STABILITY PROGRAMME

SPAIN

2011 - 2014

CONTENTS

TABLES

1. EXECUTIVE SUMMARY

The Stability Programme presented in this document takes into account the on-going European Union economic governance reform. This reform involves the supervision of fiscal policy, placing greater emphasis on public debt and the preventive arm, but it also involves greater co-ordination of economic policies, by strengthening the supervisory mechanisms beyond fiscal policy. In particular, macro-economic imbalances are subject to monitoring and analysis, with recommendations for correction where necessary. To facilitate the achievement of these goals, the presentation of the Stability Programme from now on will take place at the same time as the National Reform Programme, within the framework of the “European Semester”.

The Government's commitment has been to implement the exit strategy from the crisis set in the previous Stability Programme Update 2009-2013. This is a comprehensive strategy that includes not only fiscal consolidation, but also an ambitious agenda of structural reforms. The National Reform Programme details these reforms for both markets and factor markets. Initiatives in the financial sector, in particular, such as the new capital requirements, are already having a positive effect on confidence, with a limited fiscal impact.

The fiscal strategy, detailed in this document, is also very ambitious. An accelerated fiscal consolidation is being carried out to which all Public Administrations must contribute. For this reason, the fiscal framework is undergoing reforms through a tighter and more frequent system of monitoring and control and also greater transparency with regard to the information on public finances. This reform will be completed at the national level after the conclusion of European economic governance reform. Spain continues to set a balanced budget as its medium-term objective and so will continue its fiscal consolidation efforts beyond 2013. In that year, the government deficit will be 3% of GDP and a primary structural surplus is expected. There is a clear commitment to the sustainability of public finances, and, as a consequence, the Government adopted a comprehensive reform of the public pension system. The savings generated will mean the increased costs associated with ageing are kept at moderate levels. Both, fiscal consolidation and lower increase in costs associated with ageing, will cause sustainability indicators to improve substantially.

These efforts are beginning to bear fruit. The public deficit in 2010 stood at 9.2% of GDP, 0.1 percentage points below the Government's commitment, and public debt reached 60.1% of GDP, 25 points below the average in the euro area. In addition, in 2010 GDP practically stabilized, the external imbalance continued to be corrected and external debt was reduced. The strict application of the fiscal measures announced and the committed implementation of the reform agenda are vital to continue to offset imbalances and gradually improve activity and employment.

2. GENERAL FRAMEWORK AND ECONOMIC POLICY OBJECTIVES

The international financial crisis and the necessary adjustment in the housing sector have weighed down economic growth in Spain over the last two years, inducing a significant increase in the unemployment rate and a major deterioration in public finances. Sovereign market debt problems in the euro area have further complicated the situation by significantly increasing the interest rate spreads required on government bonds.

In this context, the Spanish Government is implementing a comprehensive response based on unprecedented fiscal consolidation, and a number of profoundly important structural reforms to prevent a crisis like this from happening again in the future, facilitate the re-allocation of resources toward the tradable sectors and promote the overall improvement of the economy's competitiveness. These measures are crucial for achieving the Government's fundamental objective of laying the foundations for robust and balanced growth in the medium term, so as to raise the material prosperity of the population and increase quality job opportunities.

This Stability Programme and the National Reform Programme synthesize the Government's multi-year strategy in the areas of consolidation and sustainability of public finances and structural reforms, respectively. Both were submitted to the EU institutions together, following approval of their referral by the Council of Ministers on April 29th, 2011. The Stability Programme has been designed taking into account the Council's Recommendation dated December 2nd, 2009, under article 126.7 of the Treaty to correct the excessive deficit. It also takes into consideration the opinion of the Ecofin Council on the previous Stability Programme Update, the Integrated Guidelines for Europe 2020, the extraordinary Ecofin Council conclusions dated May 9th, 2010, the Eurogroup Guidelines from June 2010, for the fiscal policies of euro area Member States, the Ecofin Council conclusions dated February 15th, 2011, launching the European Semester, and the European Council in March. The structure and information contained in this document conforms to the Code of Conduct.

2.1 Fiscal consolidation

One of the most adverse results of the crisis in Spain has been the deterioration of public finances, which placed the deficit at 11.1% of GDP in 2009. Although the initial situation was very favourable, the ratio of public debt to GDP was increasing significantly, so a decision was made to initiate the process of fiscal consolidation at the end of 2009. Furthermore, in the context of sovereign debt problems in the euro area, the Government decided to accelerate fiscal consolidation plans in May 2010.

Thus, the target of the Spanish fiscal consolidation strategy is to achieve a deficit of 3% of GDP in 2013 and 2.1% in 2014. To do this, the intermediate budget targets are: a deficit of 9.3% of GDP in 2010, 6% in 2011 and 4.4% in 2012. The Programme establishes an annual fiscal effort in excess of 1.5% of GDP on average until 2013, more intense in 2011 (and in the year just ended, 2010). The fiscal consolidation process will continue up to the medium-term objective, which is still a cyclically adjusted balanced budget.

The fiscal consolidation measures are primarily based on non-financial expenditure adjustments, and the main actions are set out in Chapter 5 of this Programme. Within this setting, the items promoting sustainable growth are prioritized; the efficiency of expenditure is improved and a rearrangement and restructuring of the public sector is implemented. Revenues also increase, while tax distortions are reduced, business growth is promoted and automatic stabilizers are reinforced. The outcome for 2010 indicates that the first intermediate target has been achieved, recording a public deficit of 9.2% of GDP.

To ensure compliance with fiscal targets, major reforms in fiscal governance have also been introduced. Thus, in 2010, with regard to the Autonomous Communities (ACs), the procedures for monitoring fiscal commitments have been intensified. Besides, the mechanisms for implementation of these commitments have been strengthened. Furthermore, the transparency of the information published has been improved. As for the Central Government and Local Governments, the Government has committed to approve a spending rule that links the growth of public spending to medium-term GDP growth, no later than three months after being approved for the European Union, with other Public Administrations adopting it. In accordance with the Spanish Budgetary Stability law, a spending ceiling in nominal terms will be approved in June before the drafting of the State Budget for 2012, which will allow the achievement of the targets set and meet the Recommendation of the European Commission for the Ecofin Council Opinion on this Stability Programme.

2.2 Sustainability of public finances

The second dimension of the Government's fiscal strategy is to ensure the sustainability of public finances in the long term. The current situation of the Social Security System is robust, showing a surplus in 2010 (excluding the Public Employment Service) and with a reserve fund at 6.1% of GDP. However, current demographic projections suggest that ageing will have a major impact in Spain, so the government has submitted to Parliament a reform of the public pension system. As detailed in Chapter 8 of the Programme, the main lines of this reform are: i) an increase in the statutory age of retirement to 67, except for those with a long contribution history; ii) a toughening of the conditions for access to partial and early retirement; iii) an extension of the period for calculating pension entitlement from the last 15 years to the last 25; and iv) the introduction of a sustainability factor according to which, after the transitional period of implementation of the reform (2027), the system parameters will be updated every five years based on changes in life expectancy. Far-reaching measures are also being introduced to reduce health spending by the rational use of prescriptions, a widespread reduction in their prices and margins, and greater efficiency in the provision of health services.

These two items, along with fiscal consolidation, which will allow the public accounts to achieve a structural primary surplus in 2013, will drastically reduce the sustainability indicators of the Spanish public finances, bringing them into the low risk zone.

2.3 Structural reforms in other areas

In addition, the Government is pushing through major reforms in both factor and product markets, as detailed in the National Reform Programme.

Factor Markets

Within factor markets, the Government has given priority to two major reforms: the financial sector and labour market.

Since the beginning of the crisis, the Government has activated a number of temporary measures to support the *financial sector* in order to avoid a credit squeeze that would prevent economic recovery. Between 2009 and 2011, this strategy was complemented by others intended to restructure the credit sector on a permanent basis and make the information provided by financial institutions more transparent. Both the creation of the Fondo de Reestructuración Ordenada Banciaria (FROB) and the reform of the legal status of savings banks, have been important driving forces behind the processes for the integration and restructuring of banks. In 2010, 12 different integration processes involving savings banks were under way, of which 9 were supported by the FROB (11.6 billion euro). Similarly, the Plan to Strengthen the Financial Sector approved in early 2011 is intended to deepen the restructuring of the sector by increasing capital requirements and adapting the instruments available to the FROB so it can cover the additional capital requirements of the entities not able to do so through the market. This Plan requires institutions to comply with a minimum capital ratio of 8% of risk-weighted assets, or 10% for those institutions that rely for more than 20% of their financing on wholesale sources and investors hold less than 20% of their capital. The FROB will make capital contributions, subject to strict conditionality and under the supervision of the Banco de España, through the acquisition of ordinary shares at market prices. FROB participation will be temporary, so that divestiture will occur within five years after the investment.

The *labour market reform*, in force since June, 2010, was supplemented by the reform of active employment policies adopted in February, 2011. This reform address four fundamental aspects of the labour market: i) hiring and firing, through the reinforcement of the permanent “fomento” contract, the clarification of the causes for fair dismissal and the increase in the termination costs for temporary contracts; ii) internal flexibility for firms, by facilitating the use of opt-out clauses from collective agreements signed at a higher level, and by introducing mechanisms for working time adjustments; iii) intermediation in the labour market, by allowing private for profit employment agencies to operate and by widening the range of activities covered by temporary employment agencies; and iv) improvement of employability, by softening the eligibility criteria for training contracts and focusing social security contributions rebates on long term young unemployment with low educational levels. In this same field, soon the Government will approve a draft bill to introduce a major reform in the collective bargaining system that incorporates the current negotiations by the Social Agents.

Product Market

Four major reforms can be highlighted for the product market. Firstly, 2010 was the first year in which the transposition of the *Services Directive* has been fully implemented. Secondly, in Royal Decree Law 13 dated December 3rd, 2010, and in the *2011 State Budget* steps were taken to streamline and simplify the process of business creation and tax distortions in favour of owned real estate were eliminated, so strengthening the rental market. Thirdly, the *Sustainable Economy Law,* adopted on March 5th, includes incentives for investment in R&D+i and in human capital, and reduces the administrative burden on businesses; this Act will be supplemented with the enactment of the new Science, Technology and Innovation Act, currently at an advanced stage of parliamentary review. Fourthly, in the field of *professional services* a draft bill to liberalize the sector and improve the quality of regulation by eliminating unnecessary requirements for the exercise of professional activities will be submitted to Parliament before the summer.

Chapter 2 of the National Reform Programme contains a quantitative assessment of the macro-economic impacts of these structural reforms. This assessment does not include the reforms in the financial sector, due to their enormous complexity. In terms of economic activity, the initiatives with the greatest impact are the Sustainable Economy Law and the Labour Market Reform; the reforms in the labour sector are obviously the ones with the greatest effect on structural unemployment. The transposition of the Services Directive also has a very significant impact on activity and less so on the unemployment rate, as do the measures adopted in the housing and rental markets. Finally, it is worth mentioning that these estimates only partially reflect the impact of the pension reform, of which the full effect on potential output will become visible later on, once its implementation has been completed.

3. ECONOMIC SITUATION AND PROSPECTS

3.1 Macroeconomic adjustment in 2010

The GDP of the Spanish economy stabilized in 2010 (-0.1%) after a 3.7% fall in real terms in 2009. This evolution was compatible with the process of re-absorption of the imbalances accumulated during the previous expansionary period and occurred within the context of a major consolidation of public accounts. Thus, the reallocation of resources towards more productive activities continued, although the economy was still unable to generate net employment.

The net borrowing needs of the Spanish economy stood at 3.9% of GDP, 1.2 percentage points lower than the previous year. All components of the balance of payments decreased their deficit (income, transfers and non-energy goods) or increased their surplus (services and capital) with the exception of energy products, which increased their negative balance due to higher oil prices. In addition, external debt fell in 2010, reaching 164.1% of GDP, almost three points less than in 2009.

In fact, for the third consecutive year, the contribution of net exports to growth was positive, reaching 1.1 percentage points in 2010. This result was due to exports of goods and services registering a growth of 10.3%, causing sales abroad to represent 30.6% of GDP in real terms, 2.9 points more than in 2009 and very close to the peak in 2007. The export base has widened in the last three years, as the number of companies exporting goods increased by 12.6%. Total export growth was higher than that of some of the big European Union economies such as France, Italy and Britain, although it was nearly two points lower than the growth of world trade in goods and services (12%). For their part, imports increased by almost half the growth rate of exports, 5.4%, bringing their share in GDP to 34.8%, with an increase of only 1.8 percentage points, far below the peaks reached over the past decade.

Significant improvements were also observed from a domestic perspective. In the case of families, private consumption grew by 1.2% in real terms, associated with improved confidence, increased financial wealth and lower interest rates. As a result, the savings rate fell to 13.1% of disposable income. However, given that household investment, which mostly takes the form of housing investment, continued to decrease (-12.6% in nominal terms), its financing capacity reached 4% of GDP, compared to the important financing needs households experienced before the crisis.

Housing investment declined in real terms by 16.8% in 2010, decreasing its share of GDP to below 5%, within the range considered to be in line with its long-term contribution. However, new house sales rose slightly in 2010 (1.6%), which, coupled with the sharp fall in completed homes intended for sale (-37%), resulted in a reduction in the stock of unsold homes for the first time since 2006. Factors such as the improvement in financing conditions for households, the adjustment in housing prices and changes in taxation were all responsible for reactivation of the real estate market.

Meanwhile, business investment also expanded in 2010, driven by the dynamism of external demand and improved profitability of business projects in the context of a low interest rate environment. Despite this increased spending, non-financial corporations as a whole recorded a financing capacity that stood at 0.4% of GDP. In this context, credit to finance productive activities declined by 0.6% in 2010. However, the sector breakdown reveals that the reallocation of resources is going in the right direction, since credit did not grow in the industrial sector, showed a modest increase in non-real-estate services, and contracted significantly in construction and real estate.

In 2010, employment continued adjusting, with a decline of 2.4%. Hiring increased (2.8%) following two years of declines, but not sufficiently to offset the layoffs and terminations of temporary contracts (which together were about 25% lower than in 2009), and the incorporation of new entrants into the labour force. Consequently, the unemployment rate rose to 20.1%. Part-time contracts increased by 7.5% throughout the year and, although permanent contracts decreased by 5.9% overall, a type of indefinite contract, the "contrato de fomento" promoted by the June labour market reform increased by 22.1%. This emerging shift in the labour market was supported by wage moderation, as the compensation per employee fell from a 4.1% increase in 2009 to an increase of only 0.7% in 2010; in fact, labour costs decreased in the third and fourth quarters of 2010 compared to the previous year. The ordinary wage component increased by 0.3%, representing a negative wage drift of 1 percentage point on wage increases set in collective bargaining agreements, in line with the current cyclical position of the economy. Wage moderation and productivity growth associated with the reallocation of resources towards the tradable sectors resulted in a reduction of 1.5% in unit labour costs. This allowed a significant improvement in the competitiveness of the economy, given that the export prices of our trading partners increased by over 6%.

In 2010, inflation in Spain as measured by the harmonized consumer price index, increased to reach an average of 2% over the year, 0.4 percentage points higher than in the euro area as a whole. However, this increase was a result of either transitory factors related to changes in indirect taxation (inflation at constant taxes was 1.3%, 0.2 percentage points less than in the euro area) or to imported inflation (import prices rose 6.5% annually on average, particularly in the case of raw materials). On the contrary, the domestic component of inflation was greatly attenuated. Thus, core inflation stood at 0.9%, 0.1 percentage points less than in the euro area.

3.2 External assumptions and monetary and financial conditions

Since late 2009, the global economy has been recovering from the severe crisis of 2008 and 2009. The intensity of the recovery is different across areas, higher in the case of emerging countries and lower in more mature economies. Moreover, the strong recovery in international trade (see Table 3.1), after a large fall in previous years, has tended to favour economies with a larger share of exports in their final demand, as is the case of Germany, China and

Japan, among others. However, as time has passed, an increasing number of countries have been joining the recovery.

Table 3.1. EXTERNAL AND FINANCIAL ASSUMPTIONS						
	2009	2010 (F)	2011 (F)	2012 (F)	2013 (F)	2014 (F)
Interest rates						
Short-term interest rates	1.2	0.8	1.6	2.6	2.9	3.1
Long-term interest rates	3.8	2.7	3.4	3.7	4.0	4.3
Exchange Rates						
Dollars per euro	1.39	1.33	1.40	1.41	1.41	1.41
Nominal effective exchange rate in the euro area (% change)	2.8	-6.7	1.0	0.5	0.0	0.0
Nominal effective exchange rate in the EU-27 (% change)	-5.4	-7.4	2.4	0.5	0.0	0.0
GDP and world trade						
World GDP growth excluding the EU[1]	-0.6	5.6	4.6	4.7	4.6	4.5
GDP growth in the EU[1]	-4.1	1.8	2.0	2.0	1.9	1.9
Growth of export markets in the EU[2]	-10.7	11.5	7.6	7.3	7.2	7.1
World imports, excluding EU	-13.6	13.0	8.3	7.9	7.8	7.8
Commodity prices						
Oil price (Brent, USD/barrel)	61.5	80.2	112.8	112.0	112.0	112.0

[1] Real percentage change
[2] Intra and extra EU trade
(A) Advance and (F) Forecast
Sources: European Commission and Ministerio de Economía y Hacienda

GDP growth in the euro area was 1.8% in 2010 and the most recent indicators point towards continued expansion. The Interim Forecast published by the European Commission in February, 2011, predicts that the euro area will grow by 1.6% in 2011. The GDP of the United States grew by 2.9% in 2010, with the latest indicators showing greater strength. The IMF expects the US to grow by 2.8% in 2011 and 2.9% in 2012. Among the emerging economies, China grew by 10.3% in 2010, India by over 8% and Brazil more than 5%. Labour markets in most countries have reflected with some delay the effects of the recovery, so unemployment rates are still above pre-crisis levels. A return to previous levels will require some time as well as continued growth.

The remarkable growth of emerging economies and the recovery of more mature countries has resulted in a significant increase in commodity prices. According to data from The Economist Index, prices of commodities in euro have risen more than 50% since February, 2010. In the case of oil, the situation is further complicated by the events in some North African countries, causing the price per barrel to remain above $120 for several weeks.

Throughout 2010, the extraordinary fiscal and monetary measures implemented during the crisis have begun to be withdrawn, as per the cyclical circumstances per country, and it is expected this trend to continue in 2011. In the case of the euro area, after keeping the interest rate on refinancing operations at 1% since May, 2009, the European Central Bank raised it by 25 basis points in early April. Meanwhile, the US Federal Reserve has maintained intervention interest rates at record low levels since late 2008 and interest rate increases are not expected in the short term.

Compared to the previous Stability Programme, these new assumptions imply a significant upward revision of growth in world markets, exchange rate depreciation of the euro and lower interest rates in the euro area. In contrast, the price of oil is higher.

3.3 Forecast for Spain 2011-2014: the central scenario

The central scenario of this Stability Programme foresees a gradual recovery of the Spanish economy which would begin to see growth in annual average terms by 2011, strengthening in subsequent years. As was the case in 2010, initially the impetus will come from net exports, with a positive contribution of domestic demand later on. In particular, after subtracting 1.2 percentage points from growth in 2010 (see Table 3.2), domestic demand is expected to stabilize in 2011 and generate a positive contribution of 1.3 points to growth by 2012. The external sector will increase its contribution to growth slightly in 2011, reaching 1.3 percentage points and, as final demand strengthens, it will gradually decline to 0.6 percentage points in 2014.

Among the components of domestic demand, private consumption is expected to slow down slightly in 2011 due to the fact that modest growth in families' labour income will be offset by rising inflation and interest rates. From the second half of 2011, the combination of greater job creation, lower inflation and the increase in wealth is expected to accelerate households' spending. These consumption growth rates would enable families to undertake a modest recovery in housing investment and continue the deleveraging process.

As for public consumption, it is projected to decline until the end of the forecast horizon as a result of the adjustment measures applied to public finances, for which details are provided in Chapter 5 of this Programme.

Table 3.2. MACROECONOMIC PROSPECTS

Chained volume indexes, year 2000 = 100, unless otherwise stated

	ESA Code	2010 (A)		2011 (F)	2012 (F)	2013 (F)	2014 (F)
		Level	Annual change in%				
1. Real GDP	B1*g	122.7	-0.1	1.3	2.3	2.4	2.6
2. Nominal GDP. Billions of euro	B1*g	1062.6	0.8	2.6	3.8	4.1	4.5
	Components of real GDP						
3. Private final domestic consumption expenditure[1]	P.3	123.2	1.2	0.9	1.4	1.6	1.9
4. General Government final consumption expenditure	P.3	152.8	-0.7	-1.3	-0.8	-0.6	-0.6
5. Gross fixed capital formation	P.51	106.9	-7.6	-1.3	2.7	3.7	4.5
6. Changes in inventories (% of GDP)	P.52+P.53	157.6	0.6	0.6	0.6	0.5	0.5
7. Exports of goods and services	P.6	129.2	10.3	8.3	7.9	7.2	7.1
8. Imports of goods and services	P.7	132.9	5.4	3.0	4.1	4.7	5.2
	Contributions to real GDP growth						
9. Domestic final demand		123.8	-1.3	0.0	1.3	1.7	2.0
10. Changes in inventories	P.52 + P.53	157.6	0.1	0.0	0.0	0.0	0.0
11. External balance	B.11	142.0	1.1	1.3	1.0	0.7	0.6

[1] Includes households and NPISH (non-profit institutions serving households)
(A) Advance and (F) Forecast
Sources: Instituto Nacional de Estadística and Ministerio de Economía y Hacienda

Investment in 2011 continue to decline in line with the trend recorded in the last three years as a result of the adjustment taking place in the construction sector. However, for investment in equipment goods, 2011 is expected to see the recovery which started in 2010 to be prolonged and gradually gain strength in the years ahead. A gradual recovery in company operating surpluses and demand within the economy, especially related to its external component, and various tax measures to support investment (flexibility of depreciation and amortization schedules, etc.) should support this development. By contrast, construction investment will contract in 2011 and grow at a very moderate pace in subsequent years. In the case of residential building, the adjustment process should be completed by 2011, allowing for the initiation of a moderate recovery starting in 2012 as latent demand gradually becomes effective demand. In the case of other types of construction investment, the policy objective of reducing public expenditure, which is essential for achieving the objectives of this Stability Programme, means that public investment will be reduced this year and next and will only start to increase again in 2013. Private sector activity in other types of construction investment is expected to offset some of this process, in line with the behaviour of investment in equipment and reinforced by the Extraordinary Infrastructure Plan released in April, 2010, by the Ministerio de Fomento, which allows infrastructure to be financed through various forms of public-private partnerships.

The forecast growth in exports will result mainly from two factors: firstly, improvement in Spain's main export markets and, secondly, the significant drop experienced and subsequent moderation in unit labour costs implies a consequent gain in competitiveness. This combination should enable the Spanish economy to maintain its share of world trade in goods and services. The slowdown in imports in 2011 is attributed to the weakness of Spanish domestic demand and the slowdown in consumption and exports. Starting in 2012, the gradual recovery in domestic demand accompanied by a sustained growth in exports will lead to a resumption of growth in imports.

As regards the labour market (see Table 3.3), the adjustment that has been taking place over the past previous three years will be completed in the course of 2011. In fact, a modest job growth (0.2%) is already projected for the whole of 2011, likely occurring in the second half of the year. Subsequently, employment will maintain a moderately upward path over the next three years, in line with the expected outlook for economic activity. This will cause the unemployment rate to fall gradually, reaching 16% in 2014. It will also allow productivity gains to be obtained at an average annual rate close to 1% throughout the forecast period.

Compensation per employee will continue to grow although at a reduced pace in 2011, following a negative wage drift. Thereafter, growth will increase moderately, partly due to the Collective Bargaining and Employment Agreement signed by social agents early last year. After falling again in 2011, unit labour costs will increase very slowly, significantly below what the European Central Bank defines as nominally stable for the economy.

Table 3.3. LABOUR MARKET[1]							
	ESA Code	2010 (A)		2011 (F)	2012 (F)	2013 (F)	2014 (F)
		Level	Annual change in %				
1. Employment, persons (million)		18.7	-2.3	0.4	1.5	1.6	1.8
2. Employment, full-time equivalent (million)		17.3	-2.4	0.2	1.4	1.5	1.7
3. Labour productivity (thousands of euro)		41.2	2.2	0.9	0.8	0.8	0.8
4. Labour productivity, full-time equivalent (thousands of euro)		44.7	2.3	1.1	0.9	0.9	0.9
5. Compensation per employee(2) (thousands of euro)	D1	33.9	0.7	0.5	1.4	1.9	2.1
6. Unit Labour Cost, full-time equivalent		-	-1.5	-0.6	0.5	1.0	1.2
7. Compensation of employees (thousands of euro)		508.9	-1.5	0.8	2.9	3.5	4.0
8. Unemployment rate (% of active population)		-	20.1	19.8	18.5	17.3	16.0

(1) Data in National Accounts terms, except the unemployment rate

(2) Compensation per employee, full-time equivalent

(A) Advance and (F) Forecast

Sources: Instituto Nacional de Estadística and Ministerio de Economía y Hacienda

As for inflation (see Table 3.4), it is expected to remain at moderate levels throughout the period, following the rebound seen since mid-2010 and in early 2011. This higher inflation has a high transitory component, derived from the strong increase of commodity prices in international markets and the increases of indirect taxes that occurred in the second half of last year. In the coming months, these unique factors will be discounted, triggering a downward inflation pressure supported by the significant moderation in unit labour costs and a still negative output gap during the period.

Table 3.4. PRICE DEVELOPMENTS Year 2000=100							
	ESA Code	2010 (A)		2011 (F)	2012 (F)	2013 (F)	2014 (F)
		Indexes	Annual change in %				
1. GDP deflator		137.4	1.0	1.2	1.5	1.7	1.8
2. Private consumption deflator[1]		133.9	2.8	2.8	1.9	1.9	1.9
3. Public consumption deflator		133.4	-0.2	-0.5	1.1	1.5	1.6
4. Gross fixed capital formation deflator		137.1	2.1	1.3	1.3	1.6	1.8
5. Export deflator (goods and services)		118.0	2.7	2.3	2.2	2.1	2.0
6. Import deflator (goods and services)		112.1	6.5	4.3	2.6	2.4	2.1

1 Includes households and NPISH (non-profit institutions serving households)

(A) Advance and (F) Forecast

Sources: Instituto Nacional de Estadística and Ministerio de Economía y Hacienda

3.4 Sectoral Balances

Following the sharp correction of the net borrowing of the Spanish economy in 2009, when it fell by more than four points to 5.1% of GDP, in 2010 the adjustment of this imbalance continued with a further reduction of over one percentage point of GDP. In the coming years (see Table 3.5) a lower surplus is forecast in the capital account, due to the reduction of funds received from the European Union. Also the deficit in income and transfers is expected to increase, as interest rates increase. However, these changes will be more than offset by the adjustment of the balance of goods and services that may be in equilibrium by 2013 if commodity prices and global markets perform according to external assumptions.

As regards the distribution of the net borrowing position among domestic sectors, the important fiscal consolidation efforts by the public sector will allow the private sector to progressively reduce its lending capacity until a balance is achieved in 2014, while the borrowing requirement of the whole economy diminishes. According to estimates, this will result from a slight reduction in the saving rate of the private sector (as the lesser importance of precautionary motives will be partially offset by higher interest rates), and a significant increase in the rate of investment by corporations.

Table 3.5. SECTORAL BALANCES

(National Accounts)

		2010 (A)		2011 (F)	2012 (F)	2013 (F)	2014 (F)
		Level[1]	% of GDP				
1. Net lending(+)/borrowing (-) vis-à-vis the rest of the world	B.9	-41.0	-3.9	-3.4	-2.7	-2.3	-2.0
Balance of goods and services		-23.0	-2.2	-1.4	-0.5	0.1	0.7
Balance of primary incomes and current transfers		-25.0	-2.4	-2.5	-2.7	-2.8	-3.1
Capital account		6.9	0.7	0.5	0.5	0.4	0.4
2. Net lending(+)/borrowing(-) of the private sector	B.9	57.3	5.4	2.6	1.8	0.8	-0.1
3. Net lending(+)/borrowing(-) of the public sector	EDP B.9	-98.3	-9.2	-6.0	-4.4	-3.0	-2.1
4. Statistical discrepancy		-	-	-	-	-	-

[1] Billions of euro

(A) Advance and (F) Forecast

Sources: Instituto Nacional de Estadística y Ministerio de Economía y Hacienda

4. PUBLIC FINANCES IN 2010 AND 2011

4.1 The Results for 2010

In 2010, the Spanish General government reduced its deficit by 1.9 percentage points of GDP (see Table 4.1), registering a deficit of 9.2% of GDP compared to 11.1% in 2009. Thus, Spain delivered on its objective to reduce the public deficit in line with the target of 9.3% of GDP as set by its fiscal consolidation path for 2010. The adjustment was evenly distributed between increases in revenues (1 point of GDP, reaching 35.7%), and reductions in expenditures (-0.8 points of GDP, reaching 45% of GDP). The effort was structural, as the cyclically adjusted primary deficit decreased by 2.3 percentage points of GDP. Excluding temporary measures, the primary structural deficit would have reached 4.9% of GDP. The transitory measures, which in 2010 accounted for about 1 percentage point of GDP (half that of 2009), are broken down into 0.6% related to extraordinary funding to cushion the impact of the crisis and 0.4% in extraordinary tax deferrals and the residual effect of changes in the management of some taxes, like the system of monthly VAT refunds.

Table 4.1. GENERAL GOVERNMENT ACCOUNTS IN 2010

	Millions of euro		Percentage of GDP		Difference in percentage points
	2009	**2010 (A)**	**2009**	**2010 (A)**	
Revenues	**365,382**	**379,497**	**34.7**	**35.7**	**1.0**
Taxes	192,555	207,248	18.3	19.5	1.2
Direct	*101,010*	*99,442*	*9.6*	*9.4*	*-0.2*
Indirect	*91,545*	*107,806*	*8.7*	*10.1*	*1.5*
Social Contributions	140,327	139,977	13.3	13.2	-0.1
Other Revenues	32,500	32,272	3.1	3.0	0.0
Expenditures	**482,688**	**477,724**	**45.8**	**45.0**	**-0.8**
Public Consumption[1]	217,272	213,958	20.6	20.1	-0.5
Public Investment	46,068	39,178	4.4	3.7	-0.7
Interest Payments (EDP)	18,696	20,374	1.8	1.9	0.1
Social Benefits	152,669	161,136	14.5	15.2	0.7
Other Expenses	47,983	43,078	4.6	4.1	-0.5
Balance (EDP)	**-117,306**	**-98,227**	**-11.1**	**-9.2**	**-1.9**
Levels of government					
Central government	-98,508	-52,798	-9.3	-5.0	-4.4
Autonomous Communities	-21,007	-35,997	-2.0	-3.4	1.4
Local government	-6,120	-6,844	-0.6	-0.6	0.1
Social Security administration	8,329	-2,588	0.8	-0.2	1.0
Memorandum					
Primary balance	-98,610	-77,853	-9.4	-7.3	-2.0
Cyclically adjusted primary balance	-	-	*-8.2*	*-5.9*	*-2.3*
Cyclically and temporary measure adjusted primary balance	-	-	*-6.2*	*-4.9*	*-1.3*
Gross Debt (EDP)	561,319	638,767	53.3	60.1	6.9

[1] Excluding the gross operating surplus of general government, other indirect taxes and sales of production.
(A) Advance
Sources: Instituto Nacional de Estadística y Ministerio de Economía y Hacienda

The correction of the imbalance in public accounts during 2010 can be attributed to the fiscal consolidation measures adopted in 2009 (and included in the budget for 2010) and over the past year, which have increased revenues and reduced public spending. The automatic reversion of certain regulatory changes introduced in 2009, such as the new system of monthly VAT refunds, must also be taken into consideration. Among the measures affecting revenues, it is worth noting the partial elimination of the deduction of 400 euro from the Personal Income Tax, the increased rate for capital revenues, higher tax rates on Hydrocarbons and Tobacco Products since June 2009, and higher VAT rates from July 2010. As for expenditure, there was a significant reduction in the Central Government Budget for 2010 and a practical freeze in those of the Autonomous Communities. In addition, the Government adopted in January the Immediate Action Plan 2010, which included an expenditure reduction of 0.5% of GDP with respect to the initial budgetary figures. Furthermore, in the context of the decisions adopted by the Ecofin Council, the Government approved in May, 2010, the Royal Decree-Law 8/2010 which included a series of extraordinary measures to cut public spending, so as to further reduce deficit targets established into the Stability Programme for 2010 and the subsequent years. Among the measures with an impact in 2010 and 2011 (0.5% and 1.5% of GDP, respectively) it is worth mentioning the reduction of 5% in public sector wages and cuts in infrastructure investment, the elimination of the 'baby check', the freezing of contributory pensions (excluding minimum pensions), more stringent requirements for partial retirement and the reduction of official development assistance. Subsequently, the Autonomous Communities and Local governments agreed, within their respective relevant co-ordination bodies, to reduce the deficit targets initially established to take into account the impact of these measures, and adopted a commitment to achieve additional savings of 1.2 billion euro in 2011.

Compliance with the General government deficit target in 2010 was mainly due to the fact that the Central government achieved a deficit of 5% of GDP, below the 5.9% forecast in the fiscal consolidation path. There was some slippage by the Social Security administration and the Autonomous Communities relative to their targets, while Local governments were almost in line with their fiscal objectives. Specifically, the Social Security administration, in the context of an employment adjustment, registered a deficit of 0.2%, compared with a surplus of 0.2% initially forecast, while the Autonomous Communities recorded a deficit of 3.4%, 0.3 percentage points above the path agreed upon the Consejo de Política Fiscal y Financiera (CPFF). Examining the Autonomous Communities individually, nine registered deficits above their stability targets, so the last segment of their debt authorization, corresponding to the 2010 deficit was pending for authorization until the economic and financial Plans of these Autonomous Communities were presented and the measures contemplated within these plans were deemed suitable by the CPFF. In the Council held in April 27th, the Plans of two of them were considered appropriated, so the corresponding authorizations will be issued.

By the end of 2010, public debt stood at 60.1% of GDP, well below the average for euro area countries (85.1% of GDP). This represents an increase of 6.9 percentage points relative to 2009, which implies a negative stock-flow adjustment of 2 percentage points. This adjustment can be mainly explained by the reduction in public administrations deposits at financial institutions and by the amortization of some of the operations of the Fondo de Adquisición de

Activos Financieros (FAAF). This last factor means that during the year the Central government recovered €2.1 billion of the aid granted to the financial sector during the crisis.

4.2 The Budget for 2011

The budget for 2011 maintains the line of fiscal consolidation that began with the budget for 2010 and is consistent with the various measures taken during the past year.

Thus, the 2011 State Budget envisions a reduction of the deficit to 24.4 billion euro from 50.7 billion euro in 2010 (see Table 4.2). Among the measures with an impact on revenue in 2011, with respect to the Personal Income Tax, it is worth highlighting the residual effect of the partial elimination of the 400 euro deduction, the elimination of the 'baby check', the increases in the tax rate for capital revenues and the rise in tax rates for higher income brackets and the impact in withholdings from the partial disappearance of the deduction for house purchases. On the contrary, the new deduction for house refurbishment will mean lower revenue in this area. In the case of the Corporate Tax, there has been a broad increase in the flexibility of the depreciation schedule for fixed assets, the threshold for a company to qualify as a small- or medium-sized business for tax purposes has been raised and the tax base that is eligible to pay the reduced tax rate has been increased to 300,000 euro for these companies. In addition, the reduced rate for businesses exceeding the new threshold in the next three years is maintained. VAT collection will be driven by higher tax rates, effective from July 1st, 2010, and in the case of Excise Duties, tax rates on Tobacco Products were increased in late December 2010. All these measures together with a moderate growth in tax bases will cause tax revenues to increase by about 3.5% in 2011, but tax revenues reverting to the Central government will be reduced by 18%. This difference is due to the entry into force of the new financing system for the Autonomous Communities, which increases the share of these authorities in the collection of Personal Income Tax, VAT and Excise Duties, to be offset by lower transfers to the Autonomous Communities.

With regard to expenditure, in the context of the measures adopted by the Government in Royal Decree-Law 8/2010, May 20th, 2010, the 2011 State Budget projects reduced operating costs (salaries and purchases of goods and services), investments and transfers, while interest payments may record a significant increase in line with debt and interest rate developments. In this regard, it is worth noting the significant decline in primary expenditures excluding the resources aimed at the financing of Territorial Administrations (-12%).

In 2011 the conversion of the balance from Cash to National Accounts will represent a significant adjustment. The reason is that the liquidation of the transfers by the Central government to the Territorial Administrations for their share in the State's tax collection, which are realized two years in advance, was negative in 2010 and will also be negative in 2011.Territorial Administrations will refund the difference over five years. Obviously, for the

Territorial authorities it is necessary to make the opposite adjustment between their balances of Cash and National Accounts.

Table 4.2. STATE BUDGET[1] IN 2011

	Millions of euro			Rates of change	
	Initial budget 2010 (a)	Liquidation 2010 (b)	Initial budget 2011 (c)	(c)/(a)	(c)/(b)
Revenues	**121,206**	**127,337**	**106,020**	**-12.5**	**-16.7**
Taxes[2]	107,130	111,087	91,381	-14.7	-17.7
Other Revenues	14,076	16,250	14,639	4.0	-9.9
Expenditures	**185,036**	**179,572**	**150,056**	**-18.9**	**-16.4**
Personnel and Purchasing	31,088	31,607	30,367	-2.3	-3.9
Interest Payments	23,224	19,638	27,421	18.1	39.6
Investment	9,390	8,782	5,817	-38.1	-33.8
Transfers[3]	117,589	119,546	83,980	-28.6	-29.8
Contingency Fund	3,745		2,472	-34.0	-
Cash Balance	**-63,830**	**-52,235**	**-44,036**	**-31.0**	**-15.7**
National Accounts Adjustment	6,167	1,549	19,648	218.6	-
National Accounts Balance	**-57,663**	**-50,686**	**-24,388**	**-57.7**	**-51.9**
Memorandum					
Territorial Administration Taxes	*47,691*	*47,712*	*72,897*	*52.9*	*52.8*
Total Taxes	*154,821*	*158,799*	*164,278*	*6.1*	*3.5*
Territorial Administration financing	*52,594*	*52,594*	*28,034*	*-46.7*	*-46.7*
Expenses excluding Territorial Admin. Financing	*132,442*	*126,594*	*122,022*	*-7.9*	*-3.9*
Primary expenses excluding Ter. Admin. Financing	*109,218*	*107,340*	*94,601*	*-13.4*	*-11.9*

[1] The Central government is composed of two institutional sectors: State and Central government bodies; however, the weight of the balance of the latest in the aggregate is very small.

[2] Includes contributions to "Clases Pasivas"

[3] Current and capital

Source: Ministerio de Economía y Hacienda

The Social Security administrations foresees a budget surplus of 3.9 billion euro (see Table 4.3). Revenues from social contributions will increase by 4.5%. Measures to increase revenues in this particular item have also been adopted: i) greater increases in the bases for contributions compared to wages, and ii) strengthening of the contributivity of the special regimes for self-employed and domestic workers. Regarding expenditures, pension payments will slow significantly to a growth rate of 3.4% due to the freezing of contributory benefits (excluding minimum pensions) and the reduction in temporary disability benefits through improvements in their management. The adjustment of the balance from Cash to National Accounts in 2010 mainly reflects the amount of unemployment benefits not covered by the associated social contributions and the transfers made by the Central government.

Table 4.3. THE SOCIAL SECURITY BUDGET IN 2011					
	Millions of euro			Rates of change	
	Initial budget 2010 (a)	Liquidation 2010 (b)	Initial budget 2011 (c)	(c)/(a)	(c)/(b)
Revenues	**163,065**	**160,153**	**166,130**	**1.9**	**3.7**
Social Contributions	129,325	126,449	132,194	2.2	4.5
Current Transfers	28,608	28,407	27,875	-2.6	-1.9
Other Revenues	5,132	5,297	6,061	18.1	14.4
Expenditures	**160,456**	**159,909**	**162,323**	**1.2**	**1.5**
Personnel and Purchasing	4,974	4,576	4,537	-8.8	-0.9
Pensions[1]	97,315	97,757	101,085	3.9	3.4
Other Welfare Benefits[1]	43,557	43,095	42,738	-1.9	-0.8
Other Expenses	14,610	14,481	13,963	-4.4	-3.6
Cash Balance	**2,609**	**244**	**3,807**	**45.9**	**-**
National Accounts Adjustment	-506	-2,832	117	-	-
National Accounts Balance	**2,103**	**-2,588**	**3,924**	**86.6**	**-**

[1] Contributory and non-contributory
Source: Ministerio de Economía y Hacienda

To complete the budget information for 2011, it is necessary to analyze the situation of the Autonomous Communities, which are responsible for more than 60% of public consumption (as they bear the responsibility for health and education costs) and 36% of public investment. Table 4.4 shows the budget for all of them with the exception of Cataluña and Islas Baleares, as the latter rolled over its budget from 2010 into 2011 (with adjustments to reach the deficit target agreed for this year) and in Cataluña the budget is in the process of being drafted. Moreover, as noted previously, the full entry into force of the new financing system from January 1st, which has significantly increased Autonomous Communities share in the revenues of the Personal Income Tax, VAT and Excise Duties, will mean a significant increase in tax revenues on the one hand and a significant decrease in transfers from the Central government on the other.

The aggregation of the budgets shows that a significant correction is anticipated in the budget deficit resulting from an increase of 4.8% in revenue compared to the provisional liquidation for 2010 and an adjustment of almost 2% in expenditure. This reduction, as in the case of the Central government, is based on a decrease in consumption and current and capital transfers. Interest payments are the only item that will experience a significant increase when compared to both the initial budget and to the one that was actually liquidated. With respect to revenues, it is worth highlighting the increase experienced within some Autonomous Communities in the Excise Duty on Retail Sales of Certain Hydrocarbons, in the Excise Duty on Certain Means of Transport and in the regional tranches of the Personal Income Tax. On the contrary, all transactions aimed at creating, capitalizing and maintaining firms are exempted from the Property Transfer and Stamp Duty Tax.

Table 4.4. BUDGETS OF THE AUTONOMOUS COMMUNITIES[1] IN 2011

	Millions of euro			Rates of change	
	Initial budget 2010 (a)	Liquidation 2010 (b)	Initial budget 2011 (c)	(c)/(a)	(c)/(b)
Revenues	**116,347**	**110,359**	**115,607**	**-0.6**	**4.8**
Taxes	55,326	53,730	75,817	37.0	41.1
Transfers and Other Revenues	61,021	56,629	39,790	-34.8	-29.7
Expenditures	**134,028**	**127,136**	**124,915**	**-6.8**	**-1.7**
Personnel, Purchasing and Economic Agreements	70,155	69,754	69,321	-1.2	-0.6
Interest Payments	2,473	1,996	2,956	19.5	48.1
Investment	11,766	8,326	8,941	-24.0	7.4
Transfers[2]	49,547	47,059	43,619	-12.0	-7.3
Contingency Fund	87		78	-10.8	
Cash Balance	**-17,681**	**-16,777**	**-9,307**	**-47.4**	**-44.5**
Memorandum					
Primary balance	*-15,208*	*-14,780*	*-6,351*	*-58.2*	*-57.0*

[1] Not including Cataluña and Islas Baleares
[2] Current and capital
Source: Ministerio de Economía y Hacienda

5. THE BUDGET CONSOLIDATION STRATEGY IN THE CONTEXT OF THE EXCESSIVE DEFICIT PROCEDURE

5.1 The Budget Consolidation Strategy

Compliance with the deficit commitment in 2010, as noted in the previous chapter, puts the Spanish public finances in a favourable situation for achieving the goal of reducing the General government deficit to 3% of GDP in 2013 and to 2.1% in 2014. This implies maintaining and, if necessary, strengthening the fiscal consolidation efforts made since the 2010 budget.

The 2011-2014 fiscal consolidation strategy is based on two main elements. Within the budget, all of the measures taken so far will have permanent effect on the structure of public revenue and expenditure. Furthermore, successive budgets, reflecting budgetary austerity, will need to be drafted taking into consideration specific circumstances. Apart from public finances, the various reforms of the basic aspects of the economy, on-going or planned, such as the labour market, the financial system, the product market or pensions, should stimulate economic growth and confidence of economic agents and, ultimately, increase the tax base in the short, medium and long term.

The 2011-2014 path of fiscal consolidation contained in this Stability Programme has a key policy anchor in the Expenditure Review Plan 2011-2013, approved by the Council of Ministers on May 20th, 2010. However, the fiscal consolidation efforts by the Central government would be incomplete without a commitment by the Autonomous Communities and Local governments to contribute to meeting the targets agreed in the Stability Programme. This commitment was assumed by all of the Autonomous Communities and Municipalities through various resolutions adopted by the Consejo de Política Fiscal y Financiera and the Comisión Nacional de Administración Local. In this regard, it is worth noting the amendment to the Framework Agreement to obtain additional savings of 1.2 billion euro in expenditures of the territorial governments in 2011, of which 1 billion would correspond to the ACs and 200 million to the Local governments. Agreed deficit targets were validated in the corresponding bodies' meetings during the last week of April, when the target for 2014 was also agreed. In particular, the Consejo de Política Fiscal y Financiera on April 27th, approved the rebalancing Plans of 7 Autonomous Communities, which, together with those of País Vasco and Navarra (to be approved), implies an additional fiscal consolidation effort of more than 4 billion euro.

The cumulative reduction of the General government deficit amounts to 7.1 percentage points of GDP through 2014. As seen in Table 5.1, 1.9 percentage points correspond to increases in revenue and 5.2 percentage points to expenditure cuts. On the revenue side, about 1 percentage point of the projected increase is due to the progressive closure of the output gap, which in 2010 was estimated at -3.5% of GDP, falling to -0.5% in 2014. The impact of the permanent tax increases introduced in the 2010 and 2011 budgets as described in the previous section is estimated at 0.5 percentage points. The remaining 0.4 percentage points correspond to transitory measures expected to disappear over these years (such as extraordinary tax deferrals).

Table 5.1. BUDGETARY PROSPECTS (Excessive Deficit Procedure)							
	SEC Code	**2010 (A)**		**2011 (F)**	**2012 (F)**	**2013 (F)**	**2014 (F)**
		Level	% of GDP				
Net Lending (+)/Borrowing (-) (EDP. B9)							
1. General government	**S.13**	**-98,227**	**-9.2**	**-6.0**	**-4.4**	**-3.0**	**-2.1**
2. Central government	S.1311	-52,798	-5.0	-2.3	-3.2	-2.1	-1.5
3. Autonomous Communities	S.1312	-35,997	-3.4	-3.3	-1.3	-1.1	-1.0
4. Local government	S.1313	-6,844	-0.6	-0.8	-0.3	-0.2	0.0
5. Social Security administration	S.1314	-2,588	-0.2	0.4	0.4	0.4	0.4
6. Total revenue	TR	379,497	35.7	36.7	37.0	37.5	37.6
7. Total expenditure	TE	477,724	45.0	42.7	41.4	40.5	39.7
8. Net lending (+) or borrowing (-)	EDP B9	-98,227	-9.2	-6.0	-4.4	-3.0	-2.1
9. Interest expenditure	EDP D41	20,374	1.9	2.2	2.5	2.7	2.9
10. Primary balance		-77,853	-7.3	-3.8	-1.9	-0.3	0.8
11. Total taxes		211,109	19.9	20.7	20.9	21.2	21.4
11a. Taxes on production and imports	D.2	107,806	10.1	10.6	10.6	10.6	10.7
11b. Current taxes on income, wealth, etc.	D.5	99,442	9.4	9.7	9.9	10.2	10.3
11c. Capital taxes	D.91	3,861	0.4	0.4	0.4	0.4	0.4
12. Social contributions	D.61	139,977	13.2	13.1	13.1	13.2	13.2
13. Property income	D.4	10,088	0.9	1.0	1.0	1.1	1.1
14. Other income		18,323	1.7	1.9	2.0	2.1	2.0
15. Total revenue	**TR**	**379,497**	**35.7**	**36.7**	**37.0**	**37.5**	**37.6**
p.m.: Tax burden		334,411	31.5	32.3	32.6	33.1	33.3
16. Compensation of employees + intermediate consumption (16=16a+16b)	D.1+P.2	182,320	17.2	16.3	15.6	14.9	14.3
16a. Compensation of employees	D.1	124,038	11.7	11.2	10.7	10.2	9.7
16b. Intermediate consumption	P.2	58,282	5.5	5.1	4.9	4.7	4.6
17. Social transfers (17=17a+17b)		192,774	18.1	17.9	17.6	17.3	17.2
17a. Social transfers in kind via market	D.63[1]	31,638	3.0	2.9	2.9	2.9	2.9
17b. Social transfers other than in kind	D.62	161,136	15.2	15.0	14.6	14.4	14.3
18. Interest expenditure	EDP D.41	20,374	1.9	2.2	2.5	2.7	2.9
19. Subsidies	D.3	11,999	1.1	1.0	0.9	0.8	0.8
20. Gross fixed capital formation	P.51	39,178	3.7	2.9	2.7	2.6	2.6
21. Other expenditure		31,079	2.9	2.5	2.2	2.1	2.0
22. Total expenditure	**TE**	**477,724**	**45.0**	**42.7**	**41.4**	**40.5**	**39.7**
p.m.: Public consumption	P.3	220,775	20.8	19.9	19.2	18.6	18.0

[1] D.63=D.6311+D.63121+D.63131
(A) Advance and (F) Forecast
Source: Ministerio de Economía y Hacienda

The weight of indirect taxes as a percentage of GDP will increase by 0.5 percentage points in 2011, remaining almost stable in subsequent years. Of this increase, 80% is the result of the increase in VAT rates; the remainder is the result of increasing Excise Duties. Direct taxes progressively increase their share in GDP. This is partly due to the closing of output gap, and, the remaining, to measures taken on Personal Income Tax in 2011, partially offset by a reduction in the Corporate Tax revenue. Social contributions will initially reduce their weight as a percentage of GDP (although some policy changes were introduced in 2011), before recovering as job creation accelerates. Other income, including the adjustment for revenues unlikely to be collected, will begin to increase its share as extraordinary tax deferrals are reduced. These projections do not include the expected revenues to be derived from the recently announced auction of the electromagnetic spectrum.

The net expenditure cuts to be implemented through 2014 are projected to amount to 5.2 percentage points of GDP. Given that the interest burden will increase by about 1 percentage point during this period, cuts in primary spending will reach 6.3 percentage points. According to estimates, the reduction in unemployment and the structure of these benefits will reduce primary expenditure by around 1.1 percentage points of GDP. In addition, the transitory funds associated with the crisis represented 0.6 percentage points of GDP in 2010. Thus, the structural adjustment pending in primary expenditure stands at 4.6 percentage points. According to the Central government's 2011-2013 Expenditure Review Plan approved by the Council of Ministers on May 20th, 2010, and taking into account the initiatives of other Administrations included in their budgets and in the rebalancing Plans, these savings will be achieved through the following measures:

a) Compensation of employees in the Public Administration

   Two initiatives are measured: i) freezing the salaries of all Public Administration employees in 2011 (following the 5% cut in 2010). The impact of this measure is a reduction of 0.3 percentage points in the weight of public expenditure as a percentage of GDP. ii) Implementation of a 10% replacement rate for all staff in the overall Public Administration during 2011, 2012 and 2013, implying that, by the end of 2013, Public Administration staff will fall by 7%, reflecting an adjustment of 0.8 percentage points of GDP until 2013. These two measures and the maintenance of wage moderation for the entire Public administrations will mean a reduction of expenses of 1.5 percentage points of GDP until 2013.

b) Intermediate consumption, social transfers via the market and other costs

   Cost-saving measures implemented in the healthcare sector (generic prescriptions, single doses, reductions in reference prices, etc.) will have an estimated impact of over 1 billion euro. A reduction of 500 million euro in official development aid will be implemented in 2011 (in addition to the 300 million cut in 2010), freezing it in subsequent years. Overall, almost half of the projected cut in these items (1.9 percentage points of GDP to 2014) is already included in the budgets at various levels of government. Over the rest of the time horizon, these costs will be reduced in each budget to the extent necessary to make them compatible with the agreed upon stability goals.

c) Social Benefits

   Contributory pensions have been frozen in 2011 (excluding minimum pensions) and the application of the safeguard clause for deviations in inflation is suspended (including for civil servants pensions). This represents a cut in spending of around 1.4 billion euro in 2011. In addition, the 'baby check' has been eliminated, with savings of 1.2 billion euro, and partial retirement has been restricted, with an estimated savings of 200 million euro. Regarding other contributory benefits, major reforms are being introduced in the system for recognizing and monitoring temporary and permanent disability payments. In fact, according to the Labour Force Survey in 2010, there was an 8% reduction in the number of employed persons who worked fewer hours than normal due to illness, accident or temporary disability. The savings this entails, along with decreasing unemployment benefits, will more than offset the greater weight of pensions in 2014.

d) Subsidies

The most important measure here is the phasing out of the current Social Security contributions rebates, as they have been focused on very specific groups, such as the young, unqualified, long-term unemployed, even though new subsidies have been temporarily introduced for one year to foster the part-time employment of jobless youths. Also, in the case of housing policy, the total volume of aid programmes has been significantly reduced. On the whole, expenditure cuts associated with these measures are estimated at 0.3 percentage points of GDP.

e) Investment by the Public Administration

Public investment for infrastructure by the Central government in 2011 will be cut by 1.8 billion euro in addition to those cuts made in 2010. The State Local Investment Fund and the State Fund for Employment and Local Sustainability (which represented 6.2 billion euro in 2010 and 1 billion in 2011) will disappear. In subsequent years the investment in infrastructure in the Central government will be adjusted to meet budget consolidation requirements. The remaining investments by the Central government will be reduced by 25% in the period 2011-2013 (about 1 billion euro). Overall, this represents a decrease of 1.1% in the weight of public investment in GDP.

In addition, the Expenditure Review Plan 2011-2013 provides clear performance standards to make the commitment to the path for fiscal consolidation resilient both with respect to the macroeconomic scenario and to the possible adoption of new expenditures:

1. In case there are deviations or risks of not meeting the budget targets, the Government will take additional extraordinary measures on both revenue and expenditure sides to bring the deficit back on track.

2. The adoption of any new initiative on the spending side in this period shall be subject to compliance with the stated objective of reducing overall expenditure. For example, the impact on public spending of the recent extension of unemployment benefits for disadvantaged groups has been offset by reductions in the budgets of other departments.

3. Revenue increases beyond the initial estimates will be used in full to reduce the government deficit, and may not be used to finance increases in expenditure.

5.2 Structural balance and fiscal stance

The potential output of the Spanish economy and the output gap have been estimated to evaluate the structural component of the government deficit and fiscal policy over the projection period under review in this Stability Programme. This has been done using the methodology proposed by the European Commission and agreed upon within the Working Group on Output Gap for the preparation of the Stability Programmes, incorporating structural reforms undertaken in the Spanish economy in recent years with the impacts detailed in the National Reform Programme.

Table 5.2. CYCLICAL DEVELOPMENTS*

% of GDP, unless otherwise stated

	2009	2010	2011	2012	2013	2014
1. Real GDP growth	-3.7	-0.1	1.3	2.3	2.4	2.6
2. Net lending (+) or borrowing (-)	-11.1	-9.2	-6.0	-4.4	-3.0	-2.1
3. Interest payments (including FISIM)	1.8	1.9	2.2	2.5	2.7	2.9
4. Potential GDP growth (% change)	0.7	0.5	1.0	1.3	1.6	1.7
Contributions:						
- *Labour*	*-0.3*	*0.2*	*0.6*	*0.6*	*0.7*	*0.7*
- *Capital*	*0.7*	*0.0*	*-0.1*	*0.0*	*0.1*	*0.3*
- *Total Factor Productivity*	*0.3*	*0.3*	*0.5*	*0.6*	*0.7*	*0.8*
5. Output gap	-2.8	-3.5	-3.1	-2.1	-1.4	-0.5
6. Cyclical balance	-1.1	-1.4	-1.3	-0.9	-0.6	-0,2
7. Structural balance (2-6)	-10.0	-7.8	-4.7	-3.5	-2.4	-1.9
8. Primary structural balance (7+3)	-8.2	-5.9	-2.5	-1.0	0.3	1.0
8.a Transitory measures	-2.0	-1.0	-0.1	0.0	0.0	0.0
8.b Primary structural balance without transitory measures (8-8.a)	-6.2	-4.9	-2.4	-1.0	0.3	1.0

* Using potential GDP (production function)

Source: Ministerio de Economía y Hacienda

As seen in Table 5.2, the bulk of the fiscal adjustment made in 2010 was structural. In fact, the cyclical component contributed to raising the deficit, with the output gap reaching -3.5% of GDP. There was also an automatic withdrawal of transitory expansionary measures. In 2011, the improvement in the cyclical position of the Spanish economy will help reduce the deficit observed and, furthermore, the withdrawal of the transitory measures will be completed. Overall, the correction of the primary balance will represent 3.4 percentage points between 2010 and 2011 and 2.4 after adjusting for transitory measures. In the following years, the reduction of the structural component in the deficit becomes smaller, while the cyclical component will diminish before practically disappearing. Thus, Spanish public finances in 2014 will reach a structural primary surplus of 1% of GDP, which should increase to around 3% in subsequent years to meet Spain’s medium-term objective (a balanced budget).

5.3 Government debt developments

As a result of the high budget deficits recorded during the most challenging years of the crisis and the support measures implemented in the financial sector, the Spanish government debt increased by over 17 percentage points of GDP since 2007 to reach 53.3% in 2009. Thereafter, the fiscal consolidation policy implemented by the Spanish authorities, and the reimbursement of part of the financial sector support measures, have caused the debt to GDP ratio to reduce its annual rate of increase and it is expected to begin to decrease in 2014 (see Table 5.3).

Between 2010 and 2014, it is estimated that government debt will increase by about 8.8 percentage points to reach 68.9% of GDP. The primary deficit, in line with the fiscal adjustment measures described above, will be gradually reduced over the period until reaching a surplus in 2014, thus contributing about 5 percentage points to this increase in debt. Greater debt along with rising interest rates in financial markets, will result in interest payments becoming the factor exerting the greatest upward pressure on debt, with a contribution estimated at over 10 percentage points. Much of this contribution will be offset by nominal GDP growth, whose rate of change, positive since 2010, is expected to increase slowly, subtracting just under 10 percentage points of the increase in the debt to GDP ratio.

Table 5.3. GENERAL GOVERNMENT DEBT DEVELOPMENTS

% of GDP

	2009	2010	2011	2012	2013	2014	Variation 2010-2014
1. Gross debt	53.3	60.1	67.3	68.5	69.3	68.9	8.8
2. Change in gross debt	13.4	6.9	7.1	1.2	0.8	-0.4	8.8
3. Primary budget balance	-9.4	-7.3	-3.8	-1.9	-0.3	0.8	5.2
4. Interest expenditure	1.8	1.9	2.2	2.5	2.7	2.9	10.2
7. Effect of nominal GDP growth	1.3	-0.4	-1.5	-2.5	-2.7	-3.0	-9.7
8. Other factors (stock-flow adjustment)	1.0	-2.0	2.7	-0.7	0.5	0.5	3.0
p.m.: Implicit interest rate	4.31	3.63	3.73	3.85	4.10	4.30	

Source: Ministerio de Economía y Hacienda

A significant increase (2.7 percentage points) in the stock-flow adjustment has been estimated for 2011, after the strongly negative value in 2010. This estimate, always complex given the variety of factors involved, has taken into account the issuance expected from the Fondo de Amortización del Déficit Eléctrico (FADE), the Fondo de Reestucturación Ordenada Bancaria (FROB) and the necessary issuance to cover Spain's share of the financial contribution made by to the European Financial Stability Facility (EFSF) and the loan to Greece. On the other hand, payments coming from the Fondo de Adquisición de Activos Financieros (FAAF, 11 billion euro in 2011) are substracted. In 2012, issuance from the FADE, the EFSF and the loan to Greece will be more than offset by the revenue derived from the partial privatizations of the Aena-Airports public corporation and the National Lotteries and Gamming and the final reversal of the FAAF (6 billion euro), giving rise to an estimated negative debt-deficit adjustment in that year.

In any case, the sustainability of sovereign debt over the medium and long term depends on the starting position of the debt, the evolution of the primary deficit, interest rates on debt and GDP growth. Forecasts assure that the Spanish government debt, in a context of nominal GDP growth tending to exceed the implicit interest rate and the conversion of existing primary deficits into surpluses by the end of the period, will be sustainable over time.

5.4 Budgetary implications of structural reforms

Structural reforms outlined in the National Reform Program will have positive effects on activity in the long term. In general, although these reforms have important implications for the operation of certain public services, regular endowments are made so there are no significant direct budget costs associated with them. As regards fiscal measures, their impact is already included in the forecasts. In particular, the direct effect on revenue of the tax incentives included in both the Sustainable Economy Law and the Royal Decree law 13/2010 will amount to less than 0.1 percentage points of GDP. On the other hand, the more favourable tax treatment of rentals and refurbishment of housing would be in part offset by the partial elimination of the deduction for house purchase in the Personal Income Tax and higher VAT revenues.

As regards the budgetary impact of the reforms related to improving the tax bases, the simulations performed with the available models also reveal a mean elasticity slightly higher than one for overall tax revenue, consistent with the slightly progressive nature of the tax system as a whole. Thus, adding the impact of all of the structural reforms, we find that tax revenue in 2020 would be 10% higher than revenue obtained in the absence of all of these reforms. This represents an increase of 0.3 percentage points in the ratio of tax revenue to GDP.

6. COMPARISON WITH THE PREVIOUS UPDATE AND SENSITIVITY ANALYSIS

6.1 Comparison with the previous Update

The behaviour of the Spanish economy in 2010 was more favourable than projected in the previous Stability Programme Update. In particular, GDP almost stabilized, compared to the expected slight reduction (see Table 6.1). This was the result of better than expected export performance, private consumption and investment in equipment goods, more than compensating the major adjustment in public consumption and investment. Prices also rose by more than expected, but this was due to inflation pressures from abroad, since cuts in unit labour costs were higher than expected. In addition, the process of fiscal consolidation was frontloaded and public debt stood nearly six percentage points of GDP lower than projected.

Table 6.1. COMPARISON WITH THE PREVIOUS STABILITY PROGRAMME UPDATE

	2010	2011	2012	2013
GDP (real growth in %)				
Previous Update	-0.3	1.8	2.9	3.1
Present Programme	-0.1	1.3	2.3	2.4
Difference	**0.2**	**-0.5**	**-0.6**	**-0.7**
Private consumption deflator (annual change in %)				
Previous Update	1.4	1.8	2.0	2.0
Present Programme	2.8	2.8	1.9	1.9
Difference	**1.4**	**1.0**	**-0.1**	**-0.1**
Budget balance (% of GDP)				
Previous Update	-9.8	-7.5	-5.3	-3.0
Present Programme	-9.2	-6.0	-4.4	-3.0
Difference	**0.6**	**1.5**	**0.9**	**0.0**
General government debt (as % of GDP)				
Previous Update	65.9	71.9	74.3	74.1
Present Programme	60.1	67.3	68.5	69.3
Difference	**-5.8**	**-4.6**	**-5.8**	**-4.8**

Source: Ministerio de Economía y Hacienda

Growth projections for the current year and the two following years have been reviewed downwards in the current Stability Programme. In 2011, the revision reflects the anticipated impact of the fiscal consolidation process. In subsequent years, the adverse impact of rising interest rates and commodity prices will be partially offset by a better international outlook and the initial effects of the structural reforms being implemented. Competing forces converge on prices. On the one hand, the external environment is expected to be more inflationary in the short term. Also, 2011 will still see some impact from the indirect tax increases implemented in 2010. However, medium-term inflation generated domestically will be more moderate than expected, due to the effect of structural reforms, which will imply a greater moderation of unit labour costs. From a fiscal standpoint, the new committed path for deficit reduction represents a significant frontloading in consolidation, which, together with the process of restructuring and rationalization of the public sector (including the announced privatizations), will allow government debt as a percentage of GDP to stabilize at almost five points below the estimate in the previous Update.

6.2 Sensitivity analysis

As reflected in the Code of Conduct, the Stability Programme should include a sensitivity analysis of budget projections. The first sensitivity exercise is a reduction of economic growth by 0.5 percentage points over the entire forecast horizon. This would translate to the Spanish economy's growth only exceeding 2% in 2014 (see Table 6.2). As a result, the output gap would be more negative and, therefore, inflation would stabilize at lower levels (1.5%). On the other hand, the budget deficit would be higher due to the performance of automatic stabilizers, reaching 3.5% in 2013 and 2.8% in 2014. Logically, this would lead to further accumulation of public debt, which would stabilize slightly above 71% at the end of the projection horizon.

The other two sensitivity exercises recommended by the Code of Conduct are symmetrical: a decrease and an increase in interest rates by 100 basis points compared to those in the baseline scenario (see Table 3.1). This shock is introduced into the model assuming that the short-term rates change by 100 basis points over four years and then return to the central scenario. Long-term rates are constructed in a manner consistent with this new path for short-term rates. As seen in Table 6.2, lower interest rates have an upward impact on growth and inflation of 0.5 and 0.3 percentage points in 2014, respectively. As a result of higher growth, fiscal consolidation is more intense and accumulates less debt, which, as a percentage of GDP would be 2 percentage points lower in 2014. The symmetric scenario of higher interest rates means lower growth, lower inflation, less intense fiscal consolidation and more public debt, which, nevertheless, would reach a level around 71% of GDP.

Table 6.2. SENSITIVITY ANALYSIS

	2011	2012	2013	2014
Baseline scenario				
GDP (real growth in %)	1.3	2.3	2.4	2.6
Private consumption deflator (annual change in %)	2.8	1.9	1.9	1.9
Budget balance (% of GDP)	-6.0	-4.4	-3.0	-2.1
General government debt (as % of GDP)	67.3	68.5	69.3	68.9
Lower growth scenario: -0.5 percentage points				
GDP (real growth in %)	0.8	1.8	1.9	2.1
Private consumption deflator (annual change in %)	2.7	1.7	1.6	1.5
Budget balance (% of GDP)	-6.2	-4.8	-3.5	-2.8
General government debt (as % of GDP)	67.7	69.6	71.1	71.4
Lower interest rates scenario: -100 basis points				
GDP (real growth in %)	1.4	2.6	2.8	3.1
Private consumption deflator (annual change in %)	2.8	2.0	2.1	2.2
Budget balance (% of GDP)	-5.7	-4.0	-2.5	-1.5
General government debt (as % of GDP)	67.0	67.6	67.9	66.9
Higher interest rates scenario: +100 basis points				
GDP (real growth in %)	1.2	2.0	2.0	2.1
Private consumption deflator (annual change in %)	2.8	1.8	1.7	1.6
Budget balance (% of GDP)	-6.3	-4.8	-3.5	-2.7
General government debt (as % of GDP)	67.6	69.4	70.7	70.9

Source: Ministerio de Economía y Hacienda

7. QUALITY OF PUBLIC FINANCES

7.1 Introduction

Improving the quality of public finances becomes even more important when undertaking an accelerated process of fiscal consolidation such as the current one. Therefore, the composition of spending adjustment gives more priority to items more linked with growth. This reorientation of public spending is reinforced by the Sustainable Economy Law, which states that any expenditure will be evaluated on the principles of efficiency and streamlining of services, encouraging public sector productivity. As for income, the tax structure is evolving towards a less distortionary system that encourages sustainable growth. A broad rationalization and restructuring of the public sector is also being undertaking. Thus, the Spanish fiscal consolidation strategy is fully consistent with the Ecofin and European Council guidelines from February and March, 2011, respectively.

7.2 Public spending

In these years, despite an unprecedented deficit reduction, the Central government continued to allocate significant resources to policies that contribute to the modernization of the productive structure and, therefore, to the consolidation of economic recovery. In fact, most of the adjustments fall within the current primary expenditure and efforts are being made to improve efficiency and strength the conditionality of certain social benefits. Expenditure on research, development and innovation (R&D+i), in education, and investment in infrastructure are receiving special attention:

- As for science and technology policy, investment in R&D+i is one of the public policy areas with the least cuts with respect to the Central government budget for 2011, at 6.3%. The total budget of the Ministerio de Ciencia e Innovación is reduced by only 0.8%, which maintains funding for supporting projects, grants and contracts at universities and research centres, as well as credits for companies, at almost the same levels as in 2010. Also noteworthy is the new model of the Spanish Science-Technology-Enterprise that will increase efficiency in the allocation of resources to place emphasis on certified quality.

- In 2011, education continues to receive significant Central government resources, channelled through Territorial Co-operation Programmes. The budget for grants in 2011 will be 2.6% higher than in the previous year and, in fact, during the 2010-2011 academic year 56.9% of university students are able to obtain a scholarship to cover university enrolment fees. Finally, we will continue to promote the Income-Loans programme for University students who cannot access grants.

- To assess the resources devoted to infrastructure policy properly, it should be noted that public investment as a percentage of GDP, even after the planned cuts, still remains above the average for the euro area (2.2% according to the latest European Commission projections). The adjustment in public investment is accompanied by an effort to reduce the average cost of projects and improve the efficiency of public works.[1] However, despite these adjustments, a Special Infrastructure Plan was announced in April, 2010, to facilitate investments to be financed through forms of public-private partnership (including agreements with national- and European-level private and public financial institutions) so that the required resources are distributed throughout the life of the projects.

The Expenditure Review Plan 2011-2013 adopted by the Council of Ministers on May 20th, 2010, includes a review and analysis of all spending policies and programmes. Additionally, the rationalization of structures in the Central government and public sector enterprise sector is being implemented, in order to adapt the structure and organization to the principles of efficiency and economy. In this regard, in December, 2010, some measures to privatize and re-organize the public sector were introduced: i) inclusion of newly-recruited staff by the public sector in the General Social Security System; ii) transformation of the public entity for National Lotteries and Gaming into a public corporation, allowing the entry of up to 30% of private capital, and iii) the creation of the Aena-Airports public corporation with the possibility of the entry of up to 49% of private capital, enhancing the management of the airports including the possibility of providing access to private management through concession of individual airports.

7.3 Public revenues

The magnitude and fairness of fiscal adjustment in Spain also makes it necessary to adopt revenue measures. At the same time, the reforms aim to correct distortions and take into account the need to promote sustainable growth, also strengthening automatic stabilizers. Therefore, tax increases have focused mainly on indirect taxation, eliminating partially the tax deduction on home ownership, improving the taxation of enterprises, reducing selectively social security contributions and increasing personal taxes on higher incomes.

- Since July 2010, the general and reduced rates for the VAT have risen to 18% and 8% respectively. Excise Duties on Tobacco Products has also increased.[2] Some Autonomous Communities have increased the Excise Duty on Retail Sales of Certain Hydrocarbons and the Excise Duty on Certain Means of Transport.

- Effective since January, 2011, the deduction in the Personal Income Tax for the purchase of permanent residences has been eliminated for taxpayers with annual incomes above 24,000 euro. Furthermore, an equivalent deduction has been introduced for those who pay rent, the tax treatment of which has been improved by raising the current rate of reduction for the calculation of net income derived from rental housing. New deductions for housing refurbishment were introduced in April 2010, later increased in April 2011.

[1] Ministerial Order FOM/3317 dated December 17th, 2010.
[2] Royal Decree Law 13 dated December 3rd, 2010, on actions in the fiscal and labour areas, as well as the liberalization of economic activity.

- Starting January 1st, 2011, the threshold allowing companies to be considered small and medium size businesses and thus enjoy the tax benefits applicable to SMEs, particularly the lower tax rate in the Corporate Tax, has risen from 8 to 10 million euro of net turnover. [1] In addition, this reduced rate, which previously applied only to the first 120,000 euro of tax base, has now been expanded to 300,000 euro.

- To encourage business growth,[1] companies that lose their small size status due to exceeding this threshold or as a consequence of corporate re-organizations are allowed to continue to enjoy the special tax scheme during the next three fiscal years. As an additional measure, all operations aimed at creating, capitalizing and maintaining firms are exempt from the Property Transfer and Stamp Duty Tax. Starting January, 2011, and applicable until 2015, flexibility is possible with regard to the depreciation of assets for Corporate Tax purposes. Also, the Sustainable Economy Law has improved innovation incentives by increasing the deduction for investments in R&D+i and improving the deduction for environment-related investments. In the case of employment, there is a reduction in employers' contributions to Social Security during the first year, which may be up to 100%, for businesses creating new part-time jobs.[3]

- A selective expansion of direct personal tax starting in January 2011. Two new income brackets have been introduced in Personal Income Tax to raise the Central government marginal rate by one point for taxpayers with a general taxable income of 120,000 euro or more, and one extra point starting at 175,000 euro. Some Autonomous Communities have also raised the Personal Income Tax rates applicable to those tranches they have responsibility for. Furthermore, a limit has been set for multi-year revenues that can benefit from a 40% tax rebate and measures have been taken to prevent the deferral in the taxation of the shareholders in open-ended investment firms (SICAVs).

---

[3] Royal Decree Law 1/2011 of February 11th. Applicable to contracts signed in the twelve months following their entry into force.

8. SUSTAINABILITY OF PUBLIC FINANCES

8.1 Long-term budgetary projections: current situation

Every three years, the Working Group on Ageing Populations of the Economic Policy Committee and the European Commission prepare, based on the mandate of the Ecofin Council, public spending projections associated with the ageing of the population. The starting point of these exercises is the updated Eurostat population projection, and a macroeconomic scenario is prepared using a common methodology. This methodology assumes that there are no changes in economic policy beyond those that already have legal backing at the cut-off date of the projection exercise. Five categories of age-related public expenditure are analyzed: pensions, health care, long-term care, education and unemployment benefits. The latest projections were published in 2009 (see Table 8.1).[4]

Table 8.1. PROJECTIONS OF EXPENDITURE ASSOCIATED WITH AGEING FROM THE EUROPEAN UNION ECONOMIC POLICY COMMITTEE (2009) (% of GDP)

	2007	2010	2020	2030	2040	2050	2060
Total contributory pension expenditure (1 +2)	**8.4**	**8.9**	**9.5**	**10.8**	**13.2**	**15.5**	**15.1**
Contributory Social Security pension expenditure* (1)	**7.6**	**8.1**	**8.7**	**10.0**	**12.5**	**14.8**	**14.6**
Old-age and early retirement pensions	5.0	5.5	6.0	7.1	9.4	11.8	11.7
Disability	0.9	1.0	1.0	1.2	1.3	1.2	1.1
Survivors' pensions	1.6	1.7	1.6	1.6	1.8	1.9	1.7
Non social security benefits (2)	**0.8**	**0.8**	**0.9**	**0.9**	**0.8**	**0.6**	**0.5**
Healthcare expenditure	5.5	5.6	5.9	6.3	6.8	7.1	7.2
Long-term care expenditure (**)	0.5	0.7	0.9	1.0	1.1	1.3	1.4
Education expenditure	3.5	3.4	3.5	3.4	3.2	3.5	3.6
Unemployment expenditure	1.3	1.4	0.9	0.9	0.9	0.9	0.9
Total expenditure on ageing	**19.2**	**20.0**	**20.7**	**22.4**	**25.2**	**28.3**	**28.2**
Memorandum: Hypothesis of the exercise							
Real potential GDP growth	*3.7*	*2.9*	*3.4*	*1.8*	*0.9*	*1.1*	*1.6*
Labour productivity growth	*1.0*	*0.8*	*2.7*	*1.9*	*1.7*	*1.7*	*1.7*
Participation rate males (aged 15-64)	*81.5*	*82.0*	*81.5*	*81.0*	*81.3*	*81.9*	*81.6*
Participation rate females (aged 15-64)	*61.5*	*64.3*	*69.6*	*71.5*	*72.9*	*73.2*	*72.9*
Total participation rate (aged 15-64)	*71.6*	*73.3*	*75.7*	*76.4*	*77.2*	*77.6*	*77.3*
Unemployment rate in ages 15-64	*8.3*	*8.8*	*6.2*	*6.2*	*6.2*	*6.2*	*6.2*
Population aged 65+ / total population of working age	*24.2*	*24.4*	*27.4*	*34.3*	*46.4*	*58.7*	*59.1*

* Includes minimum pensions
Source: 2008-2060 Baseline Scenario of the Report on Projected Public Expenditure associated with Population Ageing. EPC and European Commission, 2009.

These projections, elaborated in 2008, did not show the impact of the crisis and obviously did not take into account the impact of the public pension system reform submitted to Parliament by the Government on March 25th, 2011. In this scenario, spending associated with ageing increased by 8.2 percentage points between 2010 and 2060, reaching 28.2% of GDP. This increase was primarily due to higher spending on pensions (which increased by 6.2 points), while increases in health care and long-term care expenditure were more moderate (1.6 and 0.7 points, respectively). In contrast, education

[4] "2009 Ageing Report: economic and budgetary projections for the EU-27 Member States (2008-2060)", *European Economy* 2/2009.

spending increased only slightly (0.2 points) and unemployment benefit expenditure was reduced (0.5 points).

Results of the updated projection exercise currently developed by the Working Group on Ageing under the Ecofin guidelines, will be published in 2012. These new projections will include the impact of the pension reform, once approved by the Parliament, and they will be based on new Eurostat population projections (to be published in May 2011) and a macroeconomic scenario which already takes into account the impact of the crisis. Taking into consideration this last item, in the absence of a pension reform, would make age-related public expenditure projections as a percentage of GDP somewhat higher than those provided in Table 8.1. This result further underscores the crucial need to reform the public pension system, since otherwise the system would run a structural deficit that would begin to materialize before the end of this decade, significantly increasing from 2030 onwards.

8.2 Strategy

The Pension System Reform

The draft Bill on updating and modernization of the Social Security system was submitted to Parliament by the Government on March 25th, 2011, after taking into consideration the mandatory opinions on the draft that followed the adoption of the Recommendations Report of the Parliamentary Commission for the Pacto de Toledo. This reform is by far the most ambitious since the restoration of democracy in Spain and has been achieved by consensus with social partners, which demonstrates the institutional commitment to the sustainability of public finances and strengthening of the welfare state. The reform is introduced gradually from 2013 to 2027 with transitional periods to allow citizens to adapt to the new regulations without impairing their rights and will be fully implemented just as the increased costs associated with ageing are projected to reach their greatest intensity.

The reform aims to ensure the system's sustainability and intergenerational equity, affecting both the expenditure and income sides, attempting to maintain older workers within the labor force, improving contributivity throughout their working life and the proportionality between contributions and benefits, which will result in an increase in labour supply and revenues of the system. At the same time, a cohesive system must take into account special situations, long careers and working women, as this project aims to do. A key objective of the reform is to safeguard the system from future increases in life expectancy. For this purpose, a sustainability factor is introduced as a new element in the pension legislation in Spain.

Main Reform Measures

The main measures of the pension reform are summarized as follows:

- The statutory retirement age rises by two years, to age 67, phased in between 2013 and 2027.

- Long contribution careers are recognised in such a way that retirement at age 65 is possible with 100% of the pension when a contribution period of 38 and a half years is accredited, to be achieved gradually in 2027.

- There is an increase of two years in the minimum age to early retirement, to age 63, immediately effective, provided there is a minimum contribution of 33 years (previously 30 years) and that the resulting pension should exceed the minimum pension. The reduction coefficient in pension will be 7.5% per year before the new statutory retirement age and 6.5% for workers with over 38 and a half years of contributions. As an exception, in times of crisis, workers may retire after age 61 provided they have contributed for at least 33 years and with the corresponding reduction coefficients.

- Partial retirement after age 61 is maintained, but a full contribution must be paid for both the retiring workers and the ones replacing them, gradually increasing to 100% in 2027. This will mean that the cost for the company and the worker will almost double.

- The possibility of special retirement at age 64 is eliminated.

- There are increases in incentives for voluntary extension of working life beyond the statutory retirement age (2%, 2.75% and 4% per year depending on the worker's history of contributions compared to 2% and 3% before the reform). These incentives may not cause the pension to exceed the maximum contribution base.

- The contribution bases over the last 25 years (last 15 prior to the reform), increasing gradually over the next 10 years, will be taken as the basis for pension calculation. Moreover, periods for which no contributions have been made within this timeframe will not be factored into account in their entirety with the minimum contribution base as happened before the reform.

- The minimum contributory pension supplement will be limited to the amount of the non-contributory pension.

- The contribution period for 100% pension benefit entitlements will increase from 35 to 37 years and the calculation is now made on a monthly basis (previously it was computed annually with rounding-up). The scale becomes linear after the first 15 years (when it reaches 50%) compared to the previous profile where the ratio was higher at first.

- The sustainability factor related to the evolution of life expectancy is crucial to ensure the continued improvement beyond 2027 and that the cost of the reform is shared among generations. From 2027 onwards, system parameters will be revised every 5 years and updated by the increase in life expectancy at the age of 67 between the year of the review and 2027.

- Outside the Bill, but within the context of a comprehensive pension reform, two further measures must be indicated. First, from January 2011 onwards, all newly recruited Spanish civil servants will be integrated into the General Social Security System, so the special public sector employees system (*Clases Pasivas*) governing the pension liabilities of a significant portion of public sector employees will progressively disappear. Secondly, the Government will extend the reform measures for the public pension system set out above to the public sector employees system, fulfilling one of the recommendations of the Pacto de Toledo.

The Impact of the Reform

The impact of the reform has been estimated by the Ministerio de Economía y Hacienda jointly with the Ministerio de Trabajo e Inmigración, based on the long-term Instituto Nacional de Estadística (INE) population projections (January, 2010) and a macroeconomic scenario prepared in accordance with the common methodology agreed within the EU.

As seen in Table 8.2, the aggregate impact of the reform is estimated at a savings amounting to 1.4% of GDP in 2030, 2.8% in 2040 and 3.5% in 2050. This combined effect can be broken down as follows:

- Effect on potential GDP. The delay in the retirement age will increase the participation rate among older workers in comparison to the no-reform scenario. The overall participation rate could increase by between 1.5 and 2 percentage points from 2030. As a result, the level of real GDP under the reform scenario would be 1.4%-1.7% higher over the long term. Merely due to this effect, pension expenditure as a percentage of GDP would be 0.1 to 0.2 percentage points lower.

- Lengthening of working life due to the increase in the legal retirement age. The average exit age from the labour market will increase between 1.5 and 2 years, compared to projections for 2009, reaching an age of over 65 by 2027. The effective retirement age will also increase by a similar magnitude. The increase in the effective retirement age is slightly below the increase in the statutory retirement age due to individuals with long contribution histories (38.5 years) that may retire at 65 without penalty. In any case, it reduces the number of years that individuals receive pension benefits and, therefore, the aggregate expenditure on pensions. The aggregate savings would be 1 point of GDP from 2040 onwards, gradually increasing until then.

- The period considered for calculating pension entitlements increases from 15 to 25 years. This represents considerable savings to the system, as much as 1 point of GDP in the long term. These savings are a result of incorporating somewhat smaller contribution bases during the earlier years of the labour career, especially in the case of workers in the upper contribution groups, where the highest wage levels are reached at 55 to 59 years of age. On the contrary, for lower contribution groups the impact will be much lower because their salaries throughout their working lives are more stable. Thus, the system will be more redistributive than in the past. In addition, real contribution bases will be used during more years, reinforcing the contributive nature of the system.

- Change in the percentage applicable to the bases for calculation and an increase from 35 to 37 years to reach 100% of the bases for calculation of the pension. The impact is estimated at a saving of 0.3 percentage points of GDP from 2040. Calculation by months and the linearity of the scale are important elements in achieving this effect.

- As a key element to ensure the long-term sustainability of the system, the sustainability factor would imply additional savings of about one percentage point of GDP in 2050. To estimate these savings, according to the results indicated in the preceding paragraphs, it has been assumed that the listed system parameters are linked to the increase in life expectancy at age 67, which increases by just under a year every decade.

- In accordance with the methodology of the European Commission, the impact of the transposition of this reform on the public sector employees system will be included when it is formally approved by the Government.

As a result of the described measures, the increase in pension expenditure as a percentage of GDP, will be one half that expected in the absence of reform. Spain would thus be in line with the European average for pension expenditure as a share of GDP, alongside Germany, France and Italy.

Table 8.2. ESTIMATED SAVINGS FROM THE PUBLIC PENSION REFORM
(% GDP)

	2010	2020	2030	2040	2050
GDP increase in the long term	0.0	0.0	0.1	0.2	0.2
Deferral of retirement age	0.0	0.2	0.8	1.0	1.0
Increased period for calculation of pensions	0.0	0.1	0.4	0.8	1.0
Change in the scale of the basis for calculation	0.0	0.0	0.1	0.3	0.3
Sustainability factor	0.0	0.0	0.0	0.5	1.0
Total savings in contributory pensions	**0.0**	**0.3**	**1.4**	**2.8**	**3.5**

Sources: Ministerio de Economía y Hacienda y Ministerio de Trabajo e Inmigración

Consolidation of Public Finances and the Social Security Reserve Fund

The long-term sustainability of public finances will be guaranteed by this substantial adjustment in the increase in pension expenditure and will be supported by the fiscal consolidation strategy, which will turn the primary structural deficit into a surplus, as presented in this Stability Programme. Consequently, the two basic elements of the sustainability indicator will be reduced, limiting the risk to public finances to low levels.

In the assessment of the 2009/2010 Programmes, the S2 sustainability indicator achieved a value of 15.3% of GDP, reflecting the deterioration in the primary structural balance estimated for Spain in 2009 and the increase in age-related expenditure projected at that time (see Table 8.1). This result implied that in order for long-term government revenues to equal accumulated spending, it would be necessary to permanently increase the tax burden, reduce other government spending or a combination of both in that magnitude (15.3% of GDP). Under the new demographic and macroeconomic scenario, there is a slight increase in the cost component related to ageing, resulting in a slightly greater than estimated increase in the second element of the S2 indicator relative to 2009 -the scenario without reform. However, by reducing public pension expenditure growth in the long run, the pension reform would reduce the sustainability indicator by more than 2 points. If we take into consideration also the fiscal consolidation strategy presented in section 5, which estimates the disappearance of the primary structural deficit in 2013, the aggregate sustainability indicator (S2) for Spain may lie between 4% and 5%, below the euro area average and reflecting a low risk level.

In addition, it must be pointed out that the pension system already has reserve assets, due to the Social Security surpluses (excluding the Public Employment Service) achieved even in the face of recession. Since its inception in 2000, subsequent allocations to the Social Security Reserve Fund mean that by December 2010, 64.375 million euro (6.1% of GDP) are available to meet future contributory benefit needs. The investment policy, maintained in 2010, is based on the principles of security, profitability, risk diversification and adaptation to the Fund's time horizon.

Health and Pharmaceutical Expenditure Control

Fiscal consolidation measures adopted in 2010 have had, and will continue to have, a lasting impact on public health expenditure primarily due to lower personnel costs and expenditure reforms on pharmaceuticals, both items accounted for about 65% of public spending on the health services by the Autonomous Communities (2008). In terms of reducing personnel costs, in addition to the average cut of 5% in public employees earnings beginning in the second half of 2010 and the freezing of public salaries in 2011, there has been a downward trend in employment within the hospital sector since the fourth quarter of 2009, partly due to the rule of replacing only 10% of the vacancies in the public sector from 2010 onwards. It is estimated that the public hospital sector employed about 21,000 people fewer in the third quarter of 2010 compared with the same period in 2009.

As for pharmaceuticals expenditure, the cost of official prescriptions within the national health system has recorded a significant deceleration in recent years, from a growth of 6.9% in 2008 to 4.5% in 2009 and a reduction by 3.2% in 2010. For 2011, an additional decrease is estimated at around 5.4%. This sharp reduction is explained by the decrease in the average cost per prescription, which in 2009 was reduced by 0.45% and in 2010 by 4.8%. In this way, the spending per person on prescription drugs declined for the first time in 2010 (-3%).

The two factors explaining these adjustments are, on the one hand, the increased use of generic drugs, which have had an average growth of 22% since 2003; in particular, the share of generic drugs in total prescription drugs increased from 8.8% in 2003 to 25.8% in 2010. In addition, there has been a general reduction in prices and distribution margins of drugs following the decisions taken by the Government. Specifically, the Royal Decree 4/2010, setting a one-off reduction of up to 30% in the price of generic drugs, and the Royal Decree 8/2010 establishing a 7.5% rebate (deduction) in the expenditure on other drugs. Not surprisingly, therefore, the category corresponding to pharmaceutical products in the Harmonized Consumer Price Index has fallen by over 5% in 2010 and 6% in the first three months of 2011 (an increase of 1% was recorded in the euro area). As of March 1st, 2011, the effect of reference price reductions affecting more than 7,000 products (Order SPI 3052/2010, November 26th) must also be taken into consideration. The Government estimates the impact of this last action at 1 billion euro.

It should be noted that despite the downward trend in pharmaceutical expenditure there continues to be a growth in the number of prescriptions dispensed, albeit at an increasingly smaller rate (the number of prescriptions issued increased by 2.6% in 2010 compared to 4.9% in 2009).

9. INSTITUTIONAL FRAMEWORK OF PUBLIC FINANCES

9.1 Enforcement of Budgetary Stability laws

Budgetary Stability laws have not experienced any changes since the previous Stability Programme Update but, as described in section 9.3, a new spending rule will be introduced. The European Semester has not made compulsory any immediate change in our regulation but the reform of economic governance of the European Union and the Euro-Plus Pact will require adjustments on it. Full details of the legal framework governing fiscal discipline (budget balance and debt rules) for the different levels of Public Administration might be found in the Stability Programme Update 2006-2009 (completed with additional developments in various agreements of the Consejo de Política Fiscal y Financiera, 3/2007 and 8/2009).

The law is being applied very restrictively to ensure the compliance with the Government commitment on the new fiscal consolidation path, following the adjustment measures included in the Royal Decree Law dated May 20th, 2010. Thus, under the Budgetary Stability laws:

- The report on the cyclical position of the Spanish economy, the budgetary stability objectives for the 2011-2013 period and the ceiling for the State’s non-financial expenditure in 2011 were submitted to the Council of Ministers on May 28th, 2010.

- On June 15th, 2010, the Consejo de Política Fiscal y Financiera supported the new fiscal consolidation scenario for Autonomous Communities proposed by the Government. According to this agreement, the Autonomous Communities are committed to align their budgetary targets within the new 2010-2013 deficit reduction path. As a result, savings from extraordinary measures are channelled to more ambitious deficit reduction targets. In addition, for the years 2011 to 2013 the possibility of increasing the deficit for productive investment is limited: the projected deficits in the stability targets cannot be exceeded by the productive investment programs. Thus, the deficit of the Autonomous Communities (excluding internal adjustments between administrations) is limited to 1.3% of GDP in both 2011 and 2012 and to 1.1% in 2013.

- On June 16th, 2010, the Comisión Nacional de Administración Local also unanimously endorsed the new consolidation path for Local governments in the period 2010-2013. Local governments have pledged to accelerate the pace of deficit reduction.

Regarding the budgetary process for 2012, the cyclical position report was presented on April 6th, 2011. The Consejo de Política Fiscal y Financiera supported, on April 27th, the consolidation path proposed by the Government for the ACs. The same was done for the Local governments in the Comisión Nacional de Administración Local. These budgetary stability targets were approved by the Council of Ministers on April, 29th, endorsing the path taken last year to reach a deficit of 3% of GDP in 2013 and setting out the

Government's proposal for 2014 (deficit of 2.1% for the General government, deficit of 1.5% for the Autonomous Communities, equilibrium for the Local governments and a surplus of 0.4% for the Social Security administration), which must be endorsed by Parliament before the presentation of the 2012 Draft State Budget.

9.2 Strengthening governance and improving the transparency of the Autonomous Communities and Local Governments

In order to reduce the risk of non-compliance with the Territorial Administrations' commitments, important steps were taken in 2010 to strengthen their fiscal framework. In the case of the Autonomous Communities, a new system for authorizing debt has been introduced and budgetary information is reported more frequently and made publicly available. In addition, steps have been taken to encourage the adoption of plans to streamline the structures of their respective public sectors so as to improve efficiency and reduce public expenditure:

- Debt issuance and credit operation in foreign countries are subject to authorization under the 1980 Fundamental Law on Financing the Autonomous Communities.

- Besides, other long term financial operations are subject to authorization by the Central government if the Autonomous Communities do not meet the budgetary stability target, in accordance to Budgetary Stability laws. If the ACs do not present economic and financial Plans to correct the situation, or the Plan is not declared appropriate by the Consejo de Política Fiscal y Financiera, all indebtedness operations, including short term, will require Central government authorization.

- In 2010 the compliance with the 2009 commitments were verified. All Autonomous Communities, apart from Madrid, La Rioja and Galicia, deviated from the target. As a result, those regions required authorization from the Central government for all long term financial operations. No ACs required authorization for short term operations, since all economic and financial Plans were declared appropriate by the Council.

- In order to implement the authorization process in 2010 a more gradual system was introduced which aims to keep authorizations within the deficit level agreed for each year. This system includes three authorization tranches over the year: the initial tranche is approved by the Consejo de Política Fiscal y Financiera if the measures included in the economic and financial Plan are considered appropriate. The second tranche is conditional on having no risk of deviating from the deficit target using information from the budgetary execution until the second quarter of the year. The third tranche is subject to the verification of final compliance with the annual target once the year is concluded. Thus, in 2010, an initial authorization was set at 0.75% of the regional GDP. The review of budgetary performance in the first half of the year led to some ACs being denied the second authorization (1.2% of GDP) until they show they have taken the effective steps to prevent deviation from the target set for 2010.

The third tranche authorizes 0.45% after verifying the final compliance on the year.

- The criteria for dealing with debt authorizations in 2011 will follow the same operational system. They were agreed on November 24th at the meeting of the Consejo de Política Fiscal y Financiera: debt must comply with the deficit reduction path, so debt operations may only be authorized up to the maximum amount of the deficit for 2011 (1.3% of the GDP of each region); no transactions increasing the debt will be authorized until the Council has reported favourably on the rebalancing Plan.Once they are considered suitable, each Autonomous Community will initially be allowed to issue debt representing 0.65% of their respective GDP. After the first half of 2011, the second tranche will be authorized for up to a maximum of 0.40% conditioned to the half year results of budgetary execution, and at the end of 2011, provided the consolidation objectives are met, a last tranche will be authorized for the remaining amount.

- Following the Framework Agreement approved by the Consejo de Política Fiscal y Financiera on March 22th, the Central government will take into account the compliance with the deficit reduction path to regulate the transfers to the Autonomous Communities. As a result, a provision has been introduced in the 2011 State Budget law to regulate the covenants agreed between the Central government and the Autonomous Communities.

- In accordance with the Consejo de Política Fiscal y Financiera Agreement adopted on November 24th, homogeneous information from the quarterly budgetary execution data was published for the first time on December 20th, 2010. This quarterly publication, homogenized and, therefore, comparable, is a very important step towards increasing transparency. Prior to that agreement, ACs were only required to provide such information to the Ministerio de Economía y Hacienda and to the Council, but not all of them made this information public and, in any case, the degree of homogeneity was insufficient as they reflected their own specific characteristics, with regard to both the scope of their budgets and the accounting criteria. The information is publicly available within the following 60 days after the end of the quarter.

In the case of Local governments, measures have been introduced to ensure compliance with the objectives of fiscal consolidation and debt restrictions. The Royal Decree-Law 8 from May, 2010:

- Establishes that savings resulting from reduced staff costs will be applied to further reductions of deficits, reductions of long-term debt or, when appropriate, investment fundings.

- In the 2011 financial year, it prohibits to contract long-term debt operations to finance investment, or replacing total or partial existing operations to all Local governments whenever the total outstanding debt exceeds 75% of liquidated or accrued current revenue, except when it is beneficial to the entity in terms of net present value, to decrease the financial burden, shortening the repayment period or both.

- Short-term operations to cover temporary cash-flows situations must be cancelled by December 31st each year.

The Sustainable Economy Law incorporates additional measures. It has strengthened the co-responsibility for European Union sanctions on all public authorities, as well as the mechanisms to ensure the compliance with the reporting requirements on the budget implementation by Local governments.

9.3 New public spending rule

The Government wants to take one step further on its commitment with fiscal discipline through the incorporation of a rule for spending on Budgetary Stability laws, complementary to the current budget balance rule. In this way, the preventive arm of the fiscal policy is strengthened, especially to avoid pro-cyclical behaviour. The implementation of fiscal rules will help to mitigate possible imbalances generated in expansionary periods and will enable the necessary buffers to moderate economic downturns without compromising the stability of public finances. With this initiative, the Government anticipates the requirements contained in the recently agreed Euro-Plus Pact and starts the process of adapting the stability laws to the changes to be adopted on economic governance in the European Union.

Under the new rule, in general, budgeted and implemented government spending may not exceed the medium-term reference growth rate for the Spanish economy. If regulatory changes involve a permanent increase in revenue, expenditure growth may exceed the limit established by the rule by the amount of the revenue associated to those measures; if regulatory changes adopted permanently reduce revenue, expenditure growth established by the rule will be reduced by the loss of revenue associated with it. When, exceptionally, a budget deficit involves the adoption of an economic and financial Plan in accordance with the budgetary rules or the Excessive Deficit Procedure, the evolution of expenditure must strictly adhere to the path under this plan. In either of the cases above, any income in excess of the forecasted will be used to reduce net debt and not to finance increases in discretionary spending.

The spending rule applies directly to the Central government and Local governments. The Government will promote the adoption of the spending rule by the Autonomous Communities through a timely debate and consensus within the Consejo de Política Fiscal y Financiera.

Lastly, in order to strengthen the effectiveness of the fiscal rules and the framework for stability and fiscal sustainability over the medium term, there will be a greater demand for transparency and control of the budget execution, rebalancing plans, annual debt programmes and the evolution of the public sector in the Autonomous Communities. The Government will also enforce penalties applicable to the various public administrations for any failure to comply with the regulations according to the new European economic governance. Stricter rules will be established for debt, expanding the actions monitor so as to cover not only the fulfilment of the debt rules defined in the Excessive Deficit Procedure but also other financial liabilities.