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contents

A BUDGET THAT FAILS TO INSPIRE CONFIDENCE

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The draft of the National Budget for the year 2005 that the Government has presented does not contain, as had been announced, any change regarding the pattern of growth. Foreign demand hardly gets off the ground, the GDP continues to be cut, and once again this year it is domestic demand, and more specifically private consumption, that drives the economy.

What We Lose with the National Budget 2005

It is not easy to predict 3% growth in GDP as the Government does, and less still when the public's confidence is shaken, since it is basically the general public who are called to sustain the rate of growth throughout the year 2005 with their investment and consumption decisions.

For the last six months the **Socialist Government** has been sending society the wrong messages, ranging from its political manipulation of this year's deficit in order to widen its spending margin, to the **very few economic initiatives it has introduced and which, furthermore, have been counterproductive.** In this respect, we might cite its measure to restrict free trade (See FAES Papers Nº 5), not to mention the constant negative messages it has issued concerning expectations within the property market.

"With the National Budget 2005 we will continue to slip away from the rate of real convergence with Europe, whilst job creation will be hampered. The Socialist Government has cut back on its employment objectives in order to raise apparent productivity by a small margin"

With this National Budget we shall continue to slip away throughout the year 2005 from the rate of real convergence with Europe, whilst job creation will be hampered. **The Socialist Government** has insisted on focusing on its obsession with productivity and, without any justification whatsoever, **has cut back on its employment objectives in order to raise apparent productivity by a small margin**.

It will be very difficult for prices to remain at 2% throughout the year 2005, as predicted in the National Budget. Bearing in mind the current trend in oil prices and the lackluster performance of the Spanish consumer price index compared to the European average, it is not rational to propose an expansive Budget for next year, featuring an increase in expenditure of over 6%.

The political commitments that underlie this excessive expenditure force the Government to make an **incredible revenue forecast of over 8%** in the estimated accounts for the year. In order to predict this level of revenue, it is obliged to describe an **economic climate that is excessively optimistic**.

What the National Budget actually proposes is little and harmful: an increase in some indirect taxes and a decision to partially deflate the rate of personal income tax (IRPF). This measure, which will have an unfavorable effect on the lower income bands, represents a total injection of 170 million euros, a somewhat insignificant amount compared to the 5,000 and 4,000 million euros granted to Spanish families in the income tax reductions of 1999 and 2003.

The National Budget 2005: Neither an Increase in Social Expenditure nor Greater Investment

According to the Government, the spending priorities in this budget are education, pensions, housing, investment in R+D and Innovation, as well as infrastructures. However, a close analysis of the figures reveals that **we are not dealing here with a budget that offers any increase in social expenditure or that promotes greater investment**.

First of all, **it is false to claim that this is the first time that social expenditure has accounted for more than 50% of the spending budget**. This already occurred in the previous budgets presented by the Partido Popular. Whatever the case may be, we must also take into account the fact that important areas of responsibility, such as health, have also been delegated to the Spanish Regional Governments.

Education may be considered a budgetary priority, but this matter lies in the hands of the Regional Governments, which means that the increase only really comes to 90 million euros. **There is an increase in grants of 10%, compared to 9% last year. The number of grants issued between 1996 and 2004 increased by 50%**.

"This Budget is no more socially orientated than the Partido Popular budgets. If we take into account the fact that it creates less employment, it is even less socially orientated. Only unemployment benefits will increase by 14.4%"

Pensions constitute the most important item in the Budget. Pensions will represent almost 80,000 million euros, 10% of GDP. The increase proposed for the year 2005 (6.8%), is lower than last year's increase of 7.1%. And this reduction in the rate of growth translates into a **lower participation of pensions in overall spending, falling from 32% to 31.8%.**

If we look at the figures, then, this Budget is no more socially orientated that the Partido Popular budgets. And if we take into account the fact that it creates less employment, it is even less socially orientated. Only one item of social spending does witness a considerable increase, that of unemployment benefits, which increases by 14.4%.

With regard to R+D and Innovation, if we compare the total investment figures for 2005 with those of 2004, **the increase comes to 16%**. This percentage increase is **largely due to**

an increase in borrowing, a financial instrument that is difficult to handle. **Between 1995 and 2004, investment increased by 400%.** The growth tendency for this kind of investment has, therefore, been broken. We only hope that the system of fiscal incentives for R+D and Innovation, the most generous in the entire OECD, does not witness any setbacks.

With regard to **investment in infrastructures**, the overall increase, what we would call the investment effort, **comes to 5% in this Budget. In 2004 it increased by 10.5%**, and throughout the period in which the Partido Popular governments were at the helm, this kind of investment more than doubled.

"The item that witnesses the strongest increase is that of financial assets, featuring growth of 34.8%. Throughout the last legislature the PSOE wrote this off as a hidden deficit, and yet this year it has increased it by 3,700 million euros, no doubt in honor of the new era of transparency"

With regard to **housing**, **the main effort focuses on facilitating a spending increase**, which in absolute terms comes to **200 million euros** (5 euros per Spaniard). **A large part of this increase will be set aside for the fitting out, maintenance and payments for the new Housing Ministry**. However, the increase in income tax deductions for the purchase of a main home, which last year came to over 3,000 million euros, will rise by only 1.1%.

It is striking that the item that witnesses the strongest increase is Item 8, that of **financial assets**, featuring growth of **34.8%.** This is the item that the PSOE wrote off throughout the whole of the last legislature as a hidden deficit, and yet this year it has increased it by 3,700 million euros, no doubt in honor of the new era of transparency.

The End of the Climate of Confidence by the Economic Agents

This Budget marks the end of a period of controlled public spending, which has enabled Spain, for the first time in its history, to enjoy ongoing and permanent decreases in taxation, as well as focusing the main effort on social expenditure, ensuring the feasibility of the pension system and promoting investment in infrastructures and R+D and Innovation.

"A government that does not believe in the budget's role as an instrument of economic policy cannot present a budget that inspires confidence. And without a climate of confidence, it is not possible to promote economic growth and job creation"

This Budget **also marks the end of a policy based on enhancing expectations and generating a climate of confidence within the economy**. The Government has missed the opportunity, over the last five very important months, to introduce economic measures, and it has also failed its first real test, the presentation of the Budget for the year 2005. The timidity and **lack of initiative of this Government when it comes to matters of economic policy will cost us dear next year**. This Budget, which opts for current spending and greater fiscal burdens, represents a clear renunciation of the objective of full employment. This, on its own, provides sufficient grounds to call it into question. A government that does not believe in the budget's role as an instrument of economic policy cannot present a budget that inspires confidence. And without a climate of confidence, it is not possible to promote economic growth and job creation.

"THE BEAUTIFUL GAME OF THE MACROECONOMIC PICTURE"
Criticisms of the Document Entitled "Presentation of the DraftNational Budget 2005"

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In order to understand the Budget it is essential to study its link with the main macroeconomic magnitudes. Politicians may be tempted to state that, through the Budget, they are capable of ushering in some new economic miracle. And that is how the "beautiful game of the macroeconomic picture" begins.

We can increase GDP, along with consumer spending and exports if we decide that imports, stocks and investment are engineered in such a way that the basic macroeconomic identity is maintained. This is how the politician seeks to offer people all kinds of marvels through the drafting of a National Budget.

"In an economy as open as that of the Spanish economy, strong and prolonged growth must be based on two well-balanced macroeconomic factors: the public sector and the foreign sector"

In this respect, when we are faced with a Draft Budget, it is important to know, not only the amount that the Government aims to spend or receive, but also whether this fits into a particular macroeconomic situation.

Macroeconomic Imbalances and Budgetary Stability

In an economy as open as that of the Spanish economy, strong and prolonged growth must be based on **two well-balanced macroeconomic factors**: **the public sector and the foreign sector**.

In October 2004, experts consulted by The Economist indicated that in 2005 our current account deficit would stand at 3.1% of GDP. If this should be the case, we would only be exceeded by Australia and the United States.

In order to resolve this extremely important problem, the most effective course of action would be that proposed by José Luis Feito: **a restrictive fiscal policy** combined with measures to **make the labor market more flexible and avoid any kind of indexing**[1] . The initial proposal on which the National Budget for 2005 is based[2] does not move in this direction, which is why it is obvious that we must disagree with it.

"The inflation differential and current account imbalance seem to demand, not only budgetary stability, but a budgetary surplus, given that otherwise we will have accepted discretionar y pro-cyclical decisions"

The following case for disagreement relates to **budgetary stability.** The inflation differential and current account imbalance seem to demand not only budgetary stability, but a budgetary surplus, given that otherwise we will have accepted discretionary pro-cyclical decisions.

Upon realizing this, the alarm bells already begin to ring. The document entitled "Presentation of the Draft National Budget", under the heading entitled "Reform of the

Laws on Budgetary Stability" states nothing less than the following: "The Government's aim is to immediately undertake a far-reaching reform of the current legislation concerning stability. The objectives of this reform are to introduce the idea of stability throughout the entire economic cycle in order to enable fiscal policy to serve as a stabilizing factor within the economy, to improve the framework established by the Laws concerning the Territorial Administrations, and enhance the principle of transparency"[3] . This is how a door is left ajar that leads us towards a deficit.

The first and most considerable difficulty is that of deciding whether we are currently experiencing an upward or a downward cycle, not to mention how long it will last, so that revenue and expenditure can be balanced throughout the cycle. What is more, there is always a possibility that the proposed deficits will expand at an accelerated rate, because the public debt that is maintained must be paid for through further public debt, as began to occur in the mid-1990's in Spain, which means that the loss is already assumed.

"The deficit looms large with this proposal of cyclical stability: during periods of depression, spending will shoot up only too easily, but achieving a surplus during periods of prosperity is extremely difficult, as we have recently witnessed in Spain"

It seems quite obvious that the deficit looms large with this proposal of cyclical stability: during periods of depression, spending will shoot up only too easily, but achieving a surplus during periods of prosperity is extremely difficult, as we have recently witnessed in Spain. Furthermore, since we do not know how long these periods will last, this supposed cyclical stability will always tend to generate a deficit.

The Budget also reveals a notable analytical weakness -I would dare say an almost simplistic approach- with regard to the matter of how the Government intends to improve the economic situation: by enhancing productivity. This would be attempted mainly by enhancing competition. And this is where such astonishing claims are made[4] such as the idea that productivity in the trade services sector can be enhanced through greater competition -which is true-, which is why "in the trade distribution sector the foundations have been laid on which to introduce reforms and policies that promote productivity, once the question of trading hours has been settled, eliminating the existing conflicting factors thanks to the creation of an agreed regulatory framework". (See FAES Papers N° 5)

And if we are not already sufficiently astonished at these **measures that eliminate competition and create rigidities within the trade services sector**, which, according to this Budget document -and contrary to everything economic and other empirical studies tell us- will reduce prices and raise productivity, we are served up further surprises in the following lines: "The reform policy must now be based on establishing objective and transparent criteria that ensure the freedom to set up enterprises, whilst also reviewing the legislation concerning sectors which are subject to regulation, such as the distribution of tobacco products or medicines". And, it seems, productivity will also increase simply due to the fact that the Government intends to maintain "its strong commitment to introducing measures aimed at combating the Climate Change and other commitments acquired within the framework of the Kyoto Protocol, such as the recently approved National Plan for the Allocation of Rights to Emit Greenhouse-Effect Gases, not to mention the legislative changes required for setting up a market thereof"[5] .

Let us pass on to the section entitled "Budgetary Policy for the Year 2005". **The forecast deficit in terms of National Accounting comes to 0.4% of GDP**. An obvious complication relating to social expenditure, as correctly highlighted by José Barea, is the fact that "all the Public Administration bodies are faced with the unknown deficit of the Regional Governments relating to health, which logically should be maintained by the Regional Governments themselves through the application of the principle of fiscal co-responsibility established in the new financing scheme for these authorities"[6] .

"Is economic growth, therefore, guaranteed? There is no doubt that, if this is not the case, the figures that are offered in the National Budget for 2005 relating to Government revenue based on 2004 figures, make no sense at all. Even if economic growth is achieved, many of the tax revenue increases are hardly credible"

The figures for 2005 are based on an **increase in tax revenue of 8.7% and social security payments of 9.2%** with regard to 2004. Little is said under the heading of revenue exactly how these percentages are reached, taking into account the increases or decreases that may result with regard to indirect taxes and social security payments as a whole, and why these lead to 9.4% growth in total[7]. Is economic growth, therefore, guaranteed? There is no doubt that, if this is not the case, the figures that are offered in the National Budget for 2005 relating to Government expenditure based on 2004 figures, make no sense at all[8]. Even if economic growth is achieved, many of the tax revenue increases are hardly credible.

The Macroeconomic Picture

This leads us on to the section entitled "Development of the Spanish Economy", which analyzes the macroeconomic situation throughout the years 2003 and 2004 and offers an outlook for the year 2005[9]. The international outlook is not considered to be especially optimistic: "Among the risks and uncertainties concerning the international situation we might highlight those relating to the oil market, in which the increase in demand, combined with numerous problems concerning supply, may lead to price levels that are higher than anticipated"[10]. Furthermore, "the forecast outlook of rising interest rates, which has already begun to take effect in the United States and the United Kingdom, may present a risk for those economies in which family debt levels are high, although this rising price of money is expected to take place gradually, which means that its impact may be absorbed without having any significant effect on economic expansion".

All this has immediate repercussions for our economy. By the second quarter of the year 2004 -the new Government's first term- things had already begun to visibly turn for the worse: "As far as foreign demand is concerned, its net contribution to GDP deteriorated over the second quarter as a result of slower growth under the heading of exports of goods and services and faster growth under the heading of imports. Over the first half of the year, the increase in imports (a corrected figure of 8%) was much higher than the figure recorded for exports (5.1%), due, in part, to the decrease in tourist expenditure. This deterioration in the real balance, combined with the decrease witnessed in the real exchange ratio led to an increased need for foreign financing, which reached a figure of 4.6% of GDP throughout the second quarter"[11]. This same document declares that: "The behavior of consumer prices throughout the Euro Zone was more inflationary than in Spain. The differential in August, 1 point, was 3 tenths higher than in December"[12] . However, the GDP deflator is forecast at 3.2%, compared to 3.4% in the year 2004. This seems quite unreal, and even more so when we take into account what is happening at the present time with oil prices. All this clearly smashes the price and production forecasts made by Daniel Vegara, the Secretary of State for Economic Affairs, in May 2004, which have been stubbornly maintained within the macroeconomic picture, because the current situation, as we have stated, seems to be able to bear anything at present. Of course, this is until, a year later, we are faced with what would seem to be major policy errors[13].

"The oil price and production forecasts have been stubbornly maintained within the macroeconomic picture, because the current situation seems to be able to bear anything at present. Of course, this is until, a year later, we are faced with what would seem to be major policy errors"

The document offers us other worrisome details: "Both the demand for cement as well as employment within the building sector coincide with the Quarterly National Accounts in reflecting a certain slump"[14]. Finally, on 1st September 2004, the total number of individuals paying Social Security came to 17,214,430; on 30th September, the figure came to 17,143,750[15]. At the very least, **we are witnessing a decrease in the rate of employment**. Does all this lead us to predict a GDP featuring a 3% increase in real terms through the year 2005, even accompanied by a clear improvement in the foreign balance? Sometimes we must remember that, without any kind of rigorous explanation, it is possible to simply play "the beautiful game of the macroeconomic picture"[16].

"Flores de Lemus already advised Spanish economists that they should not weigh logs -read macroeconomic figures here- on high-precision scales; that is to say, in the National Budget for 2004, and before Rodríguez Zapatero rose to government, social expenditure already accounted for half of all non-financial expenditure"

Another curious detail: The document boasts of the fact that "for the first time, social spending accounts for over half the budget and presents significant rate increases". The percentage of social expenditure with regard to Central Government's total non-financial expenditure will come to 50.2%. As highlighted by José Barea [17], social expenditure in the Budget for the year 2004, which has still not closed its accounts, came to 49.4% of the total. Flores de Lemus already advised Spanish economists that they should not weigh logs -read macroeconomic figures here- on high-precision scales; that is to say, in the National Budget for 2004, and before Rodríguez Zapatero rose to government, social expenditure already accounted for half of all non-financial expenditure.

By analyzing this document - and we have refrained from including a multitude of other critical observations - we must conclude that embarking, as this **Draft Budget** does, on the **abandonment of credible commitments**, precisely at a moment in which the Nobel Prize is being granted to Kydland and Prescott, **only increases our concern**.

1 See: **José Luis Feito**, La política anticíclica española dentro del euro ("Spanish Anti-Cyclical Policy within the Euro"), Círculo de Empresarios, Madrid, 2002.

2 **Pedro Solbes Mira**, in Presentación del proyecto de Presupuestos Generales del Estado-2005 ("Presentation of the Draft National Budget-2005") (hereinafter Presentación del proyecto, cit.) op. cit., page 5; repeated on page 9.

3 See. Presentación del proyecto, cit., page 10.

4 Presentación del proyecto, cit., page 12.

5 Presentación del proyecto, cit., page 15. On this same page, also under the heading of the Government's plans to ensure "greater competition within the markets of goods and services", in order to "promote productivity" - see these headings on pages 12 and 11, respectively - we find a text that is as full of empty and meaningless expressions as the following: "In the case of water, the replacement of an outdated Hydrological Plan with a new project, which the Government has already initiated, shows that it is feasible to rationalize in order to resolve economic and social problems simultaneously. A more efficient allocation of resources shall be promoted so that the latest technologies can be incorporated, within a framework of social dialogue, and the financial and environmental costs of the water supply may be taken into account". We can only assume that when the economists at the State Department for Taxation and Budgetary Policy, who have proven their economics credentials a thousand times, read this they must have raised their eyes to the ceiling.

6 See **José Barea**, "El Presupuesto 2005 y la estabilidad" ("The Budget 2005 and Stability"), in Cinco Días, 2nd October 2004, Year XXVI, nº 7,440, page 10.

7 Presentación del proyecto, cit., pages 51-52.

8 Presentación del proyecto, cit., pages 106-123.

9 Presentación del proyecto, cit., pages 45.

10 I expounded upon the real consequences of this matter, first of all, in my article entitled "La energía: un problema fundamental para España" ("Energy: A Fundamental Problem for Spain"), in Cuadernos de Pensamiento Político, October-December 2004, nº 4, pages 9-38; see also a commentary to the latest news which expands upon and completes various points in the previous article, in "¿Ante un nuevo choque energético?" ("A New Energy Shock?"), in ABC, 11th October 2004, Year CI, nº 32,453, page 74.

11 Presentación del proyecto, cit., pages 37-38.

12 Presentación del proyecto, cit., pages 42.

13 See the excellent article by **Estela S. Mazo**, "El crudo pone en cuarentena las previsiones del Gobierno" ("Crude Places the Government's Forecasts in Quarantine"), in Expansión, 12th October 2004, Year XIX, nº 5,538, page 21.

14 Presentación del proyecto, cit., page 39.

15 See State Department for Social Security Affairs, "Afiliación a la Seguridad Social. Septiembre 2004" ("Affiliation to the Social Security System: September 2004"), Ministry of Employment and Social Affairs, Madrid, 2004, including the table entitled "Daily Variation of Social Security Affiliation in the Month of September".

16 Governor **Caruana** of the Bank of Spain, in his appearance before the Congreso de los Diputados (Spanish Lower Chamber of Parliament) on 13th October 2004, clearly lowered this increase.

17 See: **José Barea**, "Políticas de gasto y presupuesto 2005" ("Expenditure and Budgetary Policies 2005"), in La Razón.

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