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Analysis by the Commission services of the budgetary situation in Spain following the adoption of the COUNCIL RECOMMENDATION to Spain of 2 December 2009 with a view to bringing an end to the situation of an excessive government deficit

Accompanying the document

Recommendation for a

COUNCIL RECOMMENDATION

with a view to bringing an end to the situation of an excessive government deficit in Spain

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1. INTRODUCTION

On 27 April 2009, the Council decided, in accordance with Article 104(6) of the Treaty establishing the European Community (TEC), that an excessive deficit existed in Spain and issued a recommendation to correct the excessive deficit by 2012 at the latest, in accordance with Article 104(7) TEC and Article 3 of Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure.

On 2 December 2009, the Council decided, in accordance with Article 3(5) of Council Regulation (EC) No 1467/97, that effective action had been taken and that unexpected adverse economic events with major unfavourable consequences for government finances had occurred after the adoption of that recommendation. As a result, the Council decided to adopt a revised recommendation under Article 126(7) TFEU to correct the excessive deficit by 2013 at the latest in a credible and sustainable manner by taking action in a medium-term framework. To this end, the Spanish authorities had to: (a) implement the significant deficit reducing measures in 2010 planned in the draft 2010 Budget Law; (b) ensure an average annual improvement in the structural budget balance of above 1.5% of GDP over the period 2010-2013, which should also contribute to halting the rapid rise of the government gross debt ratio, which was forecast to breach the reference value; (c) specify the measures that were necessary to achieve the correction of the excessive deficit by 2013, cyclical conditions permitting, and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than currently expected.

On 15 June 2010, the Commission concluded that Spain had taken effective action in compliance with the Council recommendation of 2 December 2009 to bring its government deficit below the 3% of GDP reference value and considered that no additional step in the excessive deficit procedure was therefore necessary.

2. EFFECTIVE ACTION

After recording a significant contraction in 2009, when real GDP fell by 3.7%, the economy continued contracting in 2010, albeit by a mere -0.1%. The economy returned to positive economic growth in 2011 (0.7%), supported by the dynamism of Spanish exports and the contraction of imports, in line with the weakness of domestic demand. However, according to the most recent Commission services' forecasts for 2012 and 2013, which is an update of the 2012 Spring Forecast incorporating the fiscal measures taken in late May 2012 at regional level and the latest economic and budgetary information, Spain is likely to fall back into recession, and record negative annual economic growth in both 2012 and 2013. Both private and public sector deleveraging and the sizeable unemployment are a heavy drag on domestic demand. In addition, the weakening of the international environment is preventing external demand from offsetting the weakness of domestic demand, resulting in a contraction of the Spanish economy.

The general government deficit reached 9.3% of GDP in 2010, down from 11.2% in 2009. The improvement in the budget balance compared to 2009 was driven by both cuts in total expenditure and an increase in total revenues, mainly as a result of discretionary measures. These included among other things a cut of 5% in public-sector wages, a pension freeze and an increase in the VAT rate.

In 2011, Spain adopted further discretionary measures on top of those already adopted in 2010, which included an increase in excise taxes, the withdrawal of the National Fund for Employment and Local Sustainability and a phasing out of some subsidies, including housing subsidies. However, the deficit outturn was significantly worse than expected, 8.5% of GDP compared with a target of 6%. The Spanish authorities informed Eurostat on 17 May 2012 that the 2011 general government deficit may be revised up by around 0.4% of GDP (from 8.5 to 8.9% of GDP) due to new information on some expenditures of the autonomous regions which had not been included in the March 2012 EDP notification. Around two thirds of the 2011 budget deviation occurred at the regional level, while central government and social security recorded much smaller slippages. The budget deviation was mainly explained by weaker-than-expected revenues due to the materialisation of a less favourable economic environment than foreseen in the 2011 stability programme and a less tax-rich growth composition, while expenditure overruns were relatively limited.

For 2012, Spain is implementing additional discretionary measures, which include increases in both the personal income tax and the corporate tax, a fiscal regularisation, measures to reduce tax fraud, and higher property tax. On the expenditure side, measures include cuts in spending on education and health care, reductions in capital transfers and deep cuts in current and capital spending by ministries. Some of these measures have been announced as being temporary, such as the increase in income tax (limited to 2012 and 2013), or will have a one-off impact, such as the change in the tax instalment system for corporate taxes in 2012 and the fiscal amnesty.

According to a Commission services' update of the 2012 Spring Forecast, the general government deficit is projected at 6.3% of GDP in 2012, which compares to a deficit target of 5.3% of GDP in the 2012 stability programme and the draft 2012 budget law. The projected deviation from the target in 2012 is mainly linked to expected revenue shortfalls, especially in social security, and higher social expenditure, due to a worse macroeconomic outlook, a less tax-rich growth composition and a stronger deterioration in the labour market. This budget forecast is still subject to major risks. A further deepening of the economic crisis and the labour market deterioration, a greater sensitivity of revenues to the economic adjustment and implementation risks at regional level also due to the fact that many budgetary measures will only apply to part of the year, could imply an even larger deviation. Very recent budgetary outcome figures for the first months of 2012 point to continued downward pressure on revenues and indicate a need to implement further structural measures without delay.

According to the most recent Commission services' forecast, which is an update of the 2012 Spring Forecast incorporating the fiscal measures taken in late May 2012 at regional level, the structural deficit was 8¾%, 7.¼% and 7% of GDP in 2009, 2010 and 2011, respectively. It is expected to reach 4.3% of GDP in 2012. This requires an average improvement of the structural balance of 1.5% of GDP between 2010 and 2012, which is in line with the minimum required average annual improvement of 'above 1.5%' of GDP stipulated over the period 2010-2013. Correcting for the change in the macroeconomic scenario between the projections underlying the Council recommendations of 2 December 2009 and the current forecast, the adjusted average annual improvement in the fiscal balance between 2010 and 2012 would be 0.5 pp. of GDP higher.

3. RECENT MACRO-ECONOMIC AND BUDGETARY DEVELOPMENTS

In 2011, the Spanish economy returned to positive economic growth (0.7%) after two years of contraction (-3.7% in 2009 and -0.1% in 2010). The recovery was driven by net trade, with Spanish exports growing by 9% in real terms, while imports were flat as domestic demand contracted sharply (-1.8% in 2011 compared to -1% in 2010). Private consumption and investment were held back by the high level of unemployment (24.4% in the first quarter of 2012), the deleveraging process of households and corporations seeking to reduce their high indebtedness (82% of GDP for households, 132% of GDP for non-financial corporations) and the lack of credit, due to the financing difficulties of the Spanish MFIs.

The expected slowdown of global economic growth in 2012 implies a weakening of the only source of growth for the Spanish economy, i.e. exports. On the domestic demand side, the same factors that weighed on private consumption and investment in 2011 will continue acting as a drag in 2012. Furthermore, the fiscal consolidation efforts that the Spanish government needs to conduct to put its public finances on a sound footing are also holding back economic growth in the short term. As a result, the update of the Commission services' 2012 Spring Forecast estimates that Spain is likely to fall back into recession, with negative real GDP growth in both 2012 and 2013. GDP is expected to fall by 1.9% in 2012 and by 0.3% in 2013 (under a no-policy change assumption). According to this forecast, net external demand would continue to contribute positively to GDP growth in 2012, but, in contrast to 2011, is likely to be driven by a fall in imports. Domestic demand is expected to contract sharply (-4.5%).

Table 1. Forecast of key macroeconic and budgetary variables

	2009	2010	2011	2012	2013	2014
Real GDP growth	-3.7	-0.1	0.7	*-1.9*	*-0.3*	*1.1*
Output gap (% of potential output)	-4.3	-4.8	-4.2	-5.3	-4.7	-2.8
General government balance (% of GDP)	-11.2	-9.3	-8.9	-6.3	-6.1	-6.4
Structural balance[1] (% of GDP)	-8.7	-7.3	-7.0	-4.3	-4.1	-5.1

Notes:

[1] Cyclically-adjusted balance excluding one-off and other temporary measures.

Source :

Commission services' 2012 spring forecast update, based on no policy change

The outcome for the years 2010 and 2011 was slightly better than expected in the Commission services' 2009 Autumn Forecast. Indeed, the 2009 Autumn Forecast, which was underlying the Council recommendation under Article 104(7) of 2 December 2009, estimated that the Spanish economy would contract by 0.8% in 2010 and grow by 1% in 2011. The observed real GDP growth was actually slightly stronger, with real GDP increasing by 0.6 percentage points over the whole period. This was a result of a larger-than-expected contribution from net external demand, due to a fall in imports but also better-than-projected export growth, which partly reflects the underlying improvement in competitiveness. The accumulated contribution to GDP growth from domestic demand was much weaker, -2.7 percentage points compared to a forecast of -1.1 percentage points, which is a typical phenomenon when growth is rebalanced towards the tradable sector. As result of the GDP mix, the evolution of the tax base was worse than expected and the revenue-raising capacity of the Spanish government was constrained.

The update of the Commission services' 2012 Spring Forecast implies a much more adverse scenario for the years 2012 and 2013 than the one implied by the Commission services' 2009 Autumn Forecast, which was based on an assumption of closure of the output gap beyond the forecast horizon. Hence, that forecast exercise implicitly assumed that the Spanish economy would grow at a faster pace than in 2011 in both these years in order for the output gap to be closed. However, the current forecast projects economic activity to contract significantly in 2012 and continue to fall, albeit slightly, in 2013 (on a no-policy change basis). In addition to this deterioration of more than 3 percentage points in the growth outlook, the composition of growth is expected to differ markedly. While in the 2009 Autumn Forecast domestic demand was expected to show positive growth in 2011, and implicitly in the following years, the current forecast foresees significant falls (-4.5% for 2012 and -2.1% for 2013), implying a significant weakening of the tax base and, thus, of tax revenues.

According to the updated Commission services' 2012 Spring Forecast, which is based on a no-policy-change assumption and which forecasts real GDP growth to shrink by 0.3% in 2013, the government deficit is forecast to reach 6.1% of GDP in that year, compared to the original target of the government of 3% of GDP. For 2013, the stability programme projects a sizeable increase in revenues from taxes on production and imports, not yet underpinned by concrete measures, which is expected to be partially compensated by lower taxes on labour. The programme also includes – so far not sufficiently specified – cuts on the expenditure side, pertaining in particular to the area of education and health care at regional level. For 2014 and 2015, the envisaged further consolidation is not yet sufficiently supported by measures to underpin the proposed deficit target and few concrete measures are included in the stability programme.

Public debt rose to 68.5 % of GDP in 2011, and according to the updated Commission 2012 Spring Forecast, it is expected to surge to 80.9% of GDP in 2012 and continue to rise to 86.8% in 2013, based on a no-policy-change scenario, thus exceeding the Treaty reference value in all years. This increase in debt is mainly driven by higher interest payments and to a lesser extent by the dynamics of the primary deficit. The stock-flow adjustment is sizeable in 2012, contributing 5.4 percentage points of GDP to the debt increase, and is linked to the plan to settle invoices of providers of public bodies and other outstanding operations. Downside risks related to the macroeconomic scenario and the budgetary targets, as well as to the additional re-financing needs of the financial sector, may contribute to a further increase in public debt.

Downside risks to the budgetary targets in 2012 and beyond are linked in particular to a possible stronger contraction of the economy, a less tax-rich composition of growth, stronger sensitivity of revenues to the structural adjustment of the Spanish economy, the recently poor track record of regions in meeting their budgetary targets, and insufficient specification of measures to underpin targets (from 2013 onward).

4. PROPOSED NEW ADJUSTMENT PATH

The substantial deterioration in the budgetary position resulting from the adverse economic developments, which also turned out less tax-rich than expected, compared to when the earlier

Council recommendation was framed, warrants an extension of the deadline for correction of the excessive deficit in Spain to 2014. In particular, the sizeable contraction of the economy has affected employment in a very negative way and unemployment has risen sharply. Together with the changing composition of GDP growth, this has had adverse effects on both the revenue and expenditure side, with a short-fall of social contributions and higher social transfers. Considering all these factors, an additional year would therefore be warranted.

Granting an additional year in the correction of the excessive deficit gives intermediate headline deficit targets of 6.3% of GDP for 2012, 4.5% of GDP for 2013 and 2.8% of GDP for 2014. The underlying improvement in the structural budget balance implied by these targets is 2.7% of GDP in 2012, 2.5% of GDP in 2013 and 1.9% in 2014. These targets for the annual improvement in the structural budget balance take into account the need to compensate for the negative second-round effects of fiscal consolidation on public finances, through its impact on GDP growth. The previous EDP correction deadline of 2013 required an average annual improvement in the structural budget balance of above 1.5% of GDP over the period 2010-2013. Given very recent fiscal outturn data for the first months of 2012, additional measures will be needed to achieve the deficit target in 2012. The situation will have to be monitored closely and further corrective action would have to be taken early on if further slippages were to materialise.

Table 2. Key budgetary and macroeconomic variables according to the new intermediate targets

	2009	2010	2011	2012	2013	2014
General government balance (% of GDP)	-11.2	-9.3	-8.9	-6.3	-4.5	-2.8
Structural balance[1] (% of GDP)	-8.7	-7.3	-7.0	-4.3	-1.8	0.1
Structural effort		1.4	0.3	2.7	2.5	1.9
Real GDP growth	-3.7	-0.1	0.7	-1.9	-2.1	-1.1

Notes:
[1] Cyclically-adjusted balance excluding one-off and other temporary measures.
Source :
Commission services

5. CONCLUSIONS

On current information, the Spanish authorities have taken measures that represent an average annual improvement in the structural budget balance of 1.5% over the period 2010-2012 in line with Council Recommendations.

For the period 2012-2013, the Spanish authorities have outlined in some detail plans for a correction of the excessive deficit situation by 2013, as recommended by the Council. According to the stability programme, total revenue-raising measures of 2.3% of GDP are planned in 2012, of which more than three fourths (1.8% of GDP) have already been adopted. Total expenditure is expected to decline by 1.2% of GDP in 2012, underpinned by cuts in ministerial spending levels.

The substantial deterioration in the budgetary position resulting from the worse-than-expected economic downturn and the weaker overall position of the economy than envisaged when the earlier Council recommendation was framed suggest that a new deadline for correction of the excessive deficit in Spain by 2014 is appropriate. Granting an additional year in the correction of the excessive deficit gives intermediate headline deficit targets of 6.3% of GDP for 2012, 4.5% of GDP for 2013 and 2.8% of GDP for 2014. The underlying improvement in the structural budget balance implied by these targets are 2.7% in 2012, 2.5% in 2013 and 1.9% in 2014, in order to bring the headline government deficit below the 3% of GDP reference value by 2014.

ANNEX. Comparison of forecasts of 2012 Stability Programme and Commission's 2012 spring forecast update

		2011	2012	2013	2014
Real GDP	COM	0.7	-1.9	-0.3	1.1
(% change)	SP	0.7	-1.7	0.2	1.8
Output gap[1]	COM	-4.2	-5.3	-4.7	-2.8
(% of potential GDP)	SP	-3.8	-4.3	-3.8	-2.1
General government balance	COM	-8.9	-6.3	-6.1	-6.4
(% of GDP)	SP	-8.5	-5.3	-3.0	-1.1
Primary balance	COM	-6.5	-3.1	-2.8	-3.1
(% of GDP)	SP	-6.1	-2.2	0.2	2.0
Cyclically-adjusted balance[1]	COM	-6.9	-4.1	-4.1	-5.1
(% of GDP)	SP	-6.9	-3.4	-1.4	-0.2
Structural balance[2]	COM	-7.0	-4.3	-4.1	-5.1
(% of GDP)	SP	-7.3	-4.4	-2.2	-0.2
Government gross debt	COM	68.5	80.9	86.8	91.8
(% of GDP)	SP	68.5	79.8	82.3	81.5

Note:

[1] Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2] Cyclically-adjusted balance excluding one-off and other temporary measures.

Source : Commission services' 2012 spring forecast update (COM) and April 2012 stability programme update (SP)