IV. The Medium-Term Fiscal Outlook 1/

1. Introduction

In July 1994, the Spanish authorities announced a new convergence plan establishing medium-term economic objectives consistent with meeting the nominal convergence targets set in the EU's Maastricht Treaty. These included the achievement by 1997 of a general government deficit of 3 percent of GDP and an annual inflation of 3.5 percent. 2/ To achieve these targets, the plan relies primarily on the effects of structural reforms on economic activity and government revenue, and on control of fiscal expenditure. Economic growth is projected to reach 3.9 percent a year in 1996-97, while expenditure (at constant prices) would grow on average by 1.6 percent. Meanwhile, strong economic activity and improved tax collection would permit revenues to expand by more than 5 percent a year in real terms. The staff analysis suggests, however, that these desirable developments would be difficult to achieve on the basis of the fiscal measures and structural reforms announced to date. In particular, the baseline projections presented below highlight that, were short-term interest rates to increase to the levels that are suggested by the current yield curve (and that could likely be necessary to attain the inflation target without further structural reforms of goods and labor markets and an early fiscal adjustment), the chances of curbing the deficit and public debt to the extent envisaged in the convergence plan and achieving strong economic growth would be remote. An alternative scenario illustrates what could be the path of the economy if further structural reforms and fiscal measures are implemented soon.

This chapter is organized as follows. Section 2 provides an overview of the convergence plan and of recent fiscal measures taken by the authorities. The baseline staff projections and corresponding analysis are presented in section 3, Section 4 discusses an alternative staff scenario, reflecting an illustrative set of fiscal measures and the full implementation of structural reforms. Section 5 summarizes the main points of the study.

2. Main aspects of the new convergence plan and the 1995 budget

Spain's original convergence plan, announced in May 1992, became outdated as a result of the economic slowdown experienced by Spain and most European countries in 1993. 3/ The 1994 convergence plan takes into consideration the setback caused by the recession and sets 1997 targets consistent with the minimum required to fulfill the Maastricht criteria, with most of the adjustment taking place after 1995. The plan projects the

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1/ Prepared by J. Levy.

2/ The Bank of Spain later announced an inflation target for 1997 of no more than 3.0 percent.

3/ The main features of the 1992 convergence plan are presented in SM/92/145 (7/24/92).

general government fiscal deficit falling from 6.7 percent of GDP in 1994 to 5.9 percent in 1995, 4.4 percent in 1996 and 3.0 percent in 1997 (Table 1). 1/ The plan assumes that GDP will grow at a rate of 2.8 percent in 1995 and 3.9 percent a year in 1996-97, supported by low interest rates and wage moderation (Table 2). The plan suggests that this moderation will translate into falling inflation rates and thus help to maintain Spain's external competitiveness. In conjunction with greater flexibility in the labor and goods markets, it will also promote an expansion of employment, which is projected to grow in the range of 1.5-1.9 percent in 1995 and of 2.6-3.3 percent in 1996-97.

Table 1. Convergence Plan, Fiscal Indicators, 1994-97

(In percent of GDP)

	1994	1995	1996	1997
General government overall deficit	6.7	5.9	4.4	3.0
I. Central administrations	5.7	5.1	3.8	2.7
State	5.0	4.6	3.5	2.5
Social security and admin. autonomous agencies	0.7	0.5	0.3	0.2
II. Territorial governments	1.0	0.8	0.6	0.3
Net public debt	60.7	63.9	65.5	65.2
Gross public debt	62.7	65.9	67.5	67.2
Central administration revenues and expenditure				
Memorandum items:				
General government primary deficit	1.1	0.5	-1.0	-2.3
Interest payments	5.6	5.4	5.4	5.3

Source: Convergence plan.

1/ The original plan projected a deficit of 1 percent of GDP for 1996.

Table 2. Convergence Plan, Summary of Macroeconomic Indicators

(In percent changes)

	1994 1/	1995	1996-1997
GDP at constant prices	1.3	2.8	3.9
External balance (contribution to GDP growth)	1,2	0.2	-0.6
Private consumption deflator	4.2	3.8	3.5
Employment	-0.7	1.5-1.9	2.7-3.3 1/

Source: Convergence plan.

1/ Depending on the final impact of labor reform on employment.

The plan comprises a set of proposals for structural reforms, general principles for expenditure moderation and projections of fiscal revenues (Table 3). Those measures are only outlined in the plan; some have been the subject of specific legislation or were incorporated in the 1995 budget, but others were neither detailed, nor given a schedule to be implemented. Structural reforms are aimed at complementing those already adopted subsequent to the 1992 convergence plan, such as modification of unemployment benefits, the creation of private employment agencies, and the announcement of a calendar for the liberalization of telecommunications. The expenditure measures outlined include savings through better allocation of public resources; a wage agreement with public servants' unions; 1/ the agreement with territorial authorities covering the financing of public health care; and the enforcement of previous measures in the area of social security and unemployment benefits. 2/ Among the fiscal goals, the increase in fiscal revenues is expected to be achieved not by higher nominal tax rates, but by economic growth and improvements in tax collection. 3/

The convergence plan notes the importance of fiscal consolidation for attaining low interest rates and the importance of the latter not only to economic activity, but for decreasing the burden of servicing the public debt. However, the path to financial consolidation embodied in the plan is very gradual. The first year reduction in the primary structural deficit is of only 0.2 percent of GDP, and no further consolidation measures, except for unidentified cuts on expenditure have been announced.

1/ The main measures to curb expenditure are: (i) the filling of no more than 50 percent of the vacancies in the public service; (ii) the reform of procurement procedures; (iii) increased cost recovery of public services; (iv) a reduction of employees in the central administrations (i.e., the central government and the part of social security under its responsibility) commensurate with the transfers of services to regional authorities; and (v) the consolidation of public enterprises. The agreement with public service unions for the 1995-97 period establishes wage increases in line with targeted inflation, to be supplemented only if inflation exceeds the official target by more than one percentage point, the fiscal and growth targets are met, and certain other conditions hold. This agreement follows two years of real wage reductions totaling 4.1 percent (in 1993-94) and three previous years of real wage increases totaling 10.9 percent (in 1990-92); it has been extended to employees of territorial authorities and includes the public health sector.

2/ The reforms pursued by the social security system since 1992 cover measures in the health sector, such as a cap on the amount of medicines prescribed per doctor and health center, an agreement with the pharmaceutical industry reducing the margin on pharmaceutical products by 3 percent and transferring old-age patients from acute-care hospitals to nursing homes. The 1995 budget law changed the eligibility criteria and the period of entitlement to temporary disability pensions with immediate savings. The agreement with regional governments limits the increase in health-care expenditure to the rate of growth of GDP. Unemployment benefits were changed in 1993, leading to a tightening of eligibility criteria and the taxation of those benefits.

3/ The authorities expect revenues to grow faster than output in part because of the "global progressivity" of the tax system, which implies that even with tax brackets adjusted for inflation, economic growth will shift taxpayers towards higher tax brackets.

Table 3. Central Administration Revenues and Expenditure

(In billion of pesetas)

	1995	1996	1997
Revenues	23,215	25,184	27,485
(percentage change at constant prices)	2.6	4.8	5.4
Expenditure	26,645	27,917	29,576
(percentage change at constant prices)	-1.1	1.2	2.4
Memorandum item:			
CPI index			
(percentage change)	3.8	3.5	3.5

Source: Convergence plan.

Although aiming at only a modest deficit reduction, the 1995 budget includes attempts to strengthen the fiscal strategy by establishing periodic monitoring of expenditure under the responsibility of the social security and ministries (in some cases monthly). The government has also announced that any slippage would be corrected as soon as it is identified. The willingness to meet the 1995 targets was recently illustrated by the swift announcement of additional (but unspecified) cuts in general expenditure as a response to higher interest payments, following the increase in the interest rates by the Bank of Spain in the first days of 1995.

3. The baseline scenario

The baseline scenario attempts to assess the path of the economy taking into account the measures already enacted or announced. It includes projections of the main aggregates of the economy and the fiscal outcome, based on the assumptions presented below.

a. Assumptions and the macro scenario

On the fiscal side, the baseline scenario incorporates the measures in the 1995 budget and recent changes in social security benefits. 1/ The scenario also reflects the impact of the several forms of financial support provided by the Government to public enterprises, which are projected to total Ptas 1.2 trillion in 1995. 2/ The effects of several measures outlined in the convergence plan, however, were not incorporated because, for a variety of reasons, they are still very difficult to assess. For instance, authorities have not published a list of the areas in the public sector where vacancies will be only partially filled, and there is no agreement with the unions on the issue; specific cost recovery measures, e.g., user fees for medical services, were also not announced; and it is still very difficult to estimate the effects of the administrative measures that have been taken to improve tax collection. 3/ For the 1996-99 period, the scenario uses the standard assumption that, except where other

1/ Among them, a once-for-all decrease in purchases of goods envisaged in the 1995 budget (e.g., the reduction of Ptas 0.09 trillion on pharmaceuticals); the expected reduction of unemployment benefits and temporary disability pensions, due to more stringent eligibility requirements, the mentioned partial forward indexation of public service wages, and the full indexation of pensions in the next three years.

2/ Public subsidies increased by 23 percent in 1993, seemingly for cyclical reasons, but were roughly stable in 1994 and are expected to remain so in 1995. Budgetary transfers to public enterprises amounted to Ptas 710 billion in 1994 and are scheduled to reach Ptas 772 billion in 1995. In 1995, the Government will become responsible for Ptas 90 billion of debts of the Public TV, Ptas 53 billion of debt of CSI steel company and Ptas 218 billion of the state-owned holding company INI. In addition, the Government will increase its participation in the capital of state enterprises by about Ptas 63 billion.

3/ Cross-checking information from outside sources was first allowed in the 1991 Income Tax Law. Last year, the Revenue Agency found irregularities in about 400,000 tax declarations and billed contributors for a total amount of Ptas 20 billion (0.03 percent of GDP). Several other proposals have been discussed, including the requirement of accounting firms to report their clients' balance sheet to the Revenue Agency, but definite measures are yet to be approved.

relevant information is available, general revenues grow in proportion to actual GDP, while expenditures rise in proportion to potential GDP. 1/

Interest payments are projected to account for an increasing share of GDP in coming years because of relatively high deficits and interest rates. Nominal interest rates are assumed to increase, consistent with the current shape of the yield curve. The steepness of the yield curve seems to be associated with concerns over the large fiscal deficit, 2/ doubts about the prospects for convergence and the expectation that monetary policy will need to bear most of the burden of containing inflation in the coming years (in the face of continuing labor and product market rigidities and the slow pace of fiscal consolidation).

Interest payments are projected to rise markedly in 1996. This reflects also portfolio operations undertaken by the Government in 1993-94 and contrasts with the assumption made in the convergence plan that interest payments would remain as a roughly constant proportion of GDP in 1995-97 (Table 1). When interest rates dropped in the second half of 1993, the Government took advantage of those low rates to borrow Ptas 2 trillion (3.3 percent of GDP) in excess of its financing requirements. The excess resources were deposited in the Bank of Spain. During 1994, the Government withdrew most of these resources (Ptas 1.9 trillion as of November) to finance its activities. The immediate effect of these operations was that interest charges as a percent of GDP leveled off in 1994 and will not rise

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1/ In the case of public enterprises, no medium-term program aiming at reducing transfers has been announced, except for the railways (RENFE). This plan specifies that the government will assume the historical debt of RENFE and the responsibility to finance the maintenance of the network of rail tracks and commuting services. This entailed an increase in central government outlays in 1995, because current transfers decrease by Ptas 28 billion (14 percent), but capital transfers increase by Pta 63 billion (107 percent). Savings in the final agreement fell short of those originally envisaged because the trimming of RENFE's labor force was almost halved during the negotiations. More generally, the authorities stated in the convergence plan that there is a relatively narrow margin for continued privatization in Spain, because the public enterprise sector is smaller in Spain than in surrounding countries. Hence, revenues from privatization in 1995 are budgeted at only Ptas 0.3 trillion, coming mainly from the sale of stock of the oil company (REPSOL). This sale, which are originally scheduled to take place in 1994, will probably not take place before the second half of 1995 and, in any case, will depend on stock market conditions.

2/ The October 1994 WEO notes that there are indications that countries with the largest fiscal imbalances were among those that have recently faced the highest increases in interest rates.

significantly in 1995. 1/ In coming years, however, interest payments will increase again, because a significant part of the notes issued in 1993 and early 1994 will mature in 1996-97 and may have to be refinanced at higher interest rates than were available when they were issued (Table 4).

Table 4. Public Debt Profile

Maturity Dates for Medium- and Long-Term Public Debt, as of September 1994

(In billions of pesetas)

	1995	1996	1997	1998	1999	After 1999
3- and 5-year notes		874	2,982	2,280	3,107	312
Long-term debt					52	5,300

Source: Ministry of Economy.

In the baseline scenario, economic growth stabilizes around 3 percent a year in 1995-96 and begins to decelerate by 1997, falling to 2.7 percent by 1999 (Table 5). This slowdown of growth can be attributed to a weakening of investment due to persistent high interest rates and the difficulties of keeping exports growing as capacity constraints in the export sector emerge. The transmission mechanism involves the direct effect of interest rates on the profitability of investment and on private consumption, and the anticipation of the repercussions of the failure to attain nominal convergence with other European countries. The econometric estimation of these effects is very difficult, especially in the case of Spain, whose economy has been subjected to many structural changes in the last 20 years. Therefore, the projections are largely judgmental, although they are not inconsistent with standard models. 2/ In the projections, domestic demand grows on average

1/ The Spanish authorities have estimated the impact of an increase of 1 percent in the discount on Treasury bills on interest payments. Such an increase, if effected early in the year, would add about Ptas 30 billion in interest payments over 1995. The baseline projections reflect the impact of the 1.75 percent increase that has taken effect since December 1994.

2/ A standard equation considering the effects of demand and interest rates on investment indicates that investment would initially grow at rates averaging 5 percent a year, decreasing to around 3.5 percent after 1997; an standard equation for consumption suggests a growth rate for this aggregate around 2.8 percent for the whole period. See SM/91/178, Sup. 1 (9/4/91) for a description of these equations and a model for the Spanish economy.

by 3.0 percent a year in 1995-97; the contribution of the foreign sector is projected to be slightly negative (-0.1 percent), with a small increase in imports. Growth of government consumption and investment are determined by the fiscal accounts and, therefore, are lower than the historical average.

In the projections, the unemployment rate stays above 20 percent. This disappointing result reflects remaining rigidities in labor markets, such as the high dismissal costs and archaic labor regulations. Employment is projected to grow by 2 percent a year in 1995-97, reflecting the relatively low elasticity of employment to growth at these fairly modest rates of growth. The growth of the labor force is also projected to weaken to less than 1 percent a year, as has historically happened during periods of relatively sluggish economic activity. 1/

As discussed in the chapter on the labor market, labor market rigidities--the costliness and difficulty of dismissal, in combination with the dominant system of industry-wide collective bargaining--have tended to make wage demands relatively unresponsive to labor market conditions. Wage negotiations are dominated by the "insiders" who have permanent jobs and strong protection against dismissal, while the employment consequences of excessive wage demands are felt almost entirely by the "outsiders" who either have fixed-term jobs or are unemployed. The moderation of wage settlements in 1993-94 came against a background of sharply rising unemployment, which threatened even the jobs of workers with indefinite contracts, as well as a two-year wage freeze in the public sector. With the economic recovery and the end of the freeze of public servants' wages, the absence of wage pressures cannot be taken for granted (even with the current unemployment rate) if further reduction of labor market rigidities is not achieved. Hence, while, in the projections, inflation continues its downward trend until 1997, in line with the medium-term target recently announced by the Bank of Spain, this reduction takes place in response to a relatively tight monetary policy, which dampens economic growth.

1/ The labor supply in Spain tends to grow slowly when economic activity is depressed; it grew by 1.7 percent a year in the late 1980s, but by only 0.8 percent a year in 1990-93.

Table 5. Spain: Medium-Term Scenarios

(Percent of GDP unless otherwise indicated)

	1993	1994	1995	1996	1997	1998	1999
Reform Scenario							
Real output growth (%)	-1.1	1.9	3.0	4.0	4.0	4.0	3.8
Potential output growth	2.0	2.3	2.3	2.3	2.7	2.8	3.1
Output gap	4.6	5.0	4.3	2.9	1.7	0.5	-0.1
Unemployment rate 1/	22.7	24.2	23.9	22.0	20.6	19.2	18.0
Inflation (CPI)	4.6	4.7	4.1	3.5	3.0	3.0	3.0
Long-term bond yield	10.2	9.8	11.3	9.5	9.0	8.5	8.0
Fiscal balance							
Overall	-7.5	-6.7	-5.9	-3.9	-2.8	-1.9	-1.4
Primary balance	-2.2	-1.4	-0.8	1.9	2.4	3.1	3.5
Interest payments	5.2	5.3	5.1	5.3	5.2	5.0	4.9
Cyclical	-2.7	-2.9	-2.5	-1.6	-0.9	-0.3	0.1
Structural	-4.8	-3.8	-3.5	-2.3	-1.9	-1.7	-1.4
Primary structural	0.5	1.5	1.7	2.9	3.4	3.3	3.4
Outstanding debt	59.9	62.8	64.8	64.4	63.2	61.0	58.5
Status-Quo Scenario							
Real output growth (%)	-1.1	1.9	3.0	3.0	2.9	2.8	2.7
Potential output growth	2.0	2.3	2.3	2.3	2.0	1.7	1.7
Output gap	4.6	5.0	4.3	3.6	2.9	1.8	0.8
Unemployment rate 1/	22.7	24.2	23.9	23.3	22.9	22.3	21.8
Inflation - (CPI in %)	4.6	4.7	4.1	3.5	3.0	3.0	3.0
Long-term bond yield (%)	10.2	9.8	11.3	11.0	11.0	10.9	10.8
Fiscal balance							
Overall	-7.5	-6.7	-5.9	-5.8	-6.0	-6.1	-6.1
Primary balance	-2.2	-1.4	-0.8	-0.3	0.1	0.4	0.7
Interest payments	5.2	5.3	5.1	5.5	6.1	6.5	6.8
Cyclical	-2.7	-2.9	-2.5	-2.1	-1.6	-1.0	-0.4
Structural	-4.8	-3.8	-3.5	-3.8	-4.4	-5.1	-5.7
Primary structural	0.5	1.5	1.7	1.8	1.7	1.4	1.1
Outstanding debt	59.9	62.8	64.8	66.9	69.5	71.7	73.9

Source: Staff estimates.

1/ In percent of the labor force.

Without a relatively well-established relationship between unemployment and the change in inflation, it is impossible to define a nonaccelerating inflation rate of unemployment (NAIRU), and thus it is difficult to measure the output gap. In the baseline scenario, the effective labor force is equivalent to that implied by an unemployment rate of 20 percent; the output gap is gradually reduced because of low investment rates and a sluggish expansion of the effective labor force. 1/

b. The fiscal outcome

The general government deficit fails to significantly decrease after 1995--hovering around 5.9 percent of GDP. The share of GDP corresponding to primary expenditure falls by 0.4 percentage points a year in 1996-99, but the share corresponding to interest payments increases from 5.1 percent in 1995 to 6.0 percent in 1997. Hence, the effects of the measures announced to date barely offset the increase in interest payments in 1996-97, and are far from enough to reduce the total deficit to the levels in the convergence plan. For instance, taking into account the measures in the health sector and those affecting the pension system, the share of health expenditure and social transfers in GDP is stable in 1995-97. This moderation in the growth of social expenditures, however, does not represent a strong enough saving to compensate for the increase in interest payments. Neither are revenue increases projected to contribute significantly to the deficit reduction; in the absence of new measures, revenues would correspond to an almost constant share of GDP. Under the above conditions, the structural deficit is stable until 1996, deteriorating afterwards.

The scenario highlights the fact that, although the fiscal measures already specified by the authorities provide for an stabilization of primary expenditure as a share of output, they do not justify the expectation of a significant increase in fiscal revenues and of a reduction of the overall deficit. Indeed, the increasing weight of the public debt and of uncertainty due to the stronger likelihood that Spain would not achieve the convergence with the rest of Europe, lead to projected interest payments that are increasingly large fractions of output and a failure to significantly reduce the overall fiscal deficit.

4. Alternative scenario

The alternative scenario reflects the staff's judgment that achieving the reduction of the fiscal deficit envisaged in the convergence plan may require further fiscal measures and the continuation of structural reforms. In particular, measures in addition to improvements in tax collection will be necessary to obtain increases in revenues in the magnitude implied in the convergence plan. The path also illustrates the scope for discretionary measures in the area of economic subsidies and the impact of further reforms in the labor and goods markets (such as reductions in dismissal costs,

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1/ The output gap is computed using a Cobb-Douglas function, with the share of labor in output equivalent to 60 percent of GDP.

greater geographical and functional mobility of workers, changes in the wage bargaining process, changes in the land market and opening up municipal and other government monopolies).

a. Selected fiscal measures

Among the measures to strengthen revenues, a reassessment of the tax base of the public health system would be one with the most immediate and large impact. As noted in Chapter I, expenditure on public health care has increased rapidly in recent years and may continue to rise as a share of GDP over the medium term. Currently, public health care is partially funded by social security contributions; transfers and loans from the central government to finance health care and other areas of the social security system are budgeted at 5 percent of GDP in 1995. 1/ Given the social choices implied in the legal principle of tax financing of public health care expenditure existing in Spain, the limited short- and medium-term effect of some ongoing efforts to contain health-care expenditures, and the fiscal consolidation targeted by the Government for the next three years, a new source of revenues to finance part of public health care appears to be needed. Hence, the introduction of a new broadly based tax, with a yield equivalent to 1 percent of GDP, earmarked to finance public health care, is assumed in the alternative scenario.

Concerning expenditure, the reduction of financial support to public enterprises would be of great importance. A gradual, but firm decline in subsidies to state enterprises would not only generate savings amounting to 0.6 percent of GDP in 1996-97, but, because the lower base would generate additional savings in outlying years, it would send an important signal to financial markets.

Tax expenditure could also be reduced, in conjunction with the implementation of structural reforms. The elimination of some tax incentives to new homeowners could bring about 0.15 percent of GDP per year in additional revenues. This amount could be at least doubled by allowing tax incentives for investments introduced in 1993 (seemingly for cyclical reasons) to lapse. The reform of the land market and greater flexibility in the housing markets could, to a large extent, substitute for the current tax relief in terms of facilitating the purchase of new houses by low- and medium-income persons. Similarly, opening new markets to competition could create new investment opportunities, without requiring distortionary tax instruments.

If implemented over the next two years, these measures could improve the primary structural balance by 1.4 percent of GDP in 1996 and by a further 0.5 percent of GDP in 1997. The staff believes that the sooner a set of specific measures is adopted, the greater will be their impact. Of

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1/ Fully funding health expenditure through taxes (hence freeing contributions to fund only wage-related benefits) would require an additional 1 percent of GDP in new resources.

course, it will be difficult to have all of these measures effective in 1995, because the budget has already been approved. However, the alternative scenario presented below incorporates the expected effect on the interest rates and on expectations in general of an earlier discussion and adoption of legislation signaling specific steps toward fiscal consolidation.

b. The macro scenario

Front-loading the fiscal adjustment and deepening of labor market reforms would bring rewards in the form of changed market expectations and lower interest rates, higher economic growth, a stronger increase in tax revenues, and a reduction in interest payments on the public debt.

The assessment of the effects of the fiscal and labor market measures on interest rates calls for considerable judgment. Currently, the peseta-deutsche mark long-term interest premium exceeds 4 percent. In the alternative scenario, it is assumed that, following the reforms described above, this differential will move toward 1-2 percent. This fall is considered to offset the effect on consumption of the reduction of private disposable income implied by the fiscal strengthening, permitting consumption growth to be 1 percentage point stronger than in the baseline scenario, despite the initial contractionary effect of higher taxes. Investment growth is projected to be 4 percentage points stronger, responding to lower interest rates, higher domestic demand growth (4.5 percent a year) and more favorable expectations. 1/ More investment permits higher exports in comparison with the baseline scenario, but the total contribution of the external sector to GDP growth is still negative (-0.4 percent), because of higher imports. Reflecting high domestic demand and a strong export sector, output grows at an average of 4 percent a year in 1996-97 (Table 5).

In the alternative scenario, additional labor market reforms, such as the limitation of the grounds in which dismissals are to be considered unjustifiable and the reduction of the role played by administrative tribunals, as well as the generalization of bargaining at the firm level, would permit to reduce the pressure for wage increases. This is estimated to contribute to a 3.5 percent annual increase in employment and a reduction of unemployment to 18 percent of the labor force (by 1999), and to the achievement of the targeted inflation rate without such a tight monetary policy. Structural reforms, the expansion of the effective labor supply,

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1/ The effects of the assumed decline in interest rates are broadly consistent with the equations mentioned above. The equations yield investment growth rates 3 percentage points higher in the alternative scenario, than in the baseline scenario due to lower real interest rates and higher demand. The consumption equation shows a slow growth in consumption in 1996 (below 2 percent), due to the smaller disposable income, and stronger growth (around 3.5 percent) afterwards.

and higher growth of investment would lead to potential output growth rates near 3 percent a year in the 1996-99 period.

c. Fiscal outcome

Reflecting the adjustment measures discussed, the 1996 overall fiscal deficit is 2 percent of GDP smaller in the alternative scenario than in the baseline scenario. The difference widens further in 1997, because of the step decrease achieved in 1996, the assumed deepening of some of those measures, higher economic growth and lower interest rates. Therefore, in the alternative scenario, nominal convergence is achieved by 1997 with the overall deficit at 2.8 percent of GDP, instead of 5.8 percent of GDP shown in the baseline scenario. Sustained economic growth thereafter helps the overall deficit to decrease in following years and eventually leads to a small cyclical surplus by 1999.

In contrast to the baseline scenario, the alternative scenario exhibits a significant primary surplus in 1996, increasing to above 3 percent by 1999 (in the baseline scenario, the primary balance is negative in 1996 and only marginally positive in 1997-99). In this scenario, interest payments are reduced to less than 5 percent of GDP, due to lower deficits and interest rates. One third of the reduction in interest payments can be attributed to lower interests, the rest reflecting a lower debt due to smaller deficits (Table 6). By 1997, the debt to GDP ratio is still above the Maastricht limit but, as envisaged in the Treaty for the cases of a ratio above 60 percent, it is clearing decreasing after 1996.

Table 6. Medium-Term Scenarios
Difference between Reform and Status Quo Scenarios

(In percent of baseline GDP)

	1996	1997	1998	1999
(Reform - Status Quo)				
Overall fiscal balance	1.9	3.1	4.1	4.6
Primary balance	1.6	2.4	2.8	3.0
Interest payments	-0.2	-0.7	-1.3	-1.6
Due to interest rates	-0.1	-0.3	-0.6	-0.6
Due to different amount of debt 1/	-0.2	-0.4	-0.8	-1.1
Outstanding debt	-1.9	-5.1	-8.8	-12.8
Cumulative GDP growth	1.0	2.1	3.3	4.4

1/ Neglecting the second order effects.

5. Conclusions

The scenarios suggest that the announcement of additional measures in the fiscal and labor market areas would be essential to achieve the goals stated in Spain's 1994 convergence plan. The fiscal measures should include the strengthening of the tax base to finance the public health care system, a cutback in the financial support to public enterprise, and reductions in tax expenditure. Such actions would help to reverse the trend of increasing interest rates, interest payments, and public debt projected for the coming years. The fiscal measures, however, would yield their full benefits only if they are accompanied by the continuation and deepening of the important structural reforms that the Spanish authorities have courageously pursued since the late 1980s. In particular, reforms such as those leading to a reduction in dismissal costs and an increase in labor mobility would be instrumental to increase the effective labor force and to permit the labor market to respond to the lower interest rate brought by a consolidated fiscal position. Fiscal strengthening, accompanied by structural reforms, can lead the Spanish economy to grow at rates near 4 percent a year in the near future, to a significant fall in the unemployment rate, and to the nominal convergence with other European countries.