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COMMISSION STAFF WORKING DOCUMENT

Analysis of the Draft Budgetary Plan of Spain

Accompanying the document

COMMISSION OPINION

on the Draft Budgetary Plan of Spain

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1. INTRODUCTION

Spain submitted its Draft Budgetary Plan (DBP) for 2018 on 16 October 2017 in compliance with Regulation (EU) No 473/2013 of the Two-Pack. In the absence of a 2018 budget law, which has been delayed compared to its normal schedule, the budgetary projections for 2018 in the DBP reflect projections on the basis of unchanged policies, including the policy measures that the government has adopted to date, but with no new planned measures for 2018. Spain has committed to submitting an updated DBP once the budget law has been presented to parliament.

Spain is currently subject to the corrective arm of the Stability and Growth Pact (SGP). The Council opened the Excessive Deficit Procedure (EDP) for Spain on 27 April 2009. On August 8 2016, the Council gave notice to Spain under Article 126(9) of the Treaty to correct the excessive deficit by 2018.[1]

Section 2 of this document presents the macroeconomic outlook underlying the DBP and provides an assessment based on the Commission 2017 autumn forecast. Section 3 presents the recent and planned fiscal developments, according to the DBP, including an analysis of risks to their achievement based on the Commission 2017 autumn forecast. In particular, it also includes an assessment of the measures underpinning the DBP. Section 4 assesses the recent and planned fiscal developments in 2017-2018 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. Section 5 provides an analysis on the composition of public finances and on the implementation of fiscal-structural reforms, including those to reduce the tax wedge. Section 6 summarises the main conclusions of the present document.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

The macroeconomic scenario underpinning the DBP projects annual real GDP growth to reach 3.1% in 2017. Domestic demand is expected to contribute to growth with 2.4 percentage points, with private consumption decelerating slightly and investment picking up compared to last year. Net exports are projected to have a contribution to growth of 0.7 percentage point of GDP, the same as in 2016. Compared to the 2017 Stability Programme submitted in April 2017, the DBP forecasts GDP growth to be 0.4 percentage point higher this year, due to a higher expected contribution of net exports and investment to growth.

[1] COUNCIL DECISION (EU) 2017/984 of 8 August 2016 giving notice to Spain to take measures for the deficit reduction judged necessary in order to remedy the situation of excessive deficit. OJ L 148/38.

The Commission 2017 autumn forecasts also projects real GDP growth of 3.1% this year, with only small divergences in the composition of growth compared to the macroeconomic scenario underlying the DBP. The main differences between the DBP and Commission forecasts for 2017 refer to both employment and prices. Despite the same real growth, a higher GDP deflator in the DBP results in nominal growth being 0.3 percentage point higher than in the Commission forecast. The DBP also projects more dynamic growth of employment and wages than the Commission forecast.

For 2018, the DBP forecasts real that GDP growth will slow down to 2.3%, 0.2 percentage point lower than the Stability Programme. The Draft Budgetary Plan attributes the now stronger deceleration to, among others, increased uncertainty arising from the recent events in Catalonia. The DBP forecasts that both private consumption and investment will ease in 2018, bringing down the contribution of domestic demand to growth to 1.8 percentage points of GDP. Exports, and to a lesser extent imports, are also expected to slow down, bringing down the contribution of net exports to growth to 0.5 percentage point. Compared to the Stability Programme, the DBP forecasts GDP growth to be 0.2 percentage point lower in 2018 due to a lower contribution of private consumption to growth, and despite higher investment and exports.

The Commission also projects real GDP growth to slow down next year, but by less than the DBP. The Commission forecasts real growth of 2.5%, 0.2 percentage point higher than the macroeconomic scenario underlying the DBP. However, contrary to the DBP, the baseline scenario of the Commission forecast does not incorporate the potential impact of the uncertainty related to the recent events in Catalonia. The risk exists that future developments could have an impact on growth, the size of which cannot be anticipated at this stage. In terms of the composition of growth, the Commission projects higher private consumption and investment than the DBP. This results in the contribution of domestic demand to growth being 0.4 percentage point higher in the Commission forecast. However, as a consequence of more dynamic domestic demand, imports are expected to grow faster in the Commission forecast. This, together with lower exports, results in a lower contribution of net exports to growth in the Commission forecast than in the DBP. As was the case in 2017, employment is expected to grow faster also in 2018 in the DBP forecast, despite lower real GDP growth. Finally, both forecasts project the same GDP deflator for 2018, but because of higher real growth, nominal GDP growth is expected to grow faster in the Commission forecast than in the DBP. Both macroeconomic scenarios imply the reversal of the negative output gap in 2018. However, the change in the output gap is larger in the Commission forecast due to the both higher real GDP growth and lower (recalculated) potential growth than in the DBP.

Overall, the macroeconomic projections underlying the DBP are plausible with regard to GDP growth in 2017 and 2018, but subject to a high degree of uncertainty in 2018.

Box 1: The macro economic forecast underpinning the budget in Spain

The macroeconomic forecasts underpinning the 2018 DBP have been endorsed by Spain's independent fiscal institution –Autoridad Independiente de Responsabilidad Fiscal (AIReF) in a report published on AIReF's website on 18 October 2017.[2] While deeming the

[2] http://www.airef.es/informes/-/asset_publisher/lj3Zi6KgDH3f/content/informe-sobre-las-previsiones-macroeconomicas-del-proyecto-del-plan-presupuestario-

macroeconomic scenario as "likely" and the assumptions underpinning it "realistic", AIReF flagged both upside and downside risks, including faster growth in trading partner countries on the one hand and lower competitiveness of Spanish exports, higher oil prices and a stronger EUR/USD exchange rate on the other. AIReF also flagged downward risks linked to future developments in Catalonia. In a report issued on 4 October 2017, it considers it "achievable" for Spain to reach a nominal deficit of 3.1% of GDP or better, attaching a 53% likelihood to this outcome.

AIReF's mandate is broad, thus allowing it to play a relevant role in Spain's budgetary processes. It is mandated, among others, to issue reports assessing the Stability Programme, the DBP, compliance of general government budget performance with numerical fiscal rules, the regions' economic and financial plans and to give advice on the activation of the correction mechanisms set out in Spain's Organic Law on Budgetary Stability and Financial Sustainability.

2018?inheritRedirect=false&redirect=http%3A%2F%2Fwww.airef.es%2Finformes%3Fp_p_id%3D101_INSTANCE_lj3Zi6KgDH3f%26p_p_lifecycle%3D0%26p_p_state%3Dnormal%26p_p_mode%3Dview%26p_p_col_id%3Dcolumn-1%26p_p_col_count%3D1

Table 1. Comparison of macroeconomic developments and forecasts

	2016	2017			2018		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	3.3	2.7	3.1	3.1	2.5	2.3	2.5
Private consumption (% change)	3.0	2.6	2.5	2.6	2.4	1.8	2.2
Gross fixed capital formation (% change)	3.3	2.8	4.2	4.1	2.6	3.4	4.0
Exports of goods and services (% change)	4.8	5.5	6.2	6.0	4.9	5.1	4.8
Imports of goods and services (% change)	2.7	4.3	4.4	4.4	4.1	4.1	4.3
Contributions to real GDP growth:							
- Final domestic demand	2.6	2.2	2.4	2.5	2.1	1.8	2.2
- Change in inventories	0.0	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	0.7	0.5	0.7	0.6	0.4	0.5	0.3
Output gap[1]	-2.2	-0.2	-0.3	-0.1	0.8	0.8	1.4
Employment (% change)	2.5	2.8	2.9	2.6	2.6	2.4	1.9
Unemployment rate (%)	19.6	17.5	17.2	17.4	15.6	15.5	15.6
Labour productivity (% change)	0.3	-0.1	0.2	0.3	-0.1	0.0	0.5
HICP inflation (%)	-0.3	1.5		2.0	1.6		1.4
GDP deflator (% change)	0.3	1.5	1.2	0.9	1.6	1.6	1.6
Comp. of employees (per head, % change)	-0.3	1.3	1.1	0.5	1.5	1.1	1.2
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	2.1	2.0	1.8	2.0	1.9	1.7	2.2

Note:

[1] In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

Driven by the cyclical improvement of the economy and significant expenditure restraint, the DBP expects the general government headline deficit to shrink from 4.5% of GDP in 2016 to 3.1% of GDP in 2017, in line with the headline deficit target required by the Council. Although the expected deficit ratio is unchanged, both the revenue and expenditure ratios are revised down by almost 0.3 percentage point, to 38.1% and 41.2% of GDP, respectively. Regarding the former, the revision is driven mainly by lower "taxes on production and imports" and "social contributions", whereas the latter is affected by downward revisions of compensation of employees, social transfers, investment and, in particular, interest expenditure (-0.2% of GDP), only partly offset by upward revisions in intermediate consumption and subsidies.

The Commission 2017 autumn forecast also projects a headline deficit of 3.1% of GDP in 2017 with marginally lower revenue and expenditure ratios than the DBP (37.9% and 41.1% of GDP, respectively). On the revenue side, slightly lower revenues from taxes and social contributions are partly offset by higher capital transfers. The latter is linked to an assumed gradual rebound in EU funds, following the sharp drop observed in 2016. A similar rebound is not included in the DBP. On the expenditure side, the expected rebound in EU funds is matched by higher public investment in the Commission forecast. As the Commission forecast has lower interest expenditure and other expenditure, however, the total expenditure ratio is marginally below that of the DBP.

For 2018, the DBP only provides projections on the basis of unchanged policies and shows the general government deficit narrowing to 2.3% of GDP, reflecting the continued cyclical upswing. The deficit reduction in 2018 is driven by a 0.2 percentage point increase in the revenue ratio, which reaches 38.3% of GDP, and a decrease in the expenditure ratio from 41.2% of GDP to 40.6% of GDP. While the revenue ratio is boosted by an increase in taxes on income and wealth, most of the reduction in the expenditure ratio reflects spending on compensation of employees and social transfers growing significantly slower than nominal GDP, but broadly in line with potential GDP growth. Growth in compensation of employees is expected to be held back in 2018 by unchanged wages per employee, as the 2017 budget is rolled over to 2018. Social transfers are held back by falling unemployment and the impact of a low annual adjustment of pensions. The public investment ratio is expected to increase by 0.1 percentage point as the DBP assumes the materialisation of contingent liabilities related to distressed toll motorways to the amount of about 0.2% of GDP (recorded as gross fixed capital formation).

The Commission 2017 autumn forecast projects a general government deficit of 2.4% of GDP in 2018, 0.1 percentage points higher than the DBP, reflecting a more prudent view on revenue developments, in particular regarding taxes on income and wealth and social contributions. This is consistent with a significantly lower employment growth projected by the Commission compared to the DBP. However, total revenues are only expected to be 0.1 percentage point lower than in the DBP, as the Commission forecast assumes a continued gradual pick-up in capital transfers following the drop in 2016 linked to a decrease in EU funds. On the expenditure side, this is matched by a similar expected rebound in public investment, not present in the DBP. Moreover, the Commission assumes a less pronounced drop in compensation of employees, as – contrary to the DBP – it does not assume the wage per employee to remain frozen throughout 2018. On the other hand, assuming average cost of new debt issuance to remain below the average cost of outstanding debt, interest expenditure is expected to decrease faster than projected in the DBP. On balance, therefore, the expenditure ratio is expected to evolve in a similar way in both the DBP and the Commission forecast, decreasing by about 0.7 percentage point compared to 2016. However, the DBP forecast also includes 0.2% of GDP of investment linked to the expected settlement regarding distressed toll motorways (which it treats as one-off expenditure). The Commission 2017 autumn forecast considers this to be a contingent liability and therefore does not yet include its impact in the deficit projection. Excluding this element reveals a larger underlying difference (0.3% of GDP) between the DBP and the Commission forecast regarding the 2018 deficit. As noted, this is also due to lower revenues from income taxes and social contributions in the Commission forecast. Despite lower real GDP growth, which moreover relies less on domestic demand than the Commission forecast, the DBP assumes brisk growth of these revenue categories, partly based on stronger employment growth.

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Spain currently standing at 1.45%[3]. As a consequence, total interest payments by the general government have continued to decrease as a share of GDP. Based on the information included in the DBP, interest expenditure in Spain is expected to fall from 2.8% of GDP in 2016 to 2.6% in 2017, a level it is projected to maintain next year. This is below the 3.5% of GDP recorded in 2014, when interest expenditure peaked. As noted, the interest expenditure forecast in the DBP is slightly more conservative than in the Commission forecast.

[3] 10-year bond yields as of 6 November 2017. Source: Bloomberg.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2016	2017			2018			Change: 2016-2018
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**37.7**	**38.3**	***38.1***	**37.9**	**38.4**	***38.3***	**38.0**	**0.6**
of which:								
- Taxes on production and imports	11.6	11.8	*11.7*	11.7	11.6	*11.7*	11.7	0.1
- Current taxes on income, wealth, etc.	9.9	10.3	*10.3*	10.2	10.7	*10.5*	10.3	0.6
- Capital taxes	0.6	0.5	*0.5*	0.5	0.5	*0.5*	0.5	-0.1
- Social contributions	12.2	12.3	*12.2*	12.2	12.2	*12.2*	12.0	0.1
- Other (residual)	3.5	3.4	*3.4*	3.5	3.4	*3.4*	3.6	-0.2
Expenditure	**42.2**	**41.5**	**41.2**	**41.1**	**40.6**	**40.6**	**40.4**	**-1.6**
of which:								
- Primary expenditure	39.4	38.7	38.6	38.6	37.9	38.0	38.1	-1.4
of which:								
Compensation of employees	10.8	10.7	10.6	10.5	10.4	10.2	10.3	-0.6
Intermediate consumption	5.1	4.9	5.0	5.0	4.7	5.0	4.8	-0.1
Social payments	18.1	17.9	17.8	17.8	17.6	17.5	17.5	-0.6
Subsidies	1.0	1.0	1.1	1.1	1.0	1.1	1.1	0.1
Gross fixed capital formation	1.9	2.0	1.9	2.1	2.1	2.0	2.2	0.1
Other (residual)	2.4	2.2	2.2	2.1	2.1	2.2	2.1	-0.2
- Interest expenditure	2.8	2.8	2.6	2.5	2.7	2.6	2.3	-0.3
General government balance (GGB)	**-4.5**	**-3.1**	**-3.1**	**-3.1**	**-2.2**	**-2.3**	**-2.4**	**2.2**
Primary balance	**-1.7**	**-0.4**	**-0.5**	**-0.6**	**0.5**	**0.3**	**-0.1**	**2.0**
One-off and other temporary measures	-0.1	-0.3	-0.2	0.0	-0.1	-0.2	0.0	-0.2
GGB excl. one-offs	**-4.5**	**-2.8**	**-2.9**	**-3.1**	**-2.1**	**-2.1**	**-2.4**	**2.4**
Output gap[1]	-2.2	-0.2	-0.3	-0.1	0.8	0.8	1.4	3.0
Cyclically-adjusted balance[1]	-3.3	-3.0	-3.0	-3.1	-2.7	-2.7	-3.1	0.6
Structural balance (SB)[2]	**-3.3**	**-2.7**	**-2.8**	**-3.1**	**-2.5**	**-2.5**	**-3.1**	**0.8**
Structural primary balance[2]	-0.5	0.1	-0.1	-0.6	0.2	0.1	-0.8	0.5

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the DBP/programme as recalculated by Commission on the basis of the DBP/programme scenario using the commonly agreed methodology.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

On the basis of the DBP, the structural deficit[4] is expected to narrow by ½ percentage points to reach 2¾% of GDP in 2017. In 2018, the DBP projects the recalculated structural deficit in Spain to narrow a further ¼ percentage point to 2½% of GDP, unchanged compared to the

[4] Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission using the commonly agreed methodology

2017 Stability Programme. The Commission 2017 autumn forecast estimates the structural deficit to narrow by about ¼ percentage point to reach just above 3% of GDP in 2017, and then to remain at that level in 2018.

As already mentioned, there are some differences between the Commission forecast and the DBP regarding one-offs. Apart from the DBP including a higher number for support to the financial sector in 2017 (0.1% of GDP), the DBP also includes a one-off in 2018 related to a possible settlement regarding distressed toll motorways, which adds 0.2% of GDP to the deficit in 2018, whereas the Commission considers that potential event as a contingent liability and does not include it in its forecast.

Against the background of slightly falling interest expenditure in the DBP, the projected improvement in the structural balance in 2017 and 2018 (¾% of GDP over the two years) is accompanied by a less pronounced improvement in the structural primary balance (½% of GDP over the two years). The impact of lower interest expenditure on the structural effort is even more marked in the Commission forecast, which expects the structural balance to improve by ¼% of GDP over 2017-18, while the structural primary balance is set to worsen by ¼% of GDP over the same two-year period.

3.2. Debt developments

The DBP projects that the debt-to-GDP ratio will decline from 99.0% of GDP in 2016, to 98.1% in 2017 and to 96.8% in 2018. This is somewhat lower than the ratios presented in the 2017 Stability Programme, mainly as a result of stock-flow adjustments in both years having been revised down to 0.1% of GDP. This contrasts with the sizeable stock-flow adjustment of -1.5% of GDP in 2016, which was mainly due to negative net acquisition of financial assets (-1.1% of GDP) and adjustments (-0.4% of GDP). The slightly declining profile of the debt-to-GDP ratio is the result of the debt-increasing impact of interest expenditure being more than offset by relatively high nominal GDP growth in both 2017 and 2018 (snow-ball effect in Table 3). Moreover, in 2018, a planned positive primary balance would support debt reduction. The DBP does not provide a breakdown of the various components of the stock-flow adjustment, which is projected to provide a slightly debt-increasing impact in both 2017 and 2018.

Compared with the DBP, the Commission 2017 autumn forecast projects only marginally higher debt ratios in 2017 and 2018. In 2017, the difference mainly reflects lower nominal GDP growth and a higher primary deficit. In 2018, the debt ratio actually decreases slightly more in the Commission 2017 autumn forecast, due to higher real GDP growth and lower interest expenditure more than offsetting a worse primary balance. The Commission 2017 autumn forecast expects the debt-to-GDP ratio to reach 98.4% in 2017 and 96.9% in 2018.

Table 3. Debt developments

(% of GDP)	2016	2017			2018		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**99.0**	**98.8**	**98.1**	**98.4**	**97.6**	**96.8**	**96.9**
Change in the ratio	-0.5	-0.2	-0.9	-0.6	-1.2	-1.4	-1.5
Contributions[2] :							
1. Primary balance	**1.7**	**0.4**	**0.5**	**0.6**	**-0.5**	**-0.3**	**0.1**
2. "Snow-ball" effect	**-0.6**	**-1.2**	**-1.5**	**-1.3**	**-1.2**	**-1.2**	**-1.6**
Of which:							
Interest expenditure	2.8	2.8	2.6	2.5	2.7	2.6	2.3
Growth effect	-3.1	-2.6	-3.0	-2.9	-2.3	-2.2	-2.4
Inflation effect	-0.3	-1.4	-1.1	-0.9	-1.6	-1.5	-1.5
3. Stock-flow adjustment	**-1.5**	**0.7**	**0.1**	**0.1**	**0.5**	**0.1**	**0.1**
Of which:							
Cash/accruals difference							
Net accumulation of financial							
of which privatisation proceeds							
Valuation effect & residual							

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual

Source:

Stability Programme 2017 (SP); Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations

3.3. Measures underpinning the draft budgetary plan

Given its no-policy-change nature the 2018 DBP largely builds on the policy measures adopted to date (and already appeared in the 2017 Stability Programme), with no new measures for 2018. However, compared to the 2017 Stability Programme, it does include new revenue measures set out in the 2017 budget law, which entered into force on 29 June 2017, i.e., after the submission of the 2017 Stability Programme. In addition, it reports the estimated budgetary impact of the recently adopted law on the self-employed. Nevertheless, these new revenue measures are relatively small in size, totalling a deficit increasing impact of well below 0.1% of GDP.[5]

The DBP reports a total positive budgetary impact of discretionary measures of EUR 4.3 billion (i.e. 0.4% of GDP) and EUR 1.2 billion (i.e. 0.1% of GDP) for 2017 and 2018,

[5] They consist of lower VAT for cultural events (with an expected incremental budgetary impact of EUR 15 million (i.e., lower revenue) and EUR 40 million in 2017 and 2018, respectively. The law on the self-employed is reported to have a deficit increasing impact of EUR 100 million through lower personal income tax.

respectively. In both years, measures are mostly on the revenue side.[6] The Commission 2017 autumn forecast takes into account a lower impact in both years – amounting to about EUR 3.2 bn (i.e. 0.3% of GDP) in 2017 and EUR 841 million (i.e. less than 0.1% of GDP) in 2018.

Differences between the expected budgetary impact of measures in the draft budgetary plan and the Commission forecast are explained by the following factors:

- Compared with the DBP for 2017, this year's DBP reports a more negative impact of the 2014 tax reform in 2016 (by 0.1% of GDP) and a more positive impact for 2017 (by 0.2% of GDP). The Commission 2017 autumn forecast maintains the valuation of the 2014 tax reform of previous forecast rounds for both years.[7]

- On the expenditure side, a source of divergence lies in the different assessment of measures on compensation of employees, in particular regarding the impact of a 1% increase in public sector wages in 2017 (EUR 1.2 billion; 0.1% of GDP according to the DBP). While the DBP attributes this increase to a discretionary measure, the Commission forecast includes it in its baseline projections for compensation of employees. Moreover, as in previous forecasts, the Commission autumn forecast includes no savings from the application at regional level of the pharmaceutical and healthcare spending rule adopted in June 2015.

- Furthermore, starting from 2016, the Commission includes the savings from the 2013 pension reform (reported at EUR 1.2 billion in 2017, i.e. 0.1% of GDP) in the baseline of social transfers other than in kind, rather than treating them as a discretionary measure.

- In addition, the Commission forecast does not take on board the impact of measures included in the programme that have not yet been adopted or that are not yet specified in sufficient detail. These include the savings expected from the public administration reform programme (EUR 400 million in 2018; less than 0.05% of GDP), which were first reported in the updated draft budgetary plan for 2017.

Finally, as previously noted, the projections in the DBP incorporate the materialisation of risks related to compensation to financially-distressed toll motorways, amounting to 0.2% of GDP in 2018. These amounts are not included in the Commission forecast, as they are treated as contingent liabilities. This implies that net of this expenditure, the DBP relies on considerably higher expenditure restraint than projected in the Commission forecast in 2018.

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[6] These amounts do not factor in two revenue measures reported in the 2018 DBP on tax deferrals and the new management system for value added tax, which starting from 2017, aims to reduce the gap between the registration or accounting of invoices and the time when the underlying economic transaction takes place. The reason is that both measures only have an impact on an ESA 2010 basis, but do not affect the deficit on an accrual basis. Table 4 does not include the reported savings on interest expense at regional level, as they have no impact at general government level.

[7] The Commission 2017 autumn forecast includes the yield of all other consolidation measures set out in Royal Decree Law 3/2016, as reported in the 2018 DBP. To note that the estimated yield of these measures has been lowered in the 2018 DBP compared with the updated DBP for 2017 and the 2017 Stability Programme.

Table 4. Main discretionary measures reported in the DBP[8]

A. Discretionary measures taken by General Government - revenue side

Components	Budgetary impact (% GDP) (as reported by the authorities)	
	2017	**2018**
Taxes on production and	0.10	0.07
Current taxes on income,	0.06	0.00
Capital taxes	0.00	0.00
Social contributions	0.06	0.00
Property Income		
Other	0.00	0.00
Total	0.21	0.07

Note:

The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that revenue increases as a consequence of this measure.

Source: Draft Budgetary Plan for 2018

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)	
	2017	**2018**
Compensation of employees	0.05	-0.01
Intermediate consumption	-0.14	-0.03
Social payments	-0.09	0.00
Interest Expenditure		
Subsidies		
Gross fixed capital formation	0.00	0.00
Capital transfers	0.00	0.00
Other		
Total	-0.19	-0.04

Note:

The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure.

Source: Draft Budgetary Plan for 2018

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[8] The DBP reports no measures in the following areas: property income (revenue), interest expenditure, subsidies (expenditure) and other expenditure. This is shown in tables 4a and 4b as blanks.

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

Spain is currently subject to the corrective arm of the Stability and Growth Pact. Box 2 recalls the main features of the Excessive Deficit Procedure opened by the Council on 27 April 2009 and the latest country-specific recommendations in the area of public finances.

Box 2. Council Recommendations addressed to Spain

On 8 August 2016, the Council gave notice to Spain under Article 126(9) of the Treaty to correct its excessive deficit by 2018. According to that Council Decision, Spain shall reduce the general government deficit to 4.6 % of GDP in 2016, to 3.1 % of GDP in 2017 and to 2.2 % of GDP in 2018. This improvement in the general government deficit is consistent with a deterioration of the structural balance by 0.4 % of GDP in 2016 and a 0.5 % of GDP improvement in both 2017 and 2018, based on the updated Commission 2016 spring forecast. Spain shall also use all windfall gains to accelerate the deficit and debt reduction. In addition to the savings already included in the updated Commission 2016 spring forecast, Spain shall adopt and fully implement consolidation measures for the amount of 0.5 % of GDP in both 2017 and 2018. Spain shall stand ready to adopt further measures should risks to the budgetary plans materialise. Fiscal consolidation measures shall secure a lasting improvement in the general government structural balance in a growth-friendly manner. Moreover, Spain shall adopt measures to strengthen its fiscal framework, in particular with a view to increasing the automaticity of mechanisms to prevent and correct deviations from the deficit, debt and expenditure targets and to strengthening the contribution of the Stability Law's spending rule to public finance sustainability. Furthermore, Spain shall set up a consistent framework to ensure transparency and coordination of public procurement policy across all contracting authorities and entities with a view to guaranteeing economic efficiency and a high level of competition. Such framework shall include appropriate ex-ante and ex-post control mechanisms for public procurement to ensure efficiency and legal compliance.

On 12 June 2017, the Council addressed recommendations to Spain in the context of the European Semester. In particular, in the area of public finances, the Council recommended that Spain ensure compliance with the Council Decision of 8 August 2016, including measures to strengthen the fiscal and public procurement frameworks and to undertake a comprehensive expenditure review in order to identify possible areas for improving spending efficiency.

4.1. Compliance with EDP recommendations

Table 5. Compliance with the EDP recommendation

(% of GDP)	2016	2017		2018	
	COM	DBP	COM	DBP	COM
Headline balance					
Headline budget balance	-4.5	-3.1	-3.1	-2.3	-2.4
EDP requirement on the budget balance	-4.6	-3.1		-2.2	
Fiscal effort - change in the structural balance					
Change in the structural balance[1]	-0.8	0.5	0.2	0.3	0.0
Cumulative change[2]	-0.8	-0.3	-0.6	0.0	-0.7
Required change from the EDP recommendation	-0.4	0.5		0.5	
Cumulative required change from the EDP recommendation	-0.4	0.1		0.6	
Fiscal effort - adjusted change in the structural balance					
Adjusted change in the structural balance[3]	-0.5	-	0.3	-	0.0
of which: *correction due to change in potential GDP estimation (α)*	-0.1	-	-0.1	-	-0.1
correction due to revenue windfalls/shortfalls (β)	-0.4	-	-0.2	-	-0.1
Cumulative adjusted change [2]	-0.5	-	-0.2	-	-0.2
Required change from the EDP recommendation	-0.4	0.5		0.5	
Cumulative required change from the EDP recommendation	-0.4	0.1		0.6	
Fiscal effort - calculated on the basis of measures (bottom-up approach)					
Fiscal effort (bottom-up)[4]	0.2	-	0.3	-	-0.1
Cumulative fiscal effort (bottom-up)[2]	0.2	-	0.5	-	0.4
Requirement from the EDP recommendation	0.0	0.5		0.5	
Cumulative requirement from the EDP recommendation	0.0	0.5		1.0	

Notes

[1] Structural balance = cyclically-adjusted general government balance excluding one-off measures. Structural balance based on DBP is recalculated by the Commission on the basis of the Draft Budgetary Plant scenario using the commonly agreed methodology. Change compared to t-1.

[2] Cumulated since the first year for correction in the lastest EDP recommendation.

[3] Change in the structural balance corrected for unanticipated revenue windfalls/shortfalls and changes in potential growth compared to the scenario underpinning the EDP recommendation.

[4] The estimated budgetary impact of the additional fiscal effort delivered on the basis of the discretionary revenue measures and the expenditure developments under the control of the government between the baseline scenario underpinning the EDP recommendation and the current forecast.

Source :

Draft Budgetary Plan for 2018 (DBP); Commission 2017 autumn forecast (COM); Commission calculations.

For 2017, the DBP plans the headline deficit to decrease from 4.5% to 3.1% of GDP, in line with the headline deficit target required by the Council. According to the Commission 2017 autumn forecast, the headline deficit requirement is also expected to be achieved.

The Council Decision of 8 August 2016 requires Spain to achieve an improvement of the structural balance of 0.5 percentage points in 2017. The Commission forecast reveals that the fiscal effort would fall short of the level required by the Council with regard to the change in

the structural balance. Specifically, the forecast projects an improvement of only 0.2 percentage point in the structural deficit for 2017. Correcting for the change in the estimated potential growth between the projections underlying the Council Decision and the Commission 2017 autumn forecast, as well as revenue shortfalls projected for 2017, the estimated change in the structural balance would be 0.3 percentage point, still 0.2 percentage point less than the required effort.

On a cumulative basis over 2016-2017, the estimated shortfall amounts to 0.7% of GDP when measured against the unadjusted change in the structural balance, and to 0.3% of GDP when adjusted for the above-mentioned elements.

The bottom-up estimate of the fiscal effort in 2017 is 0.3% of GDP. This is below the requirement of about 0.5% of GDP of measures deemed necessary in 2017 to reach the structural requirement spelled out in the new EDP recommendation. However, given the 0.2% of GDP effort in 2016, when no extra effort was requested, the bottom-up requirement is met on a cumulative basis over 2016-2017.

For 2018, according to the Commission 2017 autumn forecast, the headline deficit requirement of 2.2% of GDP is not expected to be achieved, with a forecast headline deficit of 2.4% of GDP. The Council Decision of 8 August 2016 requires Spain to achieve an improvement of the structural balance of 0.5 percentage point in 2018. However, the Commission 2017 autumn forecast projects no change in the structural deficit in 2018. On a cumulative basis over 2016-2018, the estimated shortfall amounts to 1.3% of GDP when measured against the unadjusted change in the structural balance, and to 0.8% of GDP when adjusted. The bottom-up estimate of the fiscal effort in 2018 is -0.1% of GDP. This is below the requirement of about 0.5% of GDP of measures deemed necessary in 2018 to reach the structural requirements spelled out in the Council Decision, leading to an underperformance of 0.6% of GDP in cumulative terms over 2016-2018.

5. COMPOSITION OF PUBLIC FINANCES AND IMPLEMENTATION OF FISCAL STRUCTURAL REFORMS

Composition of public finances

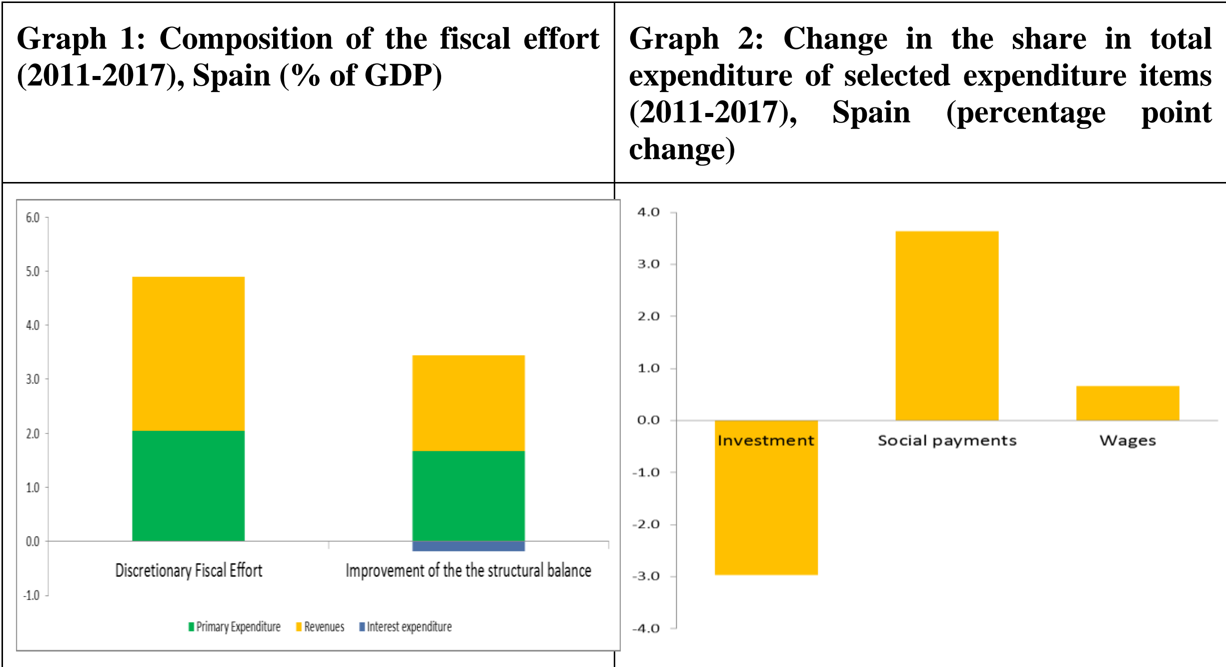
Over 2012-2017, the structural balance is estimated to have improved by 3.3 percentage points. This improvement is owed to broadly similar contributions from the revenue and the primary expenditure sides (as shown in the right-hand side of Graph 1). In turn, this pattern is broadly similar to the composition of Discretionary Fiscal Effort[9], which, however, points to a slightly larger effort on the revenue side (left-hand side of Graph 1). This is consistent with the occurrence of revenue shortfalls over the period. In 2018, the structural balance is not expected to improve.

The public-spending-to-GDP ratio stood at 45.8% of GDP in 2011 and peaked at 48.1% of GDP in 2012, under the impact of the assistance to the financial sector but also soaring social

[9] The Discretionary Fiscal Effort (DFE) combines a top-down approach on the expenditure side with a bottom-up or narrative approach on the revenue side. In a nutshell, the DFE consists of the increase in primary expenditure net of cyclical components relative to economic potential on the one hand, and of discretionary revenue measures on the other hand. See European Commission (2013): Measuring the fiscal effort, Report on Public Finances in EMU, part 3 http://ec.europa.eu/economy_finance/publications/european_economy/2013/pdf/ee-2013-4.pdf

demands and the sharp decline in nominal GDP. It is projected to have fallen back to 38.3% in 2017, as expenditure growth is being kept in check and nominal GDP continues to recover. Public investment is the spending category having experienced the largest reduction since 2011 (by 1.6% of GDP), under the pressure of the fiscal consolidation needs following the crisis. Indeed, over 2011-2017, public investment has seen its share in total general government expenditure decrease, whereas social benefits other than in kind and, to a lesser extent, compensation of employees have increased their share (Graph 2).

While the general level of taxation is lower in Spain than in the EU or the euro area, the share of various broad tax categories in total tax revenue is broadly similar to the EU and euro area average. Within taxes on labour, Spain relies to a relatively large degree on social contributions. Tax reforms undertaken in recent years have primarily aimed at lowering taxes on labour. While they were underfinanced and consequently slowed down the reduction of the general government deficit, they may have contributed somewhat to the strength of the recovery and the rapid growth of employment (See Box 3).



Graph 1: Composition of the fiscal effort (2011-2017), Spain (% of GDP)

Graph 2: Change in the share in total expenditure of selected expenditure items (2011-2017), Spain (percentage point change)

Implementation of fiscal structural reforms

The Council Decision of 8 August 2016 required Spain to strengthen its fiscal framework, in particular by increasing the automaticity of mechanisms to prevent and correct deviations from the deficit, debt and expenditure targets and strengthening the contribution of the Stability Law's spending rule to public finance sustainability.

As in the 2017 stability programme, the 2018 draft budgetary plan is silent about the review of the Stability Law's spending rule. It does not report either on measures to enhance the automaticity of the Stability Law's mechanisms to prevent and correct deviations from the fiscal targets. While risks of such deviations appear lower in 2017 than in earlier years, including at the regional level, a timely implementation of such mechanisms would help to ensure compliance with the fiscal targets in the years to come. However, the draft budgetary

plan reports on ongoing actions to implement the preventive and corrective tools set out in Spain's Stability Law; namely, the submission of economic and financial plans and of adjustment plans for regional governments not having complied with one (or several) domestic fiscal targets[10] and/or not having observed the terms of their 2016 adjustment plan under the Regional Liquidity Fund, respectively.

The Council Decision of 8 August 2016 also required Spain to strengthen its public procurement policy framework, in particular, to include appropriate ex-ante and ex-post control mechanisms for public procurement to ensure efficiency and legal compliance. On 19 October 2017, the Spanish parliament adopted a new law on public sector contracts, which intends to address the need for a consistent framework ensuring transparency in public procurement, while strengthening effective control mechanisms and coordination across government levels. It does so through changes to its governance structure and the requirement for a nation-wide Public Procurement Strategy. In particular:

- A new independent office for regulation and supervision aims to ensure the correct application of public procurement legislation, promote competition and combat irregularities. At regional level, equivalent offices may be created.
- A new cooperation committee with representatives from the central, regional and local public authorities is tasked with the drawing up and monitoring of a nation-wide Public Procurement Strategy to combat corruption, improve professionalization, promote economic efficiency, enhance the use of electronic and strategic procurement and boost the participation of SMEs. While the law sets out that the procurement strategy is binding upon all contracting authorities in Spain, regional governments can draw up their own strategies, provided they are consistent with the national strategy.
- The law upkeeps the functions of the existing central government's body (*Junta Consultiva*) for regulation and consultation on public procurement. In addition, it empowers the Junta to act as contact point with the European Commission on procurement matters and grants it sufficiency of resources to carry out its duties.

These measures can improve public procurement practices in Spain. Much of the success will, however, depend on the ambition of decisions taken at the time of implementation. For example, a considerable amount of detail on the definition of the strategy, including the controls to be carried out by the independent supervision authority/authorities, is left to the decision of the Cooperation Committee and the National Independent Office for Regulation and Supervision. At the same time, the way the new governance structure composed of the Consultative Body, the Cooperation Committee and the National Independent Office is set up and operates is crucial to deliver effective results. Moreover, ownership of the strategy by all government levels is key to develop a nation-wide public procurement policy, which in turn, can improve the efficiency of Spain's procurement.

Lastly, on 2 June 2017, Spain's Council of Ministers commissioned AIReF to carry out a spending review, focusing on public subsidies. AIReF has submitted an action plan to the Ministry of Finance. The conclusions of the review are due by the end of 2018.

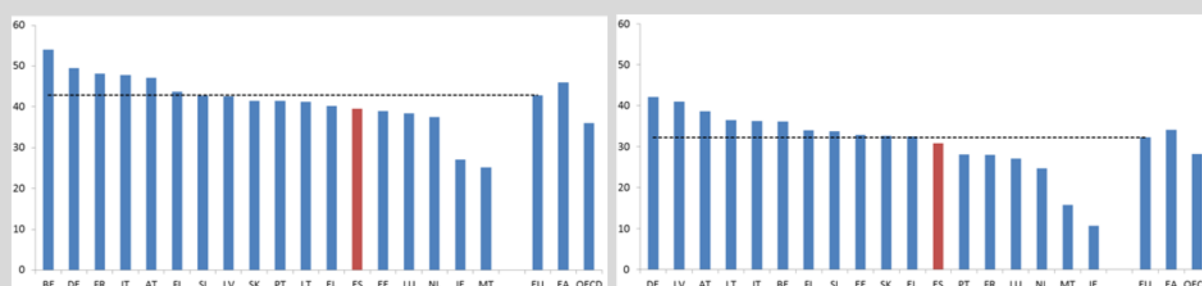
[10] I.e., the public deficit, public debt and/or the expenditure rule targets.

Box 3 – Addressing the tax burden on labour in the euro area

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against this background, the Eurogroup has expressed a commitment to reduce the tax burden on labour. On 12 September 2015, the Eurogroup agreed to benchmark euro area Member States' tax burden on labour against the GDP-weighted EU average, relying in the first instance on indicators measuring the tax wedge on labour for a single worker at average wage and a single worker at low wage. It also agreed to relate these numbers to the OECD average for purposes of broader comparability.

The tax wedge on labour measures the difference between the total labour costs to employ a worker and the worker's net earnings. It is made up of personal income taxes and employer and employee social security contributions. The higher the tax wedge, the higher the disincentives to take up work or hire new staff. The graphs below show the tax wedge in Spain for a single worker earning respectively the average wage and a low wage (50% of the average) compared to the EU average.

The tax burden on labour in Spain at the average wage and at low wage (2016)



Notes: No recent data is available for Cyprus. EU and EA averages are GDP-weighted. The OECD average is not weighted.

Source: European Commission Tax and Benefit Indicator database based on OECD data.

Benchmarking is only the first step in the process towards firm, country-specific policy conclusions. The tax burden on labour interacts with a wide variety of other policy elements such as the benefit system and the wage-setting system. A good employment performance indicates that the need to reduce labour taxation may be less urgent while fiscal constraints can dictate that labour tax cuts should be fully offset by other revenue-enhancing or expenditure-reducing measures. In-depth, country-specific analysis is necessary before drawing policy conclusions.

Although Spain's DBP does not include any new measures for 2018 affecting the tax wedge on labour (also in view of its no-policy-change nature), it does report on the budgetary impact of previous measures affecting the tax wedge, namely the 2014 personal income tax (PIT) reform and rebates in social security contributions. The PIT reform, which was phased in over 2015-16 and reduced rates across the board, went some way to reducing the tax wedge on labour by exempting income up to EUR 12 000 from personal income tax and by lowering rates. However, as it was underfunded, it contributed negatively to the general government balance. In addition, the social security contribution flat rate scheme (*tarifa plana*) of EUR 100 was replaced in March 2015 by an exemption for the first EUR 500 earned for new permanent contracts, benefiting those on lower incomes, such as young people and the low-skilled until August 2016.

While across-the-board reductions in PIT may not be the most appropriate way to promote employment, to date the effects of the targeted subsidies in promoting job creation on permanent contracts remain unclear.

6. OVERALL CONCLUSION

Based on the Commission 2017 autumn forecast, in 2017 Spain is expected to achieve a headline deficit of 3.1% of GDP, in line with the recommended target. In 2018, under a no-policy change assumption, the Commission projects a headline deficit of 2.4% of GDP, which is above the recommended target of 2.2% of GDP.

At the same time, the Commission expects that the fiscal effort requirements will only be met by the bottom-up measure cumulatively over 2016-17, while the fiscal effort in 2018 is expected to fall significantly short of the recommended effort in the Council Decision of 8 August 2016, based on all the metrics used. Overall, the budgetary strategy is based on the cyclical upswing of the economy improving the headline balance and bringing an end to the excessive deficit.

The Council Decision of 8 August 2016 also calls on Spain to take measures to strengthen its fiscal and public procurement policy frameworks. On the former, the 2018 Draft Budgetary Plan is silent about the review of the Stability Law's spending rule. It does not report either on measures to enhance the automaticity of the Stability Law's mechanisms to prevent and correct deviations from the fiscal targets. A new law on public sector contracts can improve public procurement practices in Spain, but much of its success in doing so will depend on the ambition of decisions taken at the time of its implementation.

Annex. EDP related tables

Table A1. Forecast of key macroeconomic and budgetary variables under the baseline scenario

		2015	2016	2017	2018
Real GDP growth	%	3.2	2.9	2.3	2.1
Nominal GDP growth	%	3.8	3.4	3.6	3.6
Potential GDP growth	%	0.0	0.4	0.7	0.9
Structural balance	% of pot. GDP	-2.7	-3.1	-3.2	-3.2
General government balance	% of GDP	-5.1	-4.6	-3.3	-2.7
Change in structural balance	% of pot. GDP	-0.9	-0.4	-0.1	0.0
p.m. Output Gap	% of pot. GDP	-4.0	-1.7	-0.2	0.9
Source: Commission Staff Working Document accompanying the Decision to give notice to Spain.					

Table A2. Forecast of key macroeconomic and budgetary variables under the EDP scenario

		2015	2016	2017	2018
Real GDP growth	%	3.2	2.9	1.7	1.5
Nominal GDP growth	%	3.8	3.4	3.1	3.0
Potential GDP growth	%	0.0	0.4	0.7	0.9
Structural balance	% of pot. GDP	-2.7	-3.1	-2.6	-2.1
General government balance	% of GDP	-5.1	-4.6	-3.1	-2.2
Change in structural balance	% of pot. GDP	-0.9	-0.4	0.5	0.5
p.m. Output Gap	% of pot. GDP	-4.0	-1.7	-0.8	-0.1
Source: Commission Staff Working Document accompanying the Decision to give notice to Spain.					

Table A3. Current estimates of the macroeconomic and fiscal developments

		2015	2016	2017	2018
Real GDP growth	%	3.4	3.3	3.1	2.5
Nominal GDP growth	%	4.1	3.6	4.0	4.2
Potential GDP growth	%	0.3	0.7	0.9	1.0
Structural balance	% of pot. GDP	-2.5	-3.3	-3.1	-3.1
General government balance	% of GDP	-5.3	-4.5	-3.1	-2.4
Change in structural balance	% of pot. GDP	-0.9	-0.8	0.2	0.0
p.m. Output Gap	% of pot. GDP	-4.6	-2.2	-0.1	1.4
Source: Commission 2017 Autumn Forecast					

Table A4. Adjustment of apparent structural effort for the revision in potential growth - details of calculations

ES	Potential GDP growth underlying the 2016 Council decision to give notice (%)	Potential GDP growth at the time of assessment (%)	Forecast error (%)	Structural expenditure (% of potential GDP)	Correction coefficient α (% of nominal potential GDP)
	(1)	(2)	(3)=(1)-(2)	(4)	(5)=(3)*(4)/100
2016	0.4	0.7	-0.3	41.0	-0.1
2017	0.7	0.9	-0.2	40.7	-0.1
2018	0.9	1.0	-0.1	41.0	-0.1

Table A5. Adjustment of apparent structural effort for the expected revenue windfalls/shortfalls - details of calculations

ES	Change in current revenues (yoy) (billions)		Discretionary current revenue measures (billions)		Nominal GDP growth assumptions (%)		Change in output gap		Current revenues in year t-1 (billions)		Revenue gap (billions)*	Nominal GDP	Correction coefficient β (% of nominal GDP)
	notice (1)	assessment (1')	notice (2)	assessment (2')	notice (3)	assessment (3')	notice (4)	assessment (4')	notice (5)	assessment (5')	(6)=[(1')-(2')-[(3')+(ε-1)*(4')/100]*(5')]-[(1)-(2)-[(3)+(ε-1)*(4)/100]*(5)]	assessment (7)	(8)=100*(6)/(7)
2016	4.1	7.8	-8.0	-0.4	3.4	3.6	0.0	0.0	407.1	409.0	-4.7	1118.5	-0.4
2017	23.8	18.8	5.5	0.6	3.6	4.0	0.0	0.0	411.1	416.7	-2.1	1163.5	-0.2
2018	16.0	18.0	0.2	0.9	3.6	4.2	0.0	0.0	434.9	435.5	-1.4	1212.1	-0.1

*revenue elasticity (ε): 1.0

Table A6. Forecast of key variables for the computation of the fiscal effort under the baseline scenario

			2016	2017	2018
Enters top-down	α	*Structural expenditure (% of potential GDP)*	*41.08*	*41.37*	*41.39*
		Potential GDP growth (%)	*0.45*	*0.72*	*0.9*
	β	*Current revenue (national currency)*	*411.13*	*434.88*	*450.87*
		Discretionary measures wih impact on current revenue (national currency)	*-8.04*	*5.53*	*0.19*
		Nominal GDP growth (%)	*3.4*	*3.63*	*3.56*
		p.m Output gap (% of Pot. Output)	*-1.73*	*-0.23*	*0.92*
Enters bottom-up		*Discretionary measures wih impact on total revenue net of one-offs and other temporary measures (national currency)*	*-2.75*	*5.52*	*0.19*
		Total expenditure net of one-offs and other temporary measures (national currency)	*469.48*	*480.62*	*490.7*
		Interest expenditure (national currency)	*31.47*	*30.52*	*29.61*
		Total unemployment	*4542.96*	*4136.8*	*3765.64*