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II. Medium and long-term fiscal policy challenges

Beyond the short term, fiscal policy will face three major challenges. The first challenge will be to preserve the progress made with fiscal consolidation, while at the same time maintaining sufficient flexibility in the new, more decentralised fiscal framework that is in force since 2002-03. The second medium-term challenge relates to raising public sector efficiency further in this new framework. Thirdly, and over the longer term, reforms are needed to prepare Spain for the consequences of population ageing as the viability of the public finances will be threatened by the steep rise in pensions and medical and social expenditure as of 2020-25.

Fiscal policy: being prudent, while ensuring flexibility

A prudent fiscal policy and further structural reforms are necessary in certain areas

A prudent fiscal policy over the medium term is desirable as it would underpin the gains from the structural reforms that are still necessary to achieve real convergence with the most developed countries. To this end, the latest Stability Programme (2002-06) is designed to keep the general government account balanced or to generate a small surplus (Table 9). The Programme is based on projected real GDP growth of 3 per cent per year between 2004 and 2006, which seems realistic and implies a neutral fiscal policy up until 2006. Revenue will remain approximately stable as a proportion of GDP, following the 2003 tax cut, while the share of expenditure will dip marginally as a result of a further reduction in current spending, which will be only partly offset by higher public investment. The Programme, however, rests on the assumption that the inflation differential with the euro area will progressively decline (inflation, measured on the basis of the private consumption deflator, is projected at 2½ per cent between 2004 and 2006). If the differential persists, however, Spain would probably have to contend with lower real interest rates and more relaxed monetary conditions than the rest of the euro area. This could create an unbalanced policy mix. Therefore,

Table 9. **Stability Programme 2002-06**

	Annual average percentage growth					
	2001	2002	Average 2003-06			
Macroeconomic scenario for Spain						
Real GDP	2.7	2.2	3.0			
Private consumption	2.5	1.9	2.9			
Government consumption	3.1	3.0	3.0			
Gross fixed capital formation	3.2	1.7	3.7			
External sector ¹	-0.1	0.0	-0.2			
Private consumption deflator	3.3	3.5	2.7			
Employment	2.4	1.1	1.8			
	Per cent of GDP					
	2001	2002	2003	2004	2005	2006
Government net lending²						
Spain	-0.1	-0.2	0.0	0.0	0.1	0.2
Austria	0.0	0.0	0.0	0.2	0.5	..
Belgium	0.0	0.0	0.0	0.3	0.5	..
Denmark	2.8	2.1	2.2	2.5	2.4	2.2
Finland	4.9	3.8	2.7	2.1	2.6	2.8
France	-1.4	-2.8	-2.6	-2.0	-1.3	-0.5
Germany	-2.8	-3.8	-2.8	-1.5	-1.0	0.0
Greece	-1.2	-1.1	-0.9	-0.4	0.2	0.6
Ireland	1.6	-0.3	-0.7	-1.2	-1.2	-1.2
Italy	-2.2	-2.1	-1.5	-0.6	-0.2	0.1
Luxembourg	4.1	-0.3	-0.3	-0.7	-0.1	..
Netherlands	0.1	0.7	-1.0	-0.7	-0.4	0.1
Portugal	-2.2	-2.8	-2.4	-1.9	-1.1	-0.5
Sweden	4.8	1.7	1.5	1.6	2.0	2.0
United Kingdom	-0.2	-1.8	-2.2	-1.7	-1.6	-1.6
Euro area ³	-1.5	-2.2	-1.7	-1.0	-0.6	0.0

1. Contribution to GDP growth.

2. According to the 2001-05 Stability and Convergence Programmes (SCP) for Austria; 2002-06 SCP for the other countries. Government balances in 2001 exclude one-off proceeds from the sale of UMTS licenses.

3. OECD estimates.

Source: Ministry of Economy, *Stability Programme Update Kingdom of Spain 2002-2006*; European Commission, "Public Finances in EMU – 2002", *European Economy*, No. 3/2002 and Ministry of Finance for the countries publishing their 2002-06 SCP.

further structural reforms in certain areas would be required to reduce nominal wage and price rigidities and remove the inflation differential permanently.

The reform of autonomous communities' finances will increase the regions' responsibilities...

Fiscal consolidation has prompted a change in attitudes, with a large majority of the Spanish population endorsing the goal of balancing the accounts.

Maintaining a balanced budget in the medium term could be, however, made more complicated by decentralisation. The transfer of health service management to regions ended in 2002, so that the decentralisation of the biggest spending items is complete, making Spain one of the most decentralised OECD countries (Table 10). In order to preserve the progress made with fiscal consolidation in the context of a more decentralised state, the authorities recently introduced two major reforms. The first establishes a closer link between responsibility for spending and taxation among the different levels of government. The decentralisation of health spending was accompanied by a reform of the method of financing the regions, which had been in force since 1997. The new system, described in Annex II, increases the communities' financial self-sufficiency and fiscal responsibility. Regional tax receipts are expanded and made more stable, covering 65 per cent of these authorities' resources, as opposed to 29 per cent under the previous system, and are supplemented by unconditional transfers. The tax revenue at the regions' disposal consists of a broad basket of taxes comprising a third of personal income tax, 35 per cent of the value added tax (VAT), and 40 per cent of excise tax

Table 10. Expenditure by level of government
In per cent of total consolidated public expenditure

	Consolidated central government	State, regional or provincial governments	Local governments
Spain (2001) ¹	59.0	27.5	13.5
Spain (2002 estimates)^{1, 2}	52.6	33.9	13.5
Australia (1999)	55.6	38.8	5.6
Austria (1999)	68.9	15.7	15.4
Canada (2000)	41.4	43.0	15.6
Germany (1998)	62.5	23.7	13.9
Switzerland (1999)	52.6	28.0	19.4
United States (1999)	48.5	29.7	21.8
Federal countries	54.9	29.8	15.3
Denmark (2000)	53.6		46.4
Finland (1998)	64.0		36.0
France (1997)	82.5		17.5
Italy (1999)	75.6		24.4
Netherlands ¹ (1997)	78.3		21.7
Norway (1998)	66.2		33.8
Sweden (1999)	64.6		35.4
United Kingdom (1998)	77.9		22.1
Unitarian countries	70.3		29.7

1. Local governments also include provincial ones.

2. The structure of expenditure has been estimated assuming that all health spending managed by the central government, which represented 1.7 per cent of GDP (or about 4¼ per cent of total government expenditure), was transferred to the regions.

Source: IMF, *Government Finance Statistics Yearbook*, 2001 and information provided by the Spanish authorities.

on alcohol, tobacco and fuels, as well as the totality of a number of other taxes collected in the region.²⁷ Moreover, the reform extends appreciably the communities' powers with regard to taxation, particularly income tax, and it abolishes the state guarantee ensuring that growth of their main source of tax revenue is at least equal to that of GDP. In conjunction with these changes, a reform of the system of local authority financing has also been launched with the objective, in particular, of increasing the municipalities' budgetary responsibilities. The former will also have increased powers over their taxation, while large towns will, like the regions, have a proportion of central government taxes transferred to them (Annex II).

... as will the fiscal stability law...

The second important reform is enshrined in the fiscal stability law, which was reviewed in the previous *Survey* (OECD, 2001a) and which came into effect with the 2003 Budget. The law is based on four main principles:

- *Transparency*: comprehensive information will be made available rapidly so as to monitor the financial situation of the different levels of government.
- *Joint financial responsibility*: each level of government will be required to keep its accounts in balance or in surplus. In the event of a deficit, a plan of action aimed at correcting that situation will be presented.
- *Central government expenditure* will be limited by setting a spending ceiling consistent with the medium-term projections and a contingency fund will be established, as was already the case with the 2003 Budget.
- *Fiscal discipline* will be mostly underpinned by monitoring and peer pressure. It will also be guaranteed by the central government's power to impose debt limits on both regional and local authorities should these entities fail to comply with their budgetary stability commitment. It is not, however, planned to impose penalties on authorities that do not comply with fiscal discipline, unless this results in the overall government accounts overshooting the Maastricht deficit limit of 3 per cent of GDP.

... which needs to be implemented flexibly

Coupled with the increased fiscal responsibility of the regions and local authorities, the law should help to maintain fiscal discipline over the medium term. To the extent, however, that the new framework does not take the effect of the economic situation on the budget explicitly into account, it is likely to lack flexibility, especially where regional and local government is concerned. The resources of the communities (and of the big municipalities), which are more dependent on taxes, are now more influenced by the economic situation than they were in the past. However, a large proportion of their expenditure, such as that on health, is not sensitive to the cycle. Strict application of the stability law

would have pro-cyclical effects on activity. Furthermore, it would oblige all the regions to keep their accounts in significant surplus so as to comply with the balanced budget rule in a downturn. To avoid these drawbacks, advantage should be taken of the flexibility built into the law. The deficits need to be corrected only in the medium run, as foreseen in the law, ensuring that fiscal discipline and automatic stabilisers are fully compatible. Moreover, the law explicitly allows the possibility of deficits in “exceptional circumstances”. Alternatively, a change in the rule could be envisaged with the objective of ensuring structural rather than nominal budgetary balance, as was done in Switzerland for example. Nevertheless, the practical difficulty of calculating structural budgets for the different levels of government, including the local level and public companies, should not be underestimated.

Increasing public sector efficiency has to remain a priority

In addition to continuing prudence, another major fiscal policy concern over the medium term will be to improve the quality of public finances from the standpoint of both taxes and expenditure.

Another reform of the personal income tax in 2003

A better tax system would underpin the medium-term strategy of converging with the EU average per capita GDP. An important reform of the personal income tax was introduced in 1999, consisting in a reduction of the tax burden, an extension of the tax base to include all forms of capital revenues and a re-organisation of tax deductions, which were simplified and mostly applied to the tax base rather than as tax rebates. The reform was endorsed in a special chapter of a previous survey (OECD, 2000), although it was also signalled that some areas remained where further improvement is desirable, especially concerning the neutrality of taxation with respect to long-term savings. At the end of 2002, another reform of the personal income tax was approved to be implemented in 2003, including average tax cuts of 11.1 per cent with a budgetary cost of EUR 3.6 billion (0.5 per cent of GDP). In particular, the number of tax brackets was reduced from 6 to 5, and the top and bottom marginal rates have been brought down from 48 to 45 per cent and from 18 to 15 per cent, respectively.²⁸ The reform also includes increased family allowances and their extension to new family circumstances, while new work-related deductions aim at improving the supply of labour of older workers, working mothers of young children and unemployed workers, who accept a job in a different province.

Concerning the taxation of income from savings, the basic structure of tax allowances has not been changed although some aspects have been modified. The fixed rate for capital gains has been reduced (from 18 to 15 per cent), while the deduction for income on capital held for more than two years has been raised

(from 30 to 40 per cent). Capital gains generated in mutual funds will be exempted from the tax when they are re-invested in other funds, in order to raise capital mobility across funds and thus improve competition in the sector.²⁹ The ceiling of tax-exempted contributions to private pension funds has been increased, and will be extended to new types of schemes. To favour the market for rental housing, the reform introduces a reduction of 50 per cent of net rental income for owners who offer residential dwellings for rent, plus deductions of all types of expenses, which in practice will imply a tax rate close to zero for rental income.³⁰ The reform also modifies the special regime for small self-employed and unincorporated businesses, which is based on special parameters for these businesses instead of income measured by proper accounting of their profits. A new threshold defined in terms of purchases (fixed to a maximum of EUR 300 000), which should be easier to control, has been set up for the small enterprises to benefit from this tax regime. Also, it is now required that activities are carried out in the territorial scope of the personal income tax.³¹

The reform will result in a further reduction of the tax burden, which will have a positive impact on the supply of labour and investment (Annex III). Incentives to work will be further enhanced by the specific deductions for older workers and mothers of young children, which should improve participation in the labour market of these two groups with lower than average employment ratios. The mobility incentive for unemployed workers should also help to reduce structural unemployment marginally. Tax brackets and many tax allowances and limits are not indexed, but the reform more than compensates for the lack of inflation adjustment in recent years.³² In order to make the tax system more transparent, a more systematic inflation adjustment of tax brackets and allowances could be advisable, though this should be done in the context of comprehensive tax structure decisions. The new conditions on the application of the special regime for self-employed income is welcome, as it will help to limit tax fraud, but it would be better to completely phase out the special regime, which would improve horizontal equity.

With respect to taxation of savings, progress towards greater neutrality is limited, and the tax system continues to favour savings in the form of pension funds, insurance contracts and housing purchases (OECD, 2000). Though the first may raise incentives to contribute to complementary private pension funds, the latter two are more difficult to justify. In particular, tax credits (which amounted to 0.5 per cent of GDP over the last years) benefit all tax payers when buying their main residence independently from their income level, with uncertain distributional outcomes even though the ceiling of this deduction has been kept unchanged since 1998. Neutral taxation of housing relative to other forms of savings would require imputing rents for home ownership and taxing capital gains from home sales in line with other forms of savings after deducting mortgage interest payments (OECD, 2001b). In 1999, taxation of imputed income of the main

home was suppressed for the sake of simplicity, since such income was difficult to estimate, but interest deductibility was maintained. When imputed rents are not taxed, suppressing mortgage interest deductibility would go in the direction of more neutrality, and would also help to re-direct housing demand to the rental market. This would be less costly than the granting of the new deduction for rental housing included in the recent reform; if problems concerning the supply of rental housing are detected (such as slow procedures to recover unpaid rents), the root of this problem should be addressed.

The rationalisation of the local tax system has also progressed

A rationalisation of certain aspects of local taxation has also been recently adopted. The reform includes the abolition of the tax on business activities (IAE) for about 95 per cent of taxpayers. This tax affects now only companies with a net turnover over EUR 1 million without taking account of their income or wealth and undermines horizontal equity and incentives to recruit and invest. The reform will ensure that local authorities continue to have sufficient resources, while at the same time removing some major distortions (Annex II). However, it is unlikely to reduce the dependency of municipal resources on real estate taxes, which appears excessive in the case of Spain. Two-thirds of local taxes (or a quarter of all non-financial resources) are property taxes which municipalities tend to increase with rising house prices using restrictive practices as regards the supply of building land (Chapter III). User fees or charges are, on the other hand, less utilised than in other countries (Table 11). More frequent recourse to this type of revenue

Table 11. **Local government revenue in OECD countries with federal structure**
In per cent of total revenue

	Tax revenue	Non tax revenue		Transfers
		Total	<i>of which:</i> Fees, sales, fines	
Spain (1997)	50.4	16.2	7.7	33.4
Australia (1998)	45.2	38.5	24.2	16.3
Austria (1999)	56.7	25.0	21.0	18.3
Belgium (1998)	37.9	9.1	..	53.0
Canada (2000)	41.7	17.3	13.7	41.0
Germany (1999)	41.0	24.7	14.2	34.3
Mexico (1998)	68.0	19.9	9.2	12.1
Switzerland (1999)	47.9	34.7	26.6	17.4
United States (1999)	38.7	22.9	11.8	38.4
Non-weighted average (excl. Spain)	47.1	24.0	17.2	28.9

Source: OECD, *Revenue Statistics 1965-2001*, 2002 ed.

would be a good way of financing local services, including those relating to environmental concerns (for instance, for water or waste management), a source of revenue that is likely to increase in the future. Greater use might be made of this type of revenue³³ if there was a better understanding of the costs of the services and of the externalities to be taken into account. This could be fostered by technical assistance of the central government to the many very small municipalities.

The tax to GDP ratio is well below the EU average

Following the past reforms, in particular the 1999 reform of the personal income tax, the tax to GDP ratio is considerably below the EU average (Table 12), and it will be reduced further by the recent reform. As a proportion of GDP, Spain has lower income tax revenue than most OECD countries, but indirect taxes and social security contributions are above the OECD (but below the EU) average. Future tax cuts should contribute to reduce distortions concerning labour market and savings behaviour, but must be balanced against the need for improving public infrastructure, R&D investment and human capital formation, where Spain lags

Table 12. Tax revenues in OECD countries
In per cent of GDP, 2001

	Indirect taxes	Taxes on individuals	Corporate taxes	Social security contributions	Total taxes
Spain	11.4	7.4	3.1	13.6	35.4
Austria	14.7	11.8	3.3	17.0	46.8
Belgium	12.6	14.1	3.5	15.3	45.5
Denmark	17.3	27.4	2.5	3.2	50.4
Finland	13.2	14.9	4.6	12.5	45.2
France	15.1	9.3	3.3	18.3	46.0
Germany	11.9	10.4	0.6	18.5	41.5
Greece	14.4	5.8	4.3	13.5	37.9
Ireland	12.2	9.1	3.8	5.7	30.8
Italy	14.6	11.9	3.3	12.7	42.4
Netherlands	12.6	7.6	4.2	15.3	39.9
Portugal	14.4	5.4	4.4	12.0	36.2
Sweden	16.4	18.2	4.1	15.5	54.1
United Kingdom	13.6	13.2	3.6	7.6	38.0
European Union ¹	13.5	11.0	2.8	14.5	41.8
Australia	13.7	12.1	4.4	0.0	30.2
Canada	12.8	13.2	3.9	5.0	34.9
Japan	8.5	5.8	3.4	10.7	28.3
United States	7.7	12.8	2.0	7.2	29.7
OECD ¹	10.6	10.4	2.9	9.9	33.8

1. Weighted average using 1995 GDP weights expressed in 1995 purchasing power parities.

Source: OECD.

behind other countries (Chapter III). Changing the tax mix is another option, but trade-offs need to be assessed. For instance, lowering social security contributions in a revenue-neutral manner would benefit employment creation, but would further damage the long-term sustainability of the pension system. Raising indirect, while lowering corporate taxes, could have positive effects on business and the environment, but would also have negative short-term inflationary consequences.

Following decentralisation, the authority should reassess their mode of action in several areas

Efforts aimed at improving expenditure efficiency need to continue. The authorities, aware of this need, have increased capital spending over the last years in a context of fiscal consolidation mainly based on expenditure restraint. The decentralisation to the regions also has the potential to improve the management of public finances. The communities' increased financial dependence on the taxes raised on their territory, plus their increased powers, should prompt the autonomous communities to look for tax and spending levels and structures that underpin their region's activity and respect local preferences. Being less dependent on transfers will no doubt also reduce the risk of fiscal illusion and resource wastage.

In general however, this decentralisation also implies that the authorities should reassess their mode of action in several areas. This is the case, for example, in the health sector. The main role of central government now is to co-ordinate the different regional health systems in such a way as to guarantee equality of access to good basic medical care throughout the country. It is important, however, that this co-ordination, the details of which were spelled out in a draft bill (*Ley de Cohesión y Calidad Sanitaria*, LCC) at end-2002, is organised in such a way as to exploit the opportunities that decentralisation provides to stimulate the regions' efforts to improve efficiency.

The effectiveness of spending would benefit from a greater use of benchmarking...

Efficiency gains can be encouraged by regularly publishing performance indicators for the different regions. The existence of reliable and homogeneous indicators comparing the quality of financial management and the provision of regional public services would make it easier to assess the communities' performance and act as an incentive to adopt better practices.³⁴ For this to happen, decentralisation must be accompanied by improvements in regional and national statistical information, not the loss or segmentation thereof. In this context, the Health Ministry decision to set up a Health Information Institute enabling all the communities to access information on the National Health System, such as on hospital waiting lists, is very welcome.

... and management based on output and from enhanced co-ordination between regions

The reform of autonomous community financing adopted with the decentralisation of health spending, which is fairly complex, is designed to achieve a balance between reinforcing budgetary responsibilities and maintaining solidarity between communities. Greater co-ordination between central government and the regions is however needed to reduce duplication. Such a duplication is no doubt the cause of the increase in total public employment despite the rule (just terminated) stipulating that, at every level of government, only one in every four civil servants retiring should be replaced. Also, some of the characteristics of the reform could have the effect of restricting the expected benefits. The minimum expenditure obligation concerning health limited to the first three years, for example, is liable to curb the regions' efforts to be efficient. It would be preferable to monitor the homogeneity of regional service supply on the basis of indicators concerning outputs, or even outcomes, rather than input criteria. Also, renewed efforts are probably needed to step up co-ordination between the communities in a number of sectors such as health, education and taxation. The experience gained by other federal countries, such as Switzerland, demonstrates the importance of this sort of co-ordination in taking more fully into account the effects of economies of scale and spillovers that a decentralised supply of services such as hospitals, universities or employment services does not provide (OECD, 2002a). Taking insufficient account of such spillovers tends to result in sub-optimal supply, which can, for example, generate an excessive number of universities (Chapter III), an inadequate matching between labour supply and demand and long waiting lists in certain hospitals. In this regard, the introduction of compensatory financial transfers in the event of one region's hospital services being used by the inhabitants of another region in specific services, as well as the Health Cohesion Fund, will contribute to a more efficient utilisation of this infrastructure.

Provision of health care and control over pharmaceutical spending should be more efficient

Overall, public spending on health, which is financed by taxation and amounted to 5½ per cent of GDP in 2000, has been effectively contained over the past few years (Table 13). However, substantial upward pressures persist on demand for health care. Evidence is provided by the fact that public consumption of drugs has been rising steeply for more than ten years and accounts for a larger proportion of the health budget than in other countries. This restricts the resources available for ambulatory, hospital and preventive care. Different measures have been adopted over the last years to curb the consumption of pharmaceuticals. It remains however vital to increase the efficiency of public health care provision and to exercise tighter control over consumption of

Table 13. Evolution of health expenditure

	Spain			United States			Japan			EU average		
	Change over period ¹		Level 2000 ²	Change over period ¹		Level 2000 ²	Change over period ¹		Level 2000 ²	Change over period ¹		Level 2000 ²
	1990-95	1995-00		1990-95	1995-00		1990-95	1995-00		1990-95	1995-00	
In % of GDP	1.1	-0.1	7.7	1.4	-0.2	13.0	1.1	0.8	7.7	0.7	0.0	8.1
Private expenditure on health	0.8	0.1	2.3	0.1	0.0	7.2	0.2	0.3	1.8	0.4	0.1	2.2
Public expenditure on health	0.2	-0.1	5.4	1.3	-0.2	5.7	0.9	0.5	5.9	0.3	-0.1	5.9
<i>of which:</i>												
In % of public expenditure on health												
Investment	-1.6	0.2	3.2	-0.1	-0.2	0.8	1.0	-2.4	3.0	-0.7	-0.2	3.1
Current expenditure	1.6	-0.2	96.8	0.1	0.2	99.2	-1.0	2.4	97.0	1.6	0.3	96.9
<i>of which:</i>												
Pharmaceutical and other medical goods ³	2.5	2.7	22.3	0.5	1.9	5.9	1.2	-4.6	13.5	0.8	0.3	13.9
In-patient care ⁴	2.2	-1.6	55.4	-2.6	-3.9	53.0	-4.5	9.1	44.1	0.0	3.9	55.3
Out-patient care ⁵	-1.8	-1.0	15.6	2.0	1.0	27.1	-2.7	-9.5	35.5	-1.1	1.3	25.4
Prevention and public health	-0.3	0.2	1.0	-0.5	0.7	8.5	1.8	-0.4	0.5	2.1
Other	-1.0	-3.0	2.3	0.7	0.4	4.7	2.1	2.3	-5.7	0.2

1. Changes expressed in percentage points.

2. Or latest available data.

3. Including therapeutic appliances.

4. Including expenditure on ancillary services (clinical laboratory, diagnostic imaging, transport and emergency rescue).

5. Including expenditure on home health care services.

Source: OECD Health Data, 2002.

pharmaceuticals in order to avoid pressures on demand for medical spending to weigh on the communities' budgets or to lead to a deterioration in the quality of health care provision.

Improvements are still needed in hospital management. Few hospitals have taken advantage of the possibility they have had since 1999 of opting for public foundation status, with greater administrative autonomy and the possibility of recruiting staff on more flexible contracts. Only newly created establishments have opted for this more flexible legal framework, while converting existing hospitals has proved difficult, principally because of the obstacles deriving from the status of serving staff.³⁵ Yet the lack of any link between the remuneration and the performance of such staff, who enjoy job security thanks to the civil servant status, does undermine hospitals' efficiency. Moreover, the latter also suffer from a lack of flexibility in the management of their resources and insufficient information about their costs (Monge, 2002). This leads to wastage, such as the overbilling of hospitals' spending on drugs, which was uncovered by the Court of Auditors in 2001.³⁶ Steps also need to be taken to ensure better co-ordination between hospital and ambulatory care. An example of this lack of co-ordination is the handling of hospital emergencies, a very large proportion of which requires care that is neither really urgent nor specialised. Apparently, patients prefer to visit a hospital, and sometimes wait for a long time, rather than consulting their own doctor because in this way they can choose when to go and, above all, they avoid having to come back for more analyses. This situation shows that primary care provision is not properly tailored to user needs. If doctors in primary care centres were properly organised, they would be better placed than hospitals to meet these needs, bearing in mind their comparative advantage in keeping medical track of patients. What happens in practice is that doctors providing basic care, whose resources have been hardest hit by the budgetary restrictions – perhaps undermining their motivation³⁷ – tend to focus primarily on monitoring patients suffering from chronic complaints and on prescriptions, the amount of which perhaps makes up for shorter consultations.

Public spending on prescription drugs is continuing to increase rapidly, despite efforts to restrain growth. The rise in spending, which exceeded 10 per cent per year between 1991 and 1999, did however fall to some 7¼ per cent in 2000-01 as a result of a series of measures which included incentives to prescribe generic medicines, the introduction of a system of reference prices, cuts in the prices of certain products and a squeeze on distributors' profit margins on reimbursable drugs. Though these results were encouraging and did result in more widespread use of generic products, they may not last because of the temporary effect of some of the measures adopted.³⁸ Indeed, growth of spending on prescription drugs accelerated in 2002 and reached almost 10 per cent despite the implementation of an agreement for the period 2002-04 between the authorities and the various players that influence drug consumption. This agreement sharply

increases the part that the pharmaceutical industry and distributors play in financing public expenditure on research, and it includes a mechanism for increasing the level of financing if consumption of medication grows at an excessive rate. This mechanism will raise the contribution of the pharmaceutical industry to public research by EUR 112 million, equivalent to 1.4 per cent of public drug consumption in 2002. Such an increase does not appear to be much of a deterrent, however, for a sector accustomed to spending large amounts on research, and the authorities have announced that they intend to modify this agreement. The agreement with the pharmaceutical industry also encourages the use of reference prices and generic medicines, which are not as yet very widespread, compared to other OECD countries. In addition, the authorities have recently decided to review antibiotic medicine packaging in order to reduce waste and to limit the pressure of the pharmaceutical industry on doctors' prescriptions. These positive changes could be supplemented by additional measures. One interesting route, for example, would be to give pharmacists freedom of substitution between generic and non-generic products and to encourage doctors to prescribe on the basis of active ingredients instead of brand names. In addition, pharmacists' remuneration could also depend partly on services rendered to customers on a fixed basis, instead of always being proportionate to expenditure, as in other OECD countries. Lastly, as previous surveys have suggested, cost/benefit analysis of new medicines should be improved before they are made refundable. Moreover, the practice of providing drugs free for retired people, which has often been abused, could be replaced by a means-tested system of patients' co-payments, which would also help to curb consumption of drugs.

The consequences of ageing: pension reform is more urgent than generally perceived

The previous *Survey* showed that population ageing was posing a serious problem as regards the long-term viability of public finances. The recent growth of immigration, as revealed by the latest population census, will, even if it continues, have only a limited and doubtless temporary effect on the budgetary consequences of ageing (Chapter IV). In the light of the latest demographic projections published by the National Institute of Statistics (INE), the increase in public expenditure on pensions might amount to about 6 per cent of GDP by 2050, compared with 3 to 4 per cent in other OECD countries. Furthermore, labour force growth due to increased immigration might aggravate the problem of financial viability beyond the 2050 horizon. The present pension system is not actuarially neutral, with the result that pensioners on average receive more than they have contributed on a discounted basis.

The recent efforts of the authorities with regard to pension reform have focused mainly on improving incentives for older persons to continue working, in

line with the agreement signed by the social partners in March 2001. Moreover, since January 2002, the possibilities of phased and flexible retirement have been expanded. Older workers are now entitled to draw a (smaller) pension while remaining in employment on a part-time basis, and persons continuing to work after reaching the age of 65 are exempted from social security contributions and are able to build up their pension entitlement even if they have already contributed for 35 years. Partial exemption of social contributions is also granted to workers over 60 years old with an indefinite contract and a minimum experience of five years within the firm. The possibilities of combining severance pay with unemployment benefit, often used by firms proposing early retirement schemes, have been reduced. These measures, which *a priori* increase the financial sustainability of the pension system, have been accompanied by appreciable increases in minimum and survivors' pensions³⁹ and new fiscal incentives for private pension plans. On the other hand, maintenance of a prudent fiscal policy over the recent period has made it possible to increase the social security reserve fund to 1 per cent of GDP as of 2003, a year earlier than expected, and to reduce the public debt.

To ensure the long-term sustainability of the pension system, more far-reaching measures are needed. The authorities have accordingly drawn up a strategy for meeting the challenges posed by the ageing process. They propose to separate medium-term budget policy from the long-term financial problem of ageing. Although the importance of a prudent fiscal policy is recognised, a wide range of measures in the context of a multidimensional strategy is judged to be necessary (Ministry of Economy, 2001). Apart from balancing the budget that will allow a progressive reduction of the debt ratio, this strategy aims at improving the labour market performance by fostering participation rates and reducing early retirement incentives. In addition, a progressive consensual approach to pension reform is promoted through the process initiated with the Toledo Pact, which provides for regular reviews of the situation. In that context, discussions should recommence in 2003. Generally, however, the official analysis by the Ministry for Social Affairs stresses the present financial ease of the pension system and the absence of upward pressure on expenditure until 2015. The uncertainties inherent in the projections beyond 2015 are also stressed, thus downplaying the urgency of reform (Ministry of Labour and Social Affairs, 2002).⁴⁰

The authorities' aim of building a consensus on pension reform is commendable. But it necessitates the issuing of adequate information on the consequences of ageing. In this regard, analyses bearing on the period beyond 2015-20, *i.e.* when the impact of ageing will be felt, is useful. The findings of the numerous studies already carried out are clear and convergent, even though uncertainties exist and there is a need for regular updates.⁴¹ Spain will experience a demographic shock later but more severely than most other OECD countries. And the key parameters of the national pension system are more generous in Spain than in most OECD countries. The projections on which this assessment is based

necessarily extend quite far into the future and are therefore uncertain, like those for all other countries.⁴²

In the light of the analyses available, calls for an ambitious and speedy reform of the pension system appear justified. Essentially this involves a revision of the pension system's parameters so as to make it actuarially neutral and to slow the growth of pension expenditure as from 2015-20.⁴³ A reform of this kind, needs to be anticipated and phased in.⁴⁴ A first significant step towards bringing the method of pension calculation into line with the one applying in most other OECD countries would be to base the pension on the worker's entire career instead of the last 15 years, as is the case at present. The possibility of phasing in such a measure could be discussed during the negotiations scheduled for 2003. The reform, which would reduce the pension income disparities generated by the present system (Jimeno, 2002a), would not affect current pension levels but would slow the growth of future pensioners' incomes. This type of reform is not incompatible with measures to protect the elderly against the risks of poverty to which some of them are still exposed, notably elderly women because of their low labour market participation.

Notes

1. As in the rest of the euro area, the introduction of the fiduciary euro resulted in a fall in demand for notes during the course of 2001, households being compelled to clear their cash reserves. That saving, put at 2½ per cent of GDP by the BBVA (2002a), seems to have been partly spent on consumer durables and housing in late 2001. This may have stimulated consumption by between ¼ and ½ percentage point in 2001, which would partly explain why it grew more slowly in early 2002 (Laborda, 2002).
2. According to Farré and Raymond (2002), the wealth effect on household behaviour is significant and of the same order of magnitude in Spain as in the other main OECD countries: a rise in total wealth by one euro results in a fall in the saving ratio by nearly 4 cents. These authors claim that the bulk of the reduction (by 4 percentage points) in the household saving ratio between 1995 and 2000 was due to the increase in wealth (over 40 per cent in real terms), itself stemming from the rise in the relative prices of financial assets and real estate. Since 2000, the continuing rise in house prices has offset the stock market fall.
3. The number of dwellings has increased on average by nearly 500 000 over the last four years, whereas the number of new households has risen by only 200 000 (Bank of Spain, 2002a).
4. According to Tinsa Real Estate Appraisals, approximately one-third of real estate purchases in autumn 2002 were for investment purposes. This investment, which takes the form of purchases of second homes or of property for children, is one of households' favourite ways of saving to protect themselves against the risk of inflation.
5. The proportion of households with both members working rose between 1992 and 2000 by 12 percentage points to 43 per cent, though this remains well below the European average (60 per cent). Measured against household income, the effort required to finance an average mortgage loan remains fairly moderate from an historical point of view, despite the recent rise in real estate prices (Bank of Spain, 2002a). A discussion of the risks of a speculative bubble is also provided by Balmaseda *et al.* (2002).
6. In the Balearic Islands, moreover, the introduction of a special green tax on tourism may have had an effect.
7. Prices of hotel and tourism services have climbed by an annual average of 9½ per cent since 1997, which is 6½ per cent more than in France and 4½ per cent more than in Italy.
8. For example, lower wage costs in countries such as the Slovak Republic prompted the car manufacturer Seat to transfer part of its production to that country during autumn 2002. According to Muñoz (2002a), foreign firms have been cutting back on their net investment in the industrial sector in Spain, though not in services. This

author argues, however, that this process has more to do with the restructuring by multinationals throughout Europe than with Spain losing its comparative advantage in terms of wage costs.

9. Temporary employment accounted for only 13.2 per cent of total employment in the EU in 2001. The reduced use made of temporary contracts in the private sector in Spain was partly offset by an increase in the public sector.
10. The capital-labour ratio has fallen in recent years and the share of salaries in value added, which went from 52.2 per cent in 1993 to 49.8 per cent in 1996, rose slightly to 50.1 per cent in 2001.
11. At end-2003, the National Statistical Institute (INE) will present the revised ESA 95 national accounts figures, calculated for the base year 2000. There are a number of indicators, such as the buoyancy of tax receipts and the steeper-than-expected population rise (revealed by the 2001 census) resulting from increased immigration, which suggest that GDP might be revised upwards.
12. Between 1995 and 1999 (the period for which detailed data are available), 70 per cent of jobs (measured in full-time equivalent) were created in sectors where productivity was lower than the national average. Over 50 per cent of jobs were created in sectors where apparent labour productivity was less than 75 per cent of the national average. See also Estrada and López-Salido (2001) on this subject.
13. According to a study carried out by the Bank of Spain (Estrada *et al.*, 2001a) for the period 1996-99, nearly three-quarters of Spain's productivity gap with the EU is due to a different production structure, whereas only a quarter of the gap derives from a lower level of sectoral productivity.
14. The statistical changes that the INE introduced in the labour force survey with effect from the first quarter of 2002 brought some major revisions in labour market statistics. As reported in the previous survey (OECD, 2001a), there have been three main changes: *i*) a revision of the labour force to take account of new immigration figures; *ii*) an adjustment in the system of reweighting the sample deriving from the labour force survey; *iii*) the way unemployment is calculated has been made consistent with Eurostat norms. For 2001, these changes meant revising employment upwards by 8 per cent and the labour force by 5 per cent, while the unemployment rate was reduced by 2½ percentage points.
15. According to the INE, the total cost of work, per worker and per month, has risen by some 5 per cent on average across the whole economy since early 2001. This is 1½ percentage points higher than in the euro area for which Eurostat publishes homogeneous statistics. In the case of Spain, the sharp rise in labour costs partly reflects a bigger increase in non-wage costs than in the other countries, this being due to the raising of the ceiling on social security contributions for the least skilled workers, which is now the same for all job categories. The rise in non-wage costs may also be partly attributable to the suspension of the subsidies, which certain contracts had hitherto benefited from.
16. Rogers (2001), for example, draws attention to the existence of a price convergence phenomenon in the case of Spain. The empirical findings presented in this study depend, however, on the specification of the equation estimated.
17. As indicated in the previous OECD survey (OECD, 2001a), for example, it is hardly likely that price convergence between Spain and the euro area is the result of rising wages in the service sector due to a catch-up in industrial productivity, as described by Balassa and Samuelson. Productivity growth has been lower in Spain than in the

other countries in recent years and the increase in prices of services is closely linked with the trend in profit margins in the latter sector.

18. According to the Spanish Government, the effect of the introduction of the euro on inflation in 2002 may have been slightly more marked than in the other countries because of the special difficulty of converting pesetas into euros.
19. Taylor rules typically relate short-term interest rates to the output gap and inflation developments relative to inflation target. Such rules, estimated on the basis of underlying inflation for the euro area but used for Spain, suggest that short-term interest rates should be around 5¼ per cent if a 1½ inflation target is assumed and around 4½ per cent in the case of a 2 per cent target. The three-month interest rate averaged only 2.85 per cent in early January 2003.
20. As in 2001, activity in 2002 turned out lower than forecast. The 2001 budget was initially based on an assumption of real GDP growth of 3.6 per cent, and of 2.9 per cent for the 2002 budget. In 2001, growth finally reached 2.7 per cent and was around 2 per cent in 2002.
21. In 2002, with inflation overshooting the initial target by nearly 2 percentage points, pensions expenditure again had to be increased by a total of EUR 2.1 billion, or 0.3 per cent of GDP, which is spread evenly over the 2002 and 2003 budgets.
22. Monitoring of the budget out-turn was also difficult in 2002 because of the ongoing process of decentralisation and the lack of information at the regional level. Discussions concerning the quarterly publication of government (including regional) accounts are under way with a view to improving the monitoring of the budget outturn. A new Eurostat regulation will effectively be in force as from 2003 whereby all levels of government will be obliged to report quarterly budget outturns. One of the obstacles to the implementation of this regulation is the difficulty of applying the ESA 95 methodology to lower levels of government.
23. The agreement in the public service also provides for a 3.2 per cent increase in 2004, of which 0.5 per cent represents a deferred wage increase in the form of a pension fund set up for civil servants.
24. Over the past 15 years, the number of civil servants has risen by 800 000, which is 3 per cent per year (Caixa, 2002). This sharp increase is attributable in particular to decentralisation and the development of the autonomous communities, where over 80 per cent of these jobs were created, whereas the number of central government public servants has declined. Despite having risen so rapidly, the proportion of government jobs, at 14.5 per cent of total employment, was not high in international comparison (OECD, 2001a). Recently, the restrictions on recruitment to the civil service have resulted in an appreciable increase in temporary jobs, especially at the regional and local level. The share of temporary employment in the public sector, for example, rose from 16.6 to 22 per cent between 1997 and 2002, whereas it fell from 38.8 to 34 per cent in the private sector.
25. Sometimes information on general government is presented with reference to the forecast end-2002 outturn, which is useful, but is usually made in comparison with the initial 2002 Budget, which is inadequate.
26. The projections are based on the following assumptions: oil prices are assumed to stay at USD 31 per barrel in the first half of 2003 before falling to USD 25 in the second half and remain there until the end of the projection period; exchange rates are fixed at their level of 7 February 2003 (1 EUR = 1.08 USD), implying an appreciation of the euro *vis-à-vis* the US dollar of 20 per cent since the first half of 2002.

27. The basket also includes the tax on electricity and on car registration and devolved taxes (on wealth, inheritance and donations, gambling and stamp duty).
28. The previous income tax reform lowered the top rate from 56 to 48 per cent, and the minimum rate from 20 to 18 per cent.
29. Revenues from mutual funds are considered as capital gains by the 1999 law, not capital income, so that they are taxed at a flat 15 per cent rate (instead of the marginal rate), if generated in more than one year.
30. Tax exemption for rental income, though good for the development of the market of rental housing and labour mobility will also subsidise the numerous holiday rentals.
31. Those businesses whose activity falls outside the geographic application of the tax (like exporters and importers) will not be allowed to pay tax under this regime.
32. After the 1999 reform, the tax brackets were modified in 2000 but not in 2001 and 2002.
33. According to the 1998 law, local authorities can only resort to fees if a direct link can be established with the cost of the service to be financed. According to Martinez (2000), the municipalities' lack of information in this area partly explains why little use is made of this source of finance.
34. Spending efficiency will be enhanced by management improvements. A recent example is the extension to the whole of Spain of a control system developed in Andalusia for prescriptions of anti-inflammatory drugs. More generally, the indicators could gauge the budgetary management of the regions and the central government. The publication of such information in other federal countries, coupled with the existence of local referenda, represents a powerful incentive to take account of the aspirations of the population and keep tighter control over public finance (OECD, 2002a).
35. Hospital reform has also been slowed by the completion of the decentralisation of health spending to the 10 communities that did not as yet have that responsibility in 2002. In late 2000, the government had suspended the reform process, pending the transfers of responsibility.
36. A 1998 Court of Auditors study on hospital activity showed that some hospitals were paying up to twice as much as others for the same drug. According to the body that managed non-decentralised health services up until 2002 (INSALUD), the rules governing tenders for procurement contracts relating to advertising and competition, as laid down by law, were not applied in half of these contracts.
37. Despite the budgetary restrictions, the number of doctors has increased since the mid-1990s, suggesting wage restraint.
38. According to official estimates, these measures had the effect of slowing the growth of public spending on prescription drugs by 7 percentage points between 1999 and 2002. However, over 40 per cent of this reduction was due to the narrowing of margins on drugs, the effect of which is temporary. Consumption of generic products rose to 3.4 per cent of pharmacy spending in value terms and was put at 6.7 per cent in real terms in May 2002.
39. In 2003, minimum pensions will be raised by 5½ per cent, *i.e.* 1½ per cent more than the inflation-linked adjustment, whilst survivors' pensions will be increased by some 8 per cent. The budgetary cost of these measures amounts to EUR 335 million.
40. The bulk of the 28-page report on Spain's national strategy by the Ministry for Social Affairs concerning the future of the pension system deals with the period 2000-15, whereas the pressures liable to emerge after that period are discussed in only three lines. An annex to the report contains an extrapolation of pension expenditure projections up

to 2040, *i.e.* 10 years before the demographic pressures peak. Also, the projected 3¼ per cent of GDP increase in pension payments between 2020 and 2040 seems very optimistic. The assumptions underlying this projection are, first, a decrease in the number of pensions for the population aged 65 and over – despite the rise in female labour force participation and the possibilities of combining retirement and survivors' pensions without means-testing – and, second, a decrease in pensions relative to productivity (and real wages), contrary to the trend during recent years. The Stability Programme 2002-06 (Ministry of Economy, 2002) includes also unofficial projections similar to those of the Ministry of Social Affairs until 2040. These projections are extended until 2050 and project an increase of public pension spending by 4½ per cent of GDP between 2020 and 2050.

41. The INE will publish at the end of 2003 new demographic projections based on the results of the 2001 census.
42. The uncertainties, which chiefly concern economic and demographic developments, are both positive and negative, and their implications are frequently subjected to sensitivity analyses (OECD, 2001a).
43. Since 1980 pensions have been growing on average by 1½ percentage points more than wages. Were this trend to continue, there would also be problems of income distribution, especially since, according to the authorities, the elderly are less subject to poverty than labour force participants and the unemployed in particular (Ministry of Labour and Social Affairs, 2002).
44. It would seem reasonable for persons who will be retiring at age 65 in 2015-20 to know at least by age 55, how their pensions will be calculated. This means that the reform has to be adopted between 2005 and 2010, *i.e.* during the next parliamentary term.
45. The INE will present at the end of 2003 revised national accounts, which will take into account, among other things, the new census for 2001.
46. The Bank of Spain periodically publishes several indicators of convergence with the European Union. For those on the stock of public and private capital, see Bank of Spain (2002b).
47. For an exhaustive account of such externalities, see OECD (1999) that follows Calmfors (1993).
48. However, the empirical evidence in favour of this hypothesis is not conclusive (OECD, 1997a).
49. For a background for these attempts, see Bentolila and Jimeno (2002).
50. Wage increases have been more moderate at the enterprise level than at the sectoral (provincial or national) level, although this is partly due to the fact that they are usually signed in larger firms, where wage levels are higher to start with, and workers receive higher non-wage benefits (Fina *et al.*, 2001).
51. Out of 18 OECD countries, it is longer only in the Netherlands, Denmark, France and Norway.
52. Countries like the United States and the United Kingdom do not have unemployment assistance after unemployment benefits have expired, while Australia and New Zealand do not have a UI system.
53. Out of 800 000 temporary workers in agriculture, 600 000 live in Andalusia and Extremadura.

54. Abuses of the system were reported in the past. In particular, some enterprises issued false certificates of days worked, while some municipalities did the same in public works. This type of abuse seems to have almost disappeared in recent years.
55. The May 2002 decree suppressed the PER completely for new entrants, *i.e.*, for those who have not received the subsidy during the last three years. The new, temporary subsidy for new entrants in the PER system will be limited to those who have been resident in the area for at least ten years, which will exclude most immigrant workers.
56. Individual dismissals may be “justified” by the law depending on different criteria, including economic reasons. In practice, most dismissals are declared “unjustified” by courts, carrying higher severance payments.
57. Those unemployed workers who take up co-operative work and handicapped workers who set up as self employed were already able to capitalise their benefits as initial investment and will now be able to use part of their benefits to pay social security contributions.
58. Such a measure should probably be accompanied by a simplification of the different types of temporary contracts. There are too many, which makes contract management difficult.
59. Quality of university education is very difficult to pin down and measure, though the literature on this subject points to several weaknesses. The Bricall *et al.* (2000) report, written by a group of experts prior to the most recent reform, points out that the structure of university institutions is somewhat old fashioned and teaching is focused to knowledge transmission rather than learning processes. Mora *et al.* (2000) stress that high unemployment rates among the young with university degrees reflects, among other factors, the lack of preparation of Spanish graduates to changing professions and skilled requirements, as the education system is too focused on professional education. Mora and García (1999) show that the cost per student of university education is relatively low because the number of services offered other than lectures is also limited.
60. 100 per cent of children aged 5 go to school, 98 per cent at age 4, and 75 per cent at age 3. Only France, Italy and Belgium have higher rates.
61. Enrolment rates are 1.3 per cent for under one-year-olds, 5.7 per cent for those aged 1 and 13.7 per cent for those aged 2.
62. In particular, schooling at this stage will be considered “assistential” as well as educational, implying that not all pedagogic staff will be required to hold university degrees.
63. Most private schools are financed by the State through special agreements (*concertos*) covering current expenses. Investment in private education is paid by the school, which can receive extra finance from students through fees. Private schools that receive public funds are obliged to follow official guidelines in their curricula and the same admission criteria apply as in public schools.
64. That is another flexible way to obtain the compulsory secondary education certificate and provides a link with the other post-compulsory formal education paths.
65. The new national tests (*Prueba General de Bachillerato*) will substitute a previous exam that was required only for those who wanted to access university.
66. See OECD (2002c).
67. The FORCEM has been renamed after the entry of the government in its management, as the *Tripartite Foundation for Training for Employment*.

68. The number of demands for training covered 4.7 million workers in 2000; about 80 per cent were approved and implemented.
69. Good indicators of university performance are not easy to find. One possible good indicator is a low drop-out rate (although, in this case, provisions would have to be made so as to ensure that universities do not minimise drop-out rates by accepting only the best students).
70. Spending on grants is 11 per cent of total public expenditure in tertiary education (against 12 per cent in the OECD), covering mostly fees, and in some cases some help for books and transport. The fact that grants do not cover the actual cost of living is also a factor behind the low mobility of students.
71. The OECD index of tax advantages for R&D expenditures reveals that, for each unit spent by large firms on R&D, one third is recovered in lower tax payments. This is the highest ratio out of 24 OECD countries reviewed, and almost double that of the second country ranked, Canada.
72. Annual employment growth for scientists and engineers was 8 per cent between 1995 and 1999, much higher than average employment growth and one of the highest in the OECD.
73. The rise in the birth rate between 1960 and 1975 increased households' residential investment owing to the higher rate of acquisition of housing by those aged 22 to 32 years (Eguía and Echevarría, 2001), *i.e.* at the time of getting married (Namkee, 2001).
74. House purchases by non-residents have increased sharply since 1993. The pressure exerted by foreign demand in tourist areas is also causing property price disparities to widen across the country. Up to 1991, tax incentives also encouraged Spanish residents to buy second homes.
75. Land prices have more or less doubled in Madrid since 1997 (Bank of Spain, 2002a).
76. These restrictions on the rental housing market were removed by the 1985 reform.
77. Leases dating from before 1985 could be extended indefinitely. Rents relating to contracts signed before 1964 were frozen, whereas those signed between 1964 and 1985 could be linked to inflation.
78. A study of the Economic and Social Council (CES, 2002) indicates that the proportion of youngsters between 20 and 34 that have left their parents' home has decreased from 44 to 33 per cent between 1977 and 2001. This phenomenon, which reflects longer time spent at studying and problems of unemployment and unstable employment for the young, seems to be more intense than in other countries, and has probably contributed to reducing fertility rates.
79. The object of this assistance is to facilitate the purchase of a home at reduced prices by means of loans at preferential rates and subsidies.
80. In Barcelona, for example, some 50 per cent of rental accommodation comes under rules imposing low rents and the renewal of contracts until the death of the tenant or the tenant's spouse (or until their children are 25 years old) (Trilla and Carreras, 2001).
81. According to Pareja and San Martín (2002), the rate of return on rental investment has been lower than that on public debt since 1984, although the gap has narrowed since 1998.
82. The competence of the municipalities and autonomous communities as regards land management was confirmed by the decision of the Constitutional Court to rescind the

measures taken by central government in June 2000 with the objective of restricting the communities' discretionary powers as regards issuing building permits.

83. Since the Act of 1998, an urban plot of land, *i.e.* land complying with certain technical characteristics, has been considered *a priori* to be developable, unless a decision to the contrary is taken and is properly argued. Under the communities' town planning rules, however, other conditions have been imposed which *de facto* prevent owners from exercising their right to build until they have obtained formal permission from the municipal or regional authorities. The process for disposing of land for construction are long (three years on average, sometimes much more), complex and uncertain.
84. Income from principal homes occupied by their owners (imputed rents) ceased to be taxed in 1999.
85. Comunidad Valenciana, Andalusia and the Basque Country.
86. In practice, most regional governments stick to the national minimum of 13 Sundays. The autonomous community of Madrid allows the largest number of Sunday openings, namely 21.
87. The association of hypermarkets claims that about 50 new shopping centres are on the waiting list for opening permits.
88. Telefónica's share of access lines was 95 per cent at the end of 2001, 82 per cent in the national long distance market (share of minutes) and 83 per cent in international traffic minutes.
89. The approved price cut was 2 per cent, as it was foreseen in the original price cap system, although the connection fee has been taken out of the price cap system and has been increased by 8 per cent, ending the tariff re-balancing process. Simultaneously, the regulator adopted some other measures to foster competition, like a new single invoicing mechanism for pre-assigned customers, and reinforced rules for public procurement of telecommunication services.
90. Telefónica lowered its investment in cable networks in 2000 when it focused its broadband strategy towards ADSL technologies. The main company in the cable business is Auna, which also owns Retevisión (the second fixed telephony operator) and Amena (the third mobile operator).
91. The government has pressed operators to accelerate its development, and could withdraw the deposits paid by the operators when the licences were given, since investments have been delayed. The government has recently liberated cable and radio-telephony operators from their investment agreements, but not UMTS operators.
92. Modernisation measures will only apply to older vessels (5 or more years old) and only for improving security, not efficiency of catches; construction will be linked to somewhat stricter decommissioning rules for old vessels; and exports to third countries in joint venture agreements will only be possible with those countries that have signed a fishing agreements with the European Union.
93. For instance, the legislation has allowed the recent merger of the clearing and settlement systems of all secondary markets, which has taken place as a result of this initiative. Although a *de facto* monopoly system, the law leaves the door open for other competing systems.
94. New regulations on the take over bid (OPA) regime in stock markets are also being prepared, following some episodes of sales of controlling stakes which were just at the limit that obliges the launch of an OPA, although they will depend on the corresponding European directive on the issue.

95. Venture capital investment is equivalent to 0.25 per cent in Italy, 0.38 per cent of GDP in France, 0.48 per cent in the Netherlands and 0.85 per cent of GDP in the United Kingdom.
96. To protect the initial stability of stock values, stock market regulations oblige the main owner of a firm to keep a participation for some time when it is publicly offered. Up to now, this resulted in the loss of any tax advantages for the venture capital entity, which prevented them from offering the participated firms in the stock markets. The new regime addresses this problem by extending tax advantages for two years after admission to trading on a regulated market.
97. In fact, saving banks have acquired very few and very small commercial banks. On the other hand saving banks reinforce competition in the market. The possibility of privatising saving banks is not on the politic agenda.
98. In a comparison by the Bank of Spain for the period June 2001 – June 2002, profits of Spanish banks fell by 10 per cent, whereas those of French banks fell by 20 per cent and those of German and Italian banks by more than 35 per cent.
99. The two largest Spanish banks, BBVA and Santander, invested heavily in Latin America in past years. Consolidated foreign claims of Spanish institutions in the area (which exclude loans of affiliates of Spanish banks in domestic currencies, that are less prone to devaluation risks) amounted to USD 48 billion in December 2001. Of these, 32 per cent originated in Argentina, 30 per cent in Mexico, 10 per cent in Brazil and 9 per cent in Chile. Claims on Argentina fell strongly during the first half of 2002 due to devaluation and to the partial reduction of positions in the country by Spanish banks.
100. In part because the Bank of Spain imposes stricter solvency ratios for Spanish banks.
101. These two alternative scenarios assume the same exchange and nominal interest rates as the baseline scenario. Furthermore, public spending is maintained stable in real terms with respect to the reference scenario.
102. Potential growth in the euro area, which is estimated at about 2 per cent between 2005 and 2008, tends to decline slightly due to the negative effect of ageing.
103. Council Decision (2002/358/EC) of 25 April 2002 concerning the approval, on behalf of the European Community, of the Kyoto Protocol to the United Nations Framework Convention on Climate Change and the joint fulfilment of commitments thereunder.
104. Some co-generation facilities are ineligible for support as they fail to meet efficiency criteria.
105. In 2001, for example, the premium per kilowatt hour for renewable energy varied from EUR 0.03 for electricity generated from biomass to EUR 0.36 for small-scale solar energy electricity production (National Commission for Energy, 2002). Energy recovery from the incineration of waste also receives a feed-in premium. From 2007 this system will end support for larger co-generation facilities.
106. Support was granted for energy saving projects, the installation of co-generation capacity, and promoting the use of natural gas and renewable energy sources.
107. Some expansion of existing plants has been allowed.
108. Not only are emissions of carbon dioxide in this sector the highest per kilowatt hour of electricity generated, but the externalities due to other conventional pollutants are also substantially higher than for other major electricity generating sectors (CIEMAT, 1997). For example, the sulphur content of domestically produced coal is high (IEA, 2001).

109. The domestic coal industry is regionally concentrated and so appropriate, temporary assistance might be required for these regions. However, concerns over the security of supply of coal are less important (IEA, 2001).
110. For example, Capros and Mantzos (2000) estimate that marginal abatement costs of a sectoral approach with identical reduction targets would rise to EUR 348 per tonne of carbon from EUR 103 in the case of an optimal allocation of abatement efforts in Spain alone.
111. Almost three-quarters of the financing is expected to come from the European Community.
112. The expansion of gas powered electricity generation will also allow a further downsizing of support to the coal industry.
113. For emitters not participating in the EU trading scheme, carbon taxation could be usefully applied, if the implicit tax on carbon embedded in fuel taxation does not exceed the price of allowances. In particular, carbon taxation on the fuels used by small-scale combustion plants that will fall outside the EC emission trading scheme could help reduce the overall cost to the economy of achieving greenhouse gas targets.
114. Waste statistics in Spain have recently been reviewed. Reporting methodologies across autonomous communities have differed substantially over time making the determination of trends extremely difficult.
115. In particular, Directives 75/442/EEC on waste and 99/31/EC on the landfilling of waste. For this reason the European Commission has opened infringement proceedings against Spain on the grounds of several actions of illegal dumping with the view of bringing the Kingdom of Spain to the European Court of Justice.
116. *Normativa e instrumentos de gestion en materia de residuos.*
117. In reducing the amount of waste generated the government has required larger firms to prepare waste reduction strategies. In the case of packaging waste, the reduction is expressed in terms of packaging weight relative to the weight of the product.
118. These include Ecoembes (for general packaging waste), Ecovidrio (glass), and Sigre (pharmaceutical packaging). If companies do not join such a system, they are required to implement a deposit-refund scheme. Industrial packaging must be sent to an authorised operator for disposal.
119. The packaging law (following the EC directive) required that between 25 and 45 per cent of all packaging must be recycled, but that recycling of an individual packaging material need only reach 15 per cent.
120. Annual outlays have been above EUR 10 million in recent years, with remedial action taking place at 275 contaminated sites.
121. The EC Water Framework Directive will require full-cost recovery by 2011.
122. These prices refer to those charged in the Jucar and Almeria counties (Albiac-Murillo *et al.*, 2002).
123. Agricultural support policies may also be indirectly contributing to demand for irrigation water. See also Chapter IV.
124. These changes were introduced in the 1999 amendments to the Water Act. New irrigators would pay half the capital costs for new infrastructure and be required to cover operation and maintenance costs.
125. Such a policy would be equivalent to grand-fathering existing rights and allowing trading.
126. The national analysis uses a 50 year timeframe for the cost analysis with a real discount rate of 4 per cent.

127. Desalination costs vary considerably according to the size of plant and the amount of electricity that can be sold. A range of cost of between EUR 0.3 and 0.4 per m³ is suggested by Uche *et al.* (2001).
128. Almost a third of the land under irrigation is based on systems over a century old (Ministry of Agriculture, Fishery and Food, 2002).
129. Public investment is limited to existing and uncompleted irrigation systems, though new irrigation schemes of a “social nature” may also receive funding.
130. Foreigners referred to in this chapter are foreign citizens, as Spain bases its statistics on nationality rather than place of birth.
131. For an analysis of ageing in Spain see OECD (2001a).
132. Up to 2003 EU citizens were obliged in principle to obtain a residence card. As from March 2003 this obligation no longer applies to those working or studying in Spain, following the implementation of the 28 July 2000 Marseille Declaration, although EU citizens must apply for a number of identification of foreigner (N.I.E), which is necessary for bank operation, etc.
133. The total number of undocumented foreigners is uncertain. In June 2001, Enrique Fernández-Miranda, the Delegate of the Government for Immigration, declared that Spain had about 1.2 million immigrants on its territory (*El Mundo*, 10 June 2001); the number of foreign residents officially-registered by the Ministry of the Interior on 31 December 2000 was around 896 000 and 1.1 million at end 2001.
134. There are no statistics on the return of foreigners to their country of origin or to any other country.
135. Besides, income distribution is generally wider in these countries, and has often worsened since the 1980s, which makes the incentives to migrate all the greater for low-income people.
136. This figure is in addition probably underestimated, since, as in most developing countries, informal activity is high and under-employment too.
137. See OECD (2002d).
138. The countries covered in this survey are the 22 members of the League of Arab States, which includes North African countries and Arab Middle-Eastern countries, with a population of 280 million in 2000.
139. Up to 1985, Spanish legislation characterised immigration-related issues as matters of “public order” (and therefore the exclusive responsibility of the Ministry of Interior) and issues related to settlement of foreign nationals in Spain were very weakly regulated. For a review of Spanish migration policy until 1999, see Moreno Fuentes (2000).
140. Rights to meeting and association were limited, although these aspects were softened on a number of occasions by the courts; family reunification rights were not recognised.
141. The Immigration Act is the result of two laws. The “*Ley de extranjería 2000/4*” was adopted in December 1999, after two years of negotiation between all political parties in a parliamentary commission, and put a strong focus on integration issues. It was reformed a few months later by the “*Ley de extranjería 2000/8*”, that put more emphasis on the control of immigration flows. One of the main points of disagreement was the introduction of a permanent possibility for undocumented foreigners to obtain a temporary residence permit if they could prove that they had stayed two years in Spain and had sufficient means of subsistence, which was denounced as providing incentives for immigrants to come illegally. The new Act extends the period of stay to five years.

142. Undocumented foreigners do not have the rights of meeting, association, unionisation and strike. Being in Spain without authorisation is a serious offence that can be punished by expulsion instead of a fine. Documented foreigners committing offences that can be punished by one to six years of jail can also be expelled.
143. The decision was published in early January, at the same time as the quota was announced, to restrict individual applications to specific categories of people, such as those for which looking at the national employment situation is not required (*e.g.* family members of foreign residents, students, Chilean and Peruvian nationals due to preferential international agreements).
144. The publication of the number of work permits granted has been recently interrupted, and figures are not available for the whole year of 2001.
145. The persons whose application was rejected (whose number is probably inferior to 210 000 because some may have applied in the two subsequent processes) were not expelled and are likely to remain on the territory.
146. This is under the assumption that all the persons whose application was rejected in the 2000 process did apply in the 2001 process.
147. See *El País*, 14 October 2001.
148. The government has proposed a 2003 budget for expulsions of EUR 8 million, almost three times higher than in 2002.
149. France, Italy, Portugal, Bulgaria, Poland, Slovakia, Estonia, Letonia, Lithuania and Rumania.
150. 90 000 is a minimum as it is the number of persons whose application was rejected in the 2001 process. 70 000 applications were also rejected in the 2000 process, but part of those rejected in the first process have certainly participated in the second. Those who did not apply, those who entered after the processes, and those who fell into illegality because their permit expired and could not be renewed since then due to lack of a work contract should also be added.
151. The government has also announced its intention to eliminate the permanent mechanism of regularisation "*por arraigo*" (*i.e.* for settlement reasons) included in the Immigration Act, which is allowing foreigners able to prove that they have been living in Spain for five years to obtain papers.
152. Besides, migration decisions of natives may also respond to labour immigration (Brücker *et al.*, 2001). For a critical analysis of this type of studies suggesting that immigration effects on the labour market may be underestimated see Borjas (2002).
153. Dolado *et al.* (1996) consider the number of work permits granted from 1990 to 1992. In 1991 and 1992 they are dominated by the regularisation process, so that it is not the effects of immigration on the labour market *per se* that are captured, but rather the effects of the legalisation of immigrants.
154. According to the labour force survey, non-OECD immigrants as a whole are better educated than Spanish nationals. Although the share of the second and third groups of workers referred to here cannot be exactly established (due to lack of data), the third group (*i.e.* low-skill jobs) is more important than the second (high-skilled jobs). To some extent, the fact that non-OECD workers are on average better educated than Spanish nationals may reflect under-utilisation of immigrants' human capital. However, this may also reflect the non-accuracy of the figures: as noted above, the labour force survey is not completely representative for foreigners, especially for non-OECD immi-

- grants, who are more likely to live in collective housing (not covered) and have temporary visas.
155. See Colectivo IOÉ (1998) for the construction sector, Colectivo IOÉ (1999) for hotels and restaurants, and Carrasco (1999). Mendoza (1997) provides information on African employment in agriculture and construction, and Martínez Veiga (1999) for employment in domestic services, agriculture and construction.
 156. 24 per cent of the immigrants surveyed by Carrasco (1999) were without contracts; in the construction sector, 62 per cent of the Poles and 19 per cent of the Moroccans surveyed by Colectivo IOÉ (1998) had no contracts, against 1.5 per cent of the Spaniards; in restaurants, 42 per cent of the Peruvians, 23 per cent of the Dominicans and Chinese, 12 per cent of the Moroccans and 6 per cent of the Philipinos and the Spanish had no contract.
 157. In the construction sector, 52 per cent of the Moroccans were working more than 40 hours a week, against 39 per cent of Spanish; overtime hours are more often paid at the normal rate for Moroccans than for Spanish and Polish workers (Colectivo IOÉ, 1998). Foreigners also tend to work longer hours in hotels and restaurants; more than two thirds of the Dominicans and Filipinos were not paid for extra-hours, against one third for Spanish and Moroccan workers (Colectivo IOÉ, 1999).
 158. At end-1997, it was one of the lowest in the European Union in PPP terms (OECD, 1998).
 159. For example, domestic employees can be fired without notice and do not have access to unemployment benefits.
 160. Comparing the situation of young natives and young non-EU immigrants both in Belgium and Spain at labour market entry based on the EU Labour Force Survey, Kalter and Kogan (2002) find that while differences in education levels explain the disadvantage that non-EU youth face compared with natives, it is not the case in Spain.
 161. It is also likely that there is more variability in their unemployment rate than for natives, *i.e.* that they play the role of cushioning the variations in activity. It is however not possible to verify this based on the labour force survey since data for foreigners are published only annually.
 162. EU foreigners, on the other hand, include a large number of pensioners.
 163. Employment data used here is the affiliation with the social security system, available for foreigners starting in December 1999.
 164. About 55 000 foreigners were registered under the domestic employee social security regime in June 2002. It is a sector where undeclared employment is common, so that overall domestic employment is higher.
 165. See OECD (2001f).
 166. See Álvarez-Llorente (2002) and Muñoz (2002b).
 167. The important increase in temporary jobs for natives may also have played a role. Unemployment dropped from about 18 per cent in 1995 to about 11 per cent in 2002, with new employment largely situated at the low-skilled, low-productivity end.
 168. Productivity here is measured as GDP divided by the number of workers affiliated with the social security system. The number of non-EU foreigners affiliated with the social security system is not available for 1995, so that the number of existing work permits was used instead, after checking that they were quite similar to the number of affiliations in the period where both are available.

169. In Almeria, income per capita was equivalent to 82 per cent of the national average in 1999, against 73 per cent in 1991. In Huelva, the Rioja and Castellon, income per capita was equivalent to 73, 119 and 117 per cent of the national average, respectively, against 69, 110 and 108 in 1991.
170. According to the 2000 Census, one out of three EU residents were aged more than 55.
171. Revenues from the VAT on consumption are not included.
172. According to de Ayala Cañón *et al.* (2001), 70 000 households or 180 000 individuals (0.5 per cent of total population) were benefiting from a minimum income.
173. According to the OECD database on social transfers, in 1998, the benefits provided to compensate for low income represented 0.07 per cent of GDP, family benefits and services to families 0.4 per cent of GDP, and housing benefits 0.07 per cent of GDP (excluding income tax relief granted for purchasing a main residence).
174. Aparicio and Tornos (2000) estimated that they were inferior to 2.8 per cent of the expenditure they estimated at the central level in 1998. They may have somewhat increased recently.
175. See Collado *et al.* (2002).
176. As shown by Samuelson (1958), in the steady-state the system's internal rate of return must be less than or equal to the real rate of output growth in order to keep the pension regime in equilibrium. Given the effect of immigration and under the assumption of a stable annual growth of 1¼ per cent of productivity, real output could rise on average by 1¼ per cent a year over the 2000-50 period, a rate much below the estimated level of the internal rate of return of the pension system.
177. Moroccan and Peruvian immigrants surveyed in the Madrid area by Aparicio and Tornos (2000) were sending on average one to two months of their salaries in remittances to their origin country in 1999.
178. The fruit and vegetable sector, which employs many immigrants, is not benefiting from direct subsidies from the CAP, but benefit from trade protection; other sectors including the olive oil sector enjoy both trade protection and production subsidies. The regime of EU subsidies to olive oil was significantly modified in November 1998. The main modification entailed replacing the intervention price system by a private storage aid, abolishing aid to consumption and introducing an overall cash ceiling on the amount of production subsidies (these changes are not definitive; they have been extended up to 2004/05). This ceiling is distributed across countries according to the national guaranteed production level. In the event that national production exceeds the quota, the subsidy per tonne is reduced proportionately.
179. The demand from Latin American countries for reduced protection of EU markets, in particular for agricultural products, was one of the most contentious points in the last Ibero-American summit in November 2002. In March 2002, the Spanish Secretary of State for Foreign Affairs defended (during a meeting of entrepreneurs from Spain and Maghreb countries on investment opportunities in the Maghreb) the view that free trade between the EU and Maghreb, including in agricultural products, should be sought by 2010 so as to help the development of these countries and slow immigration flows. The president of Catalonia also supported this view (see *Noticias Infoagro*, 22/03/2002). For an analysis of the impact of liberalisation of Euro-Mediterranean trade in agricultural products, see Lorca Corrons (2002).
180. According to a report by the Defensor del Pueblo Andaluz (2001), in western Almeria, at least 65 per cent of the immigrants did not live in decent housing. More than 50 per

cent had no access to drinkable water, and 25 per cent to electricity, and most had no sewage.

181. For example, in Madrid, rents can vary between EUR 150 and 240 per month for a bed in shared rooms. The immigrants are also often asked to provide a bank guarantee or are required to pay a number of monthly rents in advance, while the norm is one month (*El País*, 9 April 2002).
182. According to Trilla (2001), social housing accounts for 2 per cent of the housing stock, against 18 per cent on average in the EU.
183. See *El País*, 23 January 2003.

Glossary of acronyms

ADSL	Asymmetric digital subscriber line
ALMP	Active labour market policy
BBVA	<i>Banco Bilbao Vizcaya Argentaria</i>
BIS	Bank for International Settlements
CAP	Common agricultural policy
CES	<i>Consejo Económico y Social</i> (Economic and social council)
CLH	Transportation monopoly
CMT	<i>Comisión del Mercado de las Telecomunicaciones</i> (telecommunications sector regulator)
CPI	Consumer price index
EC	European Commission
ECB	European Central Bank
EMU	European Monetary Union
EPA	Labour force survey
ESA	European System of Integrated Economic Accounts
EU	European Union
EUR	Euro
Eurostat	European Union Statistical Institute
FAO	Food and Agricultural Organisation
FORCEM	Foundation for the training of workers
GDP	Gross domestic product
GHG	Greenhouse gas
GRECO	<i>Programa Global de Regulación y Coordinación de la Extranjería y la Inmigración en España</i> (Global Programme to Regulate and Co-ordinate Foreign Residents' Affairs and Immigration in Spain)
IAE	<i>Impuesto de actividades económicas</i> (tax on business activities)
IEA	International Energy Agency
IBI	<i>Impuesto sobre bienes inmuebles</i> (real estate tax)
ICAC	<i>Instituto de Contabilidad y Auditoría de Cuentas</i> (Institute for Accounting and Auditing)
ICES	International Council for the Exploration of the Sea
ICID	International Commission on Irrigation and Drainage
ICT	Information and Communication Technology
IMF	International Monetary Fund
IMSERSO	<i>Instituto de Inmigración y Servicios Sociales</i> (national agency for migration and social services)
INE	<i>Instituto Nacional de Estadística</i> (National Statistics Institute)
INEM	<i>Instituto Nacional de Empleo</i> (National Agency for Employment)

INSALUD	<i>Instituto Nacional de la Salud</i> (National Health Institute)
NAIRU	Non-accelerating inflation rate of unemployment
NGO	Non-governmental organisation
OPA	<i>Oferta pública de adquisición</i> (take-over bid)
PER	<i>Plan de Empleo Rural</i> (special unemployment and investment regime for seasonal agricultural workers in Andalusia and Extremadura)
PES	Public employment service
PISA	Programme for International Student Assessment
PPP	Purchasing power parity
R&D	Research and Development
SCP	Stability and Convergence Programmes
SDC	<i>Servicio de Defensa de la Competencia</i> (Competition Service)
SME	Small and medium-sized enterprise
TDC	<i>Tribunal de Defensa de la Competencia</i> (Competition Tribunal)
UA	Unemployment assistance
UI	Unemployment insurance
UMTS	Universal Mobile Telephone Systems (third generation mobile telephone systems)
UNDP	United Nations Development Programme
UNFCCC	United Nations Framework Convention on Climate Change
USD	United States dollar
VAT	Value added tax

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BASIC STATISTICS OF SPAIN (2002)

THE LAND

Area (1 000 km ²):		Major cities (thousand inhabitants):	
Total	506.0	Madrid	3 017
Cultivated (1998)	185.1	Barcelona	1 527
		Valencia	762
		Seville	704

THE PEOPLE

In thousands:		Employment (thousands)	16 258
Population	41 838	Employment by sector (% of total):	
Net natural increase (2001)	45	Agriculture	5.9
Net migration (2001)	247	Industry	19.4
Number of inhabitants per km ²	82.7	Construction	11.8
		Services	62.9

PRODUCTION

Gross domestic product (GDP):		Gross fixed capital investment:	
Billion EUR	694	% of GDP	25.4
Per head (US\$)	15 631	Per head (US\$)	3 973

THE GOVERNMENT

% of GDP:		Composition of Parliament	
Consumption	17.6	(No. of seats, March 2000):	350
Revenue	38.5	Popular Party (PP)	182
Deficit	-0.1	Spanish Labour Socialist Party (PSOE)	125
Fixed investment (% of gross fixed capital formation)	13.1	Convergence and Union (CIU)	15
		Izquierda Unida (IU)	8
		Basque Nationalist Party (PNV)	7
		Other	13
		Next general elections: March 2004	

FOREIGN TRADE

Exports of goods and services (% of GDP)	28.5	Imports of goods and services (% of GDP)	30.0
Exports as a % of total goods exports:		Imports as a % of total goods imports:	
Foodstuffs	12.5	Foodstuffs	6.6
Other consumer goods	28.8	Other consumer goods	20.9
Energy	2.0	Energy	10.7
Other intermediate goods	44.6	Other intermediate goods	46.0
Capital goods	12.2	Capital goods	15.8

THE CURRENCY

Monetary unit: Euro		Currency units per US\$, average of daily figures:	
		Year 2002	1.0611
		February 2003	0.9276

Note: An international comparison of certain basic statistics is given in an annex table.

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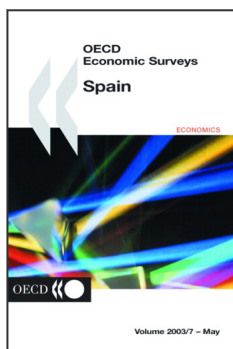
The economic situation and policies of Spain were reviewed by the Committee on 24 February 2003. The draft report was then revised in the light of the discussions and given final approval as the agreed report of the whole Committee on 27 March 2003.

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