STABILITY PROGRAMME UPDATE

SPAIN

2003 - 2007

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I. INTRODUCTION: ECONOMIC POLICY GOALS AND INSTRUMENTS

This Stability Programme Update is presented in the framework of the **multilateral supervision exercises** carried out annually by the European Union (EU). The ultimate aim of its presentation is to facilitate economic policy coordination, which is of special importance in the framework of Economic and Monetary Union (EMU).

After three years of international economic slowdown, **the Spanish economy is reporting results** which, though short of its full potential, have allowed progress towards the goal to which economic policy has been consistently directed: real convergence with the most developed economies in Europe. Spain’s economy has easily outperformed the EU average in both real economic growth and employment creation, so hastening the convergence process. The result is that Spanish per capita GDP in 2003, measured by purchasing power parity, stands at around 87% of the Eurozone average.

Economic activity has been picking up slowly but steadily since the second half of 2002. **The year 2003** will close with economic growth of 2.3%, a 2.8% increase in employment (in terms of the Labour Force Survey), a sizeable reduction in the inflation differential versus the European Union and public accounts in surplus.

International economic forecasts point to a strengthening of growth in all main economic areas. In this more favourable environment, Spain is expected to register growth rates bordering on 3% in the next few years, which will sustain the catch-up process in real per capita income with the European Union.

The economic policy lines which have delivered this performance of the Spanish economy are budgetary stability on the fiscal policy side and the deepening reform of goods, services and factor markets.

Fiscal policy has retained its medium-term focus, with the goals of fostering economic growth and macroeconomic stability by means of a firm commitment to budgetary discipline, which has been kept compatible with increased investment in physical, human and technological capital.

Budgetary stability has shown itself to be a key driver of a stable and credible macroeconomic environment conducive to the general welfare, in which economic agents can make decisions with greater confidence of success. By the same token, this stable framework has proven to give more incentives to improve the quality of public finances, with a positive impact on investment, employment creation, the decision to enter the labour market and, ultimately, the creation of wealth and social integration and cohesion. This has allowed two wide-ranging reforms of personal income tax and a lightening of the tax burden on SMEs; measures which have exerted a highly positive influence on agents’ consumption and investment decisions.

In the area of **structural reform**, attention has focused on liberalisation and increased competition in product and factor markets. The top priorities have been the modernisation and improved functioning of the labour market to reduce unemployment and increase the participation rate while providing more stable, better quality employment; the upkeep of the liberalisation and competition agenda in goods and services markets, with the accent on network industries; the enlargement of physical, human and technological capital; the advancement and diffusion of research, development and productive innovation; and the spread of the information and knowledge society.

Finally, the time frame for this Update is marked by the elections called for early 2004. This logically means that the economic policy projections and guidelines on which the text is based must be especially prudent. In any case, the forecasts it contains are fully compatible with the Stability and Growth Pact and address the recommendations specific to Spain set out in the Broad Economic Policy Guidelines 2003-2005.

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, the Progress Report on Economic Reform in Goods, Services and Factor Markets, the National Action Plan for Employment and the National Strategy Report on the Future of the Pension System express the guiding principles of the Spanish Government's economic policy design.

II. ECONOMIC POLICY, CURRENT ECONOMIC SITUATION AND OUTLOOK

1. Economic policy

As stated, the **priority objective** of Spain's recent economic policy has been to promote real convergence with the most advanced European Union economies through an increase in potential growth and employment.

The **strategy** designed to address this goal rests on the two main pillars available in a monetary union: in the first place, a fiscal policy firmly engaged with budgetary discipline, medium-term stability and improving the quality of public finances; and, in the second, structural reforms in product and factor markets, as a key supplementary means to boost the flexibility of the Spanish economy and enlarge its growth and job creation capacity.

The result of this strategy is that Spain kept up a growth differential versus Eurozone countries of 1.1 percentage points through 2002, foreseeably broadening to 2 percentage points in 2003, hand in hand with a fast pace of job creation. Our economy has thus prolonged and intensified its process of real convergence with the most developed European Union countries, and has located its per capita GDP, in terms of purchasing power parity in 2003, at approximately 87% of the Eurozone average, compared to 78% in 1995.

Besides the positive results generated, this performance represents a **significant qualitative change** with respect to previous business cycles. A change which has equipped the Spanish economy with greater resilience to external disturbances and allowed it to sustain its growth and job creation pace through a period of slowdown. There has thus been a structural change in Spain's growth pattern, freeing it of the constraints and rigidities which set back the real convergence process: an overreaction to external slowdowns in terms of growth and employment losses; the high growth threshold for employment creation; and a tendency to accumulate imbalances during expansion phases which increased the vulnerability of the economy.

1.1. Economic policy in 2002 and 2003

Fiscal policy has retained its focus on maintaining a balanced budget and improving the quality and sustainability of public finances, with the ultimate goal of building up potential growth and employment. Hence 2002 and 2003 saw a prolongation of the fiscal consolidation drive initiated in 1996, delivering budget surpluses.

Budgetary discipline has allowed ongoing improvement in the composition of public finances as regards both revenue and expense items. On the tax front, the second partial reform of Personal Income Tax, which came into force in 2003, carries on the work of the 1999 reform. Its provisions increase the neutrality of the tax system for agents' saving, investment and labour supply decisions, and will by this means add to growth. Note that the two cuts in the Personal Income Tax rate applied in the past four years have lightened the tax burden on households by 25%.

These effects have been reinforced by a parallel reform of corporate taxation, which seeks to stimulate business initiative with the accent on small and medium-size enterprises, to promote R&D and Innovation activities, and to encourage companies to make productive investments. Keynote measures in 2003 include the raising of the eligibility threshold for companies opting for the special small business corporate income tax regime, greater tax incentives for new-start companies under the New Enterprise Law and, as part of a wider reform of the local government financing system, the modernisation of the Tax on Economic Activities and its abolition for the majority of taxpayers. Innovation is encouraged by simplifying the administrative formalities to take up tax incentives for R&D and Innovation activities.

On the expenses side, a greater relative weight goes to those items with the largest impact on economic productivity; namely, investment in physical, human and technological capital.

The credibility of the balanced budget commitment, even in a slowdown phase, has been strengthened by the institutional changes enshrined in the Laws of Budgetary Stability, some of them already applied in the 2003 budget. The implementing legislation due to come into force in 2004, including the General Subsidies Law, the General Budgetary Law and the General Taxation Law, extends the stability principles at their heart to the budget process and expenditure management.

The second economic strategy pillar is **structural reform policy**, as explored in detail in the Annexe. Reform in product markets has been primarily targeted on network industries, as providers of basic inputs to the rest of the economy and in view of their capacity to increase output growth. Measures taken in 2003 complete the development of the 2000 deregulation package with the full liberalisation of the electricity and gas sectors, and bring significant advances in the telecommunications sector which will culminate in its full liberalisation in January 2005. Another priority area has been the housing sector and the development of the housing rentals market, as an added mechanism to promote labour mobility. In addition, the entry into force of the New Enterprise Law marks a major improvement in the regulatory framework for business. As a necessary corollary to sector liberalisation, competition policy has been reinforced by measures to increase transparency, a more proactive approach by the competition institutions and the enlargement of their material and human resources.

In factor markets, the past two years have brought large-scale reforms in the labour market. Measures have built on the progress made in previous years, with the goals of a more efficiently functioning market and a closer supply-demand match, higher employment and activity rates, and increased geographical mobility.

Specific mention should go to Law 45/2002, of 12 December, on the Reform of Unemployment Protection Systems and the Improvement of Employability, and Law 36/2003, of 11 November, on Economic Reform Measures, which includes employment promotion measures targeting women, young people and the over 65s.

In the capital markets, the entry to force in 2002 of the Financial System Reform Law has been followed up by new measures to increase the efficiency and transparency of financial markets, while favouring the provision of services, and reinforce user safeguards. Specifically, Law 26/2003, known as the Law of Transparency, has amended the Public Limited Companies Law and the Securities Market Law with the aim of reinforcing the transparency of listed companies and affording greater protection to shareholders.

1.2. Future economic policy guidelines

In view of the good results produced by Spanish economic policy, it will continue working to the **goals** of enlarging the economy’s potential growth and securing full employment. The **strategy** designed to meet these objectives is based, firstly, on the commitment to budgetary stability and, secondly, on structural reforms in product and factor markets. Part of this two-way strategy involves getting the right dynamic mix between government revenues and expenditures within a process of ongoing improvement in the quality of public finances which reinforces structural measures.

Fiscal policy will retain the medium-term orientation of maintaining a balanced public sector budget. This principle has been institutionalised in the regulatory framework provided by the Laws of Budgetary Stability and the General Budgetary Law, and is likewise clearly reflected in the present Stability Programme Update. The balanced budget commitment will be supplemented by improvement in the quality of public finances while ensuring their long-term sustainability.

On the revenue side, the recent reforms of direct personal taxation have improved the efficiency of the tax system. This and the fact that agents see them as permanent has boosted incentives to save, invest and hire and, consequently, the potential growth of the Spanish economy. Their effects will become fully appreciable in the medium term. Specifically, taxpayers will get the full benefits of the cut in income tax rates approved in 2003, in 2004, the first time they file returns after the reform. They will also benefit from the freeze in excise taxes, following on from that applied in 2003, which translates as a real-term reduction in their levels.

On the expenditure side, the priorities listed in the National Budget for 2004 will imply renewed investment efforts from the government sector, as a key driver of output and productivity growth. These efforts will centre on infrastructures, complementing initiatives under the European Action for Growth, as well as on human and technological capital. In global terms, central government public sector investment including allocations for direct investment and the investments made by state-owned entities will move up 10.5%, sizeably more than the envisaged rate of nominal GDP growth (5.9%). In absolute terms, the investments contemplated in the National Budget for 2004 double the figure of seven years back. Note also that this Budget factors in full the new Autonomous Community and Local Government financing schemes, which mark a large advance in administrative devolution.

R&D outlays will prioritise raising the number of working researchers and increasing their mobility. The amount allocated to this budget line will stand 7.3% higher than in 2003.

Structural reform in product markets will deepen liberalisation, thus enhancing the efficiency and flexibility of the Spanish economy. The full enforcement of 2003's liberalisation measures in energy sectors will be joined in 2004 by new initiatives targeted on telecommunications, the railways and port services.

The accomplishment of the above objectives calls for further advance in participation and employment rates and in labour market flexibility. Measures already adopted, coupled with the new Employment Law and a better design and coordination of active policies, should deliver tangible results especially in the match between demand for and supply of labour.

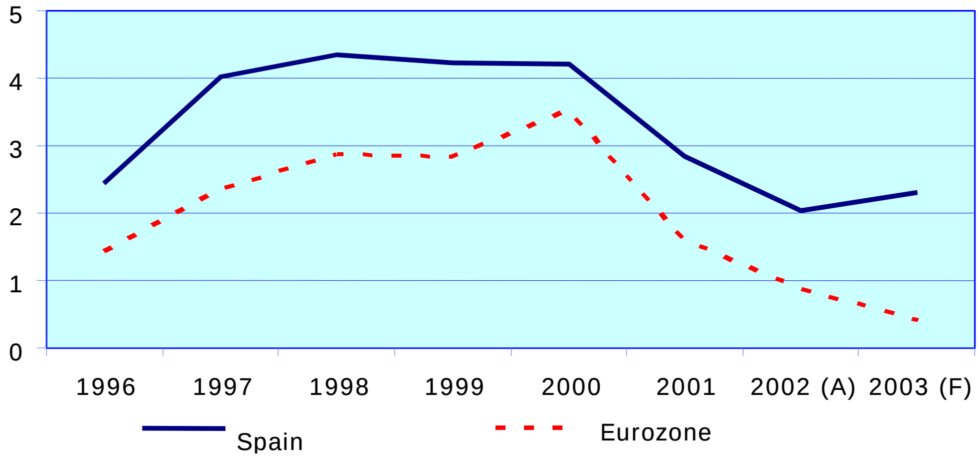
2. Performance of the Spanish economy 2002-2003

The Spanish economy **grew 2% in 2002**, eight decimal points below the previous year's rate, due to a fall in domestic demand growth compounded by a more steeply negative external sector contribution. Despite the slowdown, Spain kept up a positive growth differential of 1.1 percentage points over the Eurozone average, thereby prolonging the convergence process with the area's most developed economies.

Growth began to accelerate in the second half of 2002 and conserved this stronger momentum through **2003**, reaching a year-on-year rate in the third quarter of 2.4%, in seasonally and calendar adjusted terms. Expectations are for full-year growth of 2.3%, thanks to the contribution of domestic demand, which will partly offset a greater growth drain from net exports (-0.9 percentage points).

Figure 1

REAL CONVERGENCE OF THE SPANISH ECONOMY
Real annual growth of GDP

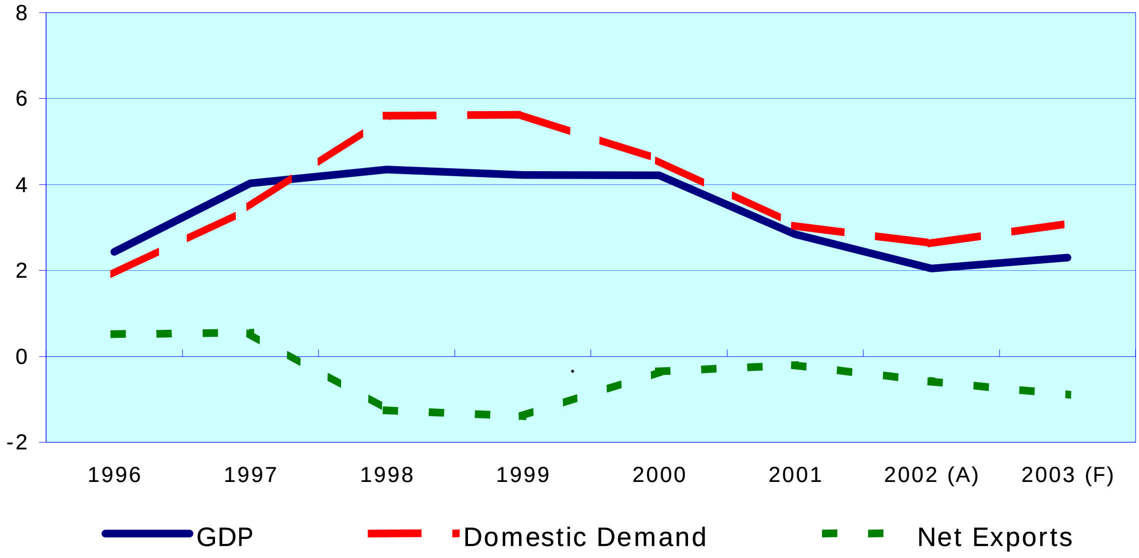


Source: INE, European Commission and Ministry of Economy
(A) Advance (F) Forecast

Despite the slowdown of 2002, **domestic demand** has kept up a relatively strong advance in the past two years. The reasons can be found in the stance of ECB monetary policy; the reform of personal income tax; a brisk rate of job creation supportive of growth in household income and private consumption; the fall in inflation, which has increased real disposable income and, generally speaking, the favourable domestic macroeconomic climate.

Looking at domestic demand by component, in 2003 final domestic consumption is expected to grow by 3.1%, with private and government consumption up by 3% and 3.6% respectively. This advance in private consumption is compatible with a degree of recovery in personal saving rates, due to the positive effects of tax reform on households' disposable income.

Figure 2
COMPOSITION OF GROWTH
Contribution to GDP growth

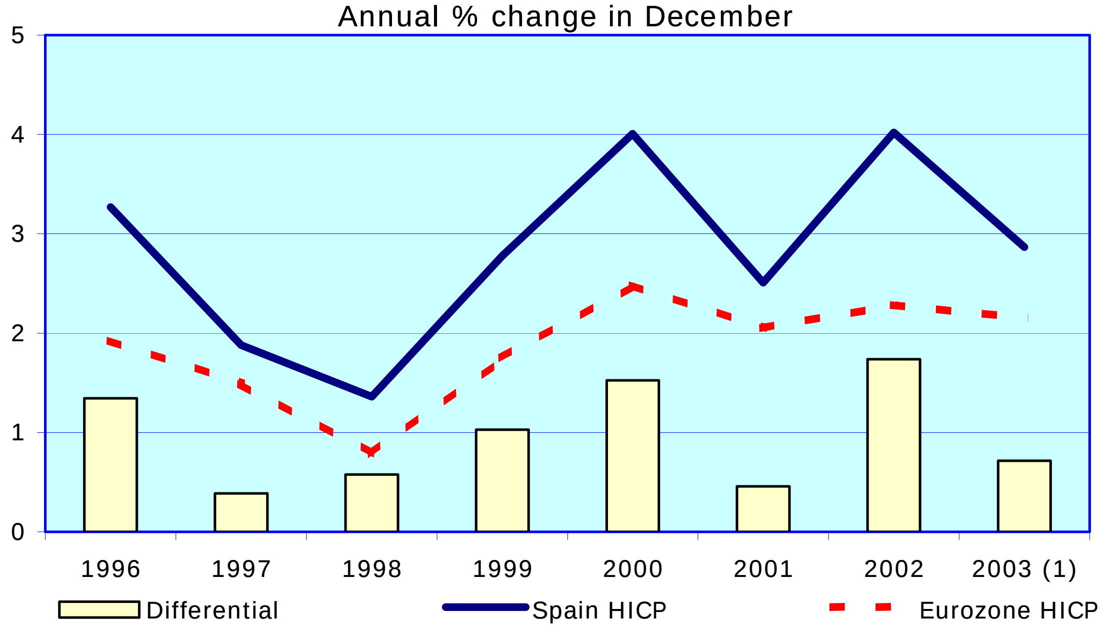


Source: INE and Ministry of Economy
(A) Advance (F) Forecast

Fixed investment is expected to expand by 3.1% in 2003, with construction conserving its growth lead (3.7%) over equipment investment (2.4%). Construction has been the most dynamic of all domestic demand components led mainly by the continuing vigour of housing demand. This variable, however, is expected to moderate with respect to 2002. Equipment investment, conversely, is back on a rising curve after last year's dip, and is expected to gather fresh momentum in a context of international economic recovery. Domestically, the conditions are right for renewed expansion: a low cost of capital use, corporate profitability ratios running high, an increase in productive capacity utilisation and a favourable growth outlook.

In the **external sector**, the growth contribution of net exports turned more negative in 2002, taking 0.6 percentage points off output growth in a context of faltering growth of both exports and imports. Goods and service exports turned flat in the year, due to the weakness of activity in Eurozone countries and the downturn in tourism that followed the terror attacks of 9/11. Imports, meantime, slowed less intensely than exports because of the still robust growth of Spanish domestic demand. The present year should show a firm recovery in both variables, which will translate as a growth contribution of –0.9 percentage points with imports outdistancing exports.

Figure 3
PRICE DIFFERENTIAL SPAIN - EMU
Annual % change in December



Source INE and Eurostat
(1) November data

Inflation picked up in 2002 due to varying factors of a transitory nature (entry of the euro, increases in certain indirect taxes, adverse weather conditions) which carried the CPI in December to a rate of 4%, compared to the 2.7% of December 2001. It has fallen back in 2003, despite the resurgence of some of these problems (summer heat-wave) and rising crude oil prices, as far as a November year-on-year rate of 2.8%, 1.2 percentage points less than in December 2002. Particularly significant is the drop in underlying inflation, which has moved down 0.9 percentage points in 2003 to a November rate of 2.6%. Note also that inflation has fallen more sharply in Spain than in the Eurozone as a whole, eroding the price differential shown by their respective harmonised Indexes of Consumer Prices from 1.7% in December 2002 to 0.7% in November 2003, i.e. a reduction of one full point. The improved conduct of the CPI and other factors like a strengthening euro should steer the GDP deflator down from 4.4% in 2002 to 4% in 2003.

Labour market variables kept up a favourable performance over 2002, with intense growth in both the labour force (addition of 482,700) and employment (256,300 persons entering work) in terms of the Labour Force Survey. Growth of both factors remained strong in 2003 and accelerated in the case of employment. As a result of the large increase in the labour force, the unemployment rate climbed to 11.4% in 2002, before decelerating gently in the central stretch of 2003 to 11.2% in the third quarter. These figures show that although 440,000 persons entered the labour force between the fourth quarter of 2002 and the third quarter of 2003, the Spanish economy was capable of generating employment on a larger scale, by rather more than 460,000 jobs, permitting the fall in the unemployment rate referred to above.

Finally, the **net borrowing position** of the Spanish economy will foreseeably increase in 2003 due to a broadening of the current account deficit to 2.6% of GDP, after its 2002 reduction to 1.5%.

3. Short-and medium-term forecasts 2003–2007: baseline scenario

3.1. International assumptions

In accordance with the Code of Conduct for Stability Programme Updates, the common assumptions prepared by the Commission on the performance of certain international variables are set out below.

The economic slowdown that started in 2001 gave way in 2003 to a **gradual recovery of the world economy**, which is expected to consolidate in the next two years. The prospect is for an uneven performance by geographical zone. The United States is assumed to have entered a strong expansion phase, which will last through 2004, delivering annual growth of 3.8%, with some deceleration in 2005 to 3.3%. The European Union will see a gradual recovery in 2003, with growth of 0.8%, which will gather strength in the next two years as far as a 2005 rate of 2.4%. Japan is expected to decelerate in 2004 after the upturn of 2003. World growth, excluding the EU, is projected to close 2003 at 4% then quicken to 4.6% in 2004 and 2005.

This context of accelerating growth in non-EU countries should entail a faster advance in their import volumes from the 6.3% projected for 2003 to 8.3% and 8.6% in the next two years. On **exchange rates**, the Commission is expecting the euro to appreciate in both nominal and effective terms in the projection period vs. the US dollar though with some levelling off as the years advance. The assumed progression path is a rate of 1.13 in 2003 rising to 1.16 en 2004, followed by a slight depreciation in 2005.

Table 1 COMMON BASIC ASSUMPTIONS			
	2003	**2004**	**2005**
Growth			
World GDP (ex. EU)	4.0	4.6	4.6
- US	2.8	3.8	3.3
- Japan	2.6	1.7	1.5
- EU	0.8	2.0	2.4
World import volumes (ex. EU-15) (a)	6.3	8.3	8.6
Change in effective euro exchange rates (%)	11.7	1.2	-0.6
Average annual $US/€ exchange rate	1.13	1.16	1.15
Interest rates (Eurozone)			
Short-term rates	2.3	2.3	3.2
Long-term rates	4.1	4.4	4.8
Commodity prices			
Crude oil ($US per barrel)	28.3	25.6	24.1
Non-oil commodity prices in $US (% change)	7.3	1.9	0.7
(a) Real percentage change SOURCE: European Commission			

The basic assumption for short-term **interest rates** is that they will hold to an unchanged 2.3% on average in 2004 vs. 2003, and then move up to 3.2% in 2005. Long rates, meantime, will start from an estimated average of 4.1% in 2003, then gain 3 decimal points in 2004 and 4 more in 2005 to 4.4% and 4.8% respectively.

Finally, the Commission's forecast for **oil prices** in US dollars are an average $28.3/barrel in 2003, dropping to $25.6/barrel in 2004 and $24.1 in 2005. The prices of other commodities, likewise in US dollars, should see more moderate growth of 1.9% in 2004 and 0.7% in 2005 after the 7.3% jump of 2003.

3.2. Macroeconomic forecasts: baseline scenario

The baseline scenario rests on the assumption of a 2.3% GDP growth rate in 2003, summing a positive 3.2 percentage points contribution from domestic demand with a negative 0.9 points from the external sector.

A. FORECASTS FOR 2004

Growth in 2004 **is expected to accelerate to 3%** on the strength of domestic demand buoyancy combined with a half-point improvement in the GDP contribution of net exports. Domestic demand expansion will be supported on an uptick of one decimal point in private consumption and a rise of eight decimal points in investment growth, essentially in fixed capital.

Table 2 MACROECONOMIC SCENARIO	2002	2003	2004	2005	2006	2007
GDP by demand component (real % change)						
Final domestic consumption expenditure	3.0	3.1	3.1	3.0	3.0	3.0
- Households (a)	2.6	3.0	3.1	3.0	3.0	3.0
- General government	4.4	3.6	2.9	2.8	2.8	2.8
Gross capital formation	1.1	3.1	3.9	3.9	3.9	3.9
- Gross fixed capital formation	1.0	3.1	3.8	4.0	4.0	4.0
- Equipment and other products	-2.7	2.4	5.0	5.2	5.2	5.2
- Construction	4.2	3.7	3.0	3.0	3.0	3.0
- Change in stocks (contribution to GDP growth)	0.0	0.0	0.0	0.0	0.0	0.0
Domestic demand	**2.6**	**3.1**	**3.3**	**3.2**	**3.2**	**3.2**
GDP growth contribution of domestic demand	2.6	3.2	3.4	3.3	3.3	3.3
Exports of goods and services	0.0	4.4	6.3	7.0	7.0	7.0
Imports of goods and services	1.8	6.6	7.0	7.2	7.2	7.2
Net exports (contribution to GDP growth)	-0.6	-0.9	-0.4	-0.3	-0.3	-0.3
GDP	**2.0**	**2.3**	**3.0**	**3.0**	**3.0**	**3.0**
- GDP at current prices €	696.2	740.6	784.6	829.5	876.9	927.0
- GDP at current prices % change	6.6	6.4	5.9	5.7	5.7	5.7
PRICES AND COSTS (% change)						
GDP deflator	4.4	4.0	2.9	2.6	2.6	2.6
Final household consumption expenditure deflator	3.5	3.2	2.7	2.4	2.4	2.4
Payments (labour cost) per employee in terms of FTEJ (b)	3.9	3.8	3.2	3.0	3.0	3.0
Unit labour costs (FTEJ) (b)	3.3	3.3	2.1	2.1	2.1	2.1
LABOUR MARKET (FTEJ) (b)						
Employment: % change	1.5	1.8	1.9	2.1	2.1	2.1
Employment: change in thousands	240.4	280.6	299.7	344.3	351.5	358.9
OTHER VARIABLES						
Net lending (+) or borrowing (-) vs. rest of world	-1.6	-2.6	-2.6	-2.6	-2.6	-2.7
Unemployment: % of labour force (LFS)	11.4	11.3	11.0	10.0	8.9	7.9

(a) Including Non Profit Institutions Serving Households
(b) Full-time equivalent jobs
SOURCE: Ministry of Economy

The pick-up in **private consumption** will draw on the reduction in next year's inflation, as well as on a quickening pace of job creation. In the meantime, growth of General Government consumption will moderate slightly on completion of transfers to territorial governments, in line with the consolidation commitment of the National Budget.

Gross fixed capital formation will gain 7 decimals points of growth thanks to the better performance of equipment and other products, while construction growth will start to taper off.

Equipment investment recovery will be spurred by faster growth of the world and Eurozone economies in 2004, this variable's keen sensitivity to changes in the cycle, the relatively low baseline levels of past years, the good position of companies, the positive performance of corporate earnings, and companies' ready access to suitable finance as regards terms, rates and volumes. In construction, the more moderate growth projected for next year owes to the slower expansion of residential building.

The economic upturn foreseen for Spain’s main trading partners in the year 2004 should push export growth higher than in 2003. Imports of goods and services should also accelerate, in parallel with exports and internal demand. The net outcome will be an **external contribution** of -0.4 percentage points, less negative than in 2003.

The Spanish economy’s net borrowing vs. the rest of the world will hold at 2.6% of GDP in 2004, despite the wider trade deficit envisaged in this scenario.

Employment creation will also gather speed in 2004 as output growth moves higher. The forecast is for an annual rate of 1.9% by the measure of full-time equivalent jobs, marking a faster advance in labour productivity with respect to 2003. These productivity gains and, the more moderate growth of labour costs will produce a deceleration of unit labour costs, which will enhance the external competitiveness of the Spanish economy.

Inflation will stick to the moderate course that has characterised the year 2003. Contributory factors will include the appreciation of the euro and slower rising raw material costs. The GDP deflator is likewise expected to moderate its growth in 2004, supported from the price side by a slower advance in the private consumption deflator and in the construction deflator as the sector decelerates; and, from the income side, by the abovementioned slowdown in unit labour costs and remaining items.

B. FORECASTS FOR THE REST FOR THE PERIOD

For the years following 2004, the **Spanish economy is forecast to grow at annual rates of 3%**. This assumes a small reduction in the real growth rate of public and private consumption with respect to 2004, reflecting, on the one hand, a possible movement by households to strengthen their financial position, and, on the other, the upkeep of fiscal consolidation efforts across all government sectors.

Gross fixed capital formation is expected to pick up slightly with equipment investment to the fore, while construction investment growth should stabilise at 3% on the slower progress of residential building tempered by an upturn in civil engineering works. The combined outcome should be a 4% advance in the GFCF variable.

Strengthening consumption and investment demand will deliver **domestic demand** growth of 3.2%. Meantime, the improved outlook for the world economy should boost the growth of goods and services exports to the region of 7%, on a par with imports. The result will be a less negative contribution from **net exports** compared to 2004.

The upkeep of 3% growth rates should assure **employment** advances at annual rates approaching 2.1% in terms of full-time equivalent jobs. This will allow further inroads into the unemployment rate, which is expected to drop below 8% in the year 2007, despite a large increase in the labour force over the intervening years.

The 2005-2007 period should see further moderation in **GDP deflators** to rates of 2.6%, in line with the slower advance projected in factor remuneration. Growth of the private consumption deflator will settle at a slightly lower 2.4%.

Finally, with the growth contribution of net exports holding stable at –0.3% of GDP, the economy's **net borrowing** position will move between 2.6% and 2.7% of GDP throughout the period considered.

III. BUDGETARY PERFORMANCE AND PROJECTIONS

1. Fiscal policy guidelines

Fiscal policy is a key piece in the economic policy strategy geared to promoting growth and employment creation, for its contribution to macroeconomic stability and its effects on agents' decision-making and productivity.

Spain's fiscal policy strategy is mainly dictated by its **medium-term effects on macroeconomic stability and capacity to enlarge the economy's potential growth**. All these elements converge in its core commitment to the **balanced budget** principle, which allows fiscal policy to offer an appropriate response at each stage of the cycle, while providing sufficient leeway to improve the quality and guarantee the sustainability of public finances. This strategy has contributed decisively to the macroeconomic performance Spain is recording, as well as to its increased ability to respond to external disturbances.

This strategy will be pursued in the present phase, with growth resuming at higher rates of around 3%, as it has been in the recent past. Likewise, in the context of a falling interest burden as a share of GDP and robust economic activity conducive to further reduction in the Public Debt ratio, fiscal policy will continue bent on the goal of fostering macroeconomic stability, sending out clear signals to economic agents while creating the margin needed for the play of automatic stabilisers.

In sum, the commitment to budgetary stability underpinning the Spanish Government's fiscal policy, as reflected in the Laws of Budgetary Stability, with their implementing regulations, and this Stability Programme Update, is at the service of the following goals:

- **Contribute actively to macroeconomic stability** and by this means lay the foundation for sustained growth, especially in the framework of Economic and Monetary Union.

- **Reinforce the credibility and predictability of the economic framework in which agents operate**, generating permanent effects on their decisions. The neutral stance of fiscal policy and the play of automatic stabilisers across the length of the cycle minimise disrupting influences on agent expectations, and create a climate of certainty and stability with incremental effects on short-term growth.

- **Maintain ongoing improvement in the quality of public finances.** The effects of structural reforms will be reinforced by a tax system neutral for agent decisions and by investment efforts supportive of private investment decisions, with positive effects on potential growth. In a converging economy like Spain's, demanding large investments in physical, technological and human capital, balanced budgets provide the margin needed to simultaneously pursue these objectives and strengthen potential growth without jeopardising the long-term sustainability of public finances.

- **Contribute to the long-term sustainability of public finances as part of a multi-way strategy**. The downtrend in Public Debt/GDP that flows from decreased public sector borrowing requirements will allow resources to be redirected from current expenditures to meeting the longer-term challenges that may affect different budget heads.

2. Budgetary performance

Although the Spanish economy will grow somewhat less **in 2003** than envisaged in the last Stability Programme Update, public accounts look set to close slightly in surplus as against the balanced outcome first projected. Pending fuller information, this result will draw on a Central Government surplus of around half a percentage point of GDP and the balanced position required by law of Territorial Governments. This follows on from the 0.1% surplus of 2002, thus cementing the fiscal consolidation process begun halfway through the past decade.

More specifically, the **last Stability Programme Update** anticipated a balanced budget for 2003, breaking down as a 0.5% deficit in GDP terms in the accounts of the State and autonomous agencies, offset by a surplus of the same scale in the Social Security budget. Territorial Governments, meantime, would close their fiscal years in balance. The divergence between these forecasts and the outcome now being presumed for 2003 (0.5% surplus) traces mainly to the Social Security system, where the good progress of social contributions will deliver a surplus near to 0.9% of GDP, that is, one decimal point more than in 2002 and four more than the projected level. Also, the additional tax revenues raised by the dynamism of nominal aggregate spending and employment will take one decimal point off the projected deficit of the State and autonomous agencies, leaving it at 0.4% of GDP, i.e. the same level as in 2002. Finally, the Autonomous Communities and Local Governments should reach balanced positions in 2003, the first year budgets have been drawn up under the precepts of the General Law of Budgetary Stability.

The surplus envisaged for 2003 draws on a two-decimal-point increase in **government revenues** to 40% of GDP, and a one-decimal-point decrease in government expenditures to 39.6% of GDP. Revenues growth owes mainly to the dynamism of consumption, home purchases and the positive progress of employment, which have driven up indirect tax receipts and social contributions. Meantime, the reform of personal income tax, with first-time effects in 2003, has reduced its GDP weight, despite a better-than-expected figure for withholding taxes on salary income.

The renewed drop in Public Debt **interest payments** explains part of the 2003 reduction in government expenditure/GDP, since primary current expenses grew just a little less than nominal GDP due to extraordinary outlays for the municipal and regional elections of Spring 2003.

The lid on **current expenditure** growth which is a key element of the Government's budgetary policy has allowed public investment to expand once more substantially ahead of output growth. This was achieved without jeopardising the fiscal consolidation process thanks to increased government saving, a variable moving in positive terrain since 1997, and which has overtaken public investment since 2002, closing 2003 at 4.6% of GDP.

Specifically, **public investment** raised its GDP weight by one decimal point to 3.5% in 2003, compared to the EU average of 2.3%. This difference is largely explained by Spain's efforts to inject enough public capital into its economy to keep up real convergence with the most developed European Union countries.

Against this backdrop, **Public Debt** has held to the downtrend versus GDP in place since the second half of the last decade. Between its peak in 1996 and the year 2003, the Public Debt ratio has fallen by over 16 percentage points, to 51.80.9%, against the estimated 63% of the European Union as a whole and the 70% of the Eurozone. In 2003 alone, the ratio moved down almost 3 percentage points of GDP. Success here rests on the primary surpluses accumulated in the period and the sustained growth of GDP.

3. Budgetary projections

3.1. Projections for 2004

Spain's economy is expected to grow 3% in 2004, that is, seven decimal points more than in 2003, within a generally more favourable international setting. Despite the presumed pick-up in activity and employment, nominal income should advance more slowly than in 2003 due to the deceleration projected for the GDP deflator.

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

Item	2002 (A)	2003 (F)	2004 (F)	2005 (F)	2006 (F)	2007 (F)	Avge 05-07
Total revenues	8.3	7.1	5.9	5.6	5.7	5.7	5.7
- Tax revenues	9.0	7.3	6.3	5.9	6.0	6.0	6.0
Total expenditures	7.5	6.0	7.0	5.6	5.4	5.4	5.5
- Current	7.1	5.7	6.4	5.2	5.2	5.2	5.2
- Capital	9.8	8.6	10.6	8.4	6.7	6.7	7.3
Gross capital formation	10.6	9.5	9.0	9.7	7.2	7.1	8.0

(A) Advance; (F) Forecast

SOURCE: IGAE and Ministry of Economy

Under these circumstances, **government revenues** will rise 1.2 percentage points less than in 2003, more or less neck and neck with GDP. The slowdown will trace primarily to social contributions and non-tax revenues while tax receipts are projected to grow slightly ahead of GDP.

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

Item	2002 (A)	2003 (F)	2004 (F)	2005 (F)	2006 (F)	2007 (F)
Total revenues	39.8	40.0	40.0	40.0	40.0	40.0
- Tax revenues	36.1	36.5	36.6	36.7	36.7	36.8
Direct	10.9	10.8	10.9	11.0	11.0	11.1
Households	7.4	7.3	7.3	7.3	7.3	7.3
Companies	3.5	3.5	3.6	3.6	3.7	3.8
Indirect	11.6	11.8	12.0	12.0	12.0	12.0
Social contributions	13.6	13.8	13.7	13.7	13.7	13.7
Total expenditures	39.7	39.6	40.0	39.9	39.8	39.7
- Current	34.8	34.6	34.7	34.6	34.4	34.2
Interest charges	2.8	2.6	2.6	2.5	2.4	2.3
- Capital	4.9	5.0	5.2	5.3	5.4	5.4
Gross capital formation	3.4	3.5	3.6	3.7	3.8	3.8
General govt. surplus (+) or deficit (-)	0.1	0.5	0.0	0.1	0.2	0.3
Central government	0.4	0.5	0.0	0.1	0.2	0.3
State and autonomous agencies	-0.4	-0.4	-0.4	-0.3	-0.2	-0.1
Social Security	0.8	0.9	0.4	0.4	0.4	0.4
Territorial government	-0.3	0.0	0.0	0.0	0.0	0.0
Autonomous Communities	-0.2	0.0	0.0	0.0	0.0	0.0
Local government	-0.1	0.0	0.0	0.0	0.0	0.0
Gross debt	54.5	51.8	49.6	47.7	45.7	43.8
Primary surplus	2.8	3.0	2.6	2.5	2.6	2.6
Gross saving	4.3	4.6	4.4	4.6	4.8	5.0

(A) Advance
(F) Forecast
SOURCE: IGAE and Ministry of Economy

Indirect tax revenues will be driven higher by the increase in economic activity and employment, but also by the rollout of the European Communities financing scheme approved at the Berlin European Council in March 1999, which could itself account for half of the jump in this item's GDP weight, to 12% (see Table 4). In 2004, the EU budget will draw more heavily on GNP-basis contributions and less on the VAT resource. The result will be that Spanish authorities get a larger part of VAT receipts, while current transfers will move up sharply due to GNP-resource payments to the rest of the world. This increase in tax pressure is only apparent and not real, because underlying it is a simple reallocation of revenues between the Spanish government authorities and those of the European Communities, after national residents have made their VAT payments.

Direct tax revenues stand to climb a little faster than GDP, raising their relative weight to 10.9%. This owes to the fading comparative effect on revenues of the personal income tax reform, as well as to the faster pace of economic activity. Also, labour cost moderation should keep companies' earnings on a rising curve, which will push up corporate tax receipts

On the **expenditure** side, current items will increase their GDP weight by one decimal point (to 34.7%). Capital items, as in past years, will grow sizeably ahead of GDP, raising their relative weight vs. 2003 by two decimal points to 5.2%.

The result of these developments is that revenues will retain a GDP weight of 40%, while expenditures will gain four decimal points to 40%. This balanced position will allow further reduction in Public Debt/GDP by over two percentage points to 49.6%.

3.2. Projections for 2005-2007

In the 2005-2007 period, government revenues will retain the same weight in GDP, while expenditures lose three decimal points. The result will be a gradually enlarging surplus.

Total **revenues** are projected to grow in parallel with nominal GDP, thereby conserving their relative weight. Specifically, government revenues are expected to record average growth of 5.7%, identically to nominal GDP, while tax revenues climb by a slightly faster 6%, lifting their GDP weight to 36.8% in 2007. The reason is that indirect taxes will retain a flat 12% of GDP while direct taxes gain two decimal points to 11.1%, on the stronger performance of corporate earnings. Social contributions will stick at the 13.7% weight of 2004, with average growth in the period estimated at 5.7%.

The government **expenditure**/GDP ratio will drop back three decimal points to close 2007 at 39.7%. Most of this reduction will fall on current expenditures, set to lose 5 decimal points of GDP between 2004 and 2007, while capital spending will close the period with a relative weight of 5.4% (5.2% in 2004) due to the rapid run-up of gross capital formation.

Of the five decimal points by which current expenditures are expected to reduce as a percentage of GDP, three will be drawn from Debt interest charges, due to a decrease in the Public Debt ratio which more than compensates the expected path of interest rates. The other two decimal points will come from final government consumption expenditure.

The significant fall in current expenditure will lift the **government saving** rate by around six decimal points to 5% of GDP in 2007. This is sizeably higher than the 3.8% investment rate projected for the same year, meaning Spanish general government accounts will close 2007 with a surplus position, after net capital transfers, in the region of 0.3% of GDP.

On the question of **budget outcomes by branch of government** in the 2005-2007 period, pursuant to the Laws of Budgetary Stability, the prospect is for a steady reduction in the State deficit, now estimated at 0.4% of GDP, to approximately 0.1% in 2007, and a surplus balance in Social Security accounts holding to the 0.4% of 2004, due to favourable developments in the period in both employment and the demographic structure. Note that the deficits foreseen for State government are compatible with the General Law of Budgetary Stability, because until the separation of financing sources between it and the Social Security System is complete, the position that counts is the consolidated result of both agents. In our baseline scenario, this surplus will enlarge progressively to 0.3% of GDP in 2007, which will coincide with the total general government position, assuming balanced budgets from the territorial governments (Autonomous Communities and Local Governments) throughout the projection period.

Table 5
CHANGES IN THE DEBT LEVEL

	2002 (A)	2003 (F)	2004 (F)	2005 (F)	2006 (F)	2007 (F)
Debt level	54.5	51.8	49.6	47.7	45.7	43.8
Change in the Debt level	-3.0	-2.8	-2.1	-1.9	-1.9	-1.9
Contributions to change in the Debt level						
Primary balance	-2.8	-3.0	-2.6	-2.5	-2.6	-2.6
Interest payments	2.8	2.6	2.6	2.5	2.4	2.3
Nominal GDP growth	-3.5	-3.3	-2.9	-2.7	-2.6	-2.5
Other factors	0.6	0.9	0.8	0.8	0.9	0.9
Pro memoria nominal GDP growth	6.6	6.4	5.9	5.7	5.7	5.7

(A) Advance
(F) Forecast
SOURCE: IGAE and Ministry of Economy

The upkeep of significant primary surpluses will support a steady reduction in the **Public Debt ratio**, in the context of a falling interest burden and economic dynamism. This ratio is expected to move eight percentage points lower between end-2003 and 2007 to close the period below 44%. The main contributory factors will be the primary surpluses accumulated in the period and economic growth, subtracting a combined 21 percentage points of GDP, while interest charges, the acquisition of financial assets and other adjustments will add approximately 13 points to the ratio.

IV. THE QUALITY AND SUSTAINABILITY OF PUBLIC FINANCES

The quality and sustainability of public finances are two central as well as interwoven concerns in the design and implementation of fiscal policy, with important repercussions for economic growth. The policy of budgetary discipline in place has provided sufficient leeway to advance in both these areas.

1. Quality of public finances

Improving the quality of public finances means achieving the right public revenues and expenditures mix for each moment in time which, within a defined and publicised fiscal policy strategy, is conducive to employment creation and growth capacity and can thus speed up the convergence process.

On the revenue side these goals have been addressed through the reforms of the direct taxation system, which seek to boost its efficiency by reducing its distorting effects on saving and investment decisions and on labour market participation.

In this regard, the salient developments have been the personal income tax reforms of 1999 and 2003, which have substantially eased the tax pressure on earned income by reducing the number of brackets and marginal rates. These reforms have provided a more neutral tax treatment of saving and its vehicles.

Personal Income Tax reform has been accompanied by changes in business taxation, primarily through successive reforms of corporate income tax, with the objective, among others, of supporting business investment in R&D and Innovation, training and entrepreneurial initiative. Particular attention has gone to the, SME sector as the true powerhouse of growth and employment creation in the Spanish economy.

In indirect taxation, as described earlier in this report, the main step taken is a freeze on excise taxes, for the second year running, which in fact implies a real-term reduction in their scale.

On the expenditure side, improvement in the quality of public finances calls for prioritising and strengthening those items with the largest impact on medium- and long-term potential growth, while respecting the budgetary stability commitment. Hence the steady rise over recent years in the allocation for government investment in infrastructure and technological capital, which has expanded ahead of GDP, raising its relative weight in the total budget.

Accordingly, the National Budget for 2004 accords expenditure priority to public investment activities, whose allocation goes up 7% approximately with respect to 2003:

- The public sector's investment efforts in physical capital centre on **infrastructure policy**, resourced with 6.4% more than in 2003. The priority here is to complete a series of basic projects to make up Spain's infrastructure deficit. These include the enlargement of the high-capacity motorways network and the high-speed rail network as well as the modernisation and upgrade of sea ports and airports, under the aegis of the 2000-2007 Infrastructure Programme, to be joined in future by other development actions under the European Action for Growth. Work will also continue on implementing the National Hydrological Plan and infrastructure projects of an environmental nature.

- **Research, development and technological innovation policy** also get priority attention in the 2004 Budget, with a 9.1% increase in expenditure versus 2003. Actions in this area are framed by the "National Scientific Research, Development and Technological Innovation Plan 2004-2007", which seeks to broaden and deepen the Spanish Science and Technology system and improve its resources and results. The main instrument for coordinating and organising Plan priorities and actions is the "National R&D and Innovation Fund", which finances grants, research projects and projects arranged between companies and public research centres. R&D and Innovation policy spans a number of budget lines, among them "Scientific Research" earmarked for basic investigative work in all fields of knowledge, and "Promotion and Coordination of Scientific and Technical Research", which manages the aforementioned Fund and channels priority initiatives under the Plan.

The **development of skilled human capital** is seen as a key means to enhance productivity and thereby the growth capacity of the economy. This conviction is expressed in the greater resources assigned to this area and closer attention to their use. Specific measures target a closer match between training contents and the real and emerging needs of the labour market, the application of new technologies and broad-ranging improvements in curricular results and life-long training.

Note, finally, that decentralisation has meant the large-scale transfer of powers in precisely these areas to the Autonomous Communities. As such, the budget resources assigned by Central Government are only part of a broader effort. The investments made by the Autonomous Communities may be managed and financed directly, as in the case of education, infrastructure and technological development, or else through partnership agreements with Central Government.

2. Long-term sustainability

Balanced public finances ensure the commitment to long-term budgetary sustainability is met, and prevent a build-up of persistent fiscal imbalances that would endanger the upkeep of sustained growth.

In order to guarantee the long-term sustainability of public finances and address the budgetary impact of demographic change, Spain is applying a multi-way strategy which combines:

a) The **budgetary stability** commitment, which means conserving the current stance of fiscal policy and recording balanced budgets. This will enable further reductions in the Public Debt while providing the margin to accommodate long-term budgetary challenges.

More specifically, public deficit reduction and compliance with the Stability and Growth Pact, along with the sustained growth of the Spanish economy, will bring the Debt ratio down from the 68.1% of GDP recorded in 1996 to a projected 43.8% in 2007.

Also, the surplus balances in Social Security accounts are allowing larger transfers to the pensions Reserve Fund. The last such allocation, €2 billion approved in December 2003, has lifted the Fund's total assets to €12 billion, equivalent to 1.6% of GDP. This would suffice to cover almost three months of pension entitlement, surpassing the 2004 target set in the Agreement on Improving and Perfecting the Social Security System; namely, that the Reserve Fund should hold enough to finance one ordinary pension payment plus a pro rata share of extraordinary payments. Finally, the recently enacted Law 28/2003 on the Reserve Fund stipulates that contributory surpluses should be earmarked "mainly and preferably" for the enlargement of the Fund. This principle was also singled out for ratification in the Toledo Pact renewal agreement, which assures it continuity.

This undertaking, and the surpluses projected for the Social Security account, should allow Fund assets to double in volume to €24 billion in 2007, equivalent to approximately 2.6% of the same year's GDP.

b) Labour market reform, which contributes to sustainability by way of higher participation and employment rates. Measures have sought to attract more women into work, alongside other collectives with special difficulties joining or remaining in the labour market, and workers aged over 45. In addition to measures approved to promote active ageing, mention should be made of the following:

- Incentives to the labour market participation of women with children and disabled women.

- Promotion of self-employed working among young people and women aged over 45, and of employment in the social economy for those on contributory unemployment benefit.

- Encouraging older workers into activity by allowing them to combine paid work with the receipt of unemployment subsidy.

- Reform of the Public Employment Services, whose intermediation labours will include more personalised and preventive care, with the accent on disadvantaged collectives. Also, tighter coordination between government branches and departments at the service of greater labour market efficiency.

c) Measures in the pensions sphere

c.1. Measures to prolong working life.

A key means to improve the sustainability of public finances which affects both participation rates and the costs of demographic change is the prolongation of working life. Hence the incentives provided for later retirement or flexible working in retirement age, and other measures to dissuade workers from taking early retirement.

c.2. Reform of the public pension system

The reform of the pension system is seen as an ongoing process with social consensus at its root. Central to this process is the Toledo Pact Commission, whose remit is to regularly evaluate the sustainability of the system and propose support measures as required while assuring an adequate level of social protection. The Commission conducts its reviews every five years; a sufficient interval to track developments in the system and adjust it to intervening changes in the country's economic and social fabric.

The Toledo Pact Commission agreed the renewal of the original Pact in October 2003, in order to update and enlarge on its recommendations and to make new proposals which take on board the economic and institutional changes occurring in Spain since 1995, within a framework of political and social consensus. The willingness to agree on basic principles and recommendations is especially heartening given that Spain is now entering an electoral period.

The priorities set in the renewed Pact are to assure an adequate balance between contributions and benefits, to guarantee the long-term financial viability of the pension system and to improve its transparency and efficiency. Hence its text identifies as key lines of action the separation and clarification of financing sources, maintenance of the purchasing power of pensions, appropriation to the Reserve Fund, the simplification and integration of special regimes, improvement in contribution bases, employment-oriented contributions, tighter system management, the fight against fraud, reinforcing the contributory nature of the system, the prolongation of working life, social solidarity and the sufficiency warranty, and the development of supplementary systems.

The main conclusions of the renewed Pact are:

- **The contributory principle is upheld as a cornerstone of the system's long-term financial viability**. Hence the Commission's recommendation to go on working to increase the proportional link between pension benefits and contributions, in line with recent measures. This should be a gradual process taking due account of solidarity concerns.

- **System reform measures should be audited for their financial impact**. In practice, this means checking regulatory proposals for their impact on expenditure scenarios and, in particular, on the system's break-even contribution rate.

- **Additional recommendations** are put forward in areas like new forms of work and professional development, women and social protection, dependence, disability, immigration, and reference to the pensions system at EU level.

Note in closing that the Toledo Pact timetabled certain measures in 1997 whose phased implementation was to be concluded in 2003. Chief among them was a steady increase in the proportional link between contributions and benefits by lengthening the pay-in period for calculating pension entitlement. This period has duly been extended from the 8 years used in 1997, to the present 15 years.

c.3. Development of the Second and Third Pillars: promotion of supplementary pension schemes at individual and company level.

Employment pension plans promoted by companies for their employees were supported by new tax incentives and an improved regulatory treatment. This kind of scheme was extended to public sector workers in November 2002, with the establishment of a Pension Fund for civil servants. The object of the Fund is to supplement employees' state pensions while promoting the use of similar instruments in other branches of the government administration. A first allocation of €54.7 million will be made in 2004. Thereafter, the percentage of the annual wages bill to be assigned will be specified in each year's Budget.

Individual retirement saving received fresh encouragement in the personal income tax reform implemented 1 January 2003, which raised the threshold for contributions and therefore the reduction allowed in taxable income. Also legislated for was a new kind of voluntary instrument known as the Insured Retirement Plan, with an equivalent tax treatment to pension plans.

d) Other actions. In the area of **health spending**, further headway was made in the structural policy of pharmaceutical cost contention with the approval of a new system of drug reference prices, within the framework of the Law of National Health System Cohesion and Quality, recently given regulatory development by an Order of the Ministry of Health and Consumer Affairs.

The new scheme, to come into force on 1 January 2004, tightens up cost contention mechanisms by bringing more medicines under their control and imposing steeper cuts in prices. It also strengthens present mechanisms to reduce price dispersal in drug families with at least one generic, which it is hoped will net substantial savings in some of the drugs in widest use.

3. Long-term projections for public finances

The Code of Conduct on Stability Programme content and format makes the inclusion of long-term projections on the budgetary impact of demographic change a matter for each country to decide on a voluntary basis. It also allows Member States to submit projections of their own differing from those of the Economic Policy Committee, provided all such divergences are accounted for.

Spain made use of this option in its Stability Programme Update 2002-2006, and included the long-term projections sent to the European Commission in September 2002, based on the National Strategy Report on the Future of the Pension System. These projections differed from those of the Economic Policy Committee mainly in the demographic scenarios factored. In particular, discrepancies arose in the calculation of the baseline population (year 2000) – a difference of 700,000 people, though the final data show that the right figure is 1.1 million – and in estimates of net migration over the period considered.

Table 6
DEMOGRAPHIC SCENARIOS

	Total population (million)		Population aged 16-64 (million)		Dependency ratio (% retired / working age)	
	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.	27.5	n.a.	25.3	n.a.

n.a.: not available.
SOURCE: Ministry of Employment and Social Affairs; Ministry of Economy and EPC

In 2003, the ECOFIN Council mandated the Economic Policy Committee to update the expenditure projections associated to population ageing in the long term. The new figures will be based, firstly, on the population forecasts Eurostat presents next year (drawn up jointly with National Statistics Offices) and, secondly, on a series of mutually agreed assumptions. Pending the reviewed figures, Spain has opted to maintain the projections it submitted in the Stability Programme Update 2002-2006.

Table 7 LONG-TERM SUSTAINABILITY OF PUBLIC FINANCES								
	2000	**2005**	**2010**	**2015**	**2020**	**2030**	**2040**	**2050**
Pensions 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								

These projections say the Spanish system will have a surplus in hand for the next 15 years, in which time all required actions can be taken to ensure its sustainability, in an ongoing reform process based on the social consensus of the Toledo Pact and a multi-way strategy that encompasses budgetary discipline, labour market reform and the reform of the state pension system supplemented by private retirement saving.

V. SENSITIVITY ANALYSES

This Stability Programme Update puts forward a scenario in which the year 2004 will conclude with a budgetary position in balance, leading onto a steadily growing surplus which will reach 0.3% of GDP in 2007. The sensitivity analysis described below shows how these outcomes might stand up to a lower-than-baseline growth scenario.

1. Alternative growth scenarios

The lower growth model rests on a later and less vigorous world recovery than in baseline assumptions, as well as a slower advance in domestic demand. The result is a 2004 growth rate of 2.5% which repeats across the whole 2005-2007 period.

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

	2003 (F)	2004 (F)	2005 (F)	2006 (F)	2007 (F)
Baseline scenario					
GDP	2.3	3.0	3.0	3.0	3.0
GDP deflator	4.0	2.9	2.6	2.6	2.6
Employment: change in %	1.8	1.9	2.1	2.1	2.1
Unemployment: % labour force (LFS)	11.3	11.0	10.0	8.9	7.9
Net lending (+)/borrowing(-) vs. rest of world [1]	-2.6	-2.6	-2.6	-2.6	-2.7
Lower growth scenario					
GDP	2.3	2.5	2.5	2.5	2.5
GDP deflator	4.0	2.9	2.5	2.5	2.5
Employment: change in %	1.8	1.6	1.6	1.6	1.6
Unemployment: % labour force (LFS)	11.3	11.2	10.6	10.1	9.5
Net lending (+)/borrowing(-) vs. rest of world [1]	-2.6	-2.5	-2.5	-2.5	-2.6

[1] Percentage of GDP
(F) Forecast
SOURCE: Ministry of Economy

In the alternative scenario both employment and domestic demand have a rather less expansive tone, while the net external contribution turns less negative. A delayed and weaker world recovery puts a lid on export growth while the slower advance of certain domestic demand variables dampens import growth to below the baseline rate. The result is a reduction in the negative growth contribution of net exports. As a consequence, the trade deficit narrows versus baseline assumptions, which reduces the net borrowing position of the Spanish economy.

Table 9 SENSITIVITY ANALYSIS: budgetary performance						
	2002 (A)	2003 (F)	2004 (F)	2005 (F)	2006 (F)	2007 (F)
Baseline growth scenario						
General government surplus (+)/deficit (-)	0.1	0.5	0.0	0.1	0.2	0.3
Public Debt	54.5	51.8	49.6	47.7	45.7	43.8
Lower growth scenario						
General government surplus (+)/deficit (-)	0.1	0.5	-0.1	0.0	0.0	0.1
Public Debt	54.5	51.8	50.0	48.4	46.9	45.4
(A) Advance (F) Forecast SOURCE: IGAE and Ministry of Economy						

The change in macroeconomic assumptions also affects budgetary projections. In the lower growth scenario, with an identical fiscal policy stance to baseline, the budgetary position is slightly negative in 2004, pulls into balance in 2005 and 2006 then closes 2007 with a surplus of 0.1%.

The combination of a smaller surplus and lower nominal output growth slows the pace of Public Debt/GDP reduction with respect to our baseline scenario.

2. Interest rate sensitivity analysis

Two alternative scenarios have been modelled to gauge the sensitivity of our budgetary projections to variations in interest rates. Both assume a parallel shift of one percentage point in the interest rate curve used in our baseline scenario, upwards in one case (higher rates scenario) and downwards in the other (lower rates scenario).

The interest rate shifts considered here are confined to Debt payments, and apply only to new issues to replace maturing Debt or meet increased borrowing requirements. Assuming other budget items are not affected and that changes in interest payments pass through in full to the budget balance, the effects on public sector accounts and the Debt ratio will be as shown in Table 10.

In the final year of the two scenarios the budgetary positions vary by 0.2% of GDP, while Public Debt ratios show a difference of half a point. As the average life of Spain’s Public Debt stands around 6 years at the 2003 close, the effect of an interest rate shift would not be immediately perceptible and would only show through as the years progress. However, the effects of changes in interest rates on the budget balance would extend beyond the reference period.

Table 10 SENSITIVITY ANALYSIS: interest rates (National Accounts, ESA-95. As % of GDP)						
Scenarios	**2002 (A)**	**2003 (F)**	**2004 (F)**	**2005 (F)**	**2006 (F)**	**2007 (F)**
Higher rates						
Budget balance	0.1	0.5	0.0	-0.1	0.0	0.1
Public Debt	54.5	51.8	49.7	47.8	46.0	44.3
Baseline						
Budget balance	0.1	0.5	0.0	0.1	0.2	0.3
Public Debt	54.5	51.8	49.6	47.7	45.7	43.8
Lower rates						
Budget balance	0.1	0.5	0.1	0.2	0.3	0.5
Public Debt	54.5	51.8	49.6	47.5	45.4	43.3

(A) Advance
(F) Forecast
SOURCE: IGAE and Ministry of Economy

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

Table 11 DIFFERENCES VS. PREVIOUS STABILITY PROGRAMME UPDATE					
	2002	**2003**	**2004**	**2005**	**2006**
GDP growth					
Update 2002-2006	2.2	3.0	3.0	3.0	3.0
Present Update	2.0	2.3	3.0	3.0	3.0
Difference	-0.2	-0.7	0.0	0.0	0.0
Budget balance					
Update 2002-2006	-0.2	0.0	0.0	0.1	0.2
Present Update	0.1	0.5	0.0	0.1	0.2
Difference	0.3	0.5	0.0	0.0	0.0
Gross debt					
Update 2002-2006	55.2	53.1	51.0	49.0	46.9
Present Update	54.5	51.8	49.6	47.7	45.7
Difference	-0.7	-1.3	-1.4	-1.3	-1.2

SOURCE: Ministry of Economy

The steeper-than-expected slowdown of the world economy has pushed 2002 and 2003 growth rates below the levels projected at the time of drawing up the last Update. However, growth forecasts for the last two years of the period have been left unchanged at 3%.

Despite the economic slowdown, public accounts will close in more positive form than projected last year. The difference in balances, however, is a relatively small one. In 2002, the improvement owes to revenue growth beyond the rate foreseen in the previous Update. This is likely to again be the case in 2003, leading to a more favourable budget outcome.

VI. HORIZONTAL ISSUES IN PUBLIC FINANCES

Budgetary discipline, as stated before, is at the heart of Spanish fiscal policy. This commitment finds its institutional expression in the legislative corpus comprising the Laws of Budgetary Stability and three recently approved implementing laws whose contents are discussed below.

The Laws of Budgetary Stability write the balanced budget objective into Spain's legal system with effect on both Central and Territorial Governments. After the setting of this general framework, and under the Laws' own mandate, a microeconomic approach was adopted, and their principles have been applied to the budget process - a purpose served by the recently enacted General Budgetary Law. In addition, and to complement it, two other laws have been approved: on the one hand, the General Taxation Law, which pursues greater efficiency in tax management, and on the other, the General Subsidies Law, seeking greater transparency and efficiency in the use of public funds.

1. General Subsidies Law 38/2003, of 17 November

The text applies the guiding principles of the Laws of Budgetary Stability to government spending on subsidies, one of the main budget components. It seeks to promote a more rational and efficient use of subsidies while enhancing the transparency and control of all related processes. Specific goals are as follows:

- Safeguard the principles of publicity, objectivity and competition in the granting of subsidies.
- Promote the efficient and transparent management of the funds allotted.
- Establish a control system for detecting fraud, including coordination mechanisms between different decision centres to take corrective measures as required.
- Facilitate the application of the law's principles in regional regulations, while respecting the constitutional distribution of powers, and provide the means to achieve effective collaboration between different layers of government.
- Ensure the regulation of subsidies is coherent with European rules on Community and state aids.

The Law provides that subsidising entities must draw up strategic plans, and lays down measures to guarantee that funds are used for the purposes intended. It also establishes disciplinary proceedings for infractions, with penalties which include the partial or total return of subsidies.

2. General Budget Law 47/2003, of 27 November

This Law incorporates and develops the following guiding principles of the Laws of Budgetary Stability — transparency, efficiency and a multiannual perspective — at the service of budgetary process rationalisation. It also codifies the rules governing the accounts, control and economic-financial regime of the Public Sector.

It sets a stability objective for the Public Sector, and establishes a regime whereby budget management is bound by the ceiling set on non-financial State expenditures. The text also introduces multiyear budget scenarios in surplus or in balance with a three-year horizon, as framed by successive Stability Programme Updates. These should set out the targets to be met, the means and activities to be employed, an investment schedule for the three-year period and the indicators used to track compliance. This multiyear scenario provides both a guide and a check on the commitments that may be assumed annually in the National Budget.

The Law, moreover, prescribes a system of budgeting and management by objectives, complete with ongoing evaluation of expenditure policies and their compliance with the targets set, alongside more flexible budget management.

Finally, it redefines the rules on permissible changes in the Budget following the creation of the National Budget Contingency Fund, which is equivalent to 2% of non financial expenditures, to meet non-discretionary calls on funds which were not foreseen in the original budget.

3. General Taxation Law 58/2003, of 17 December

The General Taxation Law sets out to improve and simplify tax management and aid taxpayers in complying with their fiscal obligations. Specific goals include:

- Provide a modern and comprehensive legal frame of reference for the tax system.
- Simplify relations between the taxpayer and the administration through the use of new technologies.
- Strengthen taxpayers' rights and guarantees, offering them greater legal certainty.
- Align tax procedures more closely with the general rules of administrative procedure.
- Put more arms at the disposal of the tax authorities in the fight against tax fraud and evasion, by new rules on fraud in law and on tax offences and sanctions.

VII. CONCLUSIONS

In an international economic outlook foreseeably more positive than in previous years, this Stability Programme Update makes **prudent projections of economic and budgetary performance**. Spain will hold general elections next year, and the authorities have opted accordingly to posit a neutral economic policy which complies fully with the terms of the Stability and Growth Pact, while avoiding any policy undertakings which could only be made by a Government with a longer run in office.

By the end of the period, projections suggest, the Spanish economy will have witnessed:

- Sustained economic growth prolonging the rapid progress in real convergence with the European Union's most developed economies which has characterised the past years. A process which has lifted Spain's per capita GDP, measured by purchasing power parity in 2003, to almost 87% of the Eurozone average, a gain of just under nine percentage points in the past eight years;

- A fall in unemployment rates to under 8%, with an increase in employment rates to upwards of 67%, narrowing the gap versus European partners and setting Spain well on its way to meeting the objectives of the Lisbon Council;

- Price and labour cost developments eroding differentials versus the European average to stable rates consistent with the progress of real convergence;

- A marked downward trend in the Public Debt, which will close the period at less than 44% of GDP;

- External financing needs at sustainable rates in keeping with the country's investment requirements.

To remark in closing that the Public Debt reduction facilitated by short- and medium-term budgetary stability, structural reforms at the service of economic growth and higher participation and employment, alongside reforms in the state pension system and development of the second and third pillars of retirement saving have configured the **Spanish Government's strategy to ensure the long-term sustainability of public finances, with particular regard to the challenges of demographic change**. Furthermore, the Toledo Pact, as a national agreement between political and social forces, the establishment of the Social Security Reserve Fund and the engagement of the authorities with enlarging its allocation are not only important financial measures but also a clear signal to society of the efforts required in future to respond successfully to demographic challenges.

ANNEXE

STRUCTURAL REFORMS

The major structural reforms initiated in Spain over the past few years in product markets – primarily network industries – and factor markets are being developed and enforced according to schedule. Although the growth dividend may not be immediately apparent in some cases, the impetus given to the Spanish economy is patent in the positive growth differential kept up in relation to the EU average.

The measures of the past year take their cue from the Broad Economic Policy Guidelines 2003-2005 and the recommendations of the Annual Report of the Economic Policy Committee. Their ultimate aim, in any case, is to enlarge the potential growth rate of the Spanish economy, assure it the flexibility to confront change and secure full employment.

The Spanish Government has just presented its Sixth Report on reforms in product and factor markets. The main points of this document are summarised in the following pages.

I. PRODUCT MARKETS

1. Energy

Measures in energy markets have sought to strengthen effective competition by encouraging ownership disintegration and removing barriers to new entrants, while promoting transparent and equitable access to network facilities.

1.1. Electricity

Supply liberalisation has extended to all consumers since 1 January 2003. This means over 22 million clients, the vast majority of them household consumers, are now free to choose their electrical power supplier. In the last year, 190,000 small consumers have taken up this option — 147,000 of them householders and the remainder small and medium-sized businesses. They come to join the high-voltage consumers already exercising their right of choice, who in 2002 represented 67% of liberalised demand.

Measures in the year aimed to **increase effective competition in the wholesale market** via the entry of new generating operators, the start-up of combined-cycle plants and the laying of the legal bases for a forward electricity market. Also, an international agreement with Portugal will bring the Iberian Electricity Market (MIBEL) into being in April 2004.

1.2. Natural gas

Supply liberalisation has extended to all consumers since 1 January 2003.

New measures have focused on encouraging competition by more efficient rules on third-party access to essential transmission, regasification and storage facilities. This has been achieved through greater transparency in capacity contracting, and tougher rules to stop the underuse of capacity tied up by outstanding contracts.

The vertical separation of regulated activities proceeded in the year. Specifically, a new divestment round was ordered in the gas system operator and main transporter, ENAGAS, such that **no single company may hold more than 5%** of its share capital. The dominant market agent, Gas Natural, has thus seen its stake reduced from 100% in 2001 to 5%.

1.3. Liquid hydrocarbons

Work continued on applying the **pro-competition measures** initiated in 2000. The **process of broadening CLH's shareholder base concluded in the year**. None of its three top shareholders now hold more than 25% of the logistics operator's capital, and their combined share has been reduced from 95% to 45%.

2. Telecommunications

Measures prized a more flexible organisation of the telecommunications market in the context of the transposition to Spanish law of the new EU regulatory framework for electronic communications.

The corresponding legal text, the **General Law of Telecommunications**, **progresses in** freedom of entry to the market, reduces ex-ante regulation in favour of supervision ex-post, progresses in price liberalisation, selectively enlarges the scope of universal service provision and the protection of determined users, and gives more weight to the principle of efficient spectrum usage.

New liberalisation moves in the price sphere included the rollover of the tariff framework of the dominant fixed-line operator under more flexible conditions, and the freeing-up of retail prices for ADSL services. In sum, the conditions are in place to conclude the sector's progress from an original situation of monopoly to one of full liberalisation in January 2005, subject solely to the rule of competition law. Indeed, among the signal achievements of telecoms liberalisation are the large numbers of operators now providing services in the market, the significant reduction in traffic prices over recent years and the development of mobile telephony, whose user numbers have clearly overtaken those of fixed telephony. Another important consequence of market development and the promotion of broadband use is the high penetration of this kind of access among the population of Internet users. Specifically, 2003 will close with two million broadband clients — 1,500,000 via ADSL and 500,000 via cable modem — accounting for over 25% of households with Internet access.

3. Transport

In road transport, new legislation tackling safety and competition issues strengthens the mechanisms available to combat anti-competitive practices, and imposes greater transparency while increasing the quality and safety of service provision.

In maritime transport, measures in the year sought to speed up portside operations. Following the accident of the oil tanker “Prestige”, new measures have been adopted on seagoing safety and the prevention of marine pollution, enforcing compliance with international safety rules and establishing new standards for passenger vessels. Also, recent legislation on port services will boost competition in this market.

In rail transport, European Directives were transposed by the recently approved **Rail Sector Law**. This text establishes a legal separation between infrastructure management and rail transport services, going beyond the simple accounting separation prescribed in the Directives package. It also regulates infrastructure access by rail transport companies, which will advance the development of the freight and passenger transport markets.

4. Water

Progress continued towards a more efficient, sustainable use of this resource. Regulatory changes in the year tightened up groundwater protection and anti-dumping controls, while providing the necessary instruments for water rights exchange under contract between the interested parties or with eventual public centres.

5. Postal services

The process of liberalising postal services and opening the sector to competition continued throughout the year with the transposing of Community internal rules. Spain’s postal sector is now liberalised to a greater degree than provided for in current EU legislation, with certain services such as city mail and direct advertising already open to competition.

6. The knowledge-based society

Efforts were stepped up to **increase skilled human capital** with encouraging results as regards the growing number of students in all age groups. The provisions of the Law of Educational Quality and Law on Qualifications and

Vocational Training were implemented in the year with the following objectives: promote and advance the integration of vocational training opportunities, adapt the training range to socio-economic realities, make work and training fully compatible and foster labour market unity.

Actions in the **R&D and Innovation** sphere included tax and financial incentives to private-sector innovation and research, support to the creation of technology-based companies and technology transfer through technology parks and research transfer bureaux. At the same time, the existence of high-quality public research is seen as a vital support to private activity, to which end greater budgetary resources have been assigned to R&D and Innovation policy.

The goal of **disseminating new information and communication technologies** was addressed in two packages of measures: one of a regulatory nature, providing a normative framework for new technologies and information tools and their use by different agent groups; and the other of a development nature, comprising a battery of programmes for the advancement of the information society. New laws on telecommunications and information society services were accompanied by the launch of the **"España.es"** plan to promote Internet use in schools, libraries and rural areas, the wider take-up of electronic signatures and the application of new technologies in the public administration.

An encouraging development is the rapid growth being recorded in the use and penetration of new technologies. By the third quarter of 2003, the number of households owning a computer was up to 43%, compared to 36% the year before, while the total of Internet users now exceeds 34% of the adult population.

7. Competition policy

Actions taken in 2003 built on the initiatives of previous years. Main advances were as follows:

- The deadlines for review **procedures** on Competition Service acts have been tightened and more **transparency** imposed on the actions of competition institutions, including the immediate publication of the opinions issued by the Competition Tribunal.

- **Perfecting of the system and its regulatory framework** and the switch from the reactive approach of pursuing outlawed conducts to a more proactive one. Competition institutions have been **reinforced** financially and in terms of their staff resources by the approval, among other measures, of a new Competition Tribunal Statute.

- Implementing of the **new decentralised enforcement system** whereby Autonomous Communities so choosing can set up their own competition bodies. Meantime, the year's focus was very much on the close oversight of newly liberalised **strategic sectors** and the use of advocacy.

- The **levels of state aids** has been **brought down** steadily and significantly and their use redirected towards horizontal objectives. These initiatives are fully in line with the reform agenda of the new General Subsidies Law.

II. CAPITAL MARKETS

Measures in the **banking and securities markets** have sought to boost the efficiency of our financial services markets (Order on SME Securitisation Funds, Law on Collective Investment Undertakings), maximise transparency and consumer protection (Aldama Law on Good Governance, Royal Decree on Takeover Bids and the Automated Teller Machine Order), dismantle obstacles to the provision of services (Royal Decree on Participating Units), and create new instruments or remove impediments to their use in Spain (preference shares).

The newly approved implementing regulations to Law 26/2003 ("The Law of Transparency") set out obligations of information and transparency, including an Annual Report on Corporate Governance, a directors' code of conduct and the obligation to adopt provisions to ensure good corporate governance.

In **private insurance** steps were taken to enhance the system's efficiency and its financial soundness. Citizens were also given a wider choice of saving products by the introduction of insured retirement plans.

In **pension funds**, one of the year's innovations was the regulation of a supplementary pension scheme for government employees.

III. THE LABOUR MARKET

Initiatives in the year addressed the following main objectives:

- **Raise labour-market participation rates**, especially via the new tax incentives provided in the Law on Measures to Reform the Unemployment Protection System and Improve Employability, and Law 36/2003 of 11 November on Economic Reform Measures.

- Promote **female employment**, through incentives for **self-employed working**, childcare support measures like more, better quality educational services and a deduction for crèche expenses, and a broader catchment for social security deductions in respect of women wishing to return to work within 24 months of having a child.

- **Continue to facilitate the geographical mobility of labour**, through subsidies to companies and workers and new tax incentives. An example of this last is the promotion of **the home rentals market** via tax reductions for reinvestment in housing properties for let, and for individuals renting out urban properties.

- Extend the **principle of equal pay for men and women** by the amendment of the Workers' Statute, the introduction of gender mainstreaming and the rollout of the EU project ISOS.

- **More employment opportunities for other collectives with difficulties in finding work**, basically by working to eliminate barriers to the hiring of disabled workers.

- **Reduce segmentation across different types of contracts** through Employment Promotion Plans plus measures to promote indefinite hirings and prevent the misuse of fixed-term contracts.