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COMMISSION STAFF WORKING DOCUMENT

Analysis of the updated Draft Budgetary Plan of Spain

Accompanying the document

COMMISSION OPINION

on the updated Draft Budgetary Plan of Spain

{C(2018) 3182 final}

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1. INTRODUCTION

Following the submission of a 'no-policy-change' 2018 Draft Budgetary Plan (DBP) in October 2017, Spain submitted its updated DBP for 2018 on 30 April 2018 in compliance with Regulation (EU) No 473/2013 of the Two-Pack. The updated DBP contains projections based on the measures presented to the Spanish parliament in the draft budget law on 3 April as well as additional expenditure on pensions (including raising pensions by 1.6% rather than the stipulated minimum revaluation by 0.25% in 2018) only partly financed by additional revenue measures. The updated DBP was submitted together with the 2018 Stability Programme with identical macroeconomic and budgetary projections for 2018.

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 8 August 2016, the Council gave notice to Spain under Article 126(9) of the Treaty to correct the excessive deficit by 2018.

Section 2 of this document presents the macroeconomic outlook underpinning the updated DBP and assesses it based on the Commission 2018 spring forecast. Section 3 presents the recent and planned fiscal developments, according to the updated DBP, including an analysis of risks to the achievement of the set budgetary targets based on the Commission 2018 spring forecast. It also includes an assessment of the measures presented in the updated DBP. Section 4 assesses the recent and planned fiscal developments in 2017-2018 (also taking into account the risks to the achievement of the targets) against the obligations stemming from the Stability and Growth Pact. Section 5 provides an analysis of implementation of fiscal-structural reforms in response to the latest country-specific recommendations adopted by the Council in the spring of 2017. Section 6 summarises the main conclusions of the present document.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

The macroeconomic scenario underpinning the updated DBP projects annual real GDP growth to reach 2.7% in 2018, after 3.1% in 2017. Domestic demand is expected to contribute to growth by 2.3 pps, with both private and public consumption and investment decelerating compared to last year. Net exports are projected to have a positive contribution to growth of 0.4 pps of GDP, slightly higher than in 2017. Compared to the 2018 'no-policy-change' DBP submitted last October, when uncertainty stemming from the developments in Catalonia were expected to weigh on consumption and investment decisions, the updated DBP forecasts real

GDP growth to be 0.4 pps higher this year. The upward revision is attributed both to decreased uncertainty surrounding the situation in Catalonia and the positive macroeconomic impact of the fiscal measures put forward in the updated DBP.

The Commission 2018 spring forecast projects real GDP growth at 2.9% this year, i.e. 0.2 pps higher than the updated DBP. Lower real growth in the updated DBP is accompanied by a higher GDP deflator growth, and, therefore, nominal GDP growth is projected to be broadly similar in the two forecasts. The Commission forecast also incorporates a positive impact on domestic demand from the measures contained in the updated DBP, though of a smaller magnitude than the updated DBP macroeconomic scenario, given that the Commission forecast includes a smaller set of measures (see Section 3.3). Divergences in the composition of real growth mainly relate to a lower projection for private consumption in the updated DBP, despite higher employment (in persons) and wage growth. By contrast, the updated DBP forecasts slightly higher investment and net exports (on account of lower import growth) than the Commission forecast. The positive output gap is lower in the updated DBP (1.1 % of potential GDP) than in the Commission 2018 spring forecast (1.4%).

Overall, the macroeconomic projections underlying the updated DBP are plausible.

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

The macroeconomic forecasts underpinning the updated 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 27 March 2018.[1]

AIReF deems the macroeconomic scenario as "prudent" and the growth composition as "credible". Regarding the external environment, it considers the external assumptions underpinning the growth projections as "feasible" and the risks related to it as broadly balanced. AIReF also notes that while the worst scenarios associated to the increased uncertainty in Catalonia have been averted, protracted uncertainty could eventually affect Spain's growth outlook. Finally, AIReF also considers the macroeconomic impact of the measures contained in the draft DBP as feasible. Later on, in a report issued on 17 April 2018, AIReF considers it "difficult but feasible" for Spain to reach a nominal deficit at or below 2.2% of GDP, attaching a 40% likelihood to this outcome.

1 http://www.airef.es/documents/10181/746894/2018+04+23+2+-+2018+03+27+Informe+AIReF+Cuadro+Macro+PGE+2018/02e5404a-e95d-4434-a467-c250f0f46966 and http://www.airef.es/documents/10181/765056/2018+05+04+Informe+prev.+macro+APE.pdf/dd48e714-6d10-48e9-89b4-6ca061d17ede

Table 1. Comparison of macroeconomic developments and forecasts

	2016	2017			2018		
	COM	SP 17	DBP 18	COM	SP 17	DBP 18	COM
Real GDP (% change)	3.3	2.7	3.1	3.1	2.5	2.7	2.9
Private consumption (% change)	3.0	2.6	2.4	2.4	2.4	2.0	2.3
Gross fixed capital formation (% change)	3.3	2.8	5.0	5.0	2.6	4.7	4.6
Exports of goods and services (% change)	4.8	5.5	5.0	5.0	4.9	4.8	5.0
Imports of goods and services (% change)	2.7	4.3	4.7	4.7	4.1	4.1	4.7
Contributions to real GDP growth:							
- Final domestic demand	2.6	2.2	2.7	2.7	2.1	2.3	2.6
- Change in inventories	0.0	0.0	0.1	0.1	0.0	0.0	0.0
- Net exports	0.7	0.5	0.3	0.3	0.4	0.4	0.2
Output gap[1]	-2.2	-0.2	-0.2	-0.2	0.8	1.1	1.4
Employment (% change)	2.5	2.8	2.6	2.6	2.6	2.6	2.4
Unemployment rate (%)	19.6	17.5	17.2	17.2	15.6	15.5	15.3
Labour productivity (% change)	0.3	-0.1	0.2	0.2	-0.1	0.2	0.2
HICP inflation (%)	-0.3	1.5		2.0	1.6		1.4
GDP deflator (% change)	0.3	1.5	1.0	1.0	1.6	1.5	1.4
Comp. of employees (per head, % change)	-0.3	1.3	0.1	0.1	1.5	1.2	1.1
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	2.1	2.0	2.0	2.0	1.9	1.9	1.7

Note:

[1] In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the updated Draft Budgetary Plan for 2018 / 2018 Stability Programme macroeconomic scenario using the commonly agreed methodology.

Source:

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

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

Driven by the cyclical improvement of the economy, lower interest expenditure and a slight increase in the tax burden, the general government headline deficit shrank 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 notice of August 2016. Both the no-policy-change DBP submitted in October 2017 and the 2017 Stability Programme expected the deficit ratio in 2017 to be 3.1% of GDP. However, the former projected the revenue and expenditure ratios to be 0.2 pps higher than the outturn, while in the latter they were forecast to be about ½% of GDP higher, with taxes on production and imports as well as interest and other expenditure being particularly over-estimated (by around 0.2 % of GDP each).

For 2018, the updated DBP shows the general government deficit narrowing to 2.2% of GDP, reflecting the continued cyclical upswing. The updated DBP includes the measures in the draft 2018 budget bill presented to parliament in early April, in particular the tax cut for low-income earners and a 3% increase in the lowest pensions. It also includes some additional measures regarding pensions that have been agreed in the course of the budget discussions in parliament, in particular a general revaluation of pensions of 1.6% to compensate for CPI inflation (See Section 3.3 for a more detailed description of these measures). The deficit reduction in 2018 is driven by a 0.4 pps increase in the revenue ratio, which reaches 38.3% of GDP, and a decrease in the expenditure ratio from 41.0% of GDP to 40.5% of GDP, again driven by lower interest expenditure and a denominator effect related to the projected dynamic GDP growth. While revenue is boosted by an increase in the ratio of taxes on income and wealth (+0.2 pps) as well as social contributions (+0.1 pps), most of the reduction in the expenditure ratio is driven by spending on compensation of employees (−0.3 pps), interest expenditure (−0.2 pps) and social transfers (−0.1 pps) growing significantly slower than nominal GDP (though above potential GDP).

More in detail, the updated DBP expects compensation of employees to grow only slightly faster than inflation in 2018, due to an agreed wage hike of 1.75% for public sector workers. At the same time, the updated DBP implicitly assumes very little public employment growth in 2018, despite the strong increase recorded in the second half of 2017 creating a strong carry-over effect into 2018. Data for the first quarter of 2018 published after the cut-off date of the Commission forecast show public employment growing strongly also in early 2018[2]. Social transfers are affected by higher pensions, but their increase is held back by falling unemployment benefits. Partly offsetting these reductions in the ratios, the public investment ratio is expected to increase by 0.2 pps also because the updated DBP assumes that the government will take over the infrastructure of distressed toll motorway companies, with a budgetary impact of about 0.15% of GDP recorded partly as one-off gross fixed capital formation and partly as a capital transfer in the DBP. As many of the motorways concessions entered the liquidation phase in the first months of 2018 (and the remaining ones are expected to follow) and given the obligation of the government to take over the road infrastructure within six months, it appears plausible to assume that the cost will affect 2018.

The Commission 2018 spring forecast projects a general government deficit of 2.6% of GDP in 2018, 0.4 pps higher than the updated DBP, reflecting a more prudent view on revenue developments, in particular regarding social contributions, and somewhat higher expenditure projections, in particular regarding compensation of employees and other expenditure. In particular, the Commission assumes the total wage bill to grow somewhat faster at 3.2%, reflecting the agreed 1.75% wage hike and expectations of strong growth in public sector employment. The Commission 2018 spring forecast also includes investment linked to the expected settlement regarding distressed toll motorways (close to 0.2% of GDP, based on the estimate presented in the no-policy-change DBP of last October). However, the Commission forecast includes neither the additional expenditure on pensions announced after the cut-off date of the Commission forecast (including raising pensions by 1.6% rather than the stipulated minimum revaluation of 0.25% in 2018) nor the additional revenue measures partially funding this expenditure.

[2] The Labour Force Survey (INE) showed public employment growing by 1.0% in the first quarter compared to the fourth quarter of 2017. Compared with the first quarter of 2017, public employment was 4.4% higher.

The main risks to budgetary targets and debt projections in the updated DBP stem, on the revenue side, from social contributions not reaching the planned levels and, on the expenditure side, from compensation of employees being higher than forecast. Although the updated DBP incorporates the budgetary impact of the possible settlement regarding distressed toll motorways, other contingent liabilities, such as the compensation for land expropriations and the cancellation of the ATLL water concession in Catalonia, constitute a risk.

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Spain currently standing at 1.24%.[3] As a consequence, total interest payments by the general government have continued to decrease as a share of GDP. The updated DBP expects interest expenditure to fall from 2.6% of GDP in 2017 to 2.4% in 2018, well below the 3.5% of GDP recorded in 2014, when interest expenditure peaked. This is in line with the Commission 2018 spring forecast.

[3] 10-year bond yields as of 3 May 2018. Source: Bloomberg.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2016	2017			2018			Change: 2016-2018
	COM	**SP 17**	**DBP 18**	**COM**	**SP 17**	**DBP 18**	**COM**	**DBP 18**
Revenue	**37.7**	**38.3**	***37.9***	**37.9**	**38.4**	***38.3***	**38.1**	**0.6**
of which:								
- Taxes on production and imports	11.6	11.8	*11.6*	11.6	11.6	*11.6*	11.7	0.1
- Current taxes on income, wealth, etc.	9.9	10.3	*10.2*	10.2	10.7	*10.4*	10.4	0.5
- Capital taxes	0.6	0.5	*0.5*	0.5	0.5	*0.5*	0.5	-0.1
- Social contributions	12.2	12.3	*12.3*	12.3	12.2	*12.4*	12.2	0.2
- Other (residual)	3.5	3.4	*3.3*	3.3	3.4	*3.4*	3.4	-0.1
Expenditure	**42.2**	**41.5**	**41.0**	**41.0**	**40.6**	**40.5**	**40.7**	**-1.7**
of which:								
- Primary expenditure	39.4	38.7	38.5	38.5	37.9	38.2	38.3	-1.2
of which:								
Compensation of employees	10.8	10.7	10.6	10.6	10.4	10.3	10.4	-0.5
Intermediate consumption	5.1	4.9	5.0	5.0	4.7	4.9	4.9	-0.2
Social payments	18.1	17.9	17.8	17.8	17.6	17.7	17.6	-0.4
Subsidies	1.0	1.0	1.0	1.0	1.0	1.0	1.0	0.0
Gross fixed capital formation	1.9	2.0	2.0	2.0	2.1	2.2	2.2	0.3
Other (residual)	2.4	2.2	2.1	2.0	2.1	2.1	2.1	-0.4
- Interest expenditure	2.8	2.8	2.6	2.6	2.7	2.4	2.4	-0.4
General government balance (GGB)	**-4.5**	**-3.1**	**-3.1**	**-3.1**	**-2.2**	**-2.2**	**-2.6**	**2.3**
Primary balance	**-1.7**	**-0.4**	**-0.5**	**-0.5**	**0.5**	**0.1**	**-0.2**	**1.8**
One-off and other temporary measures	0.0	-0.3	-0.1	0.0	-0.1	-0.2	0.0	-0.2
GGB excl. one-offs	**-4.5**	**-2.8**	**-3.0**	**-3.1**	**-2.1**	**-2.0**	**-2.5**	**2.5**
Output gap[1]	-2.2	-0.2	-0.2	-0.2	0.8	1.1	1.4	3.2
Cyclically-adjusted balance[1]	-3.3	-3.0	-3.0	-3.0	-2.7	-2.8	-3.3	0.5
Structural balance (SB)[2]	**-3.3**	**-2.7**	**-2.9**	**-3.0**	**-2.5**	**-2.6**	**-3.3**	**0.7**
Structural primary balance[2]	-0.5	0.1	-0.3	-0.4	0.2	-0.2	-0.9	0.2

Notes*:*

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance recalculated by Commission services on the basis of the updated Draft Budgetary Plan for 2018 / 2018 Stability Programme macroeconomic 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); Updated Draft Budgetary Plan for 2018 (DBP); Commission 2018 spring forecast (COM); Commission calculations

The structural deficit[4] is on the basis of the updated DBP expected to narrow by ¼ pp to reach about 2½% of GDP in 2018, slightly higher compared to the no-policy-change DBP and the

[4] Cyclically adjusted balance net of one-off and temporary measures, recalculated by the Commission on the basis of the macroeconomic scenario outlined in the 2018 DBP/SP, using the commonly agreed methodology

2017 Stability Programme. The Commission 2018 spring forecast estimates the structural deficit to widen by about ¼ pps to reach around 3¼% of GDP in 2018.

There are some differences between the Commission forecast and the updated DBP regarding one-offs. In particular, the updated DBP considers the impact of the liquidation of distressed toll motorway companies as a one-off measure, whereas the Commission considers it to have a temporary, but not one-off, effect.

Against the background of falling interest expenditure in the updated DBP, the projected ¼ pps improvement in the structural balance in 2018 is accompanied by only a marginal improvement in the structural primary balance (to -0.2% of GDP from -0.3% in 2017, based on the recalculated structural balance of the updated DBP). Still, the updated DBP projects the primary balance to turn into a small surplus in 2018, for the first time since 2007.

3.2. Debt developments

The updated DBP projects the debt-to-GDP ratio to decline from 98.3% of GDP in 2017, to 97.0% in 2018, as the debt-increasing impact of interest expenditure and stock-flow adjustment is more than offset by the small primary surplus and a rather high nominal GDP growth. The projected debt ratio for 2018 is only slightly higher than the ratio presented in the 2018 no-policy-change DBP and reflects the combination of a higher starting position, a higher debt-increasing stock-flow adjustment and a lower primary balance more than offsetting lower interest expenditure and faster nominal GDP growth. The updated DBP does not provide a breakdown of the various components of the stock-flow adjustment.

Compared with the updated DBP, the Commission 2018 spring forecast projects a somewhat smaller decline (by 0.7 pps to 97.6% of GDP) in the debt ratio in 2018, reflecting the still slightly negative primary balance in the Commission forecast and a slightly higher stock-flow adjustment,[5] while the debt-decreasing impact of nominal growth GDP outpacing the interest rate paid on debt (snowball effect) is projected to be the same.

[5] Based on the latest available government estimate at the cut-off date of the Commission 2018 spring forecast.

Table 3. Debt developments

(% of GDP)	2016	2017			2018		
		SP 17	DBP 18	COM	SP 17	DBP 18	COM
Gross debt ratio[1]	**99.0**	**98.8**	**98.3**	**98.3**	**97.6**	**97.0**	**97.6**
Change in the ratio	-0.4	-0.2	-0.7	-0.7	-1.2	-1.3	-0.7
Contributions[2] *:*							
1. Primary balance	**1.7**	**0.4**	**0.5**	**0.5**	**-0.5**	**-0.1**	**0.2**
2. "Snow-ball" effect	**-0.6**	**-1.2**	**-1.2**	**-1.2**	**-1.2**	**-1.6**	**-1.6**
Of which:							
Interest expenditure	2.8	2.8	2.6	2.6	2.7	2.4	2.4
Growth effect	-3.1	-2.6	-2.9	-2.9	-2.3	-2.5	-2.7
Inflation effect	-0.3	-1.4	-0.9	-0.9	-1.6	-1.4	-1.3
3. Stock-flow adjustment	**-1.5**	**0.7**	**0.1**	**0.1**	**0.5**	**0.5**	**0.7**

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 17); Updated Draft Budgetary Plan for 2018 (DBP); Commission 2018 spring forecast (COM); Commission calculations

3.3. Measures underpinning the draft budgetary plan

The updated DBP builds on the measures already reported in the no-policy-change DBP for 2018, while including the new measures described below (estimated incremental budget impact in brackets).

- A reduction in the personal income tax for low income households, combined with larger tax breaks regarding expenses on childcare facilities, large families and dependent spouses (-0.1% of GDP in 2018 and 2019, respectively).
- Increases in pension expenditure (0.2% of GDP in both 2018 and 2019), namely: i) the increase of pensions by 1.6% in 2018 and 1.5% in 2019, above the statutory minimum revaluation of 0.25%, ii) the increase in minimum and non-contributory pensions by 3% and iii) the increase of the survivor pensions' regulatory base by 4 pps.

  The updated DBP announces that the government will study the creation of a new tax on revenue from digital activities to fund part of the increases in pensions set out in the DBP (0.05% and 0.1% of GDP in 2018 and 2019, respectively).
- Increases in public servants' wages by 1.75% in 2018 and between 2.5% to 2.75% in 2019[6] (0.2% of GDP in 2018 and 0.3% of GDP in 2019).

[6] The final figure will depend on whether the domestic fiscal targets are met or not and on the growth rate of the Spanish economy.

- EUR 500 million on additional expenditure in 2018 for young workers benefitting from the youth guarantee. It also estimates at EUR 530 million the reduction in social contributions for the self-employed in 2018 following law 6/2017.
- A reduction in the VAT tax rate for tickets to movie theatres, with a marginal budgetary impact.
- Lastly, the updated DBP also includes investments in road infrastructure taken over from a number of bankrupt motorway companies, as well as some related capital transfers, which are treated as one-off measures, totalling EUR 1.8 billion (0.15% of GDP). This is EUR 200 million lower than previously estimated in the no-policy-change DBP for 2018.

The reported net overall impact from all fiscal policy measures (i.e., planned and already adopted) is deficit-increasing in 2018 and, to a lesser extent, also in 2019 (see table 4).

The Commission 2018 spring forecast includes a net impact from fiscal policy measures amounting to -0.4% of GDP in 2018 and a positive effect of 0.1% in 2019. The main differences between the measures reported in the updated DBP and in the Commission spring forecast are the following:

- The updated DBP attributes the salary increase in the public sector to a policy measure; the Commission forecast includes it in its baseline projections. Moreover, starting from 2016, the Commission has included the savings from the 2013 pension reform (reported at EUR 950 million in 2018 and in 2019) in the baseline of social transfers other than in kind, rather than treating them as a new policy measure.
- The Commission forecast does not include the additional increases of 1.6% and 1.5% in public pensions in 2018 and 2019, respectively, as they were announced after its cut-off date, nor does it factor in any potential compensatory measures such as the planned tax on revenue from digital activities, which is not yet fully specified.
- Unlike the updated DBP, the Commission forecast for 2018 includes an additional EUR 400 million in gross fixed capital formation as a result of the new incentives to sustainable investment projects at subnational government level.[7]
- Moreover, on the revenue side, the Commission forecast considers that the impact of the lower social security contributions for the self-employed is mostly felt in 2019, rather than in 2018 in the government forecast. Lastly, the spring forecast includes the estimate provided by the government in its April 2018 quarterly budgetary execution report for the fee for the conversion of DTAs into tax credits (0.04% of GDP in 2018).

[7] Royal Decree Law 1/2018, in force since 25 March 2018, allows local governments, under certain conditions, to spend their surpluses on an expanded list of sustainable investment projects. A similar provision, albeit with overall less strict requirements, is provided for in the draft budget law for regional governments having complied with the public deficit, public debt and expenditure rule targets in 2017.

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

A. Discretionary measures taken by General Government - revenue side

Components	Budgetary impact (% GDP) (as reported by the authorities)		
	2017	**2018**	**2019**
Taxes on production and imports	0.22	0.10	0.14
Current taxes on income, wealth, etc.	0.12	-0.06	-0.11
Capital taxes	0.00	-0.01	0.00
Social contributions	0.06	-0.04	0.00
Property Income			
Other			
Total	0.39	-0.02	0.03

Note:

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

Source: Updated 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**	**2019**
Compensation of employees	0.08	0.26	0.29
Intermediate consumption	-0.12	0.01	-0.07
Social payments	-0.12	0.17	0.09
Interest Expenditure			
Subsidies			
Gross fixed capital formation	0.00	0.10	-0.10
Capital transfers	0.00	0.05	-0.04
Other	0.02	0.01	0.04
Total	-0.14	0.60	0.20

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: Updated Draft Budgetary Plan for 2018

8 The updated 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 notice, 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 was considered 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 should ensure compliance with the Council Decision of 8 August 2016, including also 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.

Table 5. Compliance with the EDP recommendation

(% of GDP)	2016	2017		2018	
	COM	DBP 18	COM	DBP 18	COM
Headline balance					
Headline budget balance	-4.5	-3.1	-3.1	-2.2	-2.6
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]	-0.9	0.3	0.3	0.4	-0.3
Cumulative change[2]	-0.9	-0.6	-0.6	-0.1	-0.9
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	-	-0.4
of which: *correction due to change in potential GDP estimation (α)*	-0.1	-	-0.1	-	-0.1
correction due to revenue windfalls/shortfalls (β)	-0.5	-	0.0	-	0.0
Cumulative adjusted change [2]	-0.5	-	-0.2	-	-0.6
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]	0.3	-	0.4	-	-0.5
Cumulative fiscal effort (bottom-up)[2]	0.3	-	0.7	-	0.2
Requirement from the EDP recommendation	0.0	0.5		0.5	
Cumulative requirement from the EDP recommendation	0.0	0.5		1.0	

<u>Notes</u>

[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 Plan t 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.

<u>Source</u> :

Updated Draft Budgetary Plan for 2018 (DBP); Commission 2018 spring forecast (COM); Commission calculations.

After achieving the headline deficit target of 3.1 % of GDP required by the Council decision of August 2016, the Commission 2018 spring forecast projects that the headline deficit target of 2.2 % of GDP for 2018 will not be fulfilled. However, at 2.6 % of GDP, the headline deficit is forecast to be below the Treaty reference value of 3.0%, in line with the deadline set by the Council. The Council decision requires Spain to improve the structural balance by 0.5 pps in 2018. Instead, the Commission 2018 spring forecast projects a widening of the structural deficit in 2018 of 0.3 pps. Correcting for the change in the estimated potential growth between the projections underlying the Council decision and the Commission 2018 spring forecast, as well as revenue shortfalls projected for 2018 compared to the Council decision, the estimated change in the structural balance was -0.4 pps. On a cumulative basis over 2016-2018, the estimated gap with the requirement amounts to 1.5% of GDP when measured against the unadjusted change in the structural balance, and to 1.2% of GDP when adjusted. The bottom-up estimate of the fiscal effort falls short of the requirement by 0.8% of GDP over 2016-18.

5. 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.

The updated DBP reports actions taken in 2017 to implement the preventive and corrective tools set out in Spain's Stability Law, such as the adoption in 2017 of economic and financial plans for regions not having complied with some or any of the 2016 domestic fiscal targets. However, it does not report any new measures to enhance the automaticity of the mechanisms to prevent and correct deviations from the fiscal targets. Neither does it include measures to review the Stability Law's expenditure rule, with a view to strengthening its contribution to fiscal consolidation, especially during cyclical upturns, as is now the case.

Yet, as Spain is increasingly benefiting from cyclically driven revenue developments, strengthening the domestic expenditure rule could help avoiding that revenue windfalls are spent on permanent expenditure increases. In particular, the Stability Law's expenditure rule does not call on non-compliant public administrations to make up for spending slippages after their occurrence. This makes it easier to observe the rule in the year after it is not complied with, as it allows for a higher base level of expenditure. It also does not ensure convergence towards the MTO (at the aggregate level) as, unlike the expenditure benchmark of the SGP, the reference rate of growth of eligible expenditure does not depend on whether Spain has reached the MTO or not.

The Council notice 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. Law 9/2017, on public sector contracts, in force since 9 March 2018, sets out among other things, a new structure governing Spain's public procurement. However, the new legislation can only improve the efficiency and transparency of public procurement if it is swiftly and ambitiously implemented, by setting up the new governance structure and enhancing control mechanisms of procurement procedures at all levels of government. The new cooperation committee, a collegiate body with representatives from the central, regional and local public authorities tasked with the drawing up and monitoring of a nation-wide Public Procurement Strategy, convened on 19 February for the first time. Other elements of the governance structure, i.e., the new independent office for public procurement regulation and supervision, had not been set up at the time of writing.

Lastly, on 11 July 2017, the Council, upon recommendation by the Commission, recommended Spain to undertake a comprehensive expenditure review in order to identify possible areas for improving spending efficiency. On 2 June, Spain's Council of Ministers commissioned AIReF to carry out a spending review, focusing on public subsidies. The review is expected to be completed by early 2019.

6. OVERALL CONCLUSION

Based on the Commission 2018 spring forecast, Spain is expected to achieve a headline deficit of 2.6% of GDP in 2018, above the target of 2.2% of GDP set by the Council, but below the Treaty reference value of 3.0% of GDP. Thus, Spain is likely to correct its excessive deficit by 2018, the deadline established by the Council.

At the same time, the fiscal effort in 2018 is expected to fall significantly short of the recommended effort in the August 2016 Council notice, based on all the metrics used, also cumulatively over the 2016-18 period. The measures contained in the updated DBP actually increase the deficit. 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. Moreover, the increases in pensions and the postponement of the sustainability factor proposed during the adoption process of the draft 2018 budget call into question the commitment to the pension reforms.

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 updated DBP 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. The 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	2.9
Nominal GDP growth	%	4.1	3.6	4.0	4.2
Potential GDP growth	%	0.3	0.6	1.0	1.2
Structural balance	% of pot. GDP	-2.4	-3.3	-3.0	-3.3
General government balance	% of GDP	-5.3	-4.5	-3.1	-2.6
Change in structural balance	% of pot. GDP	-0.9	-0.9	0.3	-0.3
p.m. Output Gap	% of pot. GDP	-4.7	-2.2	-0.2	1.4

Source: Commission 2018 Spring 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	0.6	-0.2	40.9	-0.1
2017	0.7	1.0	-0.3	40.7	-0.1
2018	0.9	1.2	-0.3	40.8	-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	7.0	-8.0	0.8	3.4	3.6	0.0	0.0	407.1	409.0	-8.0	1118.5	-0.7
2017	23.8	19.8	5.5	-0.6	3.6	4.0	0.0	0.0	411.1	416.7	2.6	1163.7	0.2
2018	16.0	18.9	0.2	0.4	3.6	4.2	0.0	0.0	434.9	435.9	0.2	1213.0	0.0

*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*