for sector operators. As new entrant offerings are no longer constrained by the need to pay interconnection by minutes of use, they are free to market their services more innovatively.

TELEFONICA's second Subscriber Loop Offer, approved in the year, is clearer and stricter about guarantees and offers greater security as to the form, conditions and costs of service provision and the formalities involved, leaving little room for discretionary action. It also marks a complete overhaul of loop access service prices, with reductions at times exceeding 30%.

Indirect competition gets a helping hand via enlargement of the services eligible for pre-selection to include network intelligence calls. Also, the bar on client recovery moves by the access operator is extended from two to four months. Other measures target a greater symmetry in inter-operator dealings.

A new type of licence has been introduced for virtual mobile operators, i.e. those operating without their own network, in order to stimulate market competition. Other measures lay the groundwork for virtual loop leasing, that is, the issue of a single bill to pre-selected users, and seek to increase competition in government purchasing of telecom services. Finally, the price cap for 2003 has been modified with the dropping of rental charges from the basket of final fixedwire services.

Liberalisation has had heartening effects on the degree of market competition. The market share of the incumbent fixedwire operator has come down significantly, and competitive pressure has been building up strongly from the cable operators in particular. Prices have headed consistently lower as far as a cumulative decline of 47% since the start of sector liberalisation. The internet market has continued to consolidate as far as a penetration rate of 22.7%. The mobile telephony market remains in expansion, with newer competitors wresting some share from the leading operator. Mobile prices have likewise moved down; by a cumulative 53% since 1998.

3. Transport

The five-year strategy plan for the road haulage sector (PETRA), approved in 2001, got off to a start in 2002, and a sister plan is now being drawn up for road passenger transport. The prices of freight transport and discretionary road passenger transport have been fully liberalised, with the Development Ministry discontinuing its issue of reference tariffs in the latter case.

In maritime transport, Compañía Trasmediterránea has been fully privatised. The Government has signed agreements with the company for the public-interest sea routes awarded by tender, as laid down by the European Commission.

In ports, the focus was on a building competition in the sale of oil products in port authority precincts, pursuant to the liberalisation package approved by the Government in June 2000. A new reform of the regulatory framework for ports and port services is now in preparation, with a clearly liberalising intent. Measures will seek to reduce goods transit costs in port areas, making them more competitive, and to favour short-haul transport and intermodality with the rail network.

As to railway transport, work has begun on writing “rail package” directives into Spanish law. The main thrust of the reform will be to liberalise service provision while guaranteeing network access, by means of a cleaner separation between transport and infrastructure and the levying of a fee on carriers for railtrack use. In many aspects, the current draft goes further than Community directives stipulate.

4. Water

A start has been made on executing works and investments under the National Hydrological Plan (NHP) approved July 2001. The NHP was joined this year by the National Irrigation Plan, likewise extending to 2008, which stands as an organisational and modernisation blueprint for irrigation practises.

5. Postal services

Directive 2002/39/EC, of the European Parliament and Council has set a fresh calendar for service liberalisation. Transposing legislation, begun this year, circumscribes the weight ranges reserved for public operators in the intercity delivery of letters and postcards to a limit of 100 grams as of 1 January 2003 and 50 grams as of January 2006, which goes further than the above Directive, and reaffirms the openness to competition of services like urban mail and direct advertising.

Furthermore, it prohibits the cross financing of universal mail services in the non reserved sector from the revenues raised in reserved activities, except where such funds are required to meet specific universal service obligations linked to the contested segment.

The law also regulates the regime to govern postal service prices (authorised for reserved services, free for non reserved services), and makes it incumbent on universal service providers to exercise transparency and non discrimination on applying special prices to companies, the senders of mass mailings or the mail handlers of various clients. These prices must factor costs saved with respect to full-service standard deliveries.

6. Competition policy

A series of measures in 2002 have served to strengthen the Spanish competition regime in general and competition authorities in particular, by consolidating their autonomy, endowing them with greater financial, technical and human resources and increasing the transparency and publicity of their activities.

A change in the legal nature of the Competition Tribunal transformed it in 2002 into an autonomous institution. This new status brings with it greater management autonomy and independence. The Tribunal has also been strengthened financially by an increase in its own funds, which partly fences them off from budgetary decisions. Its funds, moreover, will be incremented by 50% of the fees raised from analysing concentration operations.

The enactment of Law 1/2002, on Co-ordination of Powers between Central Government and Autonomous Communities in Competition Matters marks the start of a new decentralised enforcement system for anti-competitive conduct legislation.

New regulations on the control of merger operations, introduced on 8 February 2002, adapt the procedure to intervening legislative changes and the antitrust experience acquired over recent years, while increasing its transparency and clarity.

II. CAPITAL MARKETS

Law 44/2002 of 22 November on Financial System Reform Measures seeks to boost the efficiency of the financial system and enhance its competitiveness, to improve the financing conditions for SMEs and afford greater protection to financial service users. It also embraces two reforms of far-reaching importance, in the savings bank sector and the auditing system.

In the insurance sphere, the transitory regime of Royal Decree 1588/1999 was extended to November 2002. This norm lays down the procedural steps for externalising companies' pension liabilities with their employees through employment pension funds or group insurance contracts. The process is unfolding with a balanced mix between these two saving instruments, and has led to a dramatic increase in their membership and assets under management.

III. OTHER REFORMS AFFECTING PRODUCT AND FACTOR MARKETS

1. The regulatory environment and support to innovation

The review of the legal and regulatory framework in which businesses operate has looked at ways to cut the administrative costs of new firm creation with particular attention to small and medium-sized enterprises (SMEs). The goal of simplifying formalities is mainly being pursued through the One-Stop Shop for Business network, and the New Enterprise project now before Parliament.

Also with small firms in mind, the SME Consolidation and Competitiveness Plan 2000-2006 puts a battery of support measures and targeted incentives behind the competitiveness of SMEs, with direct input from sector entrepreneurs.

2. The Information Society

Actions under this head are mainly channelled through the Info XXI Initiative Action Plan and the programmes ARTE/PYME II and *Internet para todos.*

ARTE/PYME II is a programme financing projects based on e-commerce and advanced telecommunications services of common interest to the small firms sector, which favour the development of knowledge sharing networks and enlarge their capabilities to market products by IT and telematic means. ***Internet para todos***, meantime, is conceived as a social mobilisation programme to awaken citizens to the advantages brought by internet use.

Joining these initiatives is telecoms training programme **FORINTEL**, which pursues the ongoing adaptation and e-skilling of professions and job profiles plus improvement in the capabilities and skills of ICT industries, their employees and their user sectors. Programme funding is earmarked for lifelong training actions.

Law 34/2002 is a cornerstone text for the promotion of the information society in Spain. Its core purpose is to provide greater legal certainty to users and providers, in the process overcoming barriers to the use of internet and other interactive services. Finally, the advance of the e-Administration has continued, with the application of new principles in public management and the progressive enlargement of online services. Recent milestones include changes to the legislation on official paperwork so citizens can submit applications and communications by electronic means.

3. Scientific Research and Development and Technological Innovation

The Spanish authorities have made strenuous efforts to foster increased spending on R&D and Innovation. The objectives of the National R&D and Innovation Plan are that spending on R&D and on R&D and Innovation should represent 1.29% and 2% of GDP respectively, and that companies should be committing 65.3% of these outlays by 2003. The top priority assigned this Plan was reflected in the 7.6% increase approved in the corresponding budget line for 2002.

A number of improvements have also been made to the regulatory and fiscal framework. The text of Law 13/1986, on the Promotion and Global Co-ordination of Scientific and Technical Research was amended to permit more efficient action by government research institutions, and give them greater scope to create or participate in commercial companies. A further novelty is that institution staff can be temporarily seconded to such firms.

Spanish patent legislation now incorporates Directive 98/44/EC provisions on the legal protection of biotechnological inventions. A new definition has been drawn up of which inventions will be patentable, alongside conditions for the deposit of and access to biological material and other indispensable means to promote investment in this innovation sector.

Risk capital entities have been given easier access to preferential credit lines for investment in new or early-stage (less than two years' operation) high tech companies. Note also the **NEOTEC Initiative**, brought into being to facilitate the creation and consolidation of technological enterprises

Finally, the latest corporate income tax reform improves tax incentives to R&D and Innovation by broadening the range of deductible expenses as well as the scope of application of this and other SME-supportive measures.

ANNEXE 5

MEASURES TO COPE WITH THE AFTERMATH OF THE ECOLOGICAL DISASTER CAUSED BY OIL TANKER "PRESTIGE"

The accident and subsequent sinking of the vessel "Prestige" on 13 November has sent fuel oil spilling onto the coast of Galicia and other Autonomous Communities along the Cantabrian seaboard, and can be considered an ecological crisis of the first magnitude. To the devastating effects on the environment must be added the grave social and economic consequences that will ensue from the disaster, since the economies of the affected zones are heavily dependent on natural, maritime and coastal resources.

The enormity of the event and its social and economic repercussions have called for the sequenced deployment of palliative and repair measures, aimed at restoring the damaged zones to normality in the shortest possible time. For reasons of timing, the contents of this Stability Programme make no allowance for the budgetary actions and allocations now being designed and implemented to deal with the effects of the disaster, whose final extent is as yet unknown.

Aside from the measures taken by the Autonomous Communities and local councils of the areas affected, the Spanish Government has approved Royal Decree-Law 7/2002, providing a first round of urgent measures to alleviate the impact of the catastrophe in the Autonomous Community of Galicia. Given the subsequent course of events and the spread of the oil to other Autonomous Communities along the Cantabrian coastline, the more recent Royal Decree-Law 8/2002 supplements these initial measures and extends their geographical scope of application. The measures taken can be grouped under the following headings:

- **Public infrastructures:** repair work to public infrastructures in the affected areas was accorded emergency status, in order to restore them as quickly as possible to working order. Items within this priority category include port and coastal installations and any other public property damaged by the catastrophe.

- **Tax measures:** a series of benefits have been granted in central taxes to those in the zone whose activity has been suspended due to Autonomous Community or Government measures related to the "Prestige". These benefits are applicable not only to fishery, shellfish and aquaculture activities but to all others bearing a direct relationship.

- **Labour market and social security measures:** employers and the self-employed whose activity has been suspended due to measures related to the “Prestige” are granted a 100% deduction in social security contributions while such measures remain in force. Also unemployment benefits are adapted in the case of employees affected by temporary layoffs or short-time working as a result of the disaster. Finally, government authorities and non profit organisations carrying out repairs to public service facilities can apply to take on workers receiving unemployment benefits.

- **Aids to workers whose activity has been suspended:** state aids of up to €10 per person/day have been legislated for fishermen, shellfish collectors and other collectives affected by bans on their activity, to supplement such amounts as may be allocated by the Autonomous Communities. The combined support received from Central Government and Autonomous Communities may not exceed €40 per person/day.

- **Preferential credit lines:** preferential credit lines have been opened through the *Instituto de Crédito Oficial* to fund the repair or replacement of industrial, fishery, aquaculture or shellfishery installations affected by the catastrophe. The top amount of such credits is confined to officially certified damages, after deducting the amount of any other preferential loans extended at the initiative of Autonomous Communities.

- **Information campaigns:** campaigns will be launched in concert with the Autonomous Communities on the quality, safety and health value of fish, shellfish and aquaculture products from the regions affected.

- **Collaboration between government sectors:** the central government administration is empowered to enter into such collaboration agreements as are necessary with the Autonomous Communities to ensure a properly co-ordinated response.