

Remaining challenges to budgetary stability in Spain

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Regulation to strengthen Spain's fiscal stability, approved in 2012, was clearly a positive first step. However, design shortcomings, difficulties in implementation, and the subsequent approval of extraordinary liquidity mechanisms open the door for improvement upon existing measures.

Legislation on budgetary stability, approved in 2012, aimed to strengthen Spain's public finances, with particular attention paid to the autonomous regions. Nevertheless, breaches to established targets have already taken place and further slippage is expected. Given the widespread nature of the problem across the regions, the degree of spending cuts already applied, and the "political economy" constraints to further enforcement of the law's available control mechanisms, changes in both the legal framework and its implementation seem necessary. Moreover, recent empirical results highlight some other deficiencies and weaknesses in the current legislation and raise the possibility of introducing modifications related to some of its key pillars. Specifically, there may be room for improving the methodology for calculation of regional deficit and debt targets, structural deficit targets at the central and regional government level, and the overall path of Spanish public debt convergence. Consideration should also be given to reform of the regional financing system. The introduction of such modifications would closer align fiscal targets with the real financial capacity of Spain's regions in addition to the actual economic outlook.

Introduction

The reform of Article 135 of the Spanish Constitution in September 2011 kicked off a profound revision of the legislation on budgetary stability, which was implemented by Organic Law 2/2012 of April 27th, 2012, on Budgetary Stability and Financial Sustainability (LOEPSF). This article sets out to examine those aspects of the law that have proven to be off-target and consequently need to be revised and to detect shortcomings

in its implementation. Based on these findings, the article provides recommendations particularly targeting the regional government level, where the most pressing challenges and problems are concentrated.

Main features and weaknesses of the current budgetary stability framework

The LOEPSF introduced significant changes aimed to increase the budgetary stability of

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the general government as a whole, and the autonomous regions in particular. The four main pillars of the law include: i) the establishment of a ceiling on public expenditures that will prevent them from outpacing nominal medium-term GDP;² the establishment of a limit on public debt as a percentage of GDP (60%), with a rigid distribution across the levels of government; iii) the substitution of the concept of total deficit by that of structural deficit, with a target of zero set for 2020; and finally, iv) greater attention to the control and supervision of sub-national treasuries, including severe penalties and a requirement for more transparent budget management.³

As is typically the case with legislative changes, the LOEPSF was designed taking into consideration key issues at the time and based on a series of assumptions about how relevant agents would react, as well as how the external context would develop. If these agents react unexpectedly and/or external conditions differ from projections, the legislation will not achieve the expected results. Time pressure often times too complicates the legislative process.

In the case of the LOEPSF, time pressures were intense. The severe financial strains affecting the Spanish economy made it necessary to act rapidly and decisively to halt speculation about Spanish public debt and reaffirm the country's commitment to budgetary stability. Pressure from the European Union, led by Germany, and the European Central Bank, were key to understanding the constitutional reform of the summer of 2011 and its subsequent legislative implementation. This pressure explains the importance attached to confirming Spain's commitment to budgetary stability and the excessive rigidity/ambition of some of the law's articles and provisions. The emphasis on debt

payments being a priority budgetary obligation, when this has been the practice since the last Spanish public debt arrangement by Minister José Larraz in 1939 (Comín, 1996), provides an example of the former. As regards the latter, excessive rigidity/ambition are evident in the establishment of precise quantitative targets for public debt, both in terms of the time horizon and the distribution across levels of government.⁴

Breaches by sub-national treasuries

Data at the sub-national treasury level reveal that the local level is not a problem for budgetary stability, and on the whole never has been (Fernández Llera, 2014). The regional level, however, is another matter.

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In the case of the regions, the evolution of the deficit since 2012 has been volatile. Good progress on fiscal consolidation at the regional level was made in 2012 and 2013, but performance in fiscal year 2014 has again put the autonomous regions at the centre of Spanish and foreign analysts' attention. The budgetary execution data published for the period to November (Table 1) confirm the forecasts of the Independent Fiscal Responsibility Authority (AIReF) and Fedea. AIReF (2014a) estimated that the regional deficit

² Although the expenditure rule had been introduced a year earlier by Royal Decree-Law 8/2011 for the central government and its agencies, and for local government bodies receiving funding from transfers of national taxes.

³ A detailed analysis of the LOEPSF can be found in Hernández de Cos and Pérez (2013) and in Ruiz Almendral (2013). Additionally, Cuenca and Ruiz Almendral (2014) expand the review of the subsequent regulations amending and implementing the LOEPSF; in particular, the regulations creating the Independent Fiscal Responsibility Authority (AIReF) and specifying control over "extraordinary liquidity mechanisms", such as the Regional Liquidity Fund (FLA in its Spanish initials), created in July 2012.

⁴ It is noteworthy that the recent ruling by the Constitutional Court in January 2015 on constitutional challenge no. 557-2013 filed by the Government of the Canary Islands has upheld the law.

Table 1

Autonomous regions' net lending (+) or net borrowing (-)

Data at November of each year

Autonomous Regions	2014	2013
	% GDP	% GDP
Andalusia	-1.73	-1.39
Aragon	-1.41	-1.61
Asturias	-0.53	-0.36
Balearic Islands	-1.21	-0.65
Canary Islands	-0.47	-0.62
Cantabria	-1.05	-0.63
Castile-La Mancha	-1.40	-1.20
Castile and Leon	-0.98	-0.61
Catalonia	-1.95	-1.66
Extremadura	-2.45	-0.90
Galicia	-1.17	-1.18
Madrid region	-1.25	-0.94
Murcia region	-2.54	-2.27
Navarre	-0.99	-2.20
La Rioja	-1.03	-0.48
Valencian Community	-1.87	-1.74
Basque Country	0.64	0.49
Total for Autonomous Regions	-1.37	-1.16

Source: Ministry of Finance and Public Administration.

could end the year at 1.5% of Spanish GDP; Fedea's estimate is 1.8% (Conde-Ruiz *et al.*, 2014). Fiscal consolidation prospects for 2015 are less than promising, with a deficit target that is again being cut – from 1.0% of Spanish GDP in 2014 to 0.7%.⁵ Tightening legislation appears to have been insufficient by itself, and going beyond the existing legal possibilities appears difficult (Lago Peñas, 2013). The government faces a dilemma: it could either make full use of the deficit

control mechanisms under the current legislation, or it could seek alternatives.

The first route would be the most attractive for the central government if there was clear evidence that there was scope for savings and more rigid budget management, or if it was certain that the problem was limited to one or two badly managed regions. However, the sharp cuts to regional spending already applied since the peak in 2009 (Lago Peñas and Fernández Leiceaga, 2013) and the large number of regions likely to miss their targets limit additional recourse to existing measures. That said, the fact that the catalogue of preventive, corrective and coercive measures envisaged in the LOEFSP has not been exhausted, a point recently raised by AIReF (2014b), could also reveal its limitations from a political economy standpoint. For example, it is one thing to enshrine in law the possibility of suspending regional autonomy when regional governments breach their targets, but it is another thing to actually enforce that decision. It is also necessary to reflect on Chapter IV of the LOEFSP and eliminate the parts that cannot be applied in practice due to political constraints, so as to generate credible expectations that what remains will be applied effectively and automatically.

The government's alternatives, previously alluded to, include two, not incompatible approaches. The first, with immediate effects, is to revise the vertical and horizontal split in the debt and deficit targets. The second, the effects of which will be slower but more significant in the medium-to-long term, is to reform the regional financing system in the common regime regions (*i.e.* all of Spain except the foral communities).

The vertical split in deficit and debt targets

The current distribution of budgetary targets does not match the budgetary weight of the different

⁵ The AIReF considers the stability target for the regions in 2015 to be very difficult to meet. Its analysis of the regional budgets concludes that there is a risk of non-compliance in Aragon, the Balearic Islands, Madrid and La Rioja and that this risk in the case of Andalusia, Catalonia, Extremadura, Murcia and the Valencia region is "very high" (AIReF, 2014b).

levels of government or the significance of their respective spending powers. In particular, the regions could be given more space and their percentage of the total increased to be more in line with their share of consolidated expenditure –around a third.⁶ In the case of the distribution of the 60% debt target across all levels of government,

The current distribution of budgetary targets does not match the budgetary weight of the different levels of government or the significance of their respective spending powers.

it does not seem reasonable to have simply taken the actual figures observed in 2011 as an optimal value and objective rule. Targets should better reflect economic reality.

The horizontal split in deficit and debt targets across regions

The LOEPSF does not specify what formula to apply to establish individual deficit targets for the autonomous regions, over and above the fact that the aggregated individual targets should coincide with the deficit target for the regional level as a whole. In practice, what has been done is to imitate the application of ratios in terms of regional GDP. That is to say, for each autonomous region, the same percentage is set as for the country as a whole. The difference is that the individual targets refer to each region's GDP and the overall target to total Spanish GDP. The slight deviations from this rule in the last two years have responded to the need to give more leeway to those regions farthest from the target.

This methodology for determination of regional deficit targets lacks a solid basis. As Fernández

Leiceaga and Lago Peñas (2013) explain, leaving the foral communities aside, Spain's strong inter-territorial levelling means there is no positive correlation between GDP per capita and fiscal capacity, on the one hand, and total per capita non-financial revenues (or current revenues) on the other. It is not each region's GDP that solely supports regional finances, as happens at the national level, or in countries where the inter-territorial levelling has little relevance, such as in the United States. This explains why the Madrid region's budget is around 10% of regional GDP, whereas Extremadura's is well in excess of 20% of its GDP. Consequently, the financial capacity sustaining a given volume of debt expressed as a percentage of regional GDP is not the same in each case. For example, a debt equivalent to 20% of Extremadura's GDP is easier for the region's finances to bear than 15% of GDP is for the Madrid region's finances. The same also applies to the deficit, which is essentially just the flow variable that determines the stock of debt. In the opposite direction, the targets for surpluses in terms of a percentage of regional GDP ought to be lower in the case of those regions with higher regional GDPs in order for them to match up in terms of the degree of ambition and difficulty.

The solution to this blurring is to use the variable that matches the regions' real financial capacity to meet their deficit/surplus targets as the basis of the split.

If the aim is to achieve symmetrical distribution across the regions, the denominator of the deficit and the debt should be each region's income and not its GDP, as is already the case for local government bodies.

Thus, if the aim is to achieve symmetrical distribution across the regions, the denominator of the deficit and the debt should be each region's

⁶ Fernández Llera and Monasterio (2010), referring to the previous legislative framework, also concluded with a proposal for the regions' share of the total deficit of between a quarter and a third, depending on the state of the economic cycle.

revenue (current or non-financial) and not its GDP, as is already the case for local government bodies.

Reform of the regional taxation system

It is imperative that the regional tax system be substantially strengthened, the budgetary restrictions hardened, and the overall distribution of resources better matched to spending requirements.⁷ The first two elements are what would make it possible to hold regional governments accountable for their income in a dialogue with their citizens, bringing together both sides of the budget. International experience shows that in decentralised countries, such as Spain, the degree of autonomy or fiscal co-responsibility of sub-national governments is as or more important than rules. Fiscal discipline increases with fiscal decentralisation. (Eyraud and Lusinyan, 2011; Foremny, 2014). As regards the distribution of resources between territorial units, it is essential to calculate spending needs better and not deviate from them arbitrarily *ex post*, as is currently the case.

It is also necessary to find a solution for the disruptions generated by the system of advances and partial payments around which the financing system in the common regime revolves. Firstly, because it distorts the use of fiscal capacity, particularly in the case of personal income tax. Unlike the case of the national portion of the tax, any changes made to the regional portion are not reflected in withholdings. Therefore, taxpayers only notice them a year and a half after they have come into force, when they settle their tax. Something similar also happens with regional treasuries. Secondly, because unexpected changes in income are not offset in the implementation phase given that they will not be reflected in the

end-of-year deficit, as they are in the case of the central government. In this regard, Hernández de Cos and Pérez (2015) propose the application of an adaptive mechanism in which income forecasts are updated over the course of the year and affect the partial payments.

Lastly, it is necessary to gradually integrate the foral communities of the Basque Country and Navarre into the inter-territorial levelling mechanisms.

Structural equilibrium and the expenditure ceiling: Are they sufficient to guarantee budgetary stability?

Substituting the total deficit for the structural deficit as a target is clearly a positive move. However, there are practical problems that arise, such as the difficulty of estimating the exact position in the economic cycle, of doing so in advance (the output gap) and the sensitivity of the budget to the cycle (Hernández de Cos and Perez, 2013). The legislation in force settles the issue by stipulating that the European Commission's methodology is to be used for all these calculations, a solution backed by the Constitutional Court.⁸ Nevertheless, the available estimates of sensitivity vary substantially, depending on the method and the period analysed, and also on the current phase of the cycle. As Castro *et al.* (2008) show, at the peak of the cycle, methodologies based on the concept of output gap, such as that of the European Commission, tend to underestimate the cyclical effect; that is to say, they underestimate the transitional component of public revenues. The opposite is the case at the bottom of the cycle. A fiscal policy centred on the structural deficit estimated in this way would therefore have a procyclical bias.

The introduction of an expenditure rule such as that provided in Article 12 of the LOEPSF, which

⁷ See the recently published issue 143 of the journal *Papeles de Economía Española* for more on reform of the regional financing system.

⁸ http://ec.europa.eu/economy_finance/economic_governance/sgp/data_methods/index_en.htm.system

ties its dynamics to the medium-term nominal GDP growth rate,⁹ may help remedy this bias in practice, as it smooths out the variations in expenditure. However, it should not be overlooked that between 2000 and 2007, the expenditure/GDP ratio grew at a similar rate to nominal GDP, rising from 39.1% to 39.2%, fluctuating between 38% and 39% the remaining years.

In short, given the methodology selected to calculate the structural deficit, the combination of the zero structural deficit rule with the expenditure rule could prove imprudent in the case of a future recession. One possible solution would be to utilise the independence and technical capacity of the AIReF and the Bank of Spain to define and apply a more sophisticated methodology for calculating the structural deficit. This calculation would be preferred when it supports more sensible deficit or surplus targets than those estimated using the European Commission's methodological framework. Finally, and in a way complementary to the expenditure rule, the creation of stabilisation funds ("rainy day funds") could be considered, allowing room for manoeuvre to be built up during expansionary times (Hernández de Cos and Pérez, 2015): the occasional "excess" tax collection, as happened in Spain in the last decade, would thus not be used to pay for procyclical tax cuts or lead to a slackening of efforts to combat tax evasion.

Moreover, the LOEPSF states that "no public administration may incur a structural deficit, defined as a cyclically-adjusted deficit" (Art. 11.2). In addition, Article 16 refers to setting individual targets for the autonomous regions. In order to truly adhere to the law, each region's position in the cycle should be calculated, rather than applying a weighted average for them all as a whole. This would be impossible for municipalities, but statistically feasible at the regional level.

It is true that there is a high degree of convergence between the regions' economic cycles, as a result of the close commercial, financial and fiscal links between them. And transfers to the regions from the central government depend on how the Spanish economy as a whole is performing, which reduces the sensitivity of regional income to the performance of the regional economy. However, the cycles and characteristics of recessions in Spanish regions are not identical (Bandrés and Gadea, 2013). Moreover, the dependence on transfers varies widely between regions, due to the existence of significant differences in fiscal capacity; and it is practically zero in the case of the foral communities. Although these calculations would entail greater complexity,¹⁰ per-community structural deficit estimates should at least be explored and the size of the divergence from the national average over the last decade, for instance, be determined. This would make it possible to combine years of strong growth with others of recession in the sampling period and help in the determination of an appropriate fiscal effort.

The first transitional provision of the LOEPSF

It is difficult to envision compliance with the first transitional provision of the LOEPSF (Marín, 2014). The strong increase in public debt over the last three years makes it necessary to revise the path of Spain's public debt consolidation to 60% of GDP by 2020 to ensure it is feasible and credible. Achieving this objective would mean maintaining combinations of GDP growth and budgetary surpluses between now and 2020 that are overly ambitious even under the most optimistic economic projections available.¹¹ For example, it would require nominal economic growth of 5%

⁹ Defined in a subsequent ministerial order in December 2012 as the ten-year average of the potential real GDP estimates -those corresponding to the five previous years, the estimate for the reference year, and the projections for the four coming years.

¹⁰ In this regard, Hernández de Cos and Pérez (2013) warn of the difficulty of harmonising the regions' output gaps with Spain's as a whole. However, they also warn that the dispersion in the regional growth rates may in some years be considerable.

¹¹ We should not lose sight of the negative multiplier effects when trying to switch suddenly from the current deficit to a surplus (Estrada and Vallés, 2013).

and a total surplus equivalent to 3% of GDP, or growth of 8% and a surplus of 1%, which is the combination closest to that experienced in the years prior to the recession.

Achieving current public debt consolidation targets would mean maintaining combinations of GDP growth and budgetary surpluses between now and 2020 that are overly ambitious even under the most optimistic economic projections available.

In sum, with a debt to GDP ratio of 70% of GDP, the level recorded when the transitional provision was drafted, the 60% target may have seemed reasonable over a nine-year horizon and consistent with the other fiscal objectives set out in the law. However, with debt approaching 100%, it no longer appears possible to reach this target.

Given that the provision should be reviewed in 2015 to ensure deficit and debt targets remain on track to reaching their objectives for 2020, this could serve as an opportunity to make substantial modifications. In this regard, Marín (2014) offers a series of reasonable alternatives that, basically, extend the transitional period beyond 2020 (to at least 2025) and sidestep the strict expenditure dynamics requirements in order to reduce the debt volume.

In any event, it should be made clear that the public debt to GDP ratio will come down automatically and rapidly with the consolidation of the recovery underway. The structural deficit will approach zero and the average cost of debt will drop to levels that are low, or at least reasonable in a historical perspective. The exception to this corrective process is the part of the debt that does not derive from the deficit. The bail-out of both the financial sector and sub-national treasuries has contributed to the large increase in public debt over the last five years. What is more, as Cuenca

and Ruiz Almendral (2014) rightly point out, the way in which extraordinary liquidity mechanisms are being managed is helping create expectations of a financial bail-out for the autonomous regions and worsening the soft budget constraint problem; a problem that goes back to the origins of the regional financing model. This problem has been exacerbated, rather than solved, by the recent Royal-Decree Law 17/2014 of December 26th, 2014, on additional financial sustainability measures for the regions and local bodies. This is undoubtedly a front on which the specific application of the legislation does not entirely encourage consolidation of a medium and long-term budgetary stability framework.

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