

**Monographic May 2005:
Analysis of the Public Finances**

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1.- U.S.A.

Analysis of public-sector finances¹: unnecessary imbalance

Pages and pages of these reports have been dedicated to the situation of US public-sector finances, with the increasing deficit and its fundamentals figuring prominently. The object of this study is to arrange all this information and go into greater depth.

The budget project presented by George W. Bush at the beginning of February for the 2006 financial year (October 1 2005 to September 30) is currently being studied by the house. Our comments focus on previous data, including that relating to the current 2005 financial year.

a) "Starving the beast"

Analysing the graph that opens this report and also Table 1 which ends it is a good way to begin our analysis of developments in the main budget items.

The first crucial issue is immediately visible: the severe deterioration of the budget during Bush's time in office has a lot to do with a drastic reduction in income and little to do with increases in expenditure (which is nevertheless concentrated in defence and domestic security) or the economic cycle. A recent study carried out by the Bank for International Settlements (BIS)²

¹ This analysis does not tackle the hot topic of Social Security and its reform, as it will be the object of a special study in our next report to be released in September.

² Lebow, D.E. (2004); "Recent fiscal policies in selected industrial countries", BIS WP, 162.

estimates US budget deterioration between 2000 and 2003 at 6.4% of GDP: only 1% can be accounted for by the cycle; 1.5% would correspond to an increase in expenditure, excluding interest payments, which would have dropped by 0.8% of GDP. However, income fell by 4.7% of GDP.

Turning our attention to the Federal Government Budget, the Center on Budget and Policy Priorities calculates the cost of the Bush government's tax decisions up to 2005 at \$539bn: 48% corresponds to a decrease in income, 37% to an increase in spending on defence and domestic security and only 15% to increases in other expenditure programmes.

Looking at Table 1, it becomes quickly noticeable that:

- Government revenue has dropped in recent years, not only with respect to the Clinton era, but also in comparison to previous republican governments mainly due to income tax collection. In fact, income tax collection is at its lowest in half a century as a percentage of GDP. Despite government publicity, the tax cuts have not enabled economic growth to reach the average over the last decade (let alone job creation); a pronounced imbalance has emerged without results that could offset it³.
- Despite the campaigns in Afghanistan and Iraq and the increase in national security

³ One could say, without much risk of being wrong, that the Laffer Curve has failed for the second time.

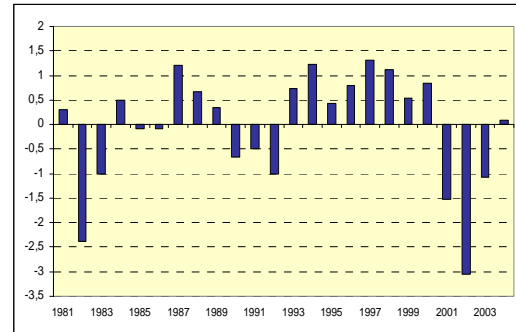
expenditure, the United States spends less on these items than in the 1980s and the beginning of the 90s. Some of the budget returns from the cold war have not run out.

- Discretionary expenditure on other items remains stagnant or is even dropping slightly (as a percentage of GDP).
- The marked deterioration of the budget (Figure 1)⁴ has occurred despite the fact that the large social programmes have seen their cost rise marginally with respect to the country's GDP (the cost of Social Security has even decreased).

In view of these data, only the ideology of certain ranks of the Republican Party and think-tanks close to them could justify insisting on cutting expenditure in order to balance the budget. They aim to recover the resources that the Federal Government has deprived itself of with successive and highly regressive tax cuts (24% of the tax cuts were directed at the richest 1% of the population) by reducing expenditure on the main social programmes. Using Paul Krugman's words (taken at the same time from conservative ideologists), the idea is to "starve the beast (the public sector)".

⁴ 2004 was only one decimal point short of becoming the fourth consecutive year of deterioration in the Federal Government Budget balance as a percentage of GDP, a record since World War II. Even still, the deterioration accumulated over the period from 2001 to 2003 is unheard of in the last six decades.

Figure 1: Federal Government Budget Balance (% of GDP; year from Jan-Dec)



Source: own elaboration with data from the BLS

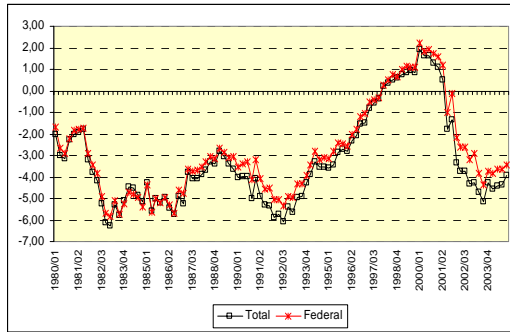
This approach has been backed by Federal Reserve Chairman Alan Greenspan, at least implicitly. The way he insisted upon the need to reduce taxes to curb public sector surpluses blows in the face of his alarm only four years later over the shortage of resources for looking after the retirement of "baby-boomers" which is on the horizon.

However, the US middle class (and the best part of their political representatives, both democrats and republicans) are seemingly unwilling to compromise on social security or medicare cuts. This became evident following the suspension of Bush's plan to partially privatise the pension system.

b) Is the deficit unsustainable?

The current public-sector deficit itself is no cause for alarm. Despite the marked deterioration mentioned previously, the negative balance is noticeably below the highs registered halfway through the 80s and in 1992 (Figure 2). The problem (and the most heated debate) is the outlook for the future in the medium and long term.

Figure 2: Federal Government Budget Balance (% of GDP, year from Jan-Dec)



Source: own elaboration with data from the BLS

The problems will begin in 2008, when the baby-boom generation reaches 62 years of age, the minimum age for retirement. Some 50% of people who reach this age exercise their right to retirement. The increase in the cost of Medicare will be even greater than that of pensions. Even though we will go over these issues in greater depth in forthcoming reports, suffice it is to cite data from the official two-party Congressional Budget Office (CBO) on the future cost of the three largest social programmes, which currently stands at 8.5% of GDP, but which would rise to 15% halfway through this century and exceed 20% in 2075.

The data provided by the Bush Government and the data from its critics have nothing in common when it comes to forecasting the deficit over the forthcoming years, before completely facing up to the effects of the demographic change.

1) According to the government, the accumulated deficit between 2006 and 2015 will be in the vicinity of one trillion dollars, with a surplus from 2012 onwards and an average annual deficit that is slightly higher

than half a point of GDP...a real balancing act.

2) When observing the data from the CBO (which are also official, but two-party), the outlook changes radically: the deficit over the decade mentioned above would climb to 2.6 trillion dollars, around 1.7% of GDP. It is not an ideal situation, nor is it as favourable as the surpluses during the Clinton era, but the deficit would be one point below the average over the past quarter of a century.

3) However, there is also a pessimistic point of view, which we will describe using the controversial paper written by William Gale and Peter Orszag⁵. They estimate the deficit over the next decade will reach 3.5% of GDP (around five and a half trillion dollars), which would be simple unsustainable taking into account the future increase in the cost of the largest social programmes.

It is difficult to understand how such diverse conclusions can be drawn so, in light of the importance of the issue, we will attempt to summarize the suppositions made which explain them:

- The most important factor is whether or not the tax cuts in 2001 and 2003 will remain in force (among other less important measures). As is normally the case in the United States, the tax cuts have an expiry date (sunset clauses). The Bush administration's

⁵ Gale, W. and Orszag, P. (2004); "The budget outlook: projections and implications", *The Economist's Voice*, Vol. 1, N° 2.

calculations assume the sunset clauses will work... despite currently preparing legislation that will prevent them from doing so and that will almost certainly be passed. The other two estimates assume the sunset clauses will not be applied and that the tax cuts will be made permanent, although the CBO estimate the cost of this to be lower than Gale and Orszag⁶.

- What seems more cynical than optimistic is that the Government insists on not assigning any expenditure to campaigns in Iraq and Afghanistan after the current financial year. The CBO respects this absurd supposition, which is treated as an increase in expenditure by Gale and Orszag.
- The Government and the CBO do not believe the Alternative Minimum Tax (AMT) will drop as a result of inflation throughout the decade, as opposed to Gale and Orszag. This indexation would substantially reduce revenue.

The AMT emerged in 1969 to prevent the highest income earners from avoiding the payment of a reasonable amount of taxes through tax deductions. Any citizen above a certain level of income⁷ must complete a tax return and the AMT, in which a good deal of the conventional tax deductions

⁶ Probably due to attributing higher interest payments that derive from the increase in the deficit in the case of these two authors.

⁷ Around 40,000 dollars a year for people who are single and 58,000 for those who are married.

disappear, including paying state and local taxes. The AMT is a unique rate of between 26% and 28%. Each person must present a tax return in which a higher rate is paid. The striking thing is that by not indexing the minimum level above which people must comply with the AMT, the tax has gone from being levied on the 3,000 richest people in the country to a tax that increasingly affects (and penalises) the middle class.

The political cost of not adjusting to inflation is growing as more and more US citizens are affected by the AMT, but the Bush government is counting on this extra revenue, which it estimates at 600 billion dollars over the next decade.

Finally, there are two further factors that could become enormously important for the future of the Federal Government's finances. In the first place, the idea of levying a tax on consumption (similar to VAT in Europe), which the US tax system structure currently lacks. Some authors believe that even a moderate rate would allow the country to face up to the economic challenges of an ageing population. Others, however, believe it would be nothing but a substitute of all income tax, with a doubtful impact on tax revenue and clearly regressive.

In the second place, Alan Greenspan's sudden concern over the deficit has led him to proclaim the need to recover the spirit of the Budget Enforcement Act from 1990 and its ensuing amendments. This norm stipulates that any increase in expenditure, but also any decrease in revenue, may only be carried out if the source of the compensation is established in the budget. The current government is willing to accept this philosophy (established when the first President

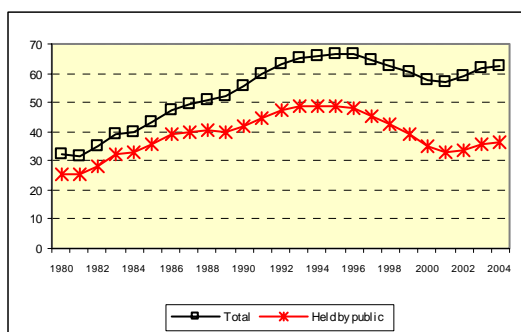
Bush was in office and vital for balancing the budget over the past decade) as far as increases in expenditure are concerned, but not in the case of decreases in revenue, which is the origin of the current imbalance.

c) Debt momentarily under control

US federal debt (Figure 3), which has doubled between the beginning of the 80s and the beginning of the 90s, was held in check and then decreased during the Clinton era, but has once again risen in recent years. Total debt currently stands at around 60% of GDP, some 10 points below the average for the European Union and is just over half of Japan's when calculated as a percentage of both regions' respective GDP.

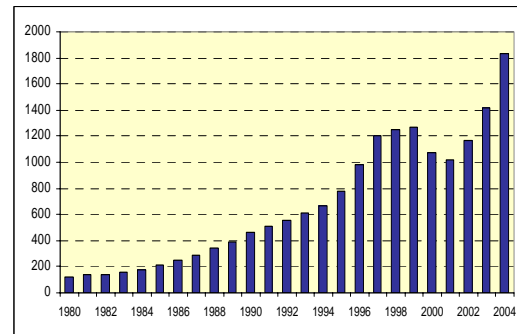
This is a moderate level of debt, which is even more so when we consider that a high percentage of the debt can be found in the pension fund of the US government itself. This is why debt figures provided by various institutions refer to the debt in the portfolios of agents outside the Government's public funds (debt held by the public). This reduces total debt to less than 40% of GDP, which is similar to the level in the United Kingdom.

Figure 3: Federal Government Debt (% of GDP; year from Jan-Dec)



Source: own elaboration with data from FRED II

Figure 4: Federal Government Debt held by foreign investors (billions of dollars; year from Jan-Dec)



Source: own elaboration with data from FRED II

The most significant feature worth highlighting in recent years is the amount of federal debt held by foreign investors (approaching two trillion dollars, a quarter of total debt – Figure 4). There is no need to insist on the fact that this situation is linked to the massive purchase of Treasury bonds on behalf of Asian Central Banks in order to fix or at least guide the exchange rate of their respective currencies with respect to the dollar.

If the negative omens with respect to the future evolution of the deficit come true, total debt will quickly recover an upward trend similar to that in the 80s (although smoothed by the fact that interest rates are considerably lower).

d) State and local governments

The 50 state governments and the infinite number of local governments that make up the United States are responsible for a considerable proportion of total public expenditure (around 40%), but for a minimal percentage of the budget imbalance, as most of these regional bodies are

obliged by law to present balanced annual budgets.

In this context, state and local government income and expenditure has inexorably averaged from 10% to 11% of GDP for more than a decade, with a deficit that barely reaches 0.1%. Being required to present an annual balance sheet that is more or less in equilibrium considerably reduces the capacity of these governments' financial policy act against the cycle. The only things they have are "rainy day funds"; part of the revenue from boom years is put in a fund and then used to maintain equilibrium during periods of crisis.

In fact, some states with surpluses throughout the best part of the expansion in the 90s (due to their own revenue and federal government transfers) increased their current expenditure (public employment and social services) and their investment, albeit to a lesser extent. When revenue plummeted from 2001 onwards (stock market crash, economic recession, less federal government transfers) most states set out to raise rates and charges, as well as making severe cuts in education, employment, health, benefit programmes and even prisons. The financial situation of state and local governments only began to breathe a little more easily in 2004, which should help to recover part of the necessary services that had suffered cuts.

In short, the US public sector is at a crossroads in light of the outlook for increased health and pension costs due to the ageing population. Apart from the structural reform that would allow these costs to be held in check over the next few decades, it is necessary to

immediate reduce the current financial imbalance of the Federal Government⁸.

History suggests that two-party action and the awareness of the future cost of the deficit lead us to believe that the situation will more than likely be progressively straightened out. However, the powerful ideological hand in all the decisions made by the current government leads us to be much more prudent and less optimistic.

Vicente J. Pallardó
Valencia, June 3 2005

⁸ Nobody seems to disagree on this issue. The question is how to go about it.

TABLE 1

FINANCIAL VARIABLES (% of GDP; data for tax years)

	1980-89 Mean	1990-99 Mean	2000-04 Mean	2005 Forecast
SPENDING	22.2	20.7	19.3	19.8
Discretionary	9.8	7.6	7.1	7.6
<i>Defense</i>	5.8	4.1	3.4	3.8
<i>Rest</i>	4.0	3.5	3.7	3.8
Committed	9.6	10.1	10.4	10.8
<i>Social Security</i>	4.5	4.5	4.3	4.2
<i>Medicare</i>	1.6	2.3	2.4	2.7
<i>Medicaid</i>	0.6	1.1	1.4	1.5
<i>Miscellaneous</i>	2.9	2.3	2.3	2.4
Interest Payments	2.8	3.0	1.8	1.4
Revenue	18.2	18.5	18.5	16.9
Income Tax	8.4	8.4	8.6	7.3
Corporate Tax	1.7	1.9	1.6	1.8
Social Security	6.3	6.6	6.6	6.5
Miscellaneous	1.8	1.6	1.4	1.3
BALANCE	-3.9	-2.1	-0.9	-3.0

Source: own elaboration with data from the Congressional Budget Office

2.- Euro-zone

Sovereign Debt Market in the Euro-zone

1) Introduction:

As pointed out in our previous report, Euro-zone governments were the most important issuers in 2004, with a 44% share of the market. Most debt is negotiable, even though "schuldschein" (promissory notes) are used a lot in Germany to finance the country's treasury. This type of paper is, in reality, a quasi-bond because it is placed on a specific secondary market, but is subject to a maximum limit of three cessions per note. Germany's treasury held a total of €47bn in this type of paper.

Debt with a duration of more than a year represents 86.9% of the total, with variable income being of minimal importance (2.1%), and perhaps concentrated in Italy's seven-year floater called CCT, which in 2003 accounted for 17% of gross debt issues. Likewise, debt issued in currencies other than the euro on represented 1% of the total at the end of 2003.

Debt as a proportion of GDP stood at 71.3% (2004), above the 60% limit set by the Maastricht Treaty and with large differences across countries. Italy, Greece and Belgium, for example, display debt/GDP ratios of more than 100% while other others such as Luxembourg or Ireland recorded ratios of 7.5% and 29.9% respectively.

Table 1: Euro-zone Member State Debt/GDP

COUNTRY	2001	2004
BEL	108	95.6
GER	59.4	66
GRE	114.8	110.5
SPA	57.8	48.9
FRA	57	65.6
IRL	35.8	29.9
ITA	110.7	105.8
LUX	7.2	7.5
HOL	52.9	55.7
AUS	67.1	65.2
POR	55.9	61.9
FIN	43.8	45.1
EUR	69.6	71.3

Source: Eurostat

The third phase of the Economic and Monetary Union, which involved putting the euro into circulation, has meant a huge change for national treasuries. Countries have been forced to adapt the management of their treasuries to a more competitive environment on losing their market niches as nations. Many created their own specialized agencies for managing debt (in the broadest sense of the word) even before the euro came into force, with the aim of implanting a more sophisticated management mechanism in order to obtain a better position in the market.

2) Structure of Sovereign Debt Issues over Recent Years

National treasuries, depending on the size of their debt, have attempted to offer investors a variety of financial assets all the way along the interest rate curve.

All Euro-zone member states except Luxembourg have short term bond programmes. By short term, we mean bonds with a duration of one year or less and that are generally discount bonds. Apart from the assets issued in euros with domestic paperwork, some countries also use other short term instruments. The Republic of Ireland, Italy and the Netherlands have commercial paper programmes and Portugal, apart from having eurocommercial paper, also issues savings certificates to retail investors.

The average weight of these programmes in relation to total debt is approximately 15%. In this sense, France and Portugal figure prominently due to extensive issuing activity which totals 20% of their respective debt in circulation. The extensive use of short term financial instruments on behalf of France is due to the need to reduce the duration of debt to a desired target.

As far as the issue of bonds is concerned, treasuries have used maturities over the period dating from 1999-2005 of 2, 3, 5, 7, 10, 15, 20, 30 and recently 50 years when issuing at a fixed rate; Italian floaters mature after seven years (CCT), Italian zero coupon bonds mature after two years, those indexed to inflation boast various maturities and France's TEC-10 bonds which mature after 10 years.

Table 2: Structure of Gross Issues from National Treasuries in the Euro-zone. 1999-2004

TERM	EUR BN	%
2	344.7	11.24%
3	67.3	14.01%
5	132.7	23.99%
7	34.5	6.38%
10	175.8	33.66%
15	33.5	3.98%
30	42.7	6.73%
TOTAL	563.5	100.00%

Source: own elaboration

The Euro-zone as a whole has a preference for issuing long or very long term bonds (44.3%), while 30.37% are medium dated securities, with an average weighted duration of 8.3 years across all issues. Since 2001, the proportion of debt with a duration of more than 10 years has risen considerably. If we go further back into the past, the change is even more noticeable. The importance of short term debt in countries with high debt ratios such as Italy, Belgium or Greece, have dropped drastically. The percentage of short term debt in Italy decreased from more than 60% (1993) to nearly (2003) in ten years.¹

¹ Occasional Paper 25th of March 2005. "Government debt management in Euro Area. Recent Theoretical Developments and Changes in Practices." G. Wolswijk, J. De Haan.

Table 3: Gross Sovereign Debt Issues by Country. 1999-2004

COUNTRIES	EUR BN	%
FRA	607.1	18.30%
AUS	93.1	2.81%
FIN	39.8	1.20%
HOL	148.6	4.48%
SPA	204.3	6.16%
ITA	1,110.3	33.47%
POR	52.7	1.59%
IRL	18.8	0.57%
GER	777.5	23.43%
BEL	129.3	3.90%
GRE	136.3	4.11%
EUR	3,317.8	100.00%

Source: own elaboration

Table 4: Average Duration of Gross Sovereign Debt Issues

YEAR	AVERAGE TERM
1999	8.4
2000	9.1
2001	7.6
2002	7.9
2003	8.1
2004	8.5
AVERAGE	8.3

Source: own elaboration

Italy, the country that issues the most, France and Germany account for 75.2% of gross issues. These countries, together with Spain, cover the most terms in the public debt curve.

Countries with average borrowing requirements such as Austria, the Netherlands, Belgium or Greece, cover between three and four points on the curve, while Finland, the Republic of Ireland or Portugal cover one or two points on the curve, which change from year to year.

ABN-Amro expects gross issues in 2005 to total €621bn, slightly down on the figure in 2004. Italy will continue to be the country that issues the most in 2005. In the first few months of the year, demand for bonds dated longer than ten years has risen significantly, with France's first issue of a 50-year bond figuring prominently. Ultra long bonds accounted for 21% total issues in the first quarter, in comparison to 10% in 2001.

The need to hedge for institutional investors to hedge certain long term obligations and historically low nominal interest rates explain why long term issues have become more important in terms of proportion.

3) Issue Mechanisms and Distribution

When talking about issue mechanisms and distribution, one must distinguish between the several instruments and markets used as well as the size or intention of the country in particular. In France, one of the main objectives of the French treasury agency, which is in charge of managing France's debt, is to "contribute to structuring the European fixed-income market by innovating." It is therefore no surprise that the FTA together with other countries have generated an interest rate curve of European debt and that they have introduced a large number of innovations in the market. Such examples are the inflation-indexed bond, the TEC-10 bond and more recently, the new 50-year reference.

Regarding bond issues in euros on behalf of national governments from the Euro-zone, significant changes have occurred when comparing before and

after, which have depended on the size of the country and overall borrowing requirements.

Market conventions and even taxes have converged considerably over this period of time, making the performance of the different countries easier to compare.

Strong competition among national issuers has bolstered greater management transparency. Information concerning the management of national treasuries can commonly be found on the internet or in print in periodical bulletins and annual reports. Furthermore, issue calendars, by term and placement objective, are commonly announced beforehand, either for the next three months or for the entire year. Thus, the possibility of launching opportunist issues to take advantage of favourable market conditions has declined.

Competitive auctions attended by a selection of financial institutions (primary dealers) were used to allot domestic bonds before 1999. With the Economic and Monetary Union coming into being, the market approach has changed in terms of size and requirements.

Most Euro-zone countries combine syndication tenders and auctions differently, except for Germany and the Republic of Ireland, which continue to issue paper using the auction method exclusively.

The combination of syndication and auctions varies across countries. Most small and medium-sized countries such as the Netherlands or Portugal, always use the syndication method and when

they place new issues on the market, they later increase the size of those issues by means of successive auctions. Other countries, such as Spain or Belgium, only syndicate new issues for bonds lasting more than five years, while others such as France or Italy, syndicate when issuing new products or if issues are very long-dated.

As far as syndication is concerned, the selecting institutions to manage the issue does not only depend on price, but also on the placement objective, strategy, capacity and mechanisms to be used in order to achieve goals. Later on, both the institutions selected and the issuer, depending on the strategy chosen, will prepare themselves conscientiously before the day of issue. An issue is practically preplaced before it is publicly announced (bookbuilding). In order to achieve this, the institutions involved will have carried out an active premarketing strategy aimed at potential investors by disseminating not only the characteristics of the issue, but also an issuer credit note. The issuer holds roadshows, that is, presentations for potential investors, either individually or in small or large groups in order to help achieve these objectives and for bookbuilding to be a success. Nevertheless, the one-by-one strategy is the most effective.

In some cases, such as the Portuguese debt management agency, the so-called POT system, within the framework of syndication, is used. This system has been imported from the US domestic bond market. The POT system enables the issuer and final investor to communicate directly by means of a programme on the internet. The investor types in its orders with quantities and prices for that issue. The

issuer can see all orders individually or grouped into countries or types of investors and decide the price it will accept according to its placement objectives. This is, in short, an auction between final investors for one issue in particular.

Issues, regardless of how they are placed on the market, use specialized financial institutions as intermediaries (primary dealers) which are periodically selected in accordance with their capacity and comparative results in the primary and secondary bond markets. Apart from intervening in auctions, they generally create a market for issues in order to contribute to issue liquidity, they promote government debt and carry out other types of operations. The number varies depending on the country in question. In the Republic of Ireland there are seven, in the Netherlands 13 and Italy 40.

Table 5: Issue Syndication Mechanism by Country

COUNTRY	SINDICATION	ISSUE
	METHOD	FREQ.
BEL	NEW+5Y	2 MONTHS
GER	NO	
GRE	NEW LONG	MONTHLY
SPA	NEW+5Y	15 DAYS
FRA	NEW PROD	15 DAYS
IRL	NO	MONTHLY
ITA	NEW VERY LONG	MONTHLY
HOL	NEW	MONTHLY
AUS	NEW	MONTHLY
POR	NEW	MONTHLY
FIN	NEW	MONTHLY

Source: own elaboration

Italy is unusual in that primary dealers, depending on the quota assigned for the three previous auctions, have the right to ask for more paper for one day following an auction and at the same

price. In the Netherlands for example, the Dutch Treasury Agency offers debt repo facilities for issues of €2.5bn or less.

Issues are normally carried out once or twice a month. Issues obviously overlap to a certain extent, particularly at the beginning of the year, because it is the sweetest moment to issue due to the large amount of liquidity on the market that is avidly awaiting investment opportunities. This is due to the fact that fund managers generally stop investing in new resources captured in the second half of November and in December.

4) The Use of Foreign Currency

The use of debt denominated in a foreign currency has not historically been for reasons of a technical nature (such as the government disincentives to raise inflation and thus protect the rights of bondholders), but rather for practical reasons. These include avoiding the saturation of the domestic market, increasing the country's reserves, gaining more international investors, due to obtaining better conditions or because foreign interest rates were well below the level of domestic interest rates.

Some smaller countries such as the Republic of Ireland, Belgium or Greece, due to the size of their market, rely strongly on the foreign sector. Italy does so to reduce the cost of the bloated public-sector debt.

Currently, with the beginning of the Euro-zone, the Republic of Ireland, Italy, Austria, Portugal and Finland have reduced their foreign debt burden, while other countries that in the past

were not allowed to do so, such as France and Germany, have now received authorization. The only country to maintain the prohibition is the Netherlands. The US dollar, the Swiss franc, the yen and the pound sterling are the most frequently used currencies.

Generally speaking, hitting foreign markets in currencies other than the euro is not prompted by interest rate differences, but by favourable arbitrage in the swap exchange market and/or that foreign markets are easier to gain access to. This results in paying a smaller margin. In fact, the risk of issues in currencies is generally hedged by means of exchange swaps.

In order to make the most of the opportunities in foreign markets, five countries in the Euro-zone have medium term note (MTN) programmes, which enable them to issue both public and private bonds on international markets very quickly. These issues are smaller and tailor-made for one or several investors. Private issues are bilateral and negotiated over the telephone with the investor through the dealer. Public issues are placed by means of syndication, using the POT system, or not.

Eurocommercial paper is another mechanism used by national treasuries. This is an instrument that generally speaking is a discount bond up to 360 days in any currency and are not listed in any official secondary market. They are negotiated over the phone or by internet. The Republic of Ireland, Italy and Portugal have this type of programme.

5) The Liquidity of Government Bonds in the Euro-zone

One of the primary objectives of national treasuries has been to substantially increase bond liquidity. In order to achieve this, treasuries have, without exception, attempted to increase the size of their issues, which has resulted in smaller Euro-zone countries reducing the number of terms on the curve that are not covered by bonds from the country in question and a decrease in the number of auctions. While the standard amount stood at €2bn before the Euro-zone came into being, 90% of the bonds issued by France have an average size of €16.3bn. The Netherlands aims to increase the size of their issues to at least €10bn.

Table 6: Average Size of Issues over €10bn and Proportion of Total Issues

COUNTRY	Average size (€bn)	% Debt
BEL	13.2	54
GER	16.5	93
SPA	12.9	81
FRA	16.3	90
ITA	16.3	89

Source: BNP Paribas

Furthermore, on reaching this size, the country becomes eligible for the most liquid trading platform for sovereign bonds which is the Euro-MTS, heir of Italy's Monte-Titoli. This market demands minimum issues of €5bn in outstanding size, or €3bn if the minimum amount indicated previously is reached in 180 days. In this market, primary dealers are continuously forced to trade within narrow margins of purchase and sale prices.

The market is divided into two blocs: the above-mentioned Euro-MTS and National MTS markets.

Governments also repurchase bonds with little liquidity, or exchange them for liquid or benchmark bonds in order to increase their liquidity and increase the size of issues and reduce the number of issues that are not very liquid. The price of these transactions can be determined by auctions or direct purchase in the secondary bond market. Annual bond repurchasing amounts to between €40bn and €50bn, while exchanges dropped from €23bn in 2000 to €6bn in 2004. As a proportion of the annual total of gross issues, repurchasing represents an average of 5.7% and exchanges 1.97% (average over the past three years).

Table 7: Repurchasing and Exchanging Debt by Country

COUNTRY	REP	EXCH
BEL	SI	SI
GER	NO	NO
GRE	NO	SI
SPA	SI	SI
FRA	SI	SI
IRL	SI	SI
ITA	SI	SI
HOL	SI	NO
AUS	NO	NO
POR	SI	SI
FIN	SI	SI

Source: BNP Paribas

6) Central Government Debt Spreads

Before the Euro-zone came into existence, public-sector debt spreads between national treasuries depended mainly on four factors: exchange rate

outlook, tax system, credit risk and liquidity. From 1999 onwards, the only factors that still counted were credit risk and liquidity.

Convergence measured in terms of standard deviation reveals that spreads narrowed between 1995 and 1999.² Spreads have continued to get narrow over recent years, particularly in the case of AAA-rated Governments, whose current spreads for 10-year bonds range from three to five basis points. If AAA-rated governments are compared to those that do not boast this rating, differences are greater. The spread between Italy (Aa2) and Germany (AAA) stands at 13bp for 10-year bonds. Spreads have converged partly due to government ratings being upgraded. Before the Euro-zone, six out of twelve countries were rated AAA by the three international agencies, two improved from AA to AAA over the period and a further four remained in lower categories. Greece's upgrade from BBB to A is also worthy of mention.

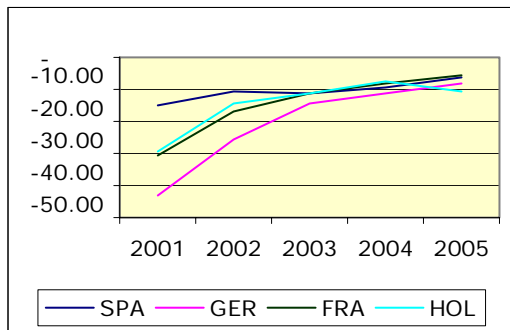
Table 8: Euro-zone Country Ratings

COUNTRY	MOODYS	S&P	FITCH
AUS	Aaa	AAA	AAA
BEL	Aa1	AA+	AA
GRE	A1	A	A
ITA	Aa2	AA-	AA
HOL	Aaa	AAA	AAA
POR	Aa2	AA	AA
SPA	Aaa	AAA	AAA
FIN	Aaa	AAA	AAA
FRA	Aaa	AAA	AAA
GER	Aaa	AAA	AAA

Source: own elaboration with data from Moody's, Standard and Poor's and Fitch.

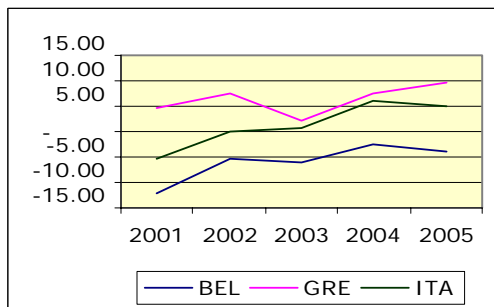
² WP 230 "The Euro Area Financial System: Structure, Integration and Policy Initiatives" by P. Hartmann and others. ECB may 2003.

Figure 1: Mid-swap spread for 10-year bonds.



Source: own elaboration with data from Reuters

Mid-swap Spread for 10-year Bonds (continued)



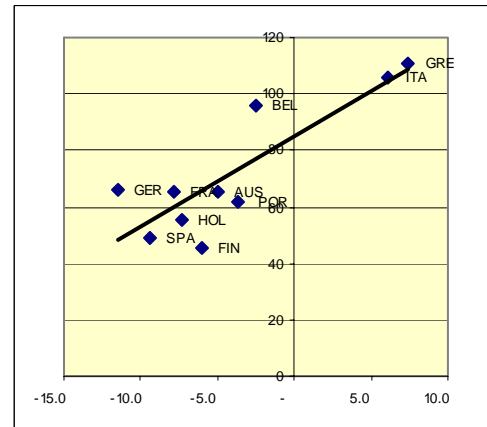
Source: own elaboration with data from Reuters

If we compare spreads in terms of swap by issue terms, a positive credit curve is observed, which mainly affects the lowest ratings. While in Germany three-year bonds are stated at Euribor-17.4bp and 30-year bonds at Euribor-9.8bp, in Italy three-year bonds are stand at -13.2bp and 30-year bonds at +12.3bp.

The relationship between the weight of the debt and credit spread is positive in econometric terms. The risk premium at the beginning of the Euro-zone is lower. A spread of 5% of the debt service/income ratio in relation to

Germany implies a spread of approximately 14bp.³

Figure 2: Spread and debt/GDP ratio in 2004



Source: own elaboration

Likewise, we can also measure the liquidity premium. A 1% increase in the size of an issue is estimated to cause a 0.7bp reduction in the spread.

7) National Treasury Financial Risk Management

Apart from managing the debt issues themselves, some governments have also taken it upon themselves to set certain management targets regarding the portfolio cost in absolute terms.

Financial risk management objectives have not followed the theories on optimum debt management, such as macro economic stabilization (Tobin, 1963). Some examples of this are: issuing in the long term when the economy is growing in order to raise long term interest rates which helps to cool down the economy; or tax

³ WP 369 "Sovereign risk premium in the European Government bond market" by K. Bernoth and others. ECB June 2004

smoothing (Barro, 1999), which is aimed at maintaining tax rates in the long term practically unchanged, thereby advising issues to be indexed to GDP; or stabilizing the deficit (missale, 2000), which suggests a combination of debt instruments that depend on the correlation matrix of GDP growth, inflation and interest rates.

Governments' financial management has not taken into account any ties with or variables in the budget. They merely aim to maintain the financial cost of long term debt low and within the realms of reasonable risk. This means considering the cost of the debt over time, monitoring debt or refinancing interest rate adjustments and the annual debt servicing cost. Having a variety of objectives undoubtedly generates contradictory situations.

Governments use derivatives in order to adjust to the objectives they have set and are extremely careful when it comes to the credit risk of their balancing bank entries, taking into account their ratings, balance or their solvency and profitability.

Management varies depending on the country in question in terms of the systems employed and how sophisticated they are. The Republic of Ireland and Portugal, examples of sophisticated management, measure the result of their management by comparing the cost of the benchmark, or the portfolio of theoretical reference, and the real portfolio over a year, taking on more or less risk depending on whether they are more or less in line with the benchmark. The National Treasury Management Agency (NTMA), which is the Republic of Ireland's

specialized agency, has an advantage in that it has an advisory committee made up of people that represent important international investment banks.

Portfolios display differences when it comes to measuring risk. The Republic of Ireland uses a weekly risk methodology in value-at-risk terms, while Portugal's is in cash-flow-risk terms. In reality, it is the same method with a different perspective; either from the point of view of cash flows or variations in the present value of the portfolio.

The specialized debt management agency in the Netherlands aims to minimize cost with maximum risk, defined as amount-at-risk at 9% of GDP. Amount-at-risk is debt after swaps that must be refinanced every year, or whose interest rate must be revised. In order to approach this figure, interest rate swaps are used. The Treasury in Italy uses both value-at-risk and sensitivity analysis as methodologies for calculating financial risk.

Finally, the treasury agency in France (Agence France Trésor) aims to achieve a particular portfolio duration, by means of interest rate swaps and using short term instruments brings duration in line with the objective. Duration is the result of seeking to minimize the cost of the portfolio in 10 years through "Monte Carlo Simulations" of the current portfolio, taking into account that the guidelines of the Treasury in terms of issues that are maintained over time, together with the correlation of macroeconomic variables.

Community Budget

1) Budget Principles

The general budget of the European Union is document in which the income and expenditure relating to the policies supported by the Union must be approved. The budget excludes the European Development Fund, which manages aid programmes to countries in Africa, the Caribbean and the Pacific and which is directly financed by contributions from the member states, as it is not subject to the annuity principle and is controlled by the European Commission, which is the body in charge of approving its projects.

The principles that govern the budget are common to those corresponding to member states and are as follows:

- a) Principle of budget unity and veracity: all income and expenditure included in one sole document.
- b) Principle of annuity: budget loans and credits are authorised for the year from January to December, except in the United Kingdom.
- c) Principle of equilibrium: borrowing is not an option.
- d) Principle of universality: income and expenditure amounts are recorded in full. There cannot compensation between them.
- e) Principle of budget speciality: loans and credits must affect one same purpose and, therefore, must have a specific objective.

f) Principle of good financial management: principles of economics, effectiveness and efficiency.

g) Principle of transparency.

Although the budget is passed on an annual basis, its approval is limited by the financial framework, which is the set of maximum limits which are approved caption by caption of groups of income and expenditure and which are in force for a period of seven years (2000-2006). The financial framework is passed jointly by the Parliament, the Council and the Commission.

The multiple-year restrictions were introduced in light of the annual tension when it came to passing budget in the 1980s, and was first employed in 1988 for a period of five years by Delors.

In the document detailing the financial framework, maximum expenditure commitments are stated in millions of constant euros and as a percentage of gross national income, in accordance with the growth forecast. In addition to this, a threshold is established for the main revenues, denominated equity, according to gross national income. A cushion or safety margin between both captions is also established in order to meet extraordinary expenses and lower growth forecasts than those initially predicted.

The aforementioned principles, such as that of annuity, the borrowing prohibition and financial restrictions for periods of several years are formally established as such in the Treaty of the European Constitution.

2) Budget Structure

Practically all budget income (more than 99%) are called equity. This set of revenues includes customs duties, agriculture duties and contributions from the sugar sector, VAT and contributions from member states according to their Gross National Income (GNI). The sum of all these annual incomes over the period from 2000-2006, in accordance with the financial framework approved, cannot exceed 1.24% of GNI. The most important source of income is the contribution from GNI, which accounts for close to 73% of total income for 2005.

Less than 1% corresponds to redeeming loans awarded by the Commission, reimbursements from community programmes, interest resulting from liquidity investments, sale of properties and other asset and miscellaneous transactions.

Table 9: 2005 Income Budget for the European Union

INCOME		
	€Mn	%
MISC. INCOME	1,041	0.98%
CUSTOMS + OTHE	12,363	11.63%
VAT	15,313	14.41%
% of GNI	77,583	72.98%
TOTAL	106,300	100.00%

Source: Diario oficial de la Unión Europea

Equity represents 0.99% of GNI in 2005 and, therefore, below the threshold contemplated in the financial framework 2000-06 of 1.24%.

Net customs duties and sugar and agricultural contributions do not all go

to the community treasury. Only 75% is included as budget income.

As far as VAT is concerned, in 2005 0.31435837 is applied to 1% of VAT with the limit of 0.5% of GNI for each member state. In order to calculate GNI shares, the coefficient of 0.7330195 is applied to 1% of each country's GNI. The famous British Cheque, which amounts to €5,115.15Mn, must be subtracted from this total. The British cheque was approved in 1984 in compensation for a country that contributed much but received little aid from the Common Agricultural Policy (CAP) at a time when its weight in the budget was excessive.

Table 10: 2005 European Union Budget Expenditure Statement

	EXPENSES	%
AGRICULTURE	49,115	46.2%
STRUCTURAL AC	32,396	30.5%
DOMESTIC POL	7,924	7.5%
FOREIGN ACT	5,476	5.2%
ADMINISTRATIO	6,351	6.0%
RESERVES	446	0.4%
PREADHESION	3,287	3.1%
COMPENSATION	1,305	1.2%
TOTAL	106,300	100.0%

Source: Diario Oficial de la Unión Europea

On the expenditure side of the balance sheet, CAP and Structural and Cohesion Funds absorb almost 77% of the Budget Expenditure Statement. A reserve allowance is generated in provision of extraordinary expenses, which amounts to 0.4% of the total.

3) Budget Approval and Control Mechanisms

The system employed to pass the European Union budget differs to those used by each member state. While in the second case it is the parliament that approves the budget and always have the last word, in the case of the EU budget, the council and the parliament actively intervene.

The first draft is prepared by the Commission, in accordance with the priorities agreed by the Parliament and the Council, which at the same time may make posterior amendments.

The draft is revised by the Council, which, following a meeting with a parliament delegation, elaborates the draft of the Council's budget.

In light of the fact that the last word on obligatory expenses corresponds to the Council, while discretionary expenses correspond to the Parliament, the draft undergoes a first hearing in the Parliament, during which amendments in discretionary expenditure can be made, together with proposals for modifications in obligatory expenses.

The draft goes back to the Council, where the amendments to discretionary expenditure are incorporated and the proposals for modifications to obligatory expenditure in the budget are either accepted or rejected, following a meeting with parliamentary delegates. At the same time, the council proposes modifications to discretionary expenditure.

Finally, the Parliament assumes the decisions made concerning obligatory expenditure and approves or rejects the

proposals on discretionary expenditure. If three out of the five votes are positive, the budget is passed. Once the budget has been passed, the Commission can propose modifications, in exceptional or unexpected circumstances.

When it comes to executing the budget, the Commission entrusts expenditure to National, Regional and Local Governments with the job of managing the funds, as is the case with CAP or Structural Funds. On the income side, member states are charged with the job of collecting revenues. The Commission must give the stamp of approval concerning whether or not the rules have been followed and European Institutions authorises payments and stipulates the conditions. The Commission also has the power to outsource services, although under its own responsibility.

As is the case in other public administrations, there is both internal and external control. Internal controls are carried out by civil servants at European institutions, who authorise expenditure or income, apart from having a monitoring system to fight fraud. External controls are carried out by an independent Accounts Tribunal, which compiles a report of account capitalisation and recommendations and the replies from the institutions involved.

4) Outlook for the 2007-13 Financial Framework

The objectives deemed vital in the financial framework for 2000-06, that establishes a 1.24% of GNI limit for equity, have been pre-accession, the

enlargement of the European Union and the reform of the CAP.

The priorities put forward by the Commission for the 2007-2013 financial framework are to foster sustainable development, give a full meaning to the concept of European citizenship and promote coherency in Europe's role as a world partner.

In order to achieve this, the following structure and limits are proposed:

- a) Sustainable development divided into two blocs:
 - Competitiveness for growth and employment: improve technological research and development, education and professional training, social political agenda and interconnecting networks.
 - Greater cohesion: convergence, regional competitiveness and employment.
 - European cooperation through across frontier programmes.
- b) Conservation and management of natural resources, including CAP, rural development, fishing policy and environmental action.
- c) Citizenship, freedom, security and justice: border control, immigration and refugee policy, public health, consumer protection, culture, youth and citizen information.
- d) The European Union as a global partner: integration of all development aid (EDF) and foreign affairs.
- e) Administration.

The Commission plans to maintain the equity threshold at 1.24%, although payment commitments will reach 1.14% - thus leaving a margin of such. However, a new source of income that does not increase the tax burden is proposed. This would be a corporate or energy tax, or a real VAT.

This proposal has not been accepted by six countries (Germany, France, the UK, Sweden, Austria and the Netherlands), which seek to lower the equity threshold to 1% of GNI. Luxembourg, current in the Presidency, proposes an intermediate solution, which would mean a threshold of 1.15%, cohesion expenditure cuts and a decrease in the British cheque. The UK, however, has threatened to veto if the cheque is reviewed.

Valencia, June 2 2005
Nicolás Jannone

3.- Spain

Introduction

The Spanish Treasury underwent a strong process of decentralization throughout the 1980s and 90s. As a result, revenue and above all expenditure of the central government and its autonomous organisms has been significantly redistributed. The State is currently responsible for 49% of total public sector expenditure, without taking into account social security, while regional governments account for 33% and local bodies the remaining 18%.

The decentralisation of expenditure has only partially spilled over into the income side of the balance sheet. The central government is still mainly in charge of income, which it receives on behalf of the public sector and later redistributes. Regional and Local Governments have limited regulatory power in financial issues.

Apart from the decentralization that the Spanish Treasury has undergone over the past two decades, other equally important changes have been witnessed that have also marked its development in recent years.

It is worth highlighting, amongst other things, that:

- Growing public sector expenditure has been curtailed.
- Government revenue has risen gradually.
- The structure of the tax system has been modified, with indirect taxation becoming the mainstay of public income.

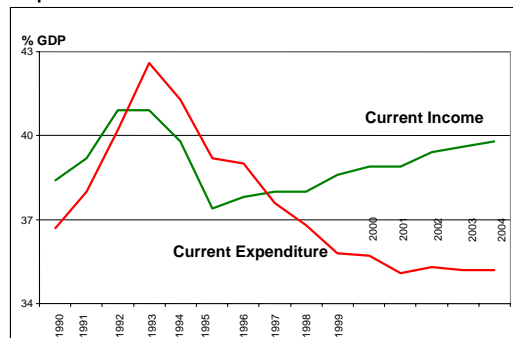
- The financial burden on government debt has been reduced.
- The saving rate has grown markedly.
- Government investment has gradually dwindled.
- Total government debt has decreased in size.
- Social security registers a surplus.
- Regional governments display imbalances.

In the next section, some of these features are discussed:

Growing public sector expenditure has been curtailed

In contrast to the tendency which began in the 1960s, characterized by a constant and uninterrupted rise in public sector spending in terms of GDP, government current expenditure has been appreciably restrained since 1993. The all-time high recorded in the 1960s of 42.6% has dropped by 7.4% in relative terms to 35.2% in 2004, one of the most significant decreases within the Organisation for Economic Co-operation and Development.

Figure 1: Current Income and Expenditure



Source: European Commission

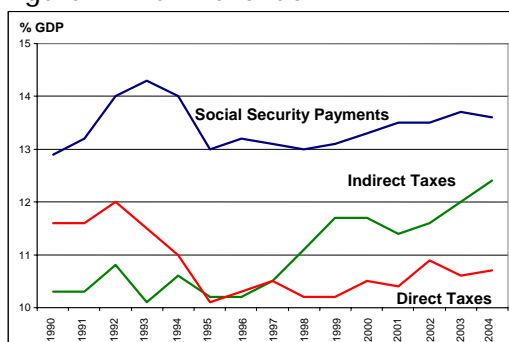
The Increase in the Tax Burden

While expenditure has been controlled, current receipts have risen gradually but constantly in relative terms. After Economy Minister Pedro Solbes agreed to lower social security payments in 1993 (the only decrease approved in this epigraph), income has grown smoothly resulting in an increase in the tax burden from 37.4% in 1995 to 39.8% in 2004.

Change in Tax Structure

Similarly, the continuous and varied tax reform bills passed in recent years have affected all taxes, but indirect taxation in particular (tax brackets have narrowed; maximum amounts subject to taxation have dropped as have rates, and bases have been indexed). As a result, there has been a change in relative importance of the various taxes and the tax system has become somewhat less progressive.

Figure 2: Tax Revenue



Source: European Commission

The three largest sources of tax revenue are as follows:

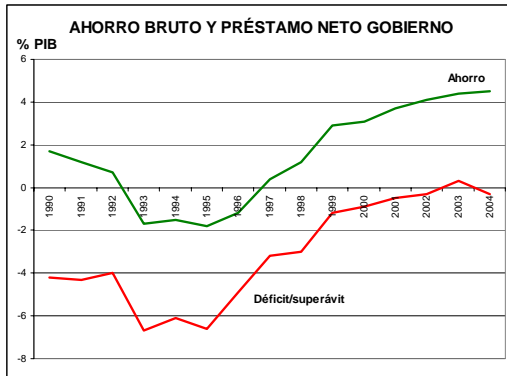
- Social security quotas, which have remained considerably stable at around 13.5% of GDP.

- Indirect taxes (particularly VAT and special taxes which have become the system's greatest earners) which have increased their share of total tax revenue from 10.2% in 1996 to 12.4% in 2004.
- Direct taxation (income tax and corporate tax, mainly) have fluctuated the most. On the one hand, more adjustments and changes have been made to direct taxes than to any other taxes in recent years. On the other hand, they are also seen to be affected the most by cyclical factors (income and profits are more volatile than expenditure). Therefore, the marked fall in 1993 (with the economic crisis) and the recovery in corporate profits that followed (which accompanied the boom in the Spanish economy in later years) explain to a great extent why the contribution of direct taxes to public sector current receipts has fluctuated so much. Nevertheless, the result of these two effects is none other than a gradual decrease in direct taxation's relative share of total income.

Deficit Disappears

The combination of both curbing expenditure and smoothly increasing income had an immediate effect on imbalances, which were corrected, and the public sector deficit, which disappeared.

Figure 3: Government Gross Saving and Net Borrowing



Source: European Commission

While the public sector needed to borrow the equivalent of 6.7% of GDP in 1993, this figure barely reached 0.3% in 2004, with the subsequently favourable impact on private funding. At the same time, this pattern has acted as a counterweight to the economic environment, which has been out of sync with the economic cycle in the Euro-zone, within the framework of single monetary policy.

The aforementioned patterns in current income and expenditure have logically resulted in a continuous improvement in the public sector savings rate, which has risen from -1,8% of GDP in 1995 to 4.5% of GDP in 2004. This is a substantial change within the framework of the Stability and Growth Pact.

The Budget as a Cycle Control Tool

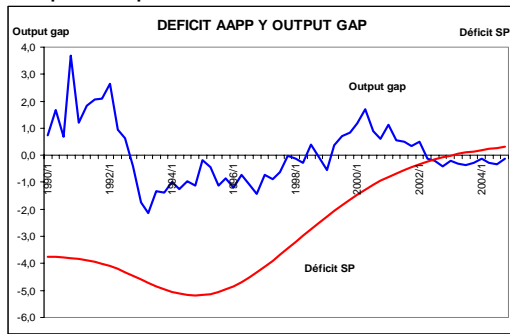
The budget has become, as indicated in the previous section, the only tool of any importance that is available to Euro-zone member states when it comes to staying on top of the current economic environment.

Being out of sync with the economic cycle in the Euro-zone and investing strongly, as has been the case with Spain in recent years, has meant that the public sector has been forced to offset expansive phases by increasing its surplus in order to smooth out tensions in aggregate demand. As a result, the domestic saving rate has increased. Therefore, the public sector will be able to face up to weak aggregate demand when the expansion inverts, without needing to comply with the stability pacts, which are indispensable in the monetary union regardless of the formula finally agreed upon.

The debate should probably focus more on whether or not the role of fiscal policy in offsetting the absence of monetary policy has been suitable. In light of the pattern of prices and marked foreign trade imbalances, the conclusions drawn cannot all be positive. Despite achieving budget equilibrium and a strong rise in the public sector saving rate, financial policy has not been flexible enough to seriously face up to the cycle, really offset the lack of one's own monetary policy and curb expansive Euro-zone monetary policy that was creating more liquidity than the Spanish economy needed.

There are several ways of measuring this pattern and analysing whether or not the public sector has controlled aggregate demand and smoothed out market tensions, thereby preventing them from overheating. Figure 4 illustrates how the Spanish economy's output gap has developed, together with smoothed public sector deficit tendency.

Figure 4: Public Sector Deficit and Output Gap



Source: Bank of Spain

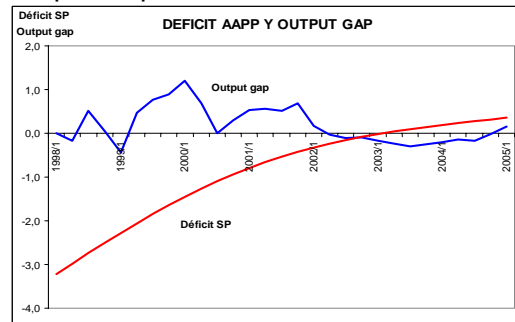
While GDP growth (before the review carried out recently) remained more or less in line with its pattern, which meant the output gap was slightly negative, by correcting its deficit the public sector clearly controlled aggregate demand, weakening it and cooling down overheated markets.

However, as soon as the correction in GDP is taken into account (base year changes from 1995 to 2000), real growth rates will be higher than those used in the estimate, the output gap will be positive and public sector deficits or surpluses will be smaller. In this case, the public sector would not have offset the cycle as much as would have been desirable.

In Figure 5 below we have only attempted to estimate the output gap once more, in light of the fact that calculating it correctly will be impossible until the chained series is available. In order to achieve this, only GDP growth figures in real terms from the second quarter of 2000 onwards are corrected. We have used the quarter growth figures in the National Accounts (base year 2000) provided by the Spanish National Institute of Statistics. The changes resulting from the data

smoothing carried out are seen to be minimal and the conclusions that could be drawn do not differ a great deal from those advanced previously.

Figure 5: Public Sector Deficit and Output Gap

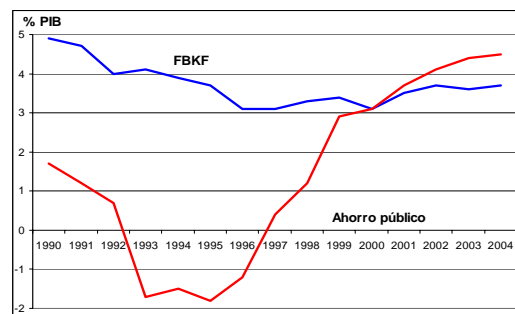


Source: Bank of Spain

Less Investment

At the same time current expenditure structure was being tightened, investment has waned, falling from almost 5% in 1990 to 3% in 1996/97. Since that time, public investment has recovered smoothly to 3.7% of GDP.

Figure 6: Public Sector Saving and Investment



Source: European Commission

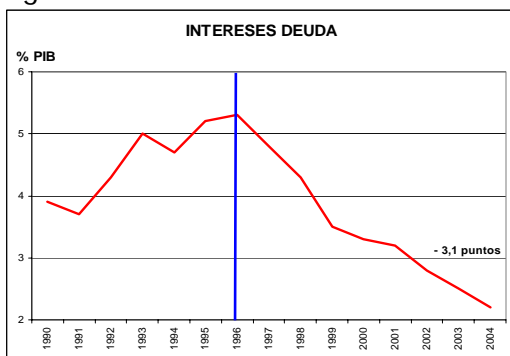
As can be appreciated in Figure 4, the rate of public sector savings has risen so spectacularly that there are sufficient funds to finance public sector investment in its entirety. It is once again difficult to find a better antidote for an internal environment

characterised by considerable investment (above all in construction) and a marked foreign trade deficit with the solution of net foreign borrowing. The high public sector saving rate props up the economy's overall saving rate and reduces the need to look abroad for financing.

Developments in the Financial Burden

Two key factors rapidly stand out when analysing the reasons behind the decrease in public sector current spending: civil servant earnings and the financial burden. While civil servant earnings have dropped by more than a point in terms of GDP since between 1992 and 2004 (from 11.8% to 10.4%), the financial burden, and debt interest payments in particular are mainly responsible for this decrease in public revenue. Between 1996 (5.3% of GDP) and 2004 (2.2%), the interest to be paid on the debt had dropped by more than three points in terms of its weight with respect to GDP. As a result, if public spending has lost ground in terms of its share of GDP to the tune of four points, more than three can be attributed exclusively to lower interest rates and the subsequent effect on debt interest payments.

Figure 7: Interest and Debt

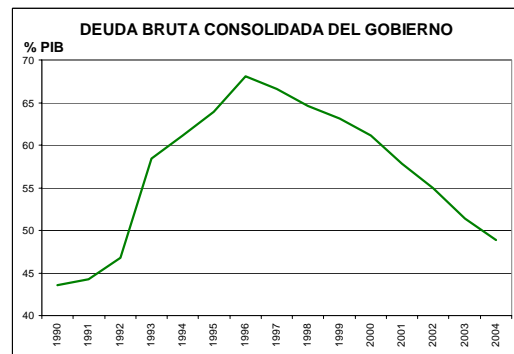


Source: European Commission

Debt

If we take into account the substantial growth in GDP throughout this economic cycle together with public sector equilibrium and the increase in the saving rate, total government debt could only go one way: down. In terms of GDP, the decrease in public debt has been unstoppable and spectacular and has, in turn, helped to reduce the financial burden and control public expenditure.

Figure 8: Consolidated Gross Government Debt



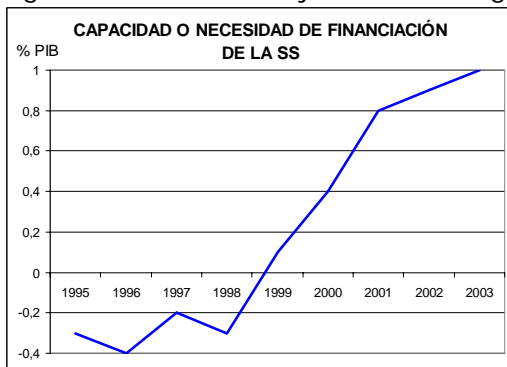
Source: European Commission

Total debt in terms of GDP has fallen uninterruptedly from 68% in 1996 to 49% in 2004. This means that Spanish gross consolidated debt has been reduced by some 18 points in eight years. Although these figures already seem spectacular, the new scenario with new GDP statistics suggests the decrease has been clearly greater. Moreover, budget equilibrium and nominal GDP growth of more than 7% are reducing total debt even more quickly than before. Gross debt will more than likely drop to 45% of GDP or less by the end of the year.

Social Security

Developments in the social security system have played a key role in the overall results obtained by the public sector in terms of increased savings and the elimination of the deficit. Historically negative results have turned into a considerable surplus that represents 1% of GDP and is consolidating aggregate accounts. The favourable economic cycle and its impact on job creation is reflected by the corresponding increase in the number of people registered. This has prompted high income rises and paved the way for initial social security budget stability, which later became a surplus.

Figure 9: Social Security Net Borrowing



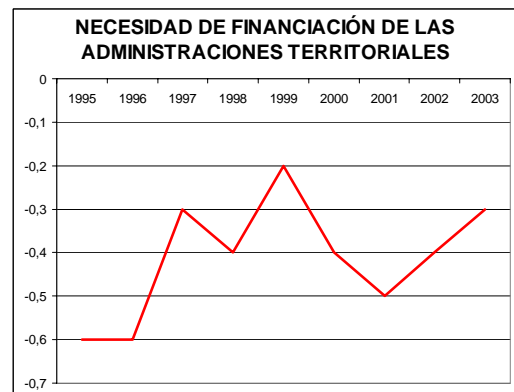
Source: Bank of Spain

Regional Government Imbalances

The surplus generated by the social security system has likewise been coupled with a decrease in net borrowing on behalf of regional and local governments. While it is fair to say that in terms of size, their debt has always been far from that of the Central Government, it is also true that the increasingly upward pattern displayed causes some uncertainty and instability in the otherwise balanced situation of central government

accounts. This has led regional governments in their entirety to behave entirely differently.

Figure 10: Regional Government Net Borrowing



Source: Bank of Spain

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(*) *This article expresses the author's personal opinion and not necessarily that of the Instituto de Crédito Oficial.*

Valencia, 29 May 2005

4.- Germany

In keeping with the layout of previous monographic supplements, the analysis of Germany's public finances will be divided into a series of relevant points. Our analysis aims to go deeper into the long term tendencies as far as possible, leaving the recent and widely known developments in Germany's financial policy aside.

1) Government Spending and the Size of the Public Sector

The important issue to be tackled is the size of Germany's public sector. The public expenditure/GDP ratio is widely considered a reliable indicator of public sector size. Well, the German public sector represents almost 50% of GDP¹ and has consolidated at around 48%, a trend that had already emerged in the 90s. It is undoubtedly a very high figure that reflects Germany's advanced social welfare state and is well above that of the United States and Japan, for example, both of which have registered ratios below 40% in recent years. However, it is not one of the highest in Europe. Take France, which is included in the table below, or the even higher percentages registered by Scandinavian countries that are approaching or above 60%. The stability the indicator has achieved is more important than the actual percentage itself. This contrasts with the increases observed in countries such as France or Japan over the same period.

¹ The figure for 1995 is excessively high, which leads us to suspect it may be wrong.

Table 1: Total Government Spending (percentage of GDP)

	France	Germany	Japan	USA
1990	50.73		31.71	37.10
1991	51.59	47.09	31.50	38.52
1992	52.92	48.08	32.45	38.53
1993	55.25	49.26	34.24	37.99
1994	54.90	48.98	34.80	37.04
1995	55.20	56.07	35.77	37.01
1996	55.37	50.28	36.26	36.53
1997	54.85	49.35	35.06	35.43
1998	53.74	48.80	41.37	34.66
1999	53.45	48.75	37.70	34.29
2000	52.56	45.75	38.22	34.18
2001	52.48	48.28	37.68	35.28
2002	53.50	48.75	38.16	36.28
2003	54.55	48.81		36.53

Source: Organisation for Economic Co-operation and Development

In recent times, analysing social expenditure has become popular when it comes to examining financial policy. Social expenditure comprises all those government expenditure items that affect people's level of well-being (health, education, social security, etc.) OECD data reveals that Germany's social expenditure represented more than 27% of GDP in 2001, which is very high given the data corresponding to other countries that same year. Furthermore, it is almost four points above the average for the EU15, which once again illustrates the power of the German Welfare State. However, the fact that social expenditure has risen by more than 4.5% in terms of GDP since the beginning of the 90s is even more striking, during a time when the relative weighting of overall government expenditure had remained stable. The reunification has undoubtedly had a lot to do with this increase, as is demonstrated by the fact that almost 4% of the 4.5% increase can be attributed to the two years that followed. However, the fact that this increase has not meant more overall

government spending with respect to GDP, at a time when the economy was not buoyant, shows that German authorities have acted responsibly in this domain.

Table 2: Social Expenditure (percentage of GDP)

	Germany	EU15	Japan	USA	Total OECD
1990	22.80	23.37	11.20	13.43	
1991	24.87	24.41	11.32	14.48	
1992	26.37	25.60	11.82	15.18	
1993	26.94	26.47	12.45	15.42	
1994	26.91	26.15	13.04	15.41	
1995	27.48	25.56	13.50	15.45	
1996	28.09	25.56	13.67	15.27	
1997	27.62	24.82	13.78	14.91	
1998	27.37	24.28	14.50	14.49	
1999	27.37	24.16	15.14	14.24	20.96
2000	27.17	23.89	16.13	14.24	20.86
2001	27.39	23.97	16.89	14.78	21.20

Source: OECD

2) Tax Income

While overall government spending has been kept in check, as mentioned in the previous section, the cost of the reunification is mainly visible in the considerable increase in tax income in relation to GDP observed over the same years. The almost 4% rise is practically double that observed in the simple (except for Japan, which has seen its ratio decrease by almost three points). The increase would have been even more pronounced if it had not been for the one-point drop in 2001, which was undoubtedly due to the downturn in income brought about by the economic crisis.

The increase tax income must have meant a very high cost in terms of efficiency at a time when the German economy was attempting to *digest* the reunification and hypothetically, it is

one of the main causes for the noticeable slowdown in German economic growth over recent years.

Table 3: Total Tax Income (percentage of GDP)

	Germany	EU15	Japan	USA	Total OECD
1990	32.9	39.2	30.0	26.7	34.8
1991	36.8	39.6	29.8	26.8	35.3
1992	37.7	40.0	28.1	26.6	35.6
1993	37.9	40.1	28.0	26.9	36.1
1994	38.1	40.4	27.1	27.3	36.1
1995	38.2	40.1	27.6	27.6	36.0
1996	37.4	41.2	27.5	27.9	36.6
1997	37.0	41.0	27.9	28.3	36.6
1998	37.1	40.9	26.8	28.9	36.5
1999	37.7	41.4	26.4	28.9	36.8
2000	37.8	41.4	27.5	29.7	37.1
2001	36.8	41.0	27.3	28.9	36.9

Source: OECD

The increase in taxation has been mainly noticeable in indirect taxes, which have risen as a percentage of GDP by two points. Direct taxation has remained unchanged, although with ups and downs. Hence, both ratios have drawn level in the last year under study.

One significant feature of German taxes (and European) in comparison to the United States (in the same data from the OECD, which are not displayed in the following graph) is the different weighting of both types of tax as percentages of GDP and of overall income. Income and corporation tax rose to 14.1% in the United States in 2001 (12.1% in 1990) and goods and services taxes remained at 4.6% (identical figure to that registered in 1990).

Table 4: Tax Income (percentage of GDP)

	Total	Income & Corporation	Goods & Services
1990	32.9	10.7	8.8
1991	36.8	11.7	10.0
1992	37.7	12.1	10.2
1993	37.9	11.7	10.6
1994	38.1	11.3	11.0
1995	38.2	11.6	10.7
1996	37.4	10.7	10.5
1997	37.0	10.4	10.3
1998	37.1	10.9	10.2
1999	37.7	11.3	10.6
2000	37.8	11.4	10.6
2001	36.8	10.6	10.6

Source: OECD

3) Budget Balance and Public Debt

In the field of public deficit/surplus, the performance of German public accounts leaves a bitter aftertaste. It is a well known fact a widespread and remarkable tax rationalisation process was undertaken in the 1990s. The effect of this phenomenon can be observed in the evolution of the all countries' and groups of countries' public deficits. Germany's public sector was no different, registering (with ebbs and flows) an increase in the deficit in terms of GDP between 1990 and 1996, followed by a decrease since then up to 2000 when a 1.33% surplus was achieved. From that moment onwards, the deficit has swelled inexorably, reaching 3.82% of GDP in 2003. Germany has violated the Stability and Growth Pact on three successive occasions (possibly four by the end of this year). However, German data at the beginning of the decade were substantially better than the rest of countries, with the peculiar exception of Japan, even despite having to face the reunification from the very beginning of

the decade, which would explain why Germany precisely was one of the firmest defenders of the implementation of the Stability and Growth Pact deficit limit of 3% of GDP.

The evolution of the deficit, together with the satisfactory financial policy one can deduce from the evolution of public income and expenditure described above all give an idea of the seriousness of the current crisis in Germany, as well as how difficult and far off its solution seems.

Table 5: Overall Public Deficit (-) / Surplus (+) (as a percentage of GDP)

	Germany	EU15	Japan	USA	Total OECD
1990	-1.97	-4.61	2.05	-4.24	-2.95
1991	-2.95	-5.00	1.81	-4.92	-3.73
1992	-2.55	-5.05	0.79	-5.77	-4.59
1993	-3.11	-5.76	-2.38	-4.94	-4.96
1994	-2.40	-5.06	-3.76	-3.56	-4.16
1995	-3.32	-5.05	-4.71	-3.14	-3.96
1996	-3.42	-4.32	-5.07	-2.18	-3.13
1997	-2.72	-2.84	-3.79	-0.79	-1.68
1998	-2.22	-2.30	-5.51	0.43	-1.23
1999	-1.49	-1.33	-7.23	0.85	-0.77
2000	1.33	0.07	-7.46	1.62	0.27
2001	-2.82	-1.71	-6.13	-0.39	-1.21
2002	-3.68	-2.42	-7.88	-3.79	-3.17
2003	-3.82	-2.75	-4.67	-4.60	-3.68

Source: OECD

On breaking down the overall deficit to the primary deficit, we can confirm the above conclusions. Germany has only registered a primary deficit during economic crises. Moreover, the gap between the overall deficit and the primary deficit in Germany has always been above the average recorded by the EU12.

Table 6: Overall and Primary Deficit (-) / Surplus (+) (as a percentage of GDP)

	Germany		Euro 12		EU15	
	O/all	Prim.	O/all	Prim.	O/all	Prim.
1991	-2.9	-0.1	-5.0	-2.2	-4.6	0.6
1995	-3.5	0.2	-5.1	0.5	-5.2	0.2
1997	-2.7	0.9	-2.6	0.5	-2.5	2.5
2002	-3.6	-0.4	-2.2	2.5	-1.9	1.5

Source: Briotti (2004)

The ratio of public debt/GDP reflects past deficits, as we know. As a result, the importance of public debt in relation to GDP rose over the 1990s, reaching 63.2% in 1998. Then, the deficit dropped to slightly over 60%, before finally rising once again to 65.1% in 2003. While this percentage is not particularly high, the increase over recent years is worrying.

Table 7: Gross Public Debt (percentage of GDP)

	Germany	Japan	USA
1990	41.5	68.6	66.6
1991	38.8	64.8	71.3
1992	41.8	68.7	73.7
1993	47.4	74.9	75.4
1994	47.9	79.7	74.6
1995	57.1	87.1	74.2
1996	60.3	93.9	73.4
1997	61.8	100.3	70.9
1998	63.2	112.2	67.7
1999	61.6	125.7	64.1
2000	60.9	134.1	58.2
2001	60.5	142.3	57.9
2002	62.9	149.3	60.2
2003	65.1	157.3	62.5

Source: OECD

4) Cyclical and Structural Budget

The structural deficit provides a measure of bias to financial policy. In this sense, Germany does its homework in the 90s, transforming an initial structural deficit of 1.9% of GDP in 1991 into a 1.4% structural surplus in 1997, precisely the year the Stability

and Growth Pact was approved. These results were similar across Europe, although in the case of Germany the lower starting figure together with the reunification process meant the ensuing surplus was lower than that of its European counterparts. From that moment onwards, as was the case in the rest of European countries, the structural deficit deteriorated, even though Germany saw its overall deficit worsen as opposed to the average of both the Euro 12 and the EU15. We once again find Germany's performance to be more orthodox in this field than that observed in the average of its neighbours.

Table 8: Overall and Structural Deficit (-) / Surplus (+) (as a percentage of GDP)

	Germany		Euro 12		EU15	
	O/all	Str.	O/all	Str.	O/all	Str.
1991	-2.9	-1.9	-5.0	-0.5	-4.6	0.0
1995	-3.5	0.1	-5.1	0.8	-5.2	0.4
1997	-2.7	1.4	-2.6	2.8	-2.5	2.7
2002	-3.6	0.0	-2.2	1.6	-1.9	1.6

Source: Briotti (2004).

5) Budget Decentralisation

The high degree of budget decentralisation in the German state is well known. This materialises in the significant percentage of the budget that is handled by regional and local tax offices, as shown in the following table. Note that except for public debt issues, the sum of Länder and local budgets is greater than that of the Federal government.

Table 9: Budget by Administration

	2002	2003	% of total 2003
Income			
Total	920,353	925,354	
Federal	246,683	241,532	26.10%
Länder	224,749	226,962	24.53%
Local	144,540	141,349	15.28%
Def/Surp			
Total	-66299	-75552	
Federal	-32728	-39231	51.93
Länder	-31223	-31669	41.92
Local	-4658	-8540	11.30
Debt			
Total	1325733	1394954	
Federal	760453	802994	57.56
Länder	414952	442922	31.75
Local	91498	91788	6.58

Source: DESTATIS.

Note: Public debt data correspond to 2003 and 2004.

In short, Germany's public sector displays all the problems that are normally associated to a European welfare state, even if its figures are not among the highest on the continent. Besides, taking into account the difficulties faced during the reunification process, Germany has made gradual progress since 1990, which does not mean it is exempt from problems in the future.

Antonio Cutanda
Valencia, May 31 2005

5.- France

As will be the case with the report on Germany, our analysis of French fiscal policy will attempt to first ascertain the long term tendencies rather than focus on the latest and all too well-known episodes in the economic environment.

1) Public Spending and the Size of the Public Sector

As its status of advanced European country would indicate, France's public sector is very large: total public-sector spending since 1990 has been 50% higher than GDP and is still growing, with ups and downs. In 2003 the figure stood at 54.55%, which is 15 points above the fluctuation range in the United States or Japan. As is the case with Germany, we are dealing with a very well developed social welfare state, although the French ratio was more than five points higher than Germany's in 2003 and is much closer to figures recorded in Scandinavian countries.

Table 1: Total Public-sector Expenditure (percentage of GDP)

	France	Germany	Japan	USA
1990	50.73		31.71	37.10
1991	51.59	47.09	31.50	38.52
1992	52.92	48.08	32.45	38.53
1993	55.25	49.26	34.24	37.99
1994	54.90	48.98	34.80	37.04
1995	55.20	56.07	35.77	37.01
1996	55.37	50.28	36.26	36.53
1997	54.85	49.35	35.06	35.43
1998	53.74	48.80	41.37	34.66
1999	53.45	48.75	37.70	34.29
2000	52.56	45.75	38.22	34.18
2001	52.48	48.28	37.68	35.28
2002	53.50	48.75	38.16	36.28
2003	54.55	48.81		36.53

Source: Organisation for Economic Co-operation and Development (OECD)

French social expenditure is also high in relative terms, practically doubling the ratios observed in Japan and the USA and higher than the EU15 average and that of the entire OECD throughout the period under study. However, it should be pointed out that this variable has increased less than half as much as total expenditure, which raises serious doubts as to whether the costs associated to the development of the public sector are too high in relation to the gains social welfare that the French people are being provided with.

Table 2: Social Expenditure (percentage of GDP)

	France	EU15	Japan	USA	Total OECD
1990	26.61	23.37	11.20	13.43	
1991	27.23	24.41	11.32	14.48	
1992	28.03	25.60	11.82	15.18	
1993	29.48	26.47	12.45	15.42	
1994	29.27	26.15	13.04	15.41	
1995	29.24	25.56	13.50	15.45	
1996	29.38	25.56	13.67	15.27	
1997	29.42	24.82	13.78	14.91	
1998	28.96	24.28	14.50	14.49	
1999	28.91	24.16	15.14	14.24	20.96
2000	28.34	23.89	16.13	14.24	20.86
2001	28.45	23.97	16.89	14.78	21.20

Source: OECD

2) Tax Income

Tax income in France represents a markedly high proportion of GDP, registering 45% in 2001. In fact, this figure has remained an average of eight points above the OECD average, four points above the average for the EU15 and around 16 points above the figure for the USA over the period dating from 1990 and 2001, without mentioning the special case of Japan. While this ratio has risen at a similar rate to those in the EU15, OECD and the USA, the figure seems too high in

relative terms. This trend figures prominently in the conclusion drawn above: the French public-sector may have become too large too quickly and perhaps an excessively high efficiency cost is being imposed, which could explain the sluggishness of job creation observed during the recovery and it would support those who believe structural reform is an absolute must and the sooner it is carried out the better.

Table 3: Total Tax Income (percentage of GDP)

	France	EU15	Japan	USA	Total OECD
1990	43.0	39.2	30.0	26.7	34.8
1991	43.2	39.6	29.8	26.8	35.3
1992	43.1	40.0	28.1	26.6	35.6
1993	43.3	40.1	28.0	26.9	36.1
1994	43.7	40.4	27.1	27.3	36.1
1995	44.0	40.1	27.6	27.6	36.0
1996	45.0	41.2	27.5	27.9	36.6
1997	45.2	41.0	27.9	28.3	36.6
1998	45.1	40.9	26.8	28.9	36.5
1999	45.7	41.4	26.4	28.9	36.8
2000	45.2	41.4	27.5	29.7	37.1
2001	45.0	41.0	27.3	28.9	36.9

Source: OECD

As far as income from the various taxes in force is concerned, the spectacular increase in the contribution of income tax and corporation tax to GDP over the 1990s must be highlighted. The figure rose by four points to 11.4% in 2001. At the same time, direct taxation has dropped a fraction (one point) to 11.3% of GDP the same year. In light of fact that such an increase in direct taxation must have been a real deterrent for private sector initiatives, the high efficiency cost of French public sector being paid by the French economy in the present day appears to be confirmed.

Table 4: Tax Income (percentage of GDP)

	Total	Income & Profits	Goods & Services
1990	43.0	7.4	12.2
1991	43.2	7.8	11.8
1992	43.1	6.9	11.5
1993	43.3	7.0	11.5
1994	43.7	7.1	11.9
1995	44.0	7.1	12.1
1996	45.0	7.6	12.5
1997	45.2	8.2	12.4
1998	45.1	10.4	12.2
1999	45.7	11.0	12.2
2000	45.2	11.3	11.7
2001	45.0	11.4	11.3

Source: OECD

3) Budget Balance and Public-sector Debt

France's public-sector deficit displays a similar pattern to that in all developed economies in the 1990s and the beginning of the 21st century. However, as opposed to all these countries (with the exception of Japan), France has never managed to chalk up a surplus during the entire period under consideration, despite starting out with a relatively small deficit. France's public sector deficit stood at 2.09% of GDP in 1990, which was less than half the average in the EU15 and United States and was considerably lower than the OECD average (2.95%). From this point onwards, the deficit grew dramatically to 5.98% of GDP in 1993 before dropping to a minimum of 1.4% in 2000. Since then, the deficit has once again grown and stood at 4.14% of GDP in 2003, provoking the all too well know repercussions in EU policy. The increase in the deficit from 2000 onwards is similar to that observed in the rest of countries, but the fact that France began with a much smaller

deficit means that in relative terms, the French figure is the highest.

Everything seems to indicate that French authorities were too relaxed during the “good times” when it came to eliminating the public sector deficit and that this factor is the basic reason that underlies the current difficulties the government has to stop it from growing further. If in addition to this we consider that France is enjoying a better economic situation than its neighbour and accomplice in failing to comply with the Stability and Growth Pact (Germany), which should in theory allow the government to employ more orthodox measures in managing public sector accounts, it is impossible to avoid thinking that perhaps this greater degree of relaxation in relative terms remains. This would explain why European Union authorities have a different attitude towards the two neighbours concerning this issue.

Table 5: Overall Public Deficit (-) / Surplus (+) (percentage of GDP)

	France	EU15	Japan	U.S.A.	Total OECD
1990	-2.09	-4.61	2.05	-4.24	-2.95
1991	-2.46	-5.00	1.81	-4.92	-3.73
1992	-4.17	-5.05	0.79	-5.77	-4.59
1993	-5.98	-5.76	-2.38	-4.94	-4.96
1994	-5.53	-5.06	-3.76	-3.56	-4.16
1995	-5.50	-5.05	-4.71	-3.14	-3.96
1996	-4.08	-4.32	-5.07	-2.18	-3.13
1997	-3.04	-2.84	-3.79	-0.79	-1.68
1998	-2.67	-2.30	-5.51	0.43	-1.23
1999	-1.77	-1.33	-7.23	0.85	-0.77
2000	-1.40	0.07	-7.46	1.62	0.27
2001	-1.53	-1.71	-6.13	-0.39	-1.21
2002	-3.26	-2.42	-7.88	-3.79	-3.17
2003	-4.14	-2.75	-4.67	-4.60	-3.68

Source: OECD

An analysis of the primary deficit further reinforces the above conclusions. France boasted a primary

surplus of 0.6% of GDP in 1991, the same as the EU15 average, while the Euro-zone average surplus stood at 2.2% of GDP. However, France's overall debt was much lower, as mentioned earlier. Only four years later, France's deficit was the highest in the sample (5.5%). At the same time, France had a primary deficit of 1.8%, while both the Euro 12 and the EU15 registered primary surpluses. France's accounts improved in 1997, as did the rest, chalking up a relatively small primary surplus of 0.7% and an overall deficit of 3%. From this point onwards France's overall deficit remains stable and the primary surplus is lost, while the Euro 12 and the EU15 continued to consolidate their financial position.

Table 6: Overall and Primary Deficit (-) / Surplus (+) as a Percentage of GDP

	France		Euro 12		EU15	
	O/all	Prim.	O/all	Prim.	O/all	Prim.
1991	-2.4	0.6	-5.0	-2.2	-4.6	0.6
1995	-5.5	-1.8	-5.1	0.5	-5.2	0.2
1997	-3.0	0.7	-2.6	0.5	-2.5	2.5
2002	-3.2	-0.1	-2.2	2.5	-1.9	1.5

Source: Briotti (2004)

The increase in French public sector debt has therefore been spectacular, even outpacing that of Germany, which had to tackle the reunification during the same period. French public-sector debt rose from 39.5% of GDP to 71.2% between 1990 and 2003. This pattern is similar to that of the rest of developed nations, reaching a high in 1998 before later dropping to 64.9% in 2001 and rising once more towards the end of the period under study. As a result, French public debt was higher as a percentage of GDP in 2003 than that of the United States, when in 1990 the French figure was almost half that of the US.

Table 7: Gross Public Debt (percentage of GDP)

	France	Japan	USA
1990	39.5	68.6	66.6
1991	40.3	64.8	71.3
1992	44.7	68.7	73.7
1993	51.8	74.9	75.4
1994	55.3	79.7	74.6
1995	63.9	87.1	74.2
1996	67.5	93.9	73.4
1997	69.4	100.3	70.9
1998	71.1	112.2	67.7
1999	67.3	125.7	64.1
2000	66.2	134.1	58.2
2001	64.9	142.3	57.9
2002	68.7	149.3	60.2
2003	71.2	157.3	62.5

Source: OECD

4) Cyclical and Structural Budget Balance

The difference between France's performance and that of other countries can also be observed in the comparison of overall and structural budgets. The situation on this front in 1990 was substantially more favourable in France than for the Euro 12 and EU15, with a structural surplus and a lower overall deficit. However, in 1995 France's overall deficit was already similar to the averages in the above two regions, while in structural terms France recorded a 1.4% deficit in terms of GDP compared to the surpluses of varying sizes registered in the Euro 12 and EU15. In the two following years the situation improved, but less in France. So, in 1997, France had a structural surplus that was less than half the average recorded by the two previously mentioned regions. It was almost inevitable that by 2002 both budgets would be worse in France, which once again recorded a 0.3% structural deficit which will have almost certainly risen further since then.

Table 8: Overall and Structural Deficit (-) / Surplus (+) as a Percentage of GDP

	France		Euro 12		EU15	
	O/all	Str.	O/all	Str.	O/all	Str.
1991	-2.4	0.1	-5.0	-0.5	-4.6	0.0
1995	-5.5	-1.4	-5.1	0.8	-5.2	0.4
1997	-3.0	1.2	-2.6	2.8	-2.5	2.7
2002	-3.2	-0.3	-2.2	1.6	-1.9	1.6

Source: Briotti (2004)

5) Budget Decentralisation

There is very little to be said about the decentralisation of the French budget. In light of the fact that the State is highly centralised, there are no regional authorities of any economic importance. Therefore, in the table below only compares the budgets of the local and central governments.

Table 9: Taxes by Government¹

	2002	%	2003	%
Total	419.9	27.5	425.6	27.3
Central	250.1	16.4	250.8	16.1
Local	76.5	5.0	79.7	5.1

Source: INSEE

In short, France's public sector represents well above 50% of GDP and is highly centralised. All indicators appear to suggest that the French public sector is oversized and as a result is incurring in very serious efficiency costs. Reducing and streamlining the public sector therefore seems necessary and unavoidable to say the least.

Antonio Cutanda
Valencia, 31st May 2005

¹ Net tax transfers and irretrievable taxes.

6.- United Kingdom

The public sector of the economy includes the central government, local governments and state-owned companies. The Chancellor of the Exchequer has established two financial rules in order to guarantee that public accounts are managed responsibly: the Golden Rule and the Sustainable Investment Rule.

The Golden Rule stipulates that the government will only borrow to finance investment projects, but not to finance current expenditure. The current budget should have a balance of zero or be positive on average in relation to GDP during the economic cycle, according to this rule. The current budget is defined as current income (for example taxes), minus current expenditure (which includes government consumption, interest payments, and social benefits), minus capital expenses, plus capital tax.

Table 1: Sectoral Share of the Public Sector Deficit (% of GDP)

Year	Central Govt.	Local Govt.	State-owned Company	Public sector
1993-94	8.1	-0.2	0.0	7.8
1994-95	6.6	0.0	-0.3	6.3
1995-96	5.1	-0.1	-0.3	4.8
1996-97	3.9	-0.1	-0.3	3.6
1997-98	1.0	0.0	-0.2	0.8
1998-99	-0.4	0.0	0.0	-0.4
1999-00	-1.7	0.1	-0.1	-1.7
2000-01	-1.6	0.0	0.0	-1.6
2001-02	-0.1	0.1	0.0	0.0
2002-03	2.4	-0.2	0.1	2.4
2003-04	3.3	-0.1	0.0	3.2
2004-05	3.0	0.1	0.0	3.0

Source: H.M. Treasury

The Sustainable Investment Rule demands that public sector net debt as a percentage of GDP should remain stable and prudent throughout the economic cycle. Public sector net debt is understood as gross debt minus liquid financial assets.

The H.M. Treasury situates the beginning of the current economic cycle in the 1999/2000 financial year and forecast it to end in the 2008/2009 financial year. The 2005 Budget (published on March 16, 2005) provides the following figures in reference to the government's current budget balance as a percentage of GDP: -1.4% in 2004/2005 and -0.5% in 2005/2006.

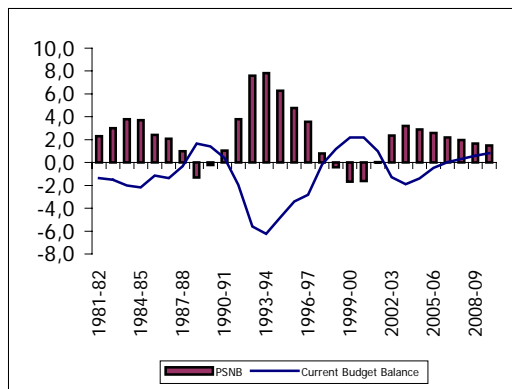
Public sector net borrowing (PSNB) is how the government prefers to measure the impact of financial policy on the economy in the short term. PSNB is the sum of current expenditure (including depreciation) and net investment, minus total income. Public Sector Net Cash Requirement is an alternative used by the British government to measure the liquidity of public sector short term borrowing requirements. It is the PSNB plus financial requirements generated by financial transactions (stemming, for example from the sale of assets, private loans or foreign loans). General Government Net Borrowing is the basis of the reports on the deficit and gross debt of the government, following the procedure concerning Excessive Deficit as stipulated in the Maastricht Treaty.

Government excessively optimistic

This financial year's budget displays an average positive balance as a percentage of GDP throughout the economic cycle, even in the least

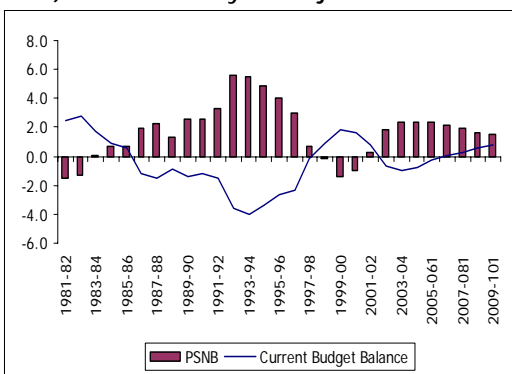
favourable macroeconomic environments. This confirms that the Golden Rule is being respected. The government estimates it will have a surplus at the end of this economic cycle in the financial year of 2008/2009 (Figures 1 & 2). As far as the other main variable is concerned, public sector net debt (Figure 3), figures will remain low and stable over forthcoming years below the 40% threshold specified by the Sustainable Investment Rule.

Figure 1: Budget Balance and Public Sector Net Borrowing (% of GDP)



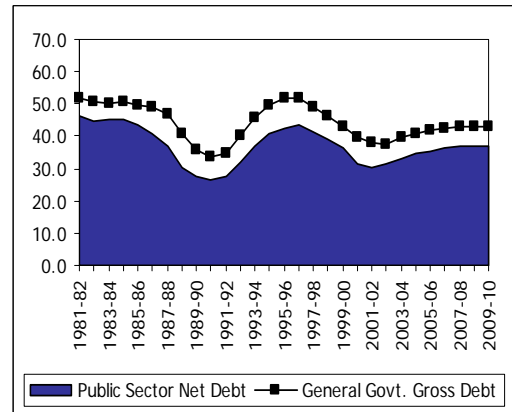
Note: 2005/2006 Budget projections for the period from 2005-2010
Source: H.M. Treasury

Figure 2: Budget Balance and Public Sector Borrowing Requirement (% of GDP). Economic cycle adjusted



Note: 2005/2006 Budget Projections for the period from 2005-2010
Source: H.M. Treasury

Figure 3: Government Debt (% of GDP)



Note: 2005/2006 Budget Projections for the period from 2005-2010
Source: H.M. Treasury

Table 2 shows how the deficit over the current budget rose from £12.5bn to £16.1bn in the 2004/5 financial year. However, it is forecast to drop to £6bn in the 2005/06 financial year. The government's self-imposed golden rule will only be followed from the 2006/07 financial year onwards, with a minimal £1bn surplus in the current budget. Financial policy is expected to be tightened from that year onwards.

As the margin for error in one-year forecasts concerning public sector net borrowing has been particularly high since 1997, the government will seemingly have to make a serious effort in the next budget if the Golden Rule is to be complied with by the end of this economic cycle (between 1998/99 and 2008/2009). For example, it has been estimated that should GDP growth dip 1% below the government's forecast, the Golden Rule would not be met until the 2009/10 financial year, which questions the definition of economic cycle.

Table 2: Budget Balance and Net Borrowing Projections

	estimation			projections					
	2003	2004	2005	2006	2007	2008	2009	2010	
Current Budget Balance									
Budget 2004	-21.3	-10.5	-5	0	4	9			
PreBudget 2004	-21.1	-12.5	-7	1	4	9	12		
Budget 2005	-20.4	-16.1	-6	1	4	9	12		
Net borrowing									
Budget 2004	37.5	32.9	31	27	27	23			
PreBudget 2004	34.8	34.2	33	29	28	24	22		
Budget 2005	35.4	34.4	32	29	27	24	22		
Economic cycle-adjusted									
Current budget balance (% of GDP)									
Budget 2004	-1.0	-0.2	-0.2	0.0	0.3	0.7			
PreBudget 2004	-1.0	-0.4	-0.4	0.1	0.3	0.6	0.8		
Budget 2005	-1.0	-0.8	-0.3	0.1	0.3	0.6	0.8		
Economic cycle-adjusted net borrowing (% of GDP)									
Budget 2004	2.4	2.1	2.3	2.1	1.9	1.6			
PreBudget 2004	2.2	2.2	2.5	2.2	2.0	1.6	1.5		
Budget 2005	2.3	2.4	2.4	2.2	2.0	1.6	1.5		
Government debt (% of GDP)									
Budget 2004	33.2	34.4	35.3	35.9	36.3	36.4			
PreBudget 2004	32.9	34.3	35.4	36.2	36.8	37.0	37.1		
Budget 2005	32.8	34.4	35.5	36.2	36.8	37.1	37.1		

Source: H.M. Treasury

Table 3: Current Receipts, Spending and Net Investment

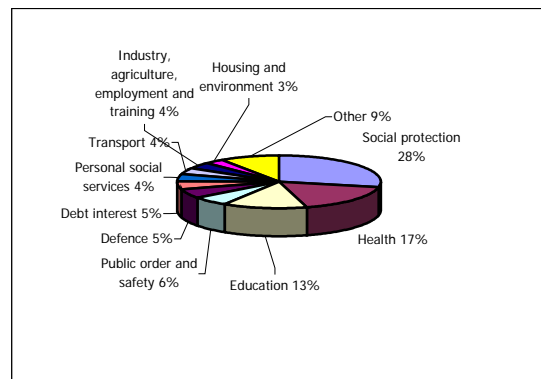
	2003-04	2004-05	2005-06	2006-07
Current receipts				
Budget 2004	421.5	455	490	522
Budget 2005	418.9	449.7	487	520
Current Expenses				
Budget 2004	428	450	479	504
Budget 2005	425.3	451.1	477	503
Current Balance				
Budget 2004	-21.3	-11	-5	0
Budget 2005	-20.4	-16.1	-6	1
Net investment				
Budget 2004	16.2	22	25	27
Budget 2005	15	18.3	26	29
Net borrowing				
Budget 2004	37.5	33	31	27
Budget 2005	35.4	34.4	33	29

Source: H.M. Treasury

Table 3 shows recent developments in current income and expenditure (see Figures 4 & 5 for a breakdown by function from the 2005 budget). The government expects receipts to increase by 7.4% in 2004/05 and by 8.3% in 2005/06, according to this year's budget. As far as current expenses are concerned, the government expects a decrease from 6.1% in 2004/05 to 5.7% in 2005/06. This means receipts would exceed

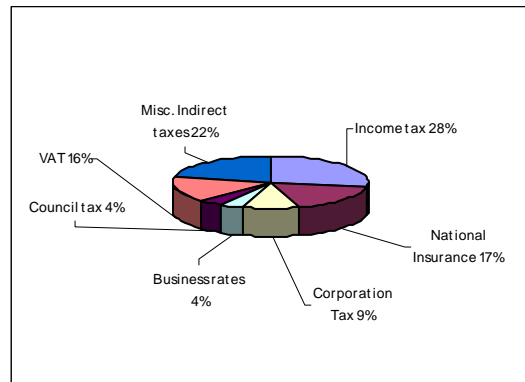
expenses by some £10bn and would guarantee a budget deficit much closer to zero. Once again, the government's projections are based on GDP growth that is unlikely, although not impossible to be reached in forthcoming years.

Figure 4: Current Spending by Function in 2005/2006 Budget (£519bn)



Source: H.M. Treasury

Figure 5: Breakdown of Current Receipts. 2005/2006 Budget (£487bn)



Source: HM-Treasury

Francisco Requena
Valencia, May 31 2005

7.- Japan

One really worrying aspect in the Japanese economy is the tax reform. The birth rate is dropping and the population is ageing, thereby increasing the pressure on public finances.

Structure

In Japan there are three regional levels whose governments can collect taxes:

1. The State
2. Prefectures
3. Towns, Cities, towns and villages

Approximately 796,000 civil servants work for the State and 3.144 million in the prefectures and towns.

Prefectures (with a population ranging from 12 to 0.6 million) and Towns are included in the "local" government framework. In total, there are 47 Prefectures and 3,400 Towns. Total expenditure is evenly distributed and represents around 10% of GDP. This spending refers to: education, social services, health, infrastructure, police, fire fighters, etc.

Table 1: Central Government's Share of Expenditure

Health	96%
Education	86%
Court cases, police, fire department	80%
Regional Development	71%
Trade, industry, farming and fisheries	57%
General Administration	53%
Social Security	51%
Miscellaneous	2%

Source: White Paper on local public finance, 2004. Ministry of Internal Affairs and Communications

The Government Ministry of Internal Affairs and Communications supervises local governments and has three main areas of responsibility:

1. Local Administration Department
2. Local Finance Department
3. Local Tax Department

The small size of towns makes it difficult to guarantee the effectiveness of public services on a local scale. Some research has revealed the presence of diseconomies of scale. Nevertheless, the Central Government has gradually grouped towns in order to guarantee they have sufficient capacity themselves, as well as exploit economies of scale. In fact, there were 10,520 towns in 1945, whereas in February 2005, there were only 3,400.

Furthermore, except for a small number of services such as water supply, urban passenger transport etc, the government's presence in the business network is minimal. The large state-owned companies such as National

Railways, National Telephone Company and the tobacco monopoly were privatised throughout the 1980s.

Prime Minister Koizumi's government is pushing for public services and companies to be privatised. The mail is no longer part of the State, becoming an independent public body in April 2003. The companies that manage the motorways are to be privatised in the not too distant future.

Tax Legislation: Local Taxes Applied to Business

The tax burden borne by companies in Japan is heavy in comparison to other jurisdictions, even more so considering the tax incentives offered by other countries.

Taxes are divided into national and local taxes in Japan:

- Municipal Taxes are collected by the prefectures and town councils. Taxes are collected by means of tax offices that belong to the local governments. The main taxes are:
 - Income and corporation taxes applied to individuals and companies residing in Japan;
 - Property tax, in the case of owning land, cars etc.
- National Taxes are:
 - Personal income tax
 - Corporation tax
 - Inheritance and gift tax
 - Consumption tax

Companies are also subject to certain municipal taxes that vary depending on where they are situated.

The general tax rate has been 30% since 1999. Companies with equity that no higher than 100 million Yen pay a tax rate of 22% on the taxable amount which may not exceed eight million. Town councils levy three additional taxes on corporate profits, whose rates vary according to the town where the business is located and the taxable amount subject to Corporation Tax. The final effective tax rate can, as a result, easily exceed 40%.

Delivering goods and carrying out services in Japan, together with imports receives an indirect tax on value added, known as the Consumption Tax. The tax rate is 5%.

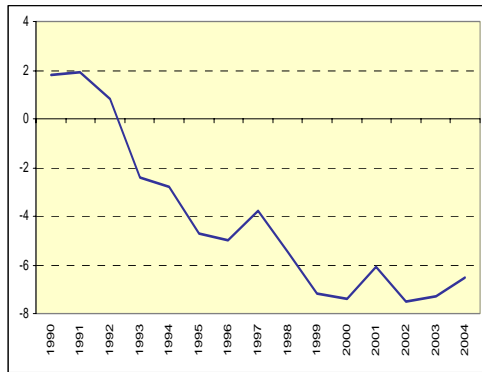
Social Welfare

Social welfare services have boomed since World War II. The needy and handicapped, the old, the retired, childhood and motherhood are all covered by these services. Several insurance systems cover the entire population. Most workers retire at the age of 55 and receive a pension of 40% of their salary. Health conditions are in general excellent. According to data for 2004, life expectancy stands at 77.7 years for men and 84.5 for women; the child death rate was very low at three per one thousand born. Japan has one doctor per 603 patients and one hospital bed per 61 inhabitants.

Tax Policy

Japan has begun to employ restrictive tax policy, as the gaping hole in public finances means the government is unable to increase the deficit and adopt a policy that counters the cycle.

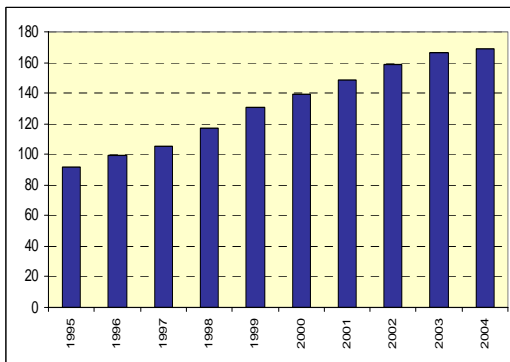
Figure 1: Overall Budget Balance (% of GDP)



M^a Luisa Martí Selva
Rosa Puertas Medina
Valencia, May 31 2005.

Note: For professional reasons, the OCEI expert on Japan since the foundation of the web site, Luis Granero, has provisionally vacated his post. These reports will in the future be compiled by the above authors, who are also responsible for analysing the Chinese economy.

Figure 2: Gross Public Debt (% of GDP)



Current policy is aimed at reducing the deficit to 3%, as is the case in other countries and thus gain an additional economic boost. Faced with the never ending recession that began in the early 1990s, the Japanese Government's surplus became a severe deficit, as the government spent money on public works and came to the rescue of the financial system that had collapsed. The overly bureaucratic approach taken, aimed at the public sector leading the recovery almost exclusively, failed. Tax policy that was less hesitant and more openly committed to stimulate private consumption would have probable been more successful and less costly.

Table 2: Tax Scheme in Japan

CORPORATION TAX. RESIDENT CORPORATIONS	
Regional tax jurisdiction	World Income
Compensation for negative taxable amounts	Yes (7 years)
Deduction to avoid paying taxes twice	YES
State tax rates	
General	30%
SMEs up to ¥8,000,000	22%
Regional and local tax rates	
Taxes calculated over state tax	
Prefectural	5 - 6%
Municipal	12.3 - 14.7%
Taxes per capita (by share capital)	
Prefectural	¥ 20,000 - 800,000
Municipal	¥ 50,000 - 3,000,000
NON-RESIDENT CORPORATIONS	
Non-resident corporations with permanent establishment	
General tax rate levied	30%
Repatriated gains tax	NO
Non-resident corporations without a permanent establishment	
Corporate profits	30%
Capital gains	30%
Interest	15 - 20%
Dividends	20%
Royalties	20%
CONSUMPTION TAX	
General tax rate	5%
Tax rebates	NO
Surtaxes	NO
Are exemptions forecast?	YES
Is the tax levied on exports?	NO
INHERITANCE AND GIFT TAX	YES
PROPERTY TAX	YES
CAPITAL GAINS TAX	NO
IMPORT TARIFFS	YES
DOUBLE TAXATION TREATY WITH SPAIN (1975)	
Tax on dividends	10 - 15%
Tax on interest	10%
Tax rate	10%
TAX INCENTIVES	
Deduction for reinvesting profits	YES
Accelerated asset amortization	YES
Tax consolidation Scheme	YES
ANTI-EVASION REGULATIONS	
Sub-capitalisation ratio	YES (3:1)
Tax haven regulations	YES
Transfer price regulations	YES
OTHER REGULATIONS	
Change Control Regulations	YES

Source: ICEX

8.- China

China's public sector is a key factor in the economy at the moment, as monetary and tax policy should must slow down economic growth and establish sustainable development.

"Market Socialism", the term that used to define the Chinese economy became a "Socialist Market Economy" between 1992 and 1997. The public sector wades into a purely merchant economy and negotiations to join the WTO begin. The Asian crisis from 1997-1998, despite not directly affecting China, hurt its economy:

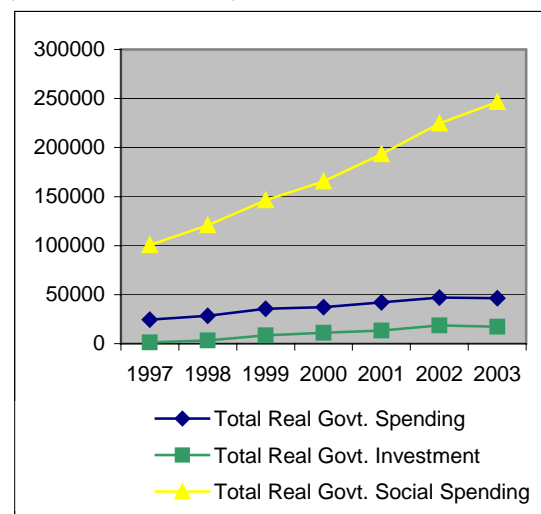
- Significant loss of competitiveness due to the appreciation of their currency with respect to those of their neighbours and the consequent downturn in exports.
- Decrease in domestic consumption, with money being channelled to savings, which negatively affected aggregate demand.
- Increase in the risk premium for foreign investment.

The Chinese government has employed active financial policy since 1998 with the aim of offsetting the adverse effect of the Asian financial crisis in 1997 and the subsequent slump in the world economy. The government decided to increase public-sector expenditure, which it financed by means of government bonds (160 billion yuans in 1998-1999). By channelling these resources to various areas, the government managed to improve economic development in the country.

The main areas were:

1. Guarantee financing for important projects
2. Improve production and living conditions in rural areas by increasing peasants' income.
3. Promote technological progress in companies
4. Continue the development of the western part of the country.
5. Promote sustainable development by accelerating the return of farming land to forestry.

Figure 1: Public Sector Expenditure (Millions of Yuans)



Source: National Bureau of Statistics

Despite managing to successfully overcome the Asian crisis, China is still faced with two great challenges:

- The reform of state-owned and run companies, many of which are inefficient and making heavy losses.
- The need to implant a modern social security system that suits

current needs (medical attention, unemployment benefit, pensions...)

Public companies are typically highly inefficient and very unprofitable. In order to alleviate the excessive number of government jobs, the Ministry of Labour and Security initiated a plan to restructure the companies in the public sector. The plan meant nine million government workers would be made redundant and some 2,500 bankrupt companies would be closed over the period dating from 2004 to 2006. This number is on top of the 3,000 public-sector companies that were closed over the period from 1994 to 2002. Some 28 million workers have lost their jobs in the public sector since 1998.

Chinese debt remained relatively small throughout 2004. The figure stood around 20% of GDP, but if we add bank liabilities (recapitalising expenses and deposit guarantees), the figure would rise higher than 100% of GDP. Nevertheless, this percentage is less significant in light of the country's high growth rates, although public finances will hinge on the planned policies for cooling down the economy.

The State Tax Administration of China announced revenue of 756 billion yuans in the first quarter of 2005, up by an annual 20%. The administration attributed the sound increase in taxes to the rapid economic development the country is undergoing and that tax policies are applied strictly. However, the Customs General Administration informed that Chinese tax revenue through tariffs had dropped by 2% with respect to the same period the previous year. This was mainly due to the

decrease in the amount of goods imported.

Currently, the tax reform mainly affects the farming sector, which will enjoy a tax cut from 8.4% to 5.4% in 11 provinces. The VAT reform, which will affect three provinces in the northeast, will lessen the burden on sectors such as chemical, car, oil and manufacturing industries.

In light of the need to solve the problems in the farming and rural sectors, the government has decided to abolish the taxes levied on farming activity in 2006, two years earlier than planned. This move aims to curb the growing gap between urban and rural income, which is the cause of great social discontent. Announcements have been made in 27 provinces, regions and towns that farming taxes will be annulled. In the remaining four (Hebei, Shandong, Yunnan and the independent region of Guangxi) taxes have already been cut in keeping with Central Government guidelines. Official statistics reveal that partial or total exemption from taxes in rural areas reached 28 billion yuans in 2004 (\$3.4bn). This means that peasants' tax burden has been cut by 30%. Chinese peasants enjoyed an annual 6% increase in income in 2004, the highest since 1997, thanks to the elimination of farming taxes and subsidies on grain.

Public accounts

China's public accounts reflect a situation of relative stability, according to figures presented on an annual basis

by the Ministry of Finance. However, there are a series of potential threats¹:

- Growth highly dependent on public investment expenditure, thereby limiting financial manoeuvrability.
- A part of public expenditure that should correspond to the state, in the form of social aid and transfers, is actually “diverted” to various public sector systems (public companies, financial system,...)
- Weak social benefit framework
- Local treasury deficits and borrowing are growing increasingly. Some 35.6% of towns in China, mainly in the west of the country, are “in the red”.

Despite these threats, tax reform does not appear to be on the top of Chinese officials' agenda. The reform could give the government the necessary room to manoeuvre that could prevent the country from going into an important economic crisis.

Following seven years of active financial policy needed to offset the impact of the Asian crisis, the beginning of March saw the Chinese Prime Minister announce the start of a period of “tight financial policy” that aims to cool down the economy (the investment rate is too high and consumption too low). The government has decided to reduce its fiscal deficit by an estimated 19.8 billion yuans in 2005 with respect to the previous year. As far as funding is concerned, five bond issues have already been carried out so far this

year. The last was in May, with bonds worth 30 billion yuans in nominal terms, at a fixed rate of 3.37%.

Furthermore, the Chinese government has decided to reduce its investment in state companies and in infrastructure and increase the funds channelled to solving social problems (subsidies for peasants, rural investment in education, science and technology).

Tax system²

The Chinese tax system comprises four different categories of taxes:

- Income and gains tax
- Goods and services tax
- Customs duties
- Miscellaneous (surcharges on corporate gains)

One peculiar aspect of the tax structure is the absence of social security contributions. They are still treated as company costs and are not, therefore, included in the national budget or in extrabudget funds.

The Chinese tax system boasts features that are typical in both developing and industrialised nations. On the one hand, tax pressure is comparable to that observed in developing countries. The low proportion of personal income tax collection (0.8%) is the only difference. On the other hand, the large share of corporate taxes is a characteristic shared by other countries undergoing transition, while the weighting of taxes on goods, services and international

¹ Cacho, L (2004): “Panorama económico en China” Boletín Económico de ICE N° 2806. May 2004.

² Bustamante, A (2002): “La economía china: la visión desde CESCE.” ICE. N°. 797.

trade is similar to that in industrialised countries.

The tax system is also characterised by a certain amount of weakness, due to the high level of indirect taxation, which generates around 65% of tax revenue. In addition to this, local authorities have considerable tax collection power, through regional taxes levied on the use of roads, rubbish collection, anti-pollution fees among others. It is worth pointing out that many of these taxes are not included in the budget.

Furthermore, the high rate of tax evasion in China aggravates the situation. Companies with foreign capital are the main culprits, by means of transfer valuations or diluting capital. Fraud is estimated at \$80bn, which is almost 8% of GDP or 50% of government revenue. The government has been making an effort to combat tax fraud since June 2004.

Companies with foreign capital are known to receive preferential treatment in terms of taxation in comparison to national companies. However, this is forecast to end in 2007 at the earliest³. This gives foreign companies time to prepare for being treated the same as their national competitors. Generally speaking, an average tax of 15% is levied on foreign companies, less than half that paid by Chinese companies (33%). This difference has created unfair competition and made applying this tax rate cross the board inevitable.

³ The Forum for the Development of Chinese Companies stated that China is studying the possibility of a transitional period of five years.

According to data from the State Tax Administration, tax revenue reached 756 billion yuans (\$91.4bn) in the first quarter of 2005, a 20% increase. These figures are the direct result of the country's economic growth, which could be threatened by raw material price increases, diminishing corporate gains. Following the release of real estate data revealing a 14.4% increase in 2004⁴, the Chinese government announced on May 13 that taxes would be applied shortly in order to eliminate the housing bubble battering the country. As a result, property owners who resell luxury houses will be taxed for the two following years on the profit made. Houses classified as "cheap" are exempt

Public companies

Despite being considerable inefficient, state-owned and run companies have chalked up a 31.2% increase in profits over the first quarter of 2005, totalling 13 billion euros, according to data from the State-owned Assets Supervision and Administration Commission. Sustained output growth and greater business efficiency are behind this bonanza. There are current 170 state-owned firms in China that are directly supervised by the central government; these companies are particularly strong in strategic sectors such as coal, oil, electricity, iron and steel, but are also under pressure due to the astronomical economic growth.

China is working to reform state-owned companies (including the four state-owned commercial banks) which are mostly in financial distress due to their

⁴ Data supplied by the Chinese National Bureau of Statistics.

lack of competitiveness. The government is trying to establish share frameworks and improve competitiveness by allowing foreign investment.

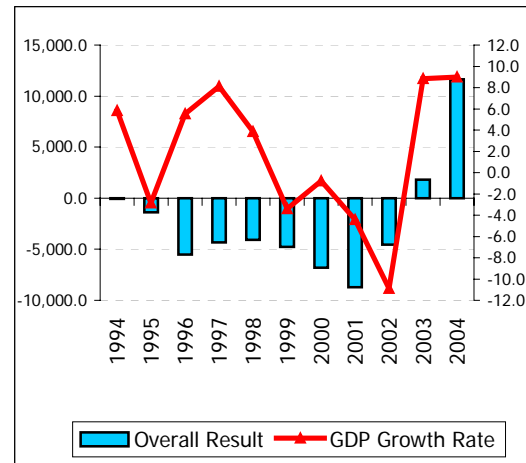
M^a Luisa Martí
Rosa Puertas
Valencia, May 31 2005

9.- Argentina

This section begins by reviewing Argentina's public sector national accounts over the last few years. We will analyse the various components in of the accounts from 1993 onwards, as the earliest data available in the database of the Ministry of Economic Affairs is from that year.

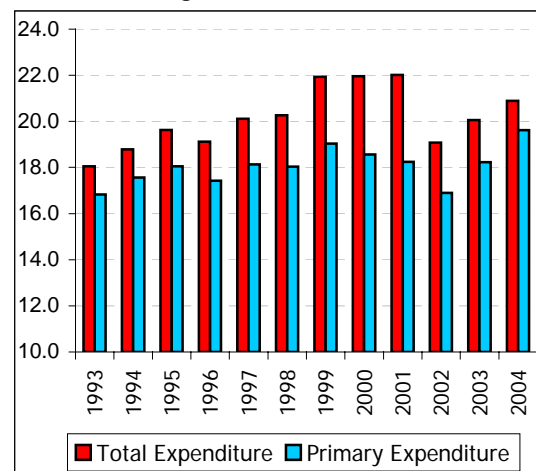
The historical data series reveals a chronic total deficit throughout the entire decade of the 90s. In addition to this, there was no sign that the government tried to counter the cycle through financial policy. The country did take full advantage of the favourable years (from 1996 to 1999) to reduce its financial deficit and continued to borrow. The recession in 2001 and 2002 saw pro-cyclical policy intensify. Public sector expenditure as a proportion of GDP, which is used as an indicator of the size of the State, increased gradually over the 1990s, rising between 1993 and 2000 by two points (Figure 2). However, as opposed to what could be expected, the percentage is very low in comparison to that observed in other countries which are commonly seen as a reference for Argentina. The ratio that includes primary expenditure in the numerator is lower still. Moreover, the latter underlines the role of public sector spending in the budget and reflects the financial discipline without taking into account financing mechanisms.

Figure 1: Economic Growth and Deficit / Surplus



Source: INDEC and the Ministry of Economic Affairs (MECON)

Figure 2: Total and Primary Expenditure as a Percentage of GDP

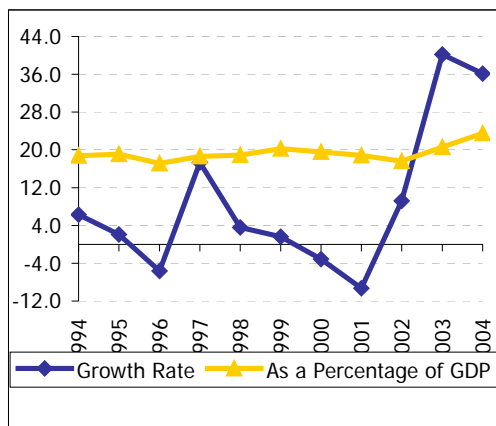


Source: MECON and own elaboration

In light of the fact that the country's chronic financial problems do not come from excessive spending, we must turn our attention to the income. Indeed, we observe that the percentage of income is very low and is not developing in accordance with GDP growth either, as it has remained around the 19% mark throughout the entire period under study (Figure 3). This initial analysis suggests that the structural problem

behind the deficit and the debt faced by the country is generated by the State's lack of ability to obtain sufficient income. Moreover, financing mechanisms have seen borrowing swell, which has resulted in a large burden in the form of interest payments.

Figure 3: Total Income



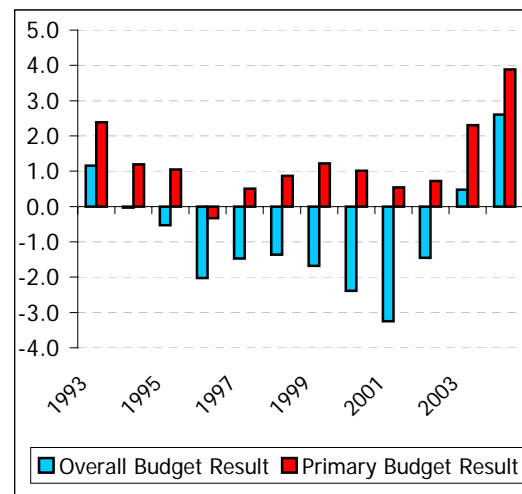
Source: MECON and own elaboration

However, the current expansive cycle is characterised by a change in terms of financial results. In this sense, it is worth pointing out that no other situation was possible, as the country went into default in 2002 and could no longer seek external financing. The only alternative left is to combine the economic recovery with financial reform that will help to recover the trust of investors and markets.

While the economy grew at rates of 8.9% and 9% in 2003 and 2004 respectively, total income rose at rates of 40.3% and 36.1%. As a result, total income as a percentage of GDP increased to 23.4% in 2004 (Figure 3). Likewise, expenditure also increased, but never exceeding the limit imposed by tax collection. This financial effort has already born its fruit. In 2003 a surplus of 0.5% of GDP was achieved

and last year the figure rose to 2.6%: a huge leap in relation to the previous decade. The discipline displayed by the government deserves further praise on analysing the primary surplus, which stood at 2.3% of GDP in 2003 and 3.9% in 2004.

Figure 4: Overall and Primary Budget Results as percentages of GDP



Source: MECON and own elaboration

Breakdown of Expenditure

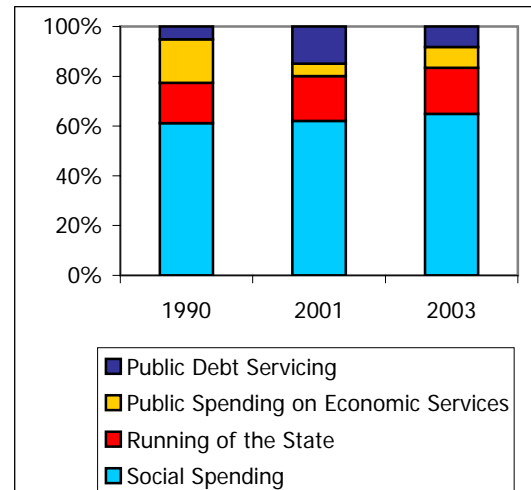
By analysing the structure of public sector spending, we can draw a series of conclusions as to the importance of various components, as well as the most significant changes that have occurred from 1990 to 2003 (latest official data available), including the crisis in 2001.

- The public sector spends the most money in proportion on social needs, accounting for more than 60% of total spending over the entire period under study. The historical data series can be divided into two periods. In the first period, from 1990 to 1996, social expenditure became

progressively more and more important. From that time onwards, this trend has been inverted.

- As opposed to what one may think, expenditure related to the running of the State is one of the items that has remained the most stable: since the beginning of the 90s, this item has represented between 18% and 19% of total expenditure (even during the second half of the decade when the deficit shot up spectacularly).
- As far as economic services are concerned, their share of total expenditure has dropped steadily from 23% in 1990 to only 5% in 2001. The main reason behind this decrease is the far-reaching privatisation process the country has undergone. However, an important upturn in economic services is observed in 2003, doubling their share of total spending.
- However, public debt servicing increased throughout the entire last decade up to the appalling crisis in 2001: in 1999 debt servicing accounted for 5.2% of total spending and 1.6% of GDP; in 2001, 15% and 5.3% respectively. From 2002 onwards, as a result of the default, this percentage dropped at a dizzying pace.

Figure 5: Composition of Public Spending



Composition of Income

Regarding the composition of income, it is worth highlighting two aspects. The first is how tax income has steadily risen. While in 1994, taxes accounted for 65% of total government income, in 2004 the figure was 80%. This proportion has increased even further over the last two years as a result of the booming economic growth and greater tax control. In the second place, income through privatising state-owned companies, which had been so important in the 90s, has practically disappeared.

In light of their high proportion of total income, we will focus on income via taxes.

The tax burden, which is the ratio between tax income and GDP, is very low. The tax burden in Turkey and Poland, which could be considered countries where development is intermediate, is almost double that of Argentina (37.9% and 29.9% in 2001 respectively). The low level of income is partly due tax evasion.

Table 1, which displays the proportion of income corresponding to each type of tax, sheds some light on the most important features of the country's tax structure:

- Corporation tax represented 22.7% of total income in 2004. This percentage, despite rising since 2002, is still very low.
- The opposite occurs with value added tax, which represents almost a third of total tax revenue.
- In short, the tax system is regressive, as the best part of income is obtained through indirect taxation.
- Social security contributions are well below the average for OECD countries, which is partly due to the high degree of black employment. Moreover, this percentage dropped in the last crisis and what is more worrying is that has continued to fall throughout the economic recovery.
- Tax income through export duties also figures prominently, rising sharply after convertibility ended.

Table 1: Tax Structure. Percentage of total tax revenue collected

	2000	2001	2002	2003	2004
Gross VAT	37.9	33.8	30.2	29.0	31.5
Corporation	20.8	22.2	17.7	20.4	22.7
S. Security	19.3	17.7	16.2	13.4	12.9
Export duty	0.1	0.1	9.9	12.8	10.5
Misc.	22.0	26.2	26	24.4	22.4

Source: MECON

Total Public Debt: the Situation is More Manageable, but the Corset will be Worn for a Long Time

We will end this section by discussing total public debt and how figures have improved following the debt swap with private creditors. As we know, some 76.15% of bondholders accepted the offer.

Total public debt stood at 127.4% of GDP in December 2004. After restructuring the defaulted debt with private creditors, total debt was reestimated to be \$125.283bn, 72% of GDP.

Table 2 shows that meeting payments to the tune of 72% of GDP still requires a mammoth effort, but the situation in the following years has become more manageable.

Table 2: Pre and Post Debt Swap Situation

Ratios	Dic-01	Abr-05
Total Public Debt/Exports	544%	364%
Interest/Exports	38%	9%
Debt (pesos)/total debt	3%	37%

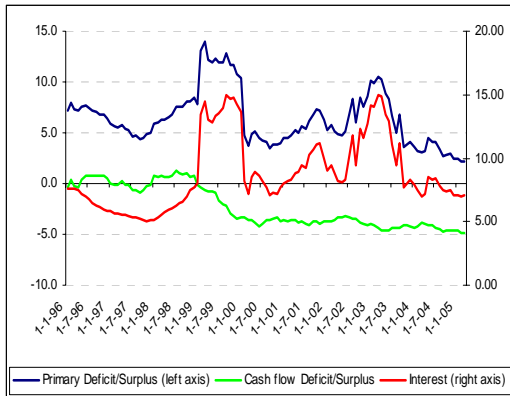
Source: MECON

Julia Torrecabota
Valencia, June 3 2005

10.- Brazil

a) Brazil's Borrowing Needs¹

Figure 1: Primary Deficit and Interest (12-month moving average; % of GDP)



Source: Central Bank of Brazil and own elaboration

Figure 1 illustrates the pattern of the primary deficit/surplus (excluding interest), the interest burden and the sum of both which gives cash flow deficit/surplus as a percentage of GDP. Brazil has maintained a primary surplus since 1992, as control measures focus their attention on this variable, whereas the interest burden is what prompts the cash flow deficit. The history of Brazil's borrowing requirements can be clearly divided into two periods:

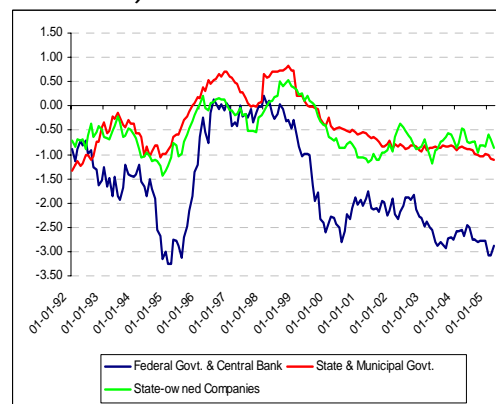
- The "Plan Real". This plan aimed at stabilising the Brazilian economy resulted in interest rates being lowered and a certain degree of control over inflation together with macroeconomic stability. This helped to significantly reduce the amount of public money spent on interest payments over

¹ This period was chosen to avoid statistical distortions due to the implementation of the "Plan Real" in 1994.

the period from 1994 to 1999. Brazil continued to register a primary budget surplus over this period, although to a lesser extent than in the previous period and the cash flow deficit decreased. In fact, Brazil registered a cash flow surplus equivalent to 0.76% of GDP in 1996.

Furthermore, privatisations, which began in 1994, helped State-owned companies to reduce their deficit while tighter tax control aided State and Local governments to balance their accounts to the point of registering a surplus of nearly 1% of GDP in this period. As far as the Federal Government and the Central Bank balances are concerned, significant decreases were observed with respect to the previous period, due to financial spending restraint, which kept the deficit at a reasonable level up to 1999.

Figure 2: Cash Flow Deficit by Institution (12-month moving average; % of GDP)



Source: Central Bank of Brazil and own elaboration

- Monetary policy was once again tightened in 1999 and 2000, when interest rates stood at 45%. This pushed up the cash flow deficit, although the increase was much more pronounced in the case of the Federal Government and the Central Bank (almost 3% of GDP) than in State and Local Governments (1% of GDP). Fluctuations in the economic cycle of the Brazilian economy (international uncertainty, deterioration of the external sector, weak domestic demand etc.) deteriorated the State's finances to a certain extent and they did not recovery until 2001, when monetary policy was relaxed and interest rates dropped to 15%. Finally, when Lula came into power and the weakness of the Brazilian economy in 2003 had once again seen public finances suffer, 2004 was characterised by vigorous GDP growth (an annual 5%), financial discipline (primary surplus target of 4.5%) and greater macroeconomic stability, both on the domestic and external fronts, saw the balance of the public sector (both consolidated and that of its federal governments) improve.

Brazil has terminated its agreement with the International Monetary Fund (IMF) due to the favourable macroeconomic conditions which, together with the decrease in the cash flow deficit and financial discipline have to a certain extent tempered one of the weaknesses of the Brazilian economy.

b) Income and Expenditure

After analysing the borrowing needs of Brazil's consolidated public sector, we will now proceed to detail the composition of public sector income and expenditure² over the period dating from 1995-2004 in which the following conclusions may be drawn:

- Brazil's total income and expenditure as a percentage of GDP displays a clearly upward trend over the period under study. Total income represented 37.9% of GDP in 1995, but in 2004 the figure had risen to 52.7%, while expenditure rose from 37.3% to 51.8% respectively, although expenditure dropped slightly in 2004 with respect to 2003.
- Current expenditure displays a downward trend (from 55.1% in 1995 to 48.4% in 2004). Both wages and social benefits followed suit, dropping from 15.7% in 1995 to 9.8% in 2004. These two variables are the most significant within Brazil's public expenditure.
- Brazil's interest in reducing the level of debt and, thus, one of the country's vulnerabilities, has prompted an increase in general and federal debt and interest payments. In 1995, 42% of total expenditure was channelled to this end, while in 2004 the figure stood at 48.3%. As a result of this effort, the Brazilian economy has

² Tables with Brazil's income and expenditure from 1995 to 2004 as a percentage of the total can be found in Appendix 1.

- terminated its agreement with the IMF and boasts its lowest ever level of country risk, measured by the EMBI.
- On the other hand, the three largest sources of income in Brazil are current income, taxes and social security contributions which represent more than 90% of total income over the period under study. Current income displays a downward trend as do taxes (52% in 1995 to 48.4% in 2004 and 19.5% in 1995 and 13.8% in 2004 respectively), as opposed to social security contributions which have risen from 23.4% in 1995 to 29.4% in 2004), bolstered by Lula's interest in minimising the problem of income inequality in Brazil.
 - Finally, refinancing credit operations has figured prominently in Brazil's income, rising from 35.5% in 1995 to 40.7% in 2004. However, this variable has levelled out somewhat since 2000, as has been the case with debt refinancing.

Analysis of Brazil's Debt

Federal Government debt aims to minimise long term borrowing and thereby guaranteeing respectable levels of risk and helping the government bond market to run smoothly.

The financial strategy for 2005 includes various issue alternatives, developed from studying different alternative scenarios. The main hypothesis taken into account in the elaboration of the different scenario was that current economic policy guidelines would be

maintained. Further suppositions were: no external shocks and continuity in the current tendencies of the domestic economy, inflation converging with the target rate, exchange rate stability and an improvement in the indicators of financial and external solvency. More pessimistic scenarios have also been established, although it is fair to say that they are not receiving as much attention.

The general guidelines of debt management are as follows:

- Extension of the average duration of public federal debt by increasing the average duration of public bond issues.
- Percentage reduction of 12-month public federal debt.
- Gradual substitution of bonds tied to the selic rate and exchange rate indexed bonds for fixed rate bonds and a price index.

a) Borrowing by Government Body

Table 1: Total Liquid Debt (% of GDP)

	Federal Government	Central Bank	State Government	Local Government.	State Enterprises	Consolidated Public Sector
1998	21,4	0,003	11,7	1,7	2,9	37,8
1999	30,2	0,4	13,4	2,0	3,1	49,1
2000	29,8	0,5	14,1	2,2	2,6	49,3
2001	31,4	0,2	15,7	2,1	2,2	51,6
2002	36,5	-0,5	16,2	2,1	2,0	56,3
2003	35,7	-0,8	17,0	2,4	1,5	55,7
2004	34,4	-0,6	16,8	2,4	0,7	53,8
2005 March	32,7	-0,4	16,2	2,3	0,3	51,0

Source: Central Bank of Brazil and own elaboration

Public sector debt is an important indicator in any country, but in South American countries it is even more so, as economic agents usually associate it with the stability of the country.

Recently notorious cases such as the default in Argentina and many others in the past in Latin America are worrying issues in this region of the world.

In this sense, Brazil is no exception, as consolidated public sector debt displayed an upward trend between 1998 and 2002, rising from 37.8% to 56.3% of GDP, before later dropping to 51% in March 2005. Brazil's total debt comes mainly from the Federal Government and to a lesser extent, State Governments. The former accounts for more than 60% of public sector consolidated debt and displays a similar trend to consolidated debt, having reached its highest level in 2002 at 36.5% then dropping off to 32.7% in March 2005. State government debt, which represents some 30% of total debt, stood at 17% in 2003 and dropped to 16.2% at the end of March 2005.

b) Internal vs. External Debt

Table 2: External and Internal Debt (% of GDP)

	Federal Govt.		Central Bank		State Govt.		Local Govt.		State Enterprises		Public Sector Consolidated Debt	
	Ext.	Int.	Ext.	Int.	Ext.	Int.	Ext.	Int.	Ext.	Int.	Ext.	Int.
1998	8,5	12,9	-7,2	7,2	0,5	11,2	0,1	1,7	1,8	1,18	3,7	34,2
1999	12,4	17,8	-4,3	4,7	0,8	12,6	0,1	1,9	1,7	1,42	10,7	38,4
2000	12,0	17,8	-4,4	5,0	0,8	13,3	0,1	2,1	1,4	1,16	9,9	39,4
2001	13,8	17,6	-5,9	6,1	0,9	14,8	0,1	1,9	1,4	0,80	10,3	41,3
2002	15,7	20,8	-5,0	4,4	1,1	15,1	0,2	1,9	0,9	1,08	12,9	43,4
2003	14,2	21,5	-3,4	2,6	1,0	15,9	0,2	2,2	0,5	1,04	12,5	43,3
2004	12,4	22,1	-4,1	3,5	1,0	15,9	0,2	2,2	0,2	0,55	9,6	44,2
March 2005	10,4	22,3	-4,7	4,3	0,8	15,4	0,1	2,2	-0,3	0,58	6,3	44,7

Source: Central Bank of Brazil and own elaboration

As opposed to other Latin American countries, Brazil's internal debt is considerable higher than its external debt, as can be observed in Table 2.

The slowdown in the Brazilian economy saw the consolidated public sector increase its external borrowing between 1998 and 2003, but the figure has since dropped to 6.3% of GDP. Internal borrowing has risen steadily over this period from 34.2% in 1998 to 44.7% in 2005. The Federal and State Governments are responsible for the best part of the debt with respect to GDP throughout the period under study, although Federal Government debt displays an upward trend, while State Government debt has remained more or less stable. As far as these governments' foreign borrowing is concerned, the Federal Government external debt is higher, although tending to decrease, while State government external debt represents 1% of GDP.

c) Indexed Debt and Duration

Table 3: National Federal Debt in Portfolio by type of yield

	ER	TR	GIMP	GPI - DA	Over/Selic	FIR
2000	22,28	4,71	1,57	4,36	52,24	14,76
2001	28,61	3,77	3,98	3,01	52,79	7,82
2002	22,38	2,05	7,93	3,06	60,83	2,19
2003	10,79	1,8	8,75	2,4	61,35	12,51
2004	5,15	2,72	9,92	1,83	57,14	20,09
01/2005	4,58	2,69	9,68	1,74	59,46	18,71
02/2005	4,26	2,64	9,56	1,68	58,36	20,42
03/2005	4,23	2,57	9,4	1,6	57,69	21,52

Source: Central Bank of Brazil

Note: debt percentage of portfolio position

ER: Exchange Rate

TR: Rate obtained from average 30-day bank deposit certificates and the fixed rate applied by commercial banks.

GIMP: General Index of Market Prices.

GPI-DA: General Price Index – domestic availability

FIR: Fixed Interest Rate

As can be observed in the above table, National Federal Debt in portfolio is mainly indexed to the reference interest rate in Brazil with 57.69% in March 2005. The pattern observed since 1999

has been in sync with Brazil's economic cycle. During expansive periods, the percentage of debt in portfolio dropped (48.76% in 2001), while slowdowns in GDP growth saw the percentage of debt rise (67% in 2003). Debt with duration of up to one year has displayed a downward trend since 1999, dropping from 58.20% in December that year to 35.35% in March 2005. However, debt with duration of between one and two years has risen steadily from 23.01% of debt in portfolio to 40% in March this year. Debt with duration of three or more years is practically insignificant, although the position debt between two and three years has remained stable at around 18%.

On the other hand, the debt indexed to a fixed interest rate displays similar features to that indexed to the Selic Rate. Short term debt is significant (in March 2005, 84.39% of debt in portfolio had a duration of one year and 13.6% between one and two years) but has dropped between 1999 and 2005 in favour of longer term debt of between two and three years. The certain degree of stability in 2004, favoured by vigorous economic growth in Brazil that year, was the reason for this, although long term borrowing is not very significant at all in view of the characteristics of South American countries.

Debt indexed to the exchange rate in Brazil has shown two peculiarities worth mentioning over the period from 1995 to 2005. The first is the decrease in short term borrowing, despite remaining significant, with 28.38% of debt having a duration of up to one year and 30.31% between one and two years in March 2005. As opposed to the

previous cases, five-year debt and higher has risen due to macroeconomic and exchange rate stability, rising from 1.06% in 1999 (debt in portfolio) to 29.42% in March 2005, similar to the level of short term debt

The only two types of medium and long term debt are tied to the price index and to a rate resulting from the average of 30-day bank deposit certificates and the fixed rate applied by commercial banks. While the former displays more evenly distributed debt in terms of duration, although five-year debt predominates with 40% of the total. In the case of commercial banks, close to 61% of debt held in portfolio is for five years or more.

The debt reorganisation strategy that began in 2003 is succeeding in strengthening the economy and the macroeconomic equilibrium is allowing the Treasury to lengthen the duration of its debt. This extension is already visible in internal debt, where retirement funds are becoming increasingly popular, particularly in the case of long term issues linked to the price index. Similarly, the "Direct Treasury", a plan for personal investment in government bonds via internet, is recording persistent growth. Finally, tax reform in the financial sector is reducing distortion, which encourages investors to participate more directly. As far as external borrowing is concerned, more and more diversified foreign investors are arriving with quite notable long term objectives.

María Jesús Herrerías
Valencia, June 1 2005

Appendix 1: Income and Expenditure of Brazil's Public Sector (% of total)

INCOME	1995	1997	1998	2000	2003	2004
Current income	52,0	42,2	39,4	38,8	41,9	48,4
Tax income	19,5	14,1	13,3	12,1	12,5	13,8
Social security transfers	23,4	22,4	18,4	21,5	24,6	29,4
Patrimonial income	2,4	1,3	2,7	1,6	1,4	1,6
Service income	2,9	1,7	1,8	2,2	2,2	2,3
Current transfers	0,0	0,1	0,0	0,0	0,0	0,0
Misc. Current income	3,7	2,6	3,0	1,4	1,1	1,2
Capital income	12,5	26,1	6,0	8,7	15,7	11,0
Loan operations	8,2	22,8	1,9	1,1	8,8	6,4
Depreciation	0,3	1,1	1,0	2,3	0,2	0,1
Loan amortization	1,6	1,1	1,1	1,9	1,4	1,9
Other capital income	2,5	1,0	2,0	3,4	5,2	2,6
Subtotal	64,5	68,3	45,4	47,5	57,5	59,3
Loan operations-refinancing	35,5	31,7	54,6	52,5	42,5	40,7
Foreign debt refinancing	0,0	31,2	0,0	50,6	41,0	39,7
Domestic debt refinancing	0,0	0,6	0,0	1,9	1,5	0,9
TOTAL	100	100	100	100	100	100

EXPENDITURE	1995	1997	1998	2000	2003	2004
Current expenses	55,1	43,9	39,9	41,4	42,3	48,4
Wages and social expenses	15,7	11,4	9,6	9,7	8,7	9,8
Interest and debt	6,9	5,4	6,2	6,4	7,2	8,2
Misc. Current expenses	32,5	27,1	24,1	25,3	26,3	30,4
State, Federal District and Local Government transfers	9,0	7,7	7,5	8,5	8,8	10,2
Gains procurement	13,5	11,9	10,7	10,7	11,9	13,5
Rest of current expenses	10,0	7,5	5,9	6,1	5,6	6,7
Capital expenditure	8,9	21,7	20,8	10,8	12,1	11,5
Investment	2,0	1,9	1,7	1,7	0,7	1,2
Financial Investment	3,1	16,3	14,3	1,9	2,6	2,4
Debt amortization	3,7	3,4	4,9	7,3	8,8	7,9
Misc. capital expenses	0,1	0,0	0,0	0,0	0,0	0,0
Subtotal	64,0	65,5	60,7	52,3	54,3	59,9
Debt amortization-refinancing	36,0	34,5	39,3	49,9	41,7	40,1
Federal debt refinancing	0,0	0,0	38,6	48,7	40,8	39,3
Contracted debt refinancing	0,0	0,0	0,8	1,1	1,0	0,8
TOTAL	100	100	100	100	100	100

Source: Brazilian Treasury and own elaboration

11.- México

Mexico has always lacked resources derived from public revenue, which creates problems when it comes to financing the government spending necessary to face up to the multiple needs that practically every sector of the country requires.

As a result, not enough money has been invested in energy and hydraulic infrastructure, public education, medical centres or, generally speaking, the programmes that actually fight the high level of poverty in the country, which affects more than half the population.

The healthy public finances the government boasts are not enough for the best part of the population to notice any real benefit in their pockets.

Public sector budget income

Mexico is one of the world's largest producers and exporters of crude oil. As a result and due to the importance of this industry in relation to the rest, government budget income is divided into two categories: oil income and non-oil income.

Tax is the most important source of non-oil income, where income tax and value added tax figure prominently.

Table 1: Public sector budget income structure (2003-2004)

Concept	2003 (%)	2004 (%)	Real Growth (%)
Total	100.0	100.0	5.9
I. Oil income	33.3	36.1	14.5
II. Non-oil income	66.7	63.9	1.6
II.1. Federal Government	48.5	46.4	1.5
II.1.1. Taxes	42.4	40.4	0.8
Income tax*	21.1	19.5	-2.2
Value Added Tax	15.9	16.1	7.1
Production and Services	1.9	1.8	1.0
Import duties	1.7	1.7	4.7
Other taxes	1.9	1.4	-21.7
II.1.2. Non-tax	6.0	6.0	6.1
II.2. Organisms and companies	18.2	17.5	1.8

* Includes Property Tax

Source: own elaboration based on information from the MFPC

Oil income has historically accounted for a significant chunk of public revenue. In 2003, oil income totalled 1,600,283.2 million pesos and in 2004 1774,176.4 million pesos.

Oil income includes the government revenue that stems from extraction rights, PEMEX operating surpluses and the Special Tax levied on petrol and diesel production and services, as well as the income from PEMEX itself.

According to Table 1, oil income represents around one third of total revenue, registering 33.3% in 2003 and 36.1% in 2004.

Oil income grew in real terms by 14.5% in 2004 in relation to 2003. This was mainly due to the increase in oil export prices and an upturn in foreign sales.

Exports in 2004 averaged 1,870,000 barrels a day at an average price of \$31.02/barrel, according to information

provided by PEMEX. The budget for 2004 was based on an average price of \$20/barrel, \$11.02 per barrel exported less than was actually the case. As a result, the country's revenue increased.

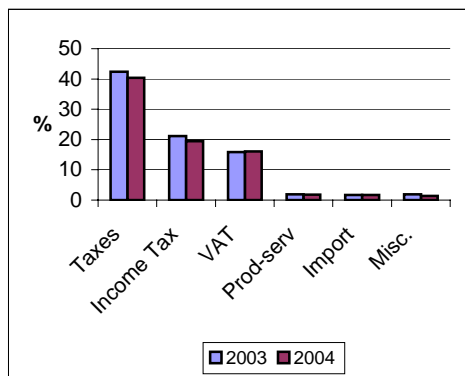
This situation is quite important in light of oil income's large share of total income, as mentioned earlier in this report.

Income tax figures prominently within the category of non-oil income, accounting for half of total tax revenue (48%) in 2004. Valued Added Tax (VAT) followed with 40%.

Only 5.242 tax payers are registered at the MFPC, half the potential number of 11 million. The best part of tax payers who are not registered are working in the black sector.

The 7.1% increase in VAT in real terms and the 4.7% increase in import duties figured prominently. Income tax decreased by 2.2%, which the Ministry of Finance attributes to the amount channelled to tax rebates and benefits. However, even when these rebates and benefits are not taken into account, income tax revenue rose by only 1.6% in relation to 2003.

Figure 1: Tax Income



Source: MFPC

Public sector income has always been too low in terms of GDP, as can be appreciated in the table below.

Table 2: Public Income as a % of GDP

Year	Public sector ordinary budget income	Tax revenue	Income tax	VAT
1990	25.6	11.1	4.9	3.5
1991	26.3	10.7	4.6	3.2
1992	26.3	11.3	5.2	2.7
1993	23.1	11.4	5.3	2.8
1994	23.1	11.3	5.1	2.7
1995	22.8	9.3	4.0	2.8
1996	23.0	8.9	3.8	2.9
1997	23.2	9.8	4.2	3.1
1998	20.3	10.5	4.4	3.1
1999	20.8	11.3	4.7	3.3
2000	21.5	10.6	4.7	3.4
2001	21.9	11.3	4.9	3.6
2002	22.2	11.6	5.1	3.5
2003	23.7	11.4	5.0	3.8

Source: Statistical appendix in the 4th Government Report

Table 2 illustrates how public sector ordinary budget income has ranged from 20% to 26% of GDP since 1990, while tax revenue has stood at between 9% and 11%. Income tax has varied from 4% to 5%, while VAT has remained between 2.7% and 3.8%.

In order to demonstrate how low Mexico's tax revenue is, all one has to do is consult the average income tax figure for OECD countries, which is nearly 14%. VAT averaged close to 7%.

The Mexican government has approved important changes in income tax for 2005. The maximum tax rate has been decreased to 30% for individuals this year. In addition to this, a flat income tax rate divided into two levels will be applied in 2006 (25% up to 2.5 million

pesos and above this figure, 29% in 2006 and 28% in 2007) along with an overall tax deduction of 76,000 pesos a year to replace the tax benefit and the wage loan. An unemployment benefit and income equality benefit are also to be created.

Similarly, federations will be able to establish tax guarantees which would range from 2% to 5% on the same base income tax rate applied to individuals.

Congress approved total income for 2005 of 1,818,441.7 million pesos. It is worth mentioning that the figure approved is 74 million pesos higher than the government's proposal due to the increase in oil price estimations from \$23 to \$27 per barrel exported, the increase in non-oil tax revenue and a larger fiscal deficit.

This disagreement between Congress and the Federal Government led the President of the Republic to declare constitutional controversy for the first time in the history of the country, which was later accepted by the Supreme Court of Justice. Consequently, the application of some items in this year's budget has been suspended.

Constitutional controversy calls, among other things, for the Supreme Court to define the Federal Government's powers in the process of passing the budget.

Budget expenditure

Total public sector budget expenditure in 2003 was 1,648,243.1 million pesos, an increase in real terms of 4.2%.

Table 3: Public Sector Budgetary Expenditure (2003/2004)

Concept	2003 (%)	2004 (%)	Var. Real (%)
Total	100.0	100.0	4.2
I. Primary Spending	88.4	88.5	4.2
I.1. Programmable	73.8	73.6	3.9
I.2. Non-programmable	14.6	14.9	6.2
Revenue sharing	13.7	13.3	1.7
Adefas	1.2	1.6	37.8
Outside operations*	-0.2	0.0	-90.5
II. Financial Costs	11.6	11.5	3.6

*Expenditure (less income) carried out by the government in the name of third parties
Source: own elaboration based on information from the MFPC

Primary expenditure represented 88.5% of total spending in 2004, practically unchanged with respect to 2003, as can be observed in Table 4, which displays a real growth rate of 4.2% with respect to the previous year.

Financial costs accounted for the remaining 11.5%, up by 3.6% with regard to 2003. Financial costs rose to 206.93 millions pesos in 2004, of which 78% corresponded to interest payments, commissions and debt related expenses, while the remaining 22% was channelled to saver and bank debtor aid programmes.

In table 4 we can appreciate the strong growth in real terms in saver and bank debtor support.

Table 4: Public Sector Budgetary Financial Cost Structure (%)

Concept	2003	2004	Real growth
Total	100.0	100.0	3.6
I. Interest, commission and expenses	84.1	78.3	-3.6
Federal Government	67.7	62.7	-4.0
Public sector	16.4	15.5	-1.6
II. Saver and debtor aid	15.9	21.7	41.1
IPAB ¹	12.5	11.9	-1.0
Misc.	3.5	9.8	192.3

Source: own elaboration based on information from the MFPC

As far as where expenditure went in 2004 is concerned, the most outstanding figure is the real 16.2% growth observed in physical budgetary investment, where 227.257 million pesos were spent. 52% of this money was spent on infrastructure for social development; 45% on infrastructure in productive areas and the remaining 3% was spent on infrastructure for government services.

Moreover, investment on behalf of the public sector rose by 13.6% in real terms in 2004 with respect to the previous year.

Spending on social development accounted for 58% of programmable expenditure in 2004, 7.7% more than in 2003.

Public Debt

Government external borrowing displayed a net surplus in 2004 to the tune of 1,685.5 million dollars, taking the overall figure to 78,852.3 million

¹ Institute for the Protection of Bank Saving

dollars. Meanwhile, internal borrowing increased by 80,235 million pesos, taking the net balance to 1,029,964,900 pesos.

At the end of 2004, total internal debt represented 12.8% of GDP, less than the 13% figure observed in 2003. Total net public sector borrowing stood at 23.9% of GDP. Foreign debt in 2004 represented 11.1% of GDP, well below the figures registered in 1982, 1983, and 1988 when it represented 40% of GDP or 1986 and 1987, when the indicator stood above 60%.

The Federal Government allocated 85.730 million pesos to cover the financial costs associated to internal debt. As far as the external debt is concerned, 6,833.5 million dollars were spent.

Table 5: Debt Indicators

Concept	Interest payments as a (%) of exports*	Net external debt in terms of imports (number of times)
2000	4.4	0.5
2001	4.4	0.5
2002	4.0	0.5
2003	4.0	0.5
2004	3.4	0.4

* Government external debt figures correspond to the end of each year.

Source: MFPC

According to the above table, the percentage of exports that corresponded to interest payments dropped significantly in 2004 (3.4%) in comparison to the 4% and 4.4% registered in previous years (4% and 4.4%).

Similarly, the ratio between net foreign borrowing and exports also improved

and stood at 41.7% at the end of 2004, below the 46.7% ratio observed in 2003.

The Institute for the Protection of Bank Saving is a heavy burden for public finances. At the end 2004 net debt represented 9% of GDP.

Public Balance

In the 1970s and 80s the government chalked up large financial deficits due to excessive spending that was financed by borrowing or by increasing the M3, sparking the crises in 1976 and 1982.

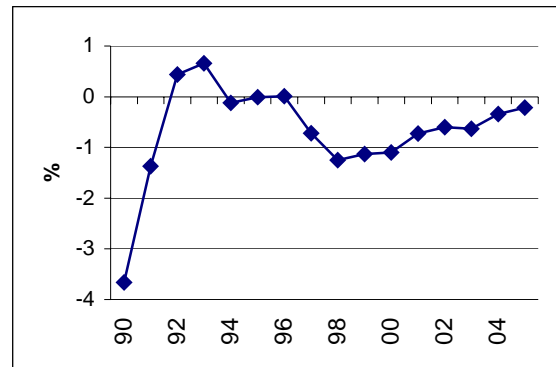
From the 1990s onwards, financial policy has focused on reducing government borrowing as a percentage of GDP. For example, in 1980 the deficit was -7.12% in relation to GDP while in 1985 it was -9.04%.

As can be appreciated in the table below, the 1990s saw the financial deficit tend downwards, dropping from -3.66% to -0.34% in 2004 as a percentage of GDP. The target for 2005 is -0.2%.

In the period under consideration, public finances only registered a surplus in 1992, 1993 and 1996.

Congress ratified the public deficit for 2005, which stands at 17 billion pesos, or 0.22% of GDP. This figure is above that provided by the government, which was 0.14%.

Figure 2: Public Sector Financial Balance (% of GDP) 1990-2005



Source: between 1990 and 2004, statistical appendix of the 4th Government Report. For 2005, Economic Policy General Criteria

Federal Government Transfers

Together with the low level of income and as a result expenditure, funds are strongly centralised. This has prompted, among other things, that some federal organisms are at a completely different stage of development to others, as Federal states and towns depend a great deal on Federal Government transfers.

Table 6: Federal Govt. Share of Total State and Town Income

Year	State	Town
2000	88.7	68.7
2001	89.4	69.1
2002	87.9	68.1
2003	88.1	67.6

Source: based on data from NISGI. State and Town Public Finances 2000-2003

The latest data from the NISGI in the table above illustrates how much federal organisms and towns depend on the Federal Government in terms of income.

States receive up to 90% of their income from Federal Government

transfers, while towns receive close to 70%.

This situation leads both states and towns to take a passive approach when it comes to making an effort to raise funds, as most of their income is guaranteed by the central government.

Adjustments to the 2005 budget

The 2005 expenditure budget decree has rules in the case of additional income as well as that when revenue is insufficient.

When additional income is made, the rule stipulates the following:

- Income from PEMEX operating surpluses, due to the increase in the price of a barrel of oil to \$27 will be channelled to investment programmes and projects, with 50% going to the Federal organisms and the remaining 50% to PEMEX.

- The extra income from non-oil tax revenue and other oil revenues not covered by the previous point will be channelled to the Oil Revenue Stabilisation Fund (25%), improving the public sector balance (25%) and investing in PEMEX (50%).

If revenue were less than expected, the rule would be the following:

If the shortfall is due to the Federal Government's oil revenue, the figure will be offset by funds from the Oil Revenue Stabilisation Fund.

Decreases in other sources of revenue will be offset by decreasing the expenditure on government dependent

bodies, trying not to affect social programmes.

Héctor Ruiz
Toluca, México, May 28, 2005

