Fiscal consolidation in Spain: Situation and outlook

Santiago Lago Peñas[1]

The Spanish government´s fiscal consolidation strategy through 2017 looks promising, but falls short of guaranteeing debt sustainability.

The Spanish government´s fiscal consolidation strategy agreed with the EU over the coming years is feasible and credible. The government has demonstrated its political will through adopting extraordinary measures to correct slippage and has taken a firmer stance with sub national treasuries. Expected economic recovery already underway should also lend support to the adjustment process. However, existing uncertainties remain over the ultimate impact of planned tax measures, as well as the efficacy of further spending cuts. Finally, despite our optimism over the government´s ability to reach deficit targets, the question of Spain´s debt sustainability remains. The combination of the accumulated stock of public debt and the low inflation rate demand higher rates of real growth and/or primary surplus to keep the debt to GDP ratio in check. Unless the EU plays its part through increased stimulus measures, Spain will need more ambitious fiscal targets.

Introduction

Spain's public finances are currently going through a particularly difficult period. Imbalances and structural challenges are taking place in parallel with the deep recession that began in late 2008 and from which the economy is only just beginning to recover. Some of Spain's challenges are similar to those faced by many other European Union (EU) countries. For example, the impact of an ageing population on the pensions system, health and long-term care is not significantly more serious in Spain than for its European peers. Moreover, like Spain, many EU countries also have in common the need to improve budgeting processes and public expenditure efficiency by aligning them more closely with social returns. Globalisation is also challenging their fiscal systems' ability to tax the earnings of multinational groups, the income of the wealthiest individuals, or electronic commerce. In this context, Spain is receiving significant attention in the areas where it is furthest below the European average: fiscal consolidation and public debt sustainability, on the one hand, and tax reform, on the other. In this article, we will focus on the budgetary and financial scenarios, leaving concerns about the tax system aside.

[1] Professor of Applied Economics and Director of GEN, University of Vigo.

The 2013 budget and the government´s outlook for the period 2014-2017

Table 1 shows the evolution of various budgetary aggregates as a percentage of gross domestic product (GDP) over the period 2012-2017. Final data for the first two years are taken from the National Audit Office (Intervención General del Estado, IGAE). Estimates for the four-year period 2014-2017 are drawn from the government's forecasts stated in its budgetary documents (Ministerio de Hacienda y Administraciones Públicas, 2014a and 2014b). The majority of the attention has been focused on non-financial income and expenditure data and the difference between them - the public deficit (as well as the primary deficit, or the public deficit ex-interest payments). The one-off cost of the financial reform has been excluded throughout, as it is not an ordinary recurrent public expenditure. Finally, the figures for the aggregate deficit of the autonomous regions and local authorities are also provided, along with the real GDP growth rate, estimated by the National Statistics Institute (INE) for the period 2012-2013 and by the government's forecast for the period 2013-2017.

There was a slight (-0.22%) reduction in the total public deficit in 2013, accounted for solely by the increase in income (+0.59%). The increase in the consumption tax rate explains this rise in a context of economic depression, in which GDP fell

Deficit reduction in 2013 was small relative to the starting point and the deficit slightly exceeded the limit finally agreed with the European Commission. However, this was achieved in a year in which the economy was in recession, the output gap widened, and there was a significant rise in interest payments on public debt.

in real terms (-1.2%). Moreover, if the increase in debt interest payments is discounted, expenditure would have remained constant. In short, deficit reduction in 2013 was small relative to the starting point and the deficit slightly exceeded the limit finally agreed with the European Commission (-6.50%). However, it should be borne in mind that

Table 1

Actual and forecast change in the deficit and its main components for 2012-2017. Figures as a percentage of GDP

	2012	2013	2014 (F)	2015 (F)	2016 (F)	2017 (F)
Total public deficit	-6.84	-6.62	-5.5	-4.2	-2.8	-1.1
Interest	3.06	3.43	3.5	3.6	3.7	3.8
Primary deficit (-) or surplus (+)	-3.78	-3.19	-2.0	-0.6	0.9	2.7
Non-financial income	37.17	37.76	38.5	38.8	38.9	39.0
Non-financial expenses	44.01	44.38	44.0	43.0	41.7	40.1
Memorandum item: Deficit of sub-national treasuries	-1.64	-1.13	-1.0	-0.6	-0.3	0.0

Notes: The expenditure and deficit figures exclude the one-off cost of the financial reform. (F) indicates a forecast.
Source: The author, based on Ministerio de Hacienda y Administraciones Públicas (2014a and 2014b).

this was achieved in a year in which the economy was in recession, the output gap widened, and there was a significant rise in interest payments on public debt. Moreover, the GDP data for 2013 are still an initial estimate. The final figure, after the usual statistical revisions envisaged by Eurostat, is likely to be slightly higher. Consequently, the ratios relative to GDP is expected to drop and thus the degree of achievement of the 2013 targets is expected to increase.

Looking at the breakdown, the items that grew most relative to GDP were interest (+0.37%), social-security benefits (+0.32%), primarily pensions; and employee compensation (+0.16%). These increases were more than offset by the drop in direct public investment (-0.24%) and intermediate consumption (-0.19%). On the income side, the increase in tax collection from consumption taxes (+0.62%) stands out, including both VAT and duties on specific products. This increase explains the overall growth in income and offsets the significant drop in social-security contributions (-0.25%).

As regards the period 2014-2017, the government has embarked on a course towards fiscal consolidation situating the public deficit below 3%. The rate of consolidation is progressive (a reduction of 1.1% of GDP in 2014, 1.3% in 2015, 1.4% in 2016, and 1.7% in 2017) and follows the anticipated process of economic recovery. The cut in the public deficit of 5.5% of GDP rests on the reduction in public expenditure. Revenues are expected to grow by 1.2% and expenditure to contract by 4.3%. Indeed, as interest payments are expected to rise by half a point, the spending adjustment would come to five percentage points of GDP (4.8%). In short, just a fifth of the adjustment would rest on the increase in revenues.

Is Spain´s fiscal consolidation process credible?

There are reasons for taking the optimistic view that the fiscal consolidation process is credible and feasible. First of all, the public deficit has fallen in the last two years, despite the increase in debt interest payments and the effect of the recession, which has made the process considerably more difficult.[2] Moreover, exceptional measures have been taken that were not planned for in the budget (in terms of employee compensation or tax rates) to correct the deviations from the objectives. Finally, the government has undertaken to devote any increase in tax collection or drop in cyclical expenditure produced by better than expected GDP growth to deficit reduction (Ministerio de Hacienda y Administraciones Públicas, 2013). There is therefore less doubt over the political will to achieve the budgetary objectives.

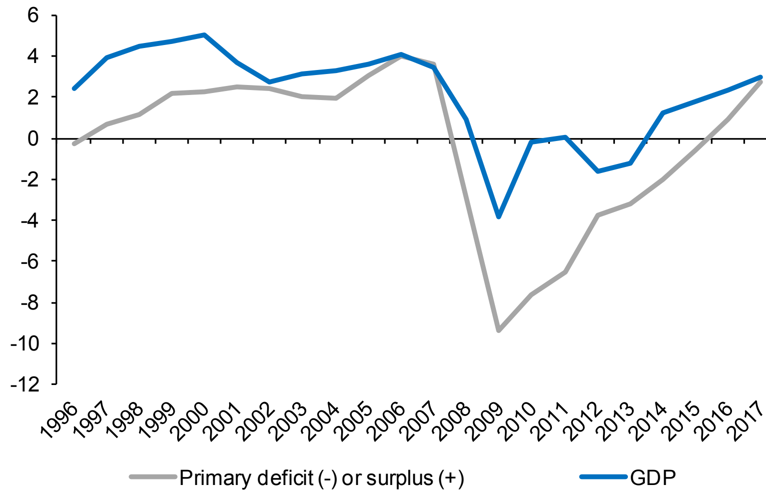
Secondly, the central government is excercising stricter control over sub-national treasuries. The government has not balked at paying the political price of a strategy many regional governments and nationalist parties perceive as an attempt at a political and financial recentralisation of Spain (Lago Peñas, 2013). The direct consequence of this

The government has not balked at paying the political price of a strategy many regional governments and nationalist parties perceive as an attempt at a political and financial recentralisation of Spain. The direct consequence of this greater control has been that sub-national treasuries' deficits have been cut substantially.

[2] According to Hernández de Cos and Moral-Benito (2013), the estimated public expenditure multipliers for the Spanish economy are higher than unity (1.4) in times of crisis and 0.6 in normal periods. These estimates are in line with more recent figures by Martínez and Zubiri (2014), which suggest a fiscal multiplier in the range of 1.3-1.7 during periods of stagnation and 1 in periods of growth.

Exhibit 1

Change in primary deficit as a percentage of GDP and real GDP growth rate (1996-2017)



Notes:The primary deficit excludes the one-off cost of the financial reform. EDP deficit estimates

Sources: The author's calculations based on IGAE and INE for the period 1996-2013 and Ministerio de Hacienda y Administraciones Públicas (2014b) for forecasts.

greater control has been that sub-national treasuries' deficits have been cut substantially. The year ended with an aggregate deficit that slightly exceeded -1.1% and is comfortably below the targets agreed with the European Commission (-1.4%). The high degree of decentralisation of budget decision-making in Spain should therefore be regarded as less of a risk factor and cause for concern.

Thirdly, as can be seen clearly in Exhibit 1, which shows the change in real GDP and the primary deficit since 1996, the paths of these two variables are highly correlated. The anticipated trend in the deficit over the four-year period 2014-2017 is consistent with that of GDP.

And fourthly, all the available indicators confirm that the Spanish economy has finally emerged from recession. The government's forecasts for 2014 and 2015 are in line with most of the available estimates. In March 2014, the consensus view of the analysts included in the FUNCAS *Panel forecast* predicted GDP growth of 1% in 2014 and 1.8% in 2015. Laborda and Fernández (2014) estimate the 2014 figure at 1.2%.

Having set out the grounds for optimism, it is also true that there are a number of factors that give rise to uncertainties that need to be cleared up or, at least, watched closely.

First of all, the quantitative impact of the measures announced by the government up to 2017 (Ministerio de Hacienda y Administraciones Públicas, 2013 and 2014b) is far from clear. On the revenue side, everything depends on how the announced tax reform is implemented. Official estimates on the effect of the tax reform reflect cuts in direct taxes, which are not fully compensated for by increases in indirect taxes. The slight increase in the revenues over GDP ratio would be explained by higher GDP growth rates. Hence most of the fiscal adjustment relies upon the cut in the expenditure over GDP ratio. This strategy does not fare well in comparisons with other European Monetary Union (EMU) countries (Exhibit 2). We will return to this point in the following section.

Setting aside the effect of economic growth on both the denominator of the expenditure over GDP ratio, and on automatic fiscal stabilizers, discretional planned measures on the expenditure side may not be enough. First of all, because GDP growth estimates for 2016 and 2017, when most of the deficit cut is planned, are quite optimistic. Especially taking into account the margin of potential error due to the uncertainty over the economic situation in the Euro zone.

The government's data on the adjustment looks at it from several perspectives. From the viewpoint of the economic classification of expenditure and in terms of the percentage of GDP, the item facing the deepest cuts between 2013 and 2017 is employee compensation (-1.8%), followed by social transfers (-1.2%), and intermediate consumption (-0.9%). Together, these total 3.9 percentage points, thus accounting for 70% of the deficit cut. The credibility of the adjustment therefore basically hinges on the credibility of the cuts in these three areas.

Let us start with staff costs. According to the *Labour Force Survey,* the total number of public sector employees in Spain at the end of 2013 was 2.79 million, down 13% from the peak in 2011. The level of public sector employment in late 2013 was similar to that in 2004. However, there has been no decrease in needs. Quite the opposite. With a similar range of public services and benefits, Spain's population has grown by 10% and its real GDP by 5%. In light of the sharp reduction in the number of employees and the successive salary cuts over the period 2011-2013, it is far from clear that it will be possible to balance the planned savings (-16% in GDP terms between 2013 and 2017) with maintaining the quality of services and public employees' work incentives. Moreover, the envisaged cut in intermediate consumption suggests that there are no plans to outsource service delivery to the private sector.

In the case of social-security benefits, despite recently enacted reforms, pensions, which are the main component, cannot be expected to shrink as a share of GDP.[3] However, on this front it should be borne in mind that spending on unemployment benefits will drop as the economic recovery takes hold. According to La Caixa's forecasts (2014), the reduction in unemployment benefits spending could be in the 0.7% to 1% of GDP range between now and 2016.

The measures envisioned to have the most significant quantitative impacts are those related to local government reform. However, in real terms, spending by the autonomous regions is currently more than 20% down from its peak in 2009 and it is difficult to see where further cuts could be made without jeopardising the basic pillars of the welfare state.

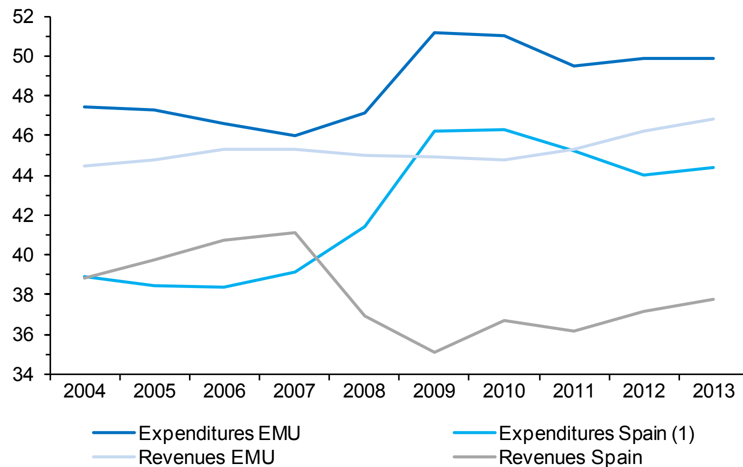
The measures envisioned to have the most significant quantitative impact are those related to local government reform. However, preliminary assessments suggest that the projected savings may be overstated (IEB, 2014). Additionally, the significant cost-cutting effort already made by regional treasuries, which are financially responsible for the main public services (health, education and social services), should not be overlooked. In real terms, spending by the autonomous regions is currently more than 20% down from its peak in 2009 and it is difficult to see where further cuts could be made without jeopardising the basic pillars of the welfare state (Lago Peñas and Fernández Leiceaga, 2013). Moreover, it should not be forgotten that local and regional elections in 2015 could produce a temptation to delay promised adjustments to avoid being punished by voters.

[3] The State Budget for 2014 envisages pension expenditure growth of +4.9% compared with 2013 (Sanz-Sanz and Romero-Jordán, 2013).

Exhibit 2

Public revenues and expenditures, Spain and EMU

Percentage of GDP



Note:(1) The expenditure figures for Spain exclude the one-off cost of the financial reform.

Source: Laborda (2014), based on Eurostat and Ministerio de Hacienda y Administraciones Públicas (2014a).

Is the adjustment enough? Public debt sustainability

The basic conclusion of the preceding section is that the substantial improvement in the economic situation and the Spanish government's commitment in recent years make fulfilment of the consolidation scenario agreed with the European Commission feasible. The government's commitment offsets the doubts about the specific discretionary measures that have been announced so far, on both the expenditure and income sides.

However, the importance of fiscal consolidation goes beyond the need to comply with Spain's commitments: it is also crucial to reining in public debt and guaranteeing its sustainability. The question should therefore revolve around whether the cut in the deficit is sufficient to curb the rising debt-to-GDP ratio to first, start to bring it back to the euro area average, and second, to the 60% limit over the longer term.[4]

Given the foreseen combination of GDP growth, inflation, and cost of debt, Maudos (2014) concludes that a primary surplus of around 1.3% is needed to stabilise the debt-to-GDP ratio at the 94% level on which it ended 2013. The Spanish economy's extremely low inflation rate makes it particularly difficult to bring down the debt burden. For comparison, keeping all other factors equal, with a GDP deflator of around 2.5%, a primary balance would be sufficient. The problem, however, is that the targets for the period to 2017 are below this figure. Even without further deficit/debt adjustments, in a scenario of economic recovery and meeting the agreed fiscal consolidation targets, in 2016, Spain's public debt will pass the 100% of GDP threshold.

The sharp fall in the risk premium on Spanish public debt is good news and is helping curb the interest burden. However, it is insufficient, even in the scenario of a return to growth. The economy of the euro area in general and the Spanish economy

[4] For a detailed analysis of the sustainability of Spain's public debt, see Gordo *et al*. (2013).

in particular need to keep the fear of deflation at bay. This calls for more robust action by the European Central Bank (IMF, 2014) and fiscal expansion in those countries with sufficient leeway. If this does not happen, a further tightening of the screw looks inevitable, with the setting of more ambitious primary surplus targets, particularly for 2014 and 2015, if the escalating debt-to-GDP ratio is to be halted. In this regard, Exhibit 2 points towards the need for a more balanced recourse to measures on the expenditure and income sides in cutting the public deficit than proposed by the government's budgetary consolidation scenarios.

Concluding remarks

The last ten years have been the most extraordinary decade in the history of Spain's public finances. In the first part of the period, the rapid growth of income and nominal GDP produced significant primary surpluses and a drastic cut in the debt-to-GDP ratio, which dropped to 36% in 2007. Spain was one of the countries that best complied with the Stability and Growth Pact, making it the star pupil and a fiscal model. But the crisis changed everything abruptly. The deficit soared to unprecedented levels, and the debt began to climb, reaching 94% of GDP. Uncertainty as to the sustainability of Spain's public debt drove up the risk premium and the expectations of a bail out or a haircut.

Fortunately, over the past year the situation has improved considerably. The support from the European institutions, the incipient recovery of the Spanish economy, and the adjustment efforts on all levels of government have combined to ease international financial markets' fears and generate confidence that the public finances are getting back on track to sustainability. In this regard, the scenario agreed for the 2014-2017 period appears to set an achievable target, although much remains to be done to consolidate the path to adjustment. The fiscal reform currently being hammered out needs to take its contribution to fiscal consolidation into account, and this consolidation will likely need to go well beyond the Spanish government's current projections.

In any event, this successful fiscal consolidation may be insufficient to allow a simultaneous slowing and drop in the public debt-to-GDP ratio; unless the European Union and the ECB are able to implement stimulus measures promoting nominal GDP growth in the euro area and hence in Spain. The combination of the accumulated stock of public debt and the low inflation rate demand higher rates of real growth and/or primary surplus to keep the ratio in check.

References

Gordo, L.; Hernández de Cos, P., and Pérez, J.J. (2013), "Developments in Spanish public debt since the start of the crisis," Bank of Spain, *Economic Bulletin*, July-August 2013: 19-36.

Hernández de Cos, P., and Moral-Benito, E. (2013), "Fiscal multipliers in turbulent times: The case of Spain," Bank of Spain, *Working Paper*, 1309.

Ieb (2014), "Reforma de la Administración local," in *Informe IEB sobre federalismo fiscal y finanzas públicas 2013*: 4-20. (http://www.ieb.ub.edu/files/INF%20IEB%20FFFP_2013.pdf).

Imf (2014), *World Economic Outlook*, April 2014. (http://www.imf.org/external/Pubs/ft/weo/2014/01/).

Laborda, A. (2014), "El déficit público: la asignatura pendiente," *El País*, 6-4-2014.

Laborda, A., and Fernández, M.J. (2014), "La recuperación de la economía española cobra fuerza, pero seguirá siendo lenta," *Cuadernos de Información Económica,* 239: 1-14.

La Caixa (2014), "Una visión a medio plazo del ajuste fiscal en España," La Caixa, *Informe mensual*, March 2014.

Lago-Peñas, S. (2013), "La nueva estabilidad presupuestaria en España: un enfoque centralizador," *Informe sobre federalismo fiscal en España 2012*, IEB, Barcelona.

Lago-Peñas, S., and Fernández, X. (2013), "Las finanzas autonómicas, expansión y crisis: 2002-2012," *Papeles de Economía Española*, 138: 129-146.

Martínez, J., and Zubiri, I. (2014), "Los multiplicadores de la política fiscal en España," *Papeles de Economía Española*, 139:174-198.

Maudos, J. (2014), "Public debt sustainability: Spain in the European context," *SEFO* 3(2): 29-40.

Ministerio de Hacienda y Administraciones Públicas (2013), *Informe sobre la acción efectiva adoptada por España conjunto de las Administraciones Públicas,* 1 October 2013.

Ministerio de Hacienda y Administraciones Públicas (2014a), *Déficit de las Administraciones Públicas en 2013*, 31 March 2014.

Ministerio de Hacienda y Administraciones Públicas (2014b), *Actualización del Programa de Estabilidad. Reino de España 2014-2017,* 30 April 2014.

Sanz-Sanz, J.F. and Romero-Jordán, D. (2013): "Los Presupuestos generales del estado para 2014: Una descripción," *Cuadernos de Información Económica*, 237: 27-37.