COMMISSION OF THE EUROPEAN COMMUNITIES

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Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

on the updated stability programme of Spain, 2002-2006

(presented by the Commission)

EXPLANATORY MEMORANDUM

Council Regulation (EC) No. 1466/97, on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], stipulated that countries participating in the single currency were to submit stability programmes to the Council and the Commission by 1 March 1999. In accordance with Article 5 of this Regulation, the Council had to examine each stability programme based on the assessments prepared by the Commission and the Committee set up by Article 114 of the Treaty (the Economic and Financial Committee). The Commission adopted a recommendation on each programme. On the basis of this recommendation and after having consulted the Committee set up by Article 114, the Council delivered an opinion, following its examination of the programme.

Spain's first stability programme covering the period 1998-2002 was submitted on 30 December 1998 and assessed by the Council on 15 March 1999[2].

According to the Regulation, the updated stability programmes, to be presented annually, may also be examined by the Council in accordance with these same procedures. The first annual update covering the period 1999-2003 was submitted on 25 January 2000 and examined by the Council on 28 February 2000[3]. The second update, covering the period 2000-2004, was submitted on 23 January 2001 and examined by the Council on 12 March 2001[4]. The third update, covering the period 2001-2005, was submitted on 9 December 2001 and examined by the Council on 12 February 2002[5].

Spain submitted its fourth updated stability programme, covering the period 2002-2006, on 27 December 2002. The Commission services have carried out a technical evaluation of this updated programme, taking into account to the Communication of the Commission to the Council of 27 November 2002 on strengthening the co-ordination of budgetary policies[6]. This evaluation warrants the following assessment:

> The information provided in the updated programme broadly complies with the revised code of conduct on the content and format of stability and convergence programmes[7], and some improvements have been made following remarks in the Council Opinion on the 2001-2005 update. However, the updated programme was presented almost four weeks beyond the 1 December deadline set in the revised code of conduct[8]. In addition, still following the previous pattern, the latest update provides year-by-year macroeconomic projections but identical, and thus less informative, growth rates for the three later programme years (2004-06).

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1 OJ L209, 2.8.1997.

2 OJ C124, 5.5.1999.

3 OJ C98, 6.4. 2000.

4 OJ C109, 10.4.2001.

5 OJ C51, 26.2.2002.

6 COM (2002) 668 final of 27.11.2002.

7 *Revised Opinion of the Economic and Financial Committee on the content and format of the stability and convergence programmes*, document EFC/ECFIN/404/01-Rev 1 of 27.6.2001 endorsed by the Ecofin Council on 10.7.2001.

8 According to the Spanish authorities, this delay was due to the ecological disaster caused by the sinking of the oil tanker "Prestige" in November 2002. However, the fiscal projections contained in the programme do not include the budgetary implications of this accident.

Overall, the economic policies as reflected in the planned measures in the programme update are consistent in part with the 2002 Broad Economic Policy Guidelines. Specifically, no major measures for overhauling the public pension system in the programme are timetabled.

Implementation in 2002 of the previous update has been broadly successful. Slightly weaker than expected growth (2.2% rather than 2.4%, due to both external and domestic factors) and some primary expenditure overrun resulted in the budget balance being a modest deficit of 0.2% of GDP compared with the original balanced budget target. By government sector, the outturn was most divergent for the autonomous communities, which recorded a deficit of 0.5% of GDP (compared with balance projected in the previous update), while the social security sector achieved a higher-than-expected surplus of 0.8% (0.5%). The debt ratio fell broadly in line with plans, reaching an estimated 55.2% of GDP at the end of 2002. Structural reform measures were implemented as planned and in accordance with the 2002 Broad Economic Policy Guidelines, notably including passage of legislation (to take effect from 2003) reforming personal income tax to give greater incentives for labour market participation, geographical mobility and long-term saving.

The update's macroeconomic scenario shows GDP growth recovering to 3.0% in 2003 and remaining at that level for the remainder of the programme period. Although this may be somewhat optimistic for 2003 (compared, for example, with the Commission's autumn forecast of 2.6%), the medium-term projection may, prudently, actually be slightly cautious, given available estimates of potential output growth. The downgraded inflation projection of 2.8% per annum for the GDP deflator (from 2.4% in the previous update) apparently reflects the expected continuation of recent poor performance.

Despite the slight deficit recorded in 2002, the updated programme retains an objective of balance for 2003, while shaving down previous targets for 2004 and 2005 (to balance and 0.1% of GDP compared with surpluses of 0.1% and 0.2% respectively in the previous update). The projection for 2006 is a marginal surplus (of 0.2% of GDP). Also slightly lower, the projected primary surplus remains almost unchanging at 2.7% of GDP throughout the programme period. In contrast, the debt-to-GDP ratio, is set to decline slightly more quickly than previously foreseen. The faster reduction, to 47% of GDP by 2006, is almost entirely due to a level of inflation almost a half-percentage point higher than projected a year ago.

The update broadly confirms the existing fiscal strategy, though revenue and expenditure shares are higher than in the previous update and the tax ratio now rises slightly during the period. Primary current expenditure is planned to decline by around a half-percentage point relative to GDP between 2002 and 2006 (with some of this reduction front-loaded in 2003); the programme does not detail how this will be achieved. This decline marginally outweighs an increase in the capital expenditure ratio; the total primary expenditure ratio remains roughly constant at just over 37% of GDP. Taking into account an easing burden of interest payments, the total expenditure ratio declines a modest half-percentage point to 39.6% in 2006. The higher ratios compared with the previous update mostly reflect overrun in 2002 not being clawed back, though the decline during the programme period is also rather less ambitious. Total revenues are set to remain stable relative to GDP at just under 40%, while rising corporate tax receipts contribute to the tax ratio increasing slightly, despite the 2003 personal income tax reform. Although reservations over the authorities' macroeconomic outlook for 2003 also apply to that year's budgetary projections, for 2004 and beyond these appear prudent, with some room for manoeuvre.

Based on trend GDP calculated by the Commission services from the programme's projected actual growth[9], the cyclically-adjusted budget balance (which in the case of Spain coincides with the underlying balance, given the absence of transitory factors) rises by over a half-percentage point over the programme period, somewhat front-loaded in 2003. The underlying position thus improves from a slight deficit in 2002 to balance in 2003 and 2004 and to a similarly-sized surplus in 2006. The Commission's autumn forecast, despite a somewhat less buoyant budgetary forecast for 2003, yields similar estimates to 2004. Accordingly, the budgetary targets in the programme, including their evaluation in underlying terms, clearly continue to respect the "close-to-balance" objective of the Stability and Growth Pact throughout the period.

By general government sub-sectors, central government excluding social security (i.e. the State and agencies) is expected progressively to narrow its deficit from an estimated 0.6% of GDP in 2002 to 0.2% in 2006. The surplus on the social security accounts is projected to halve from 0.8% of GDP to 0.4% over the same period. Territorial governments are estimated to have been in deficit by 0.4% of GDP in 2002 but are expected, within the framework of the new General Law of Budgetary Stability (prescribing the objective of a balance or surplus position for each entity in the public sector), to be in balance as from 2003. The divergence from planned outturn for the territorial governments in 2002 (the nature of which the programme does not specify) points to the need for fiscal discipline to be ensured at different levels of government. This is especially so given the transfer underway of important tax and spending powers to regional authorities. In this respect, the fiscal discipline framework set by the General Law of Budgetary Stability needs to be implemented effectively while preserving adequate margins of manoeuvre for the working of the automatic stabilisers in either direction. This includes setting surplus targets when output is above potential.

The updated programme gives greater weight compared with the previous update to the issue of the long-term sustainability of the public finances. Evidence of an adequate reorientation of policy remains lacking, however. The new programme contains projections to 2050 of public pension expenditure. These are based on significantly revised demographic projections compared with those used for the EPC exercise (pension financing or other ageing-relevant expenditure such as healthcare are not presented). The revised demographics (the uncertain nature of which is rightly emphasised) incorporate new estimates of higher net immigration from 2000 onwards leading to a total population stable through the reference period, with a more moderate ageing effect. Although this would also imply somewhat more moderate public finance pressures than the particularly exposed demographic profile previously presented, on the basis of current policies, the risk of unsustainable public finances in terms of emerging budget imbalances remains serious. The risk essentially stems from the large projected increase in age-related public expenditure, notably on public pensions.

9 These calculations are based on the Hodrick-Prescott filter.

Although recent measures make more flexible the transition to retirement and include incentives for continued employment of older workers there has been no major review of the public pension system called for both in the previous Opinion and the 2002 Broad Economic Policy Guidelines. The calendar for reform of the pension system to align more closely contributions and benefits includes only discussions beginning in 2003 and no timetable is provided for reaching policy conclusions and implementation. Assets of the public pensions reserve fund created in 2000 to finance future liabilities now stand at 1% of GDP, a target reached two years earlier than initially planned.

Finally, annexes to the update summarise recent initiatives for structural reform in the labour, capital and product markets, as well as the structural public finance reforms of personal income tax and local government financing. A focus on network industries stems from implementation of the June 2000 liberalisation package. As regards the labour market, although improvement in recent years has been notable, this was from a base of very low total and female employment and wide regional unemployment disparities. Reforms of benefits and employment regulation announced in May 2002 provide greater incentives for the unemployed to enter employment. The strengthening of the competition authority implemented in the year could be helpful to improving inflation performance.

Based on this assessment, the Commission has adopted the attached recommendation for a Council Opinion on the Stability Programme update of Spain and is forwarding it to the Council.

Recommendation for a

COUNCIL OPINION

in accordance with the third paragraph of Article 5 of Council Regulation (EC) No 1466/97 of 7 July 1997

On the updated stability programme of Spain, 2002-2006

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and co-ordination of economic policies[1], and in particular Article 5 (3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

On [18 February 2003] the Council examined Spain's updated stability programme, which covers the period 2002-2006.

The information provided in the updated programme is broadly in line with the revised code of conduct[2]. However, the updated programme was submitted approximately four weeks late.

The Council considers that the economic policies as reflected in the planned measures in the programme update comply in part with the 2002 Broad Economic Policy Guidelines. Specifically, no major measures for overhauling the public pension system in the programme are timetabled.

The Council notes that implementation in 2002 of the previous update has been broadly successful. Slightly weaker than expected growth and some primary expenditure overrun both contributed to the balanced budget target being missed, though the deficit is estimated to have been contained to a modest 0.2% of GDP (cyclically-adjusted on the basis of trend GDP, 0.3% of GDP). The negative outturn was most divergent for the autonomous communities, while the social security sector achieved a higher-than-expected surplus. The debt ratio fell broadly in line with plans, reaching an estimated 55.2% of GDP at the end of 2002. Structural reform measures were implemented as planned and in accordance with the 2002 Broad Economic Policy Guidelines, notably including passage of legislation (to take effect from

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1 OJ L209 of 2.8.1997.

2 *"Revised Opinion of the Economic and Financial Committee on the content and format of the stability and convergence programmes"*, endorsed by the Ecofin Council on 10.7.2001.

2003) reforming personal income tax with the aim of giving greater incentives for labour market participation, geographical mobility and long-term saving.

The update's macroeconomic scenario is centred on GDP growth recovering from 2.2% in 2002 to 3.0% in 2003 and remaining at that level for the remainder of the programme period. Although this may be slightly optimistic for 2003, the medium-term projection may actually be somewhat prudent relative to potential. However, the downgraded inflation projection of 2.8% per annum should not be accepted complacently. It underlines the need for further structural reforms, in particular increasing the degree of competition in the service sector and, more generally, increasing overall productivity. Phasing out of wage indexation while maintaining wage moderation, as recommended in recent Council Opinions[3], would also be instrumental in this regard.

The Council broadly welcomes the update's confirmation of the existing fiscal strategy, though revenue and expenditure shares are higher than in the previous update and the tax ratio now rises slightly during the period despite the 2003 personal income tax reform. Primary current expenditure is planned to decline modestly by around a half-percentage point during the programme period while the reduction in interest costs is balanced by strengthening investment. However, budgetary objectives of balance in 2003 and 2004 and marginal surpluses in 2005 and 2006 represent a slight shaving down in the two middle years compared with the previous update. In contrast, the debt-to-GDP ratio is set to decline slightly more quickly than previously foreseen, resulting mainly from a level of inflation almost a half-percentage point higher than projected a year ago, to a relatively low 47% of GDP by 2006. Although reservations over the authorities' macroeconomic outlook for 2003 also apply to this year's budgetary projections, for 2004 and beyond these appear prudent.

The underlying budget balance rises by over a half-percentage point over the programme period, to a surplus of 0.3% of GDP in 2006. The programme targets, including their evaluation in underlying terms, thus clearly respect the "close-to-balance or in surplus" objective of the Stability and Growth Pact throughout the period. The Council therefore considers that Spain continues to be in conformity with the provisions of the Stability and Growth Pact, with the targets set to meet the objective with an increasingly comfortable margin.

By general government sub-sectors, the update implies some sharp sectoral shifts in net lending during the programme period. Notably, territorial governments, within the framework of the General Law of Budgetary Stability which prescribes that budgets of each public entity should be drawn to be in balance or surplus, are called upon in 2003 to eliminate the deficit estimated for 2002. Especially in the light of the phased transfer underway of important tax and spending powers to regional authorities, the Council welcomes the fiscal discipline framework set by the General Law of Budgetary Stability. This needs to be implemented effectively while preserving adequate margins of manoeuvre for the working of the automatic stabilisers in either direction. This includes setting surplus targets when output is above potential.

The Council welcomes the fact that the updated programme gives greater weight compared with the previous update to the issue of the long-term sustainability of the public finances. It nevertheless considers that evidence of an adequate reorientation of policy in line with its previous Opinions remains lacking. Although the revised demographic projections presented

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[3] OJ C 51/08 26.2.2002, OJ C 109 10.4.2001 and OJ C 098 6.4.2000.

would imply a somewhat more moderate budgetary impact than earlier projections, the Council considers that on the basis of current policies the risk of unsustainable public finances in terms of emerging budgetary imbalances cannot be excluded: such a risk essentially stems from the large projected increase in age-related spending on public pensions. Strengthening long-term sustainability should therefore remain of primary concern. In this respect, the Council regrets that no major review of the public pension system has yet been undertaken, in contrast with the recommendations in both the previous Opinion and the 2002 Broad Economic Policy Guidelines. The Council recommends the Spanish authorities to agree a timetable for reaching policy conclusions and implementation of the envisaged reform of the pension system to align more closely contributions and benefits. Assets of the public pensions reserve fund created in 2000 to finance future liabilities now stand at 1% of GDP, a target reached two years earlier than initially planned. Revised targets now need to be considered, given projected social security surpluses (currently offsetting central government deficits), and the implications of setting more ambitious targets for the total general government balance.

Finally, the Council welcomes recent initiatives for structural reform in the labour, capital and product markets. It urges further significant progress in these areas to support employment-oriented growth with lower inflation than recorded hitherto. Particularly, although improvement in the labour market in recent years has been notable, persistence of relatively low total and female employment and wide regional unemployment disparities calls for sustained efforts to emulate performance achieved elsewhere. Such efforts would be consistent with the 2002 Broad Economic Policy Guidelines.