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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 for 2020 on 15 October 2019 in compliance with Regulation (EU) No 473/2013. Spain is subject to the preventive arm of the Pact and should ensure sufficient progress towards its medium-term budgetary objective. As the debt ratio was 97.6% of GDP in 2018 (the year in which Spain corrected its excessive deficit), exceeding the 60% of GDP reference value, during the three years following the correction of the excessive deficit Spain is also subject to the transitional arrangements to make sufficient progress towards compliance with the debt reduction benchmark.

At the time of submission of the Draft Budgetary Plan, Spain had only a care-taker government following the dissolution of parliament on 24 September and the announcement of general elections for 10 November. Therefore, the Draft Budgetary Plan was submitted to the Commission and the Eurogroup without a draft Budget Law being submitted in parallel to the Spanish parliament. For the same reason, the Draft Budgetary Plan is also of a no-policy-change nature, only containing measures already adopted or credibly announced by the time of the submission. The Draft Budgetary Plan does not contain all the information required according to the Code of Conduct of the Two Pack.[1]

Section 2 of this document presents the macroeconomic outlook underlying the Draft Budgetary Plan and provides an assessment based on the Commission 2019 autumn forecast. The following section presents the recent and projected fiscal developments, according to the Draft Budgetary Plan, including an analysis of risks to their achievement based on the Commission 2019 autumn forecast. It also includes an assessment of the measures underpinning the Draft Budgetary Plan. Section 4 assesses the recent and planned fiscal developments in 2019-2020 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. A box on the application of constrained judgement is contained in this section for Spain as it is flagged by the plausibility tool. Section 5 provides an analysis of implementation of fiscal-structural reforms in response to the latest country-specific recommendations in the context of the European Semester adopted by the Council in July 2019, including those to reduce the tax wedge. Section 6 summarises the main conclusions of the present document.

[1] In particular, it does not contain data on Harmonised Index of Consumer Prices inflation, on employment (hours worked) and labour productivity (hours worked).

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

The macroeconomic scenario underpinning the 2020 Draft Budgetary Plan projects real GDP growth to reach 2.1% in 2019, after 2.4% in 2018. Domestic demand is expected to give a lower contribution to growth than in the previous year, on account of decelerating private consumption and investment. However, net exports are expected to provide a large contribution to growth, of 0.6 percentage points, which contrasts with a negative contribution in 2018. Compared to the 2019 Stability Programme submitted in April, the Draft Budgetary Plan projects real GDP growth to be 0.1 percentage point lower this year, mainly due to a full percentage point lower contribution to growth from private consumption, outweighing a 0.7 percentage point higher contribution from net exports.

The Commission 2019 autumn forecast projects real GDP growth of 1.9% this year, 0.2 percentage points lower than the Draft Budgetary Plan, with small divergences in the composition of growth. Investment, and to a lesser extent, private consumption, are expected to be slightly lower in the Commission forecast. Although the Commission forecast expects higher exports and imports than the Draft Budgetary Plan, the contribution of net exports to growth is expected to be the same, reaching 0.6 percentage points. The main difference between the Draft Budgetary Plan and Commission forecasts for 2019 refers to prices, which are projected to increase faster in the Draft Budgetary Plan. The private consumption and GDP deflators are expected to be 0.6 and 0.3 percentage points higher, respectively, in the Draft Budgetary Plan than in the Commission forecast (the Draft Budgetary Plan does not provide a forecast for Harmonised Index of Consumer Prices inflation). As a result of higher real GDP growth and a higher GDP deflator, nominal GDP growth in 2019 is 0.6 percentage points higher in the Draft Budgetary Plan than in the Commission forecast. National account data for the third quarter, released after the cut-off date of the Commission forecast[2], show slightly higher real and nominal GDP growth, but lower employment than expected in the Commission forecast. Overall, the macroeconomic projections underpinning the Draft Budgetary Plan for 2019 appear slightly favourable.

In 2020, the Draft Budgetary Plan forecasts real GDP growth to decelerate to 1.8%, mainly due to a lower contribution of net exports to growth, and despite recovering domestic demand on account of higher private consumption. In the Draft Budgetary Plan, employment is projected to decelerate slightly, whereas wages should increase slightly faster than in 2019. Compared to the 2019 Stability Programme submitted in April, the Draft Budgetary Plan forecasts real GDP growth to be 0.1 percentage point lower in 2020, mainly due to slower growth of domestic demand, and in particular of private consumption.

Compared with the Draft Budgetary Plan, the Commission projects a sharper deceleration in real GDP growth, to 1.5%, mainly resulting from a weaker contribution of domestic demand. Both forecasts project a recovery of private consumption in 2020, but the expected rebound is smaller in the Commission forecast. The Commission forecast also projects weaker investment. Other differences between the Draft Budgetary Plan and the Commission forecast in 2020 relate to employment and prices, which are expected to grow significantly faster in the Draft Budgetary Plan. In the Commission forecast, employment is expected to expand by 1% in 2020, lower than the 2% projected in the Draft Budgetary Plan. The GDP deflator is also expected to grow 0.4 percentage points less in the Commission forecast, remaining

2 The cut-off date of the Commission 2019 autumn forecast is 24 of October. The flash GDP estimate for the third quarter of 2019 was released on 31 October.

unchanged compared to 2019 at 1.4%. As a result of higher real GDP growth and a higher GDP deflator, nominal GDP growth in 2020 is 0.7 percentage points higher in the Draft Budgetary Plan than in the Commission forecast. In light of all these differences, the macroeconomic projections underpinning the Draft Budgetary Plan for 2020, for both GDP growth and employment, also appear slightly favourable.

Both the Commission and the Draft Budgetary Plan forecast a widening of the positive output gap in 2019-2020. Already in 2019, the Draft Budgetary Plan has a slightly larger output gap than the Commission forecast[3] (1.7% of GDP vs. 1.6% of GDP) and this difference is projected to widen slightly further in 2020, as the difference in real GDP growth between the two forecasts is larger than the difference in potential growth estimates.

Overall, the macroeconomic projections underlying the Draft Budgetary Plan are slightly favourable in 2019 and 2020.

Box 1: The macroeconomic forecast underpinning the budget in Spain

The macroeconomic forecasts underpinning the 2020 Draft Budgetary Plan have been endorsed by Spain's independent fiscal institution – Autoridad Independiente de Responsabilidad Fiscal (AIReF) in a report published on AIReF's website on 25 October 2019.[4]

AIReF's mandate is broad, thus allowing it to play a relevant role in Spain's budgetary processes. Its mandate includes issuing reports assessing the Stability Programme, the Draft Budgetary Plan, compliance of fiscal policy, including the regions' economic and financial plans, with the domestic numerical fiscal rules, and giving advice on the activation of the correction mechanisms set out in Spain's Organic Law on Budgetary Stability and Financial Sustainability.

AIReF deems the macroeconomic scenario of the Draft Budgetary Plan and its underlying external assumptions as "feasible" and the growth composition, based on an increasing contribution of domestic demand, as "credible". The growth forecast for 2020 underpinning the Draft Budgetary Plan falls within the central part of the confidence interval of AIReF's macroeconomic projections.

In the same report, AIReF considers it "achievable" for Spain to reach a nominal general government deficit of 2.0% of GDP or better, attaching a 44% likelihood to this outcome.

[3] As recalculated by the Commission using the commonly agreed methodology.

[4] Available at: http://www.airef.es/wp-content/uploads/2018/10/NOTICIAS/JLE_COMISION_PRESUPUESTOS/Informe-DBP-2019_version-publicacion.pdf

Table 1. Comparison of macroeconomic developments and forecasts

	2018	2019			2020		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	2.4	2.2	2.1	1.9	1.9	1.8	1.5
Private consumption (% change)	1.8	1.9	0.9	0.8	1.6	1.2	1.0
Gross fixed capital formation (% change)	5.3	4.0	3.1	2.5	3.5	3.0	2.5
Exports of goods and services (% change)	2.2	2.7	1.7	2.0	2.8	2.3	2.3
Imports of goods and services (% change)	3.3	3.1	0.1	0.5	2.9	2.0	2.0
Contributions to real GDP growth:							
- Final domestic demand	2.4	2.3	1.5	1.3	1.9	1.6	1.3
- Change in inventories	0.2	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	-0.3	-0.1	0.6	0.6	0.0	0.2	0.2
Output gap[1]	1.0	1.4	1.7	1.6	1.6	1.9	1.7
Employment (% change)	2.2	2.0	2.3	2.1	1.9	2.0	1.0
Unemployment rate (%)	15.3	13.8	13.8	13.9	12.3	12.3	13.3
Labour productivity (% change)	-0.2	0.1	-0.2	-0.3	0.1	-0.2	0.5
HICP inflation (%)	1.7			0.9			1.1
GDP deflator (% change)	1.1	1.6	1.7	1.4	1.7	1.8	1.4
Comp. of employees (per head, % change)	1.0	2.1	2.1	2.4	2.2	2.2	2.2
Net lending/borrowing vis-à-vis the rest of	2.4	1.2	2.3	2.9	1.1	2.1	3.1

Note:

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

Source:

Stability Programme 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

The Draft Budgetary Plan projects a headline deficit of 2.0% of GDP in 2019, which is below the Commission 2019 autumn forecast, but in line with the target of the 2019 Stability Programme. However, in the Draft Budgetary Plan, both the revenue and the expenditure ratios are projected to be 0.2 percentage points higher than in the Stability Programme, reaching 39.3% of GDP and 41.3% of GDP, respectively. While the projections for social contributions and "other revenues" have been revised up by a total of more than 0.3 percentage points compared with the Stability Programme, taxes on production and imports have been revised down by 0.1 percentage points. Some of these revisions compared with the Stability Programme reflect methodological changes in the recording of taxes, which since September 2019 are recorded on a time-adjusted cash basis. The shift implied that revenues from taxes on production and imports as well as on income were revised down to reflect actual collection, with an offsetting upward revision of “other revenue”, as the line “taxes not likely to be collected” was set to zero (after previously exhibiting negative numbers). On the expenditure side, upward revisions of 0.2 percentage points each for compensation of employees and social transfers were only partly offset by downward revisions of interest and "other expenditure". About half of the revisions on the expenditure side stems from the revision of historical data implemented in September.

The Commission 2019 autumn forecast expects a government deficit in 2019 of 2.3% of GDP, 0.3 percentage points higher than the Draft Budgetary Plan. The difference stems mainly from different underlying (nominal) GDP projections. The fact that the Draft Budgetary Plan projects a lower expenditure ratio is consistent with the higher nominal GDP growth.

The no-policy change Draft Budgetary Plan projects a deficit reduction in 2020 of 0.3% of GDP, 0.6 percentage points less than the one targeted in the 2019 Stability Programme. However, the latter included a set of revenue-increasing measures that have not yet been adopted and hence are not included in this no-policy change Draft Budgetary Plan. Thus, the Draft Budgetary Plan assumes the revenue ratio to increase by 0.3% of GDP largely due to revenue windfalls, to 39.6% of GDP, much less than the 0.7 percentage point increase planned in the Stability Programme. The expenditure ratio is expected to remain unchanged at 41.3% of GDP in the Draft Budgetary Plan, whereas the Stability Programme planned a small reduction.

The Commission 2019 autumn forecast expects the headline government deficit to narrow by 0.1 percentage point in 2020, i.e. by 0.2 percentage points less than assumed in the Draft Budgetary Plan, to reach 2.2% of GDP. This mainly reflects the fact that the Draft Budgetary Plan projects higher nominal GDP growth. Adjusted for the latter, the main difference relates to the Commission forecast having a slightly larger decline in interest expenditure.

The Draft Budgetary Plan reports an improvement in the structural balance of 0.1% of GDP in 2020[5]. According to the Commission 2019 autumn forecast, the structural balance is expected to deteriorate by 0.1 percentage point, mirroring the difference in headline deficits and the assessment of one-offs.

The Draft Budgetary Plan includes expenditure measures that it claims are of a one-off nature of about EUR 1.1 billion (about 0.1% of GDP) in its deficit forecast for 2020, relating to the repayment of the 2012-2014 Christmas bonus affecting regional governments and to compensatory payments to households and companies for damages caused by the adverse weather conditions in 2019. The Commission forecast treats these as measures with a temporary effect that do not qualify as one-off, since they are under the control of the government and do not correspond to the strict definition of direct short-term emergency costs used by the Commission for the qualification as a one-off measure.

Euro area sovereign bond yields remain at historically low levels, with 10-year rates in Spain currently standing at 0.30%.[6] 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 Draft Budgetary Plan, interest expenditure in Spain is expected to fall from 2.4% of GDP in 2018 to 2.3% in 2019 and is projected to decrease further next year, to 2.2% of GDP, well below the peak of 4.3% recorded in 2014. The picture emerging from the Draft Budgetary Plan is broadly confirmed by the Commission forecast.

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

[6] 10-year bond yields as of 28 October 2019. Source: Bloomberg

Table 2. Composition of the budgetary adjustment

(% of GDP)	2018		2019			2020			Change: 2018-2020
	COM	DBP	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**39.2**	**39.2**	**39.1**	***39.3***	**39.3**	**39.8**	***39.6***	**39.6**	**0.4**
of which:									
- Taxes on production and imports	11.7	11.7	11.6	*11.5*	11.6	11.8	*11.6*	11.6	-0.1
- Current taxes on income, wealth,	10.6	10.6	10.7	*10.7*	10.7	11.2	*10.9*	10.9	0.3
- Capital taxes	0.5	0.5	0.4	*0.4*	0.4	0.4	*0.4*	0.4	-0.1
- Social contributions	12.4	12.4	12.7	*12.8*	12.8	12.8	*12.9*	12.8	0.5
- Other (residual)	4.0	4.0	3.7	*3.9*	3.8	3.6	*3.8*	3.9	-0.2
Expenditure	**41.7**	**41.7**	**41.1**	**41.3**	**41.7**	**41.0**	**41.3**	**41.8**	**-0.4**
of which:									
- Primary expenditure	39.3	39.3	38.7	39.1	39.4	38.7	39.2	39.7	-0.2
of which:									
Compensation of employees	10.6	10.6	10.5	10.7	10.7	10.5	10.7	10.8	0.1
Intermediate consumption	5.1	5.1	5.0	5.0	5.1	5.0	5.0	5.1	-0.1
Social payments	18.0	18.0	18.0	18.2	18.3	18.1	18.3	18.5	0.3
Subsidies	1.0	1.0	1.0	1.0	1.0	0.9	1.0	1.0	0.0
Gross fixed capital formation	2.1	2.1	2.0	2.0	2.1	2.0	2.1	2.1	0.0
Other (residual)	2.4	2.4	2.2	2.2	2.2	2.2	2.1	2.2	-0.3
- Interest expenditure	2.4	2.4	2.4	2.3	2.3	2.3	2.2	2.1	-0.2
General government balance (GGB)	**-2.5**	**-2.5**	**-2.0**	**-2.0**	**-2.3**	**-1.1**	**-1.7**	**-2.2**	**0.8**
Primary balance	**-0.1**	**-0.1**	**0.3**	**0.2**	**-0.1**	**1.2**	**0.4**	**-0.1**	**0.5**
One-off and other temporary measures	-0.3	-0.3	-0.2	-0.2	-0.2	0.0	-0.1	0.0	0.2
GGB excl. one-offs	**-2.2**	**-2.2**	**-1.8**	**-1.8**	**-2.1**	**-1.1**	**-1.6**	**-2.2**	**0.6**
Output gap[1]	1.0	1.2	1.4	1.7	1.6	1.6	1.9	1.7	0.7
Cyclically-adjusted balance[1]	-3.2	-3.2	-2.9	-3.0	-3.3	-2.1	-2.8	-3.2	0.3
Structural balance (SB)[2]	**-2.9**	**-2.9**	**-2.7**	**-2.8**	**-3.1**	**-2.0**	**-2.7**	**-3.2**	**0.1**
Structural primary balance[2]	-0.4	-0.5	-0.4	-0.5	-0.8	0.2	-0.5	-1.1	-0.1

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 corresponds to cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source:

Stability Programme 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

3.2. Debt developments

The Draft Budgetary Plan projects the debt-to-GDP ratio to decline from 97.6% of GDP in 2018, to 95.9% in 2019 and to 94.6% in 2020. For 2019, this is almost unchanged compared to the ratio presented in the 2019 Stability Programme, with a higher primary deficit and somewhat lower real GDP growth almost offset by lower interest expenditure and higher inflation. For 2020, the debt ratio is revised up by 0.6 percentage points, reflecting a 0.7 percentage points smaller contribution from the primary balance, which is only to a very limited extent offset by lower interest expenditure. The Draft Budgetary Plan indicates a debt-increasing stock-flow adjustment of 0.4 percentage points in 2020, unchanged since the Stability Programme, without specifying the nature of these.

Compared with the Draft Budgetary Plan, the Commission 2019 autumn forecast projects a higher debt ratio in both 2019 and 2020, 96.7% and 96.6% of GDP, respectively. In both years, the difference mainly reflects a higher primary deficit and lower real GDP growth and inflation in the Commission forecast.

Table 3. Debt developments

(% of GDP)	2018	2019			2020		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**97.6**	**95.8**	**95.9**	**96.7**	**94.0**	**94.6**	**96.6**
Change in the ratio	-1.0	-1.8	-1.7	-0.9	-1.9	-1.2	-0.1
Contributions[2]:							
1. Primary balance	**0.1**	**-0.3**	**-0.2**	**0.1**	**-1.2**	**-0.4**	**0.1**
2. "Snow-ball" effect	**-0.8**	**-1.2**	**-1.4**	**-0.8**	**-1.1**	**-1.1**	**-0.6**
Of which:							
Interest expenditure	2.4	2.4	2.3	2.3	2.3	2.2	2.1
Real growth effect	-2.2	-2.1	-2.0	-1.8	-1.8	-1.6	-1.4
Inflation effect	-1.0	-1.5	-1.6	-1.3	-1.5	-1.7	-1.3
3. Stock-flow adjustment	**-0.2**	**-0.1**	**-0.1**	**-0.1**	**0.4**	**0.4**	**0.4**

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 effects.

Source:

Stability Programme 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

3.3. Measures underpinning the draft budgetary plan

Given its no-policy-change nature, the Draft Budgetary Plan largely builds on the policy measures adopted to date and already reported in the 2019 Stability Programme with no new planned revenue measures. The package of tax measures put forward in the draft 2019 budget law and assumed to be implemented by 2020 in the Stability Programme have not been incorporated in the Draft Budgetary Plan. However, the Draft Budgetary Plan includes new expenditure measures amounting to a range between EUR 4.7–6.0 bn (equivalent to 0.4% - 0.5% of GDP) in 2020 falling into the following categories:

- Salary increase in the public sector according to the 2018-2020 trade unions agreements (EUR 3.264-4.575 million).
- Full pension indexation in 2020 based on the consumer price index at 0.9% (EUR 1 404 million).

The Commission 2019 autumn forecast also includes these measures, as they were deemed to have been credibly announced.

The projections in the Draft Budgetary Plan also include savings in 2020 stemming from the implementation of recommendations from three of the several spending reviews commissioned to AIReF in 2018 and 2019, which are not reported as policy measures in the Draft Budgetary Plan but are incorporated implicitly in the baseline projections. These are:

- Annual savings in social transfers that would stem from the implementation of the spending review on prescription drugs (EUR 50 million in 2019 and EUR 200 million in 2020).

- Higher social contributions that would stem from the implementation of the spending review on hiring incentives, though the review has not been concluded yet (EUR 500 million).

- The Draft Budgetary Plan assumes subsidies to grow by 1% year-on-year as from 2020 in nominal terms, based on the implementation of the recommendations from the relevant spending review.

The Commission 2019 autumn forecast includes less savings, given the caretaker nature of the government and since the Draft Budgetary Plan does not specify detailed implementation plans.

Table 4. Main discretionary measures reported in the Draft Budgetary Plan[7]

Discretionary new measures taken by General Government- expenditure side

Components	Budgetary impact (% GDP)
	2020
Compensation of employees	0.3 - 0.4
Intermediate consumption	
Social payments	0.1
Interest Expenditure	
Subsidies	
Gross fixed capital formation	
Capital transfers	
Other	
Total	**0.4 - 0.5**

Note:

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

Source:

Draft Budgetary Plan for 2020

[7] The DBP reports no new measures in 2020 on the revenue side, nor in the following areas: intermediate consumption, interest expenditure, subsidies, gross fixed capital formation, capital transfers, other expenditure. This is shown in tables 4 as blanks.

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

Spain is currently subject to the preventive arm of the Pact and should ensure sufficient progress towards its medium-term budgetary objective. Box 2 reports the latest country specific recommendations in the area of public finances. Spain is also subject to the transitional arrangements to make sufficient progress towards compliance with the debt reduction benchmark.

Box 2. Council recommendations addressed to Spain

On 9 July 2019, 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 that the nominal growth rate of net primary government expenditure does not exceed 0.9% in 2020, corresponding to an annual structural adjustment of 0.65% of GDP and use windfall gains to accelerate the reduction of the general government debt ratio.

4.1. Compliance with the debt criterion

After it corrected its excessive deficit in 2018, Spain is in the transition period for the following three years to make sufficient progress towards compliance with the debt reduction benchmark. This implies that, during this period, it is required to make sufficient progress (as defined by the minimum linear structural adjustment (MLSA)) towards compliance with the debt reduction benchmark at the end of the transition period.

The Draft Budgetary Plan does not provide sufficient information to assess compliance with the debt reduction benchmark in both 2019 and 2020. Spain is not making sufficient progress towards compliance with the debt reduction benchmark in 2019-2020 based on the Commission 2019 autumn forecast.

Table 5. Compliance with the debt criterion

	2018	2019			2020		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio	**97.6**	**95.8**	**95.9**	**96.7**	**94.0**	**94.6**	**96.6**
Structural adjustment [1]	0.0	-0.1	0.1	-0.2	0.7	0.1	-0.1
To be compared to:							
Required adjustment [2]				0.5			1.0

Notes:

[1] Applicable only during the transition period of three years from the correction of the excessive deficit for EDP that were ongoing in November 2011.

[2] Defines the remaining minimum annual structural adjustment over the transition period which ensures that – if followed – Member State will comply with the debt reduction benchmark at the end of the transition period, assuming that COM (SP) budgetary projections for the previous years are achieved.

Source:

Stability Programme 2019 (SP); Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations

4.2. Adjustment towards the medium-term budgetary objective

In 2019, Spain is subject for the first time to the requirements of the Stability and Growth Pact preventive arm. It therefore needs to ensure an appropriate adjustment path towards its medium-term budgetary objective, defined as a balanced budget in structural terms. On 13 July 2018, the Council recommended Spain to ensure that the nominal growth rate of net primary government expenditure does not exceed 0.6% in 2019, corresponding to an annual structural adjustment of 0.65% of GDP. On 9 July 2019, the Council recommended Spain to ensure that the nominal growth rate of net primary government expenditure does not exceed 0.9% in 2020, corresponding to an annual structural adjustment of 0.65% of GDP.

According to the information provided in the Draft Budgetary Plan, the growth rate of government expenditure, net of discretionary revenue measures, will in 2019 exceed the applicable expenditure benchmark rate (0.6%) leading to a deviation of 0.8% of GDP. The Draft Budgetary Plan points to an improvement in the (recalculated) structural balance of 0.1% of GDP, implying a deviation of 0.6% of GDP from the recommended improvement of 0.65% of GDP. Thus, both indicators point to a risk of significant deviation in 2019. This conclusion is confirmed based on the Commission 2019 autumn forecast, which points to a deviation of 1.2% of GDP based on the expenditure benchmark and 0.9% of GDP based on the change in the structural balance.

According to the information provided in the Draft Budgetary Plan, the growth rate of government expenditure, net of discretionary revenue measures, would in 2020 exceed the applicable expenditure benchmark rate (0.9%), leading to a deviation of 1.0% of GDP (or a two-year average deviation of 0.9% of GDP over 2019-2020). The Draft Budgetary Plan points to an improvement in the (recalculated) structural balance of 0.1% of GDP, implying a deviation from the recommended improvement of 0.6% of GDP (or a two-year average deviation of 0.6% of GDP over 2019-2020). Thus, both indicators point to a risk of significant deviation in 2020. This conclusion is confirmed based on the Commission 2019 autumn forecast, which points to a deviation of 1.2% of GDP based on the expenditure benchmark and 0.8% of GDP based on the change in the structural balance (with two-year average deviations of 1.2% and 0.8%, respectively) (See Table 6).

For 2019, the higher gap for the expenditure benchmark (relative to the structural balance indicator) is mostly due to the lower potential growth rate factored in in the expenditure benchmark calculations than in the structural balance; while the former uses as reference a 10-year moving average of annual potential growth estimates, including years with negative potential growth, the latter relies on an estimate of potential growth in 2019. In 2020, this factor remains at play, but is compounded by an impact from windfall revenues of a similar magnitude.

Following an overall assessment based on the Commission 2019 autumn forecast, the adjustment path towards the medium-term budgetary objective points to a risk of a significant deviation from requirements of the preventive arm in 2019 as well as in 2020.

Box 3. Implementation of the "constrained judgement" approach and its impact on fiscal surveillance

The objective of the "constrained judgement" approach is to have a transparent and economically grounded tool to statistically test the plausibility of the output gap estimates for individual Member States estimated on the basis of the commonly agreed methodology. To that end, the Commission developed, in consultation with the Member States, an objective screening tool based on a set of cyclically relevant indicators as well as thresholds/ranges - to signal cases when the outcomes of the common method could be interpreted as being subject to a large degree of uncertainty and therefore deserving of further investigation on the part of the Commission. In such cases, the Commission carries out an "in depth" analysis which could lead to the application of a "constrained" degree of judgement in conducting Member States' budgetary assessments.

The plausibility tool indicates that the output gap for Spain for 2019, estimated on the basis of the commonly agreed methodology, may be counterintuitive. Based on the Commission's 2019 autumn forecast, the tool provides a central estimate of 0.3% of potential GDP of the confidence band in 2019, significantly lower than the value of 1.6% obtained through the common methodology. In particular, the latter falls outside the range of the tool, which stretches from -0.8% to 1.5% of potential GDP. Applying the same 1.3 percentage points of potential GDP difference between the estimate based on the common method and the central value of the confidence band in 2020, would lead to a plausibility range of output gap estimates from 0.5% to 2.9% of potential GDP.

This different assessment could be related to the fact that Spain is still expected to record one of the highest unemployment rates in the EU in 2020 and the number of employed persons is forecast to still be about one million below its pre-crisis peak in 2008. This should contribute to contain wage pressures, especially in the private sector, as well as inflation, which is projected to remain below 2%. The very high share of involuntary part-time work, temporary employment as well as in-work poverty are further signs that the remaining slack in the labour market could be larger than implied by the output gap estimated with the production function approach. Moreover, output gap estimations for 2019 provided by other national and international institutions vary greatly and are generally lower than the estimate based on the commonly agreed methodology[8].

The above-mentioned factors confirm that for Spain the output gap estimate based on the common methodology is subject to a high degree of uncertainty. This was reflected in the 2019 Council recommendations which include an adjustment requirement of 0.65% of GDP for 2019, instead of the requirement of 1% of GDP.

[8] Output gap for 2019 is estimated at 0.0% of potential GDP by the OECD (Economic Outlook, May 2019) and at 0.6% by the IMF (World Economic Outlook of October 2019).

Table 6: Compliance with the requirements of the preventive arm

(% of GDP)	2019		2020	
Initial position[1]				
Medium-term budgetary objective (MTO)	0.0		0.0	
Structural balance[2] (COM)	-3.1		-3.2	
Structural balance based on freezing (COM)	-2.9		-	
Position vis-a -vis the MTO[3]	Not at MTO		Not at MTO	
	2019		**2020**	
(% of GDP)	**DBP**	**COM**	**DBP**	**COM**
Structural balance pillar				
Required adjustment[4]	0.7		0.7	
Required adjustment corrected[5]	0.7		0.7	
Change in structural balance[6]	0.1	-0.2	0.1	-0.1
One-year deviation from the required adjustment [7]	-0.6	-0.9	-0.6	-0.8
Two-year average deviation from the required			-0.6	-0.8
Expenditure benchmark pillar				
Applicable reference rate[8]	0.6		0.9	
One-year deviation adjusted for one-offs [9]	-0.8	-1.2	-1.0	-1.2
Two-year average deviation adjusted for one-offs [9]			-0.9	-1.2

Notes

[1] The most favourable level of the structural balance, measured as a percentage of GDP reached at the end of year t-1, between spring forecast (t-1) and the latest forecast, determines whether there is a need to adjust towards the MTO or not in year t. A margin of 0.25 percentage points is allowed in order to be evaluated as having reached the MTO.

[2] Structural balance corresponds to cyclically-adjusted government balance excluding one-off measures.

[3] Based on the relevant structural balance at year t-1.

[4] Based on the position vis-à-vis the MTO, the cyclical position and the debt level (See European Commission: Vade mecum on the Stability and Growth Pact ed. 2018, page 38.).

[5] Required adjustment corrected for the clauses, the possible margin to the MTO and the allowed deviation in case of overachievers.

[6] Change in the structural balance compared to year t-1.

[7] The difference of the change in the structural balance and the corrected required adjustment.

[8] Reference medium-term rate of potential GDP growth. The (standard) reference rate applies from year t+1, if the country has reached its MTO in year t. A corrected rate applies as long as the country is adjusting towards its MTO, including in year t.

[9] Deviation of the growth rate of public expenditure net of discretionary revenue measures, revenue increases mandated by law and one-offs from the applicable reference rate in terms of the effect on the structural balance. The expenditure aggregate used for the expenditure benchmark is obtained following the commonly agreed methodology. A negative sign implies that expenditure growth exceeds the applicable reference rate.

Source :

Draft Budgetary Plan for 2020 (DBP); Commission 2019 autumn forecast (COM); Commission calculations.

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

The Council Recommendation of 9 July 2019 required Spain to strengthen its fiscal and public procurement frameworks at all levels of government and preserve the sustainability of the pension system.

The 2020 Draft Budgetary Plan reports briefly on actions taken to implement the preventive and corrective tools set out in Spain's Stability Law following the detection of risks of deviation from the domestic fiscal targets or spending rule, notably by regional governments. However, it does not set out any new measures to make the use of those mechanisms more automatic. Neither does it include measures to strengthen the contribution of the Stability Law's expenditure rule to fiscal consolidation[9].

In the area of public procurement, limited progress has taken place in 2019. Most of the measures put forward in the Draft Budgetary Plan date back to 2018. The new law on public sector contracts, introducing measures to enhance competition and ensure transparency and effective control mechanisms in public procurement, came into force in March 2018. Its effectiveness depends, to a large extent, on the level of ambition in its implementation and on the degree of ownership at all levels of government. The new envisaged governance bodies have still not been fully set up or are not yet operational, and the adoption of the planned Procurement Strategy is delayed.

The 2011 and 2013 reforms helped to ensure the sustainability of pensions in the long term. However, a continuation of the relinking of pension increases to inflation (as decided in 2018, 2019 and planned in the Draft Budgetary Plan for 2020) and the postponement of the sustainability factor would require compensatory measures to ensure the sustainability of the pension system in the medium to long term.

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. In mid-2019, AIReF, on behalf of the Ministry of Finance, completed seven spending reviews of specific policy areas. The implementation of the recommendations stemming from the reviews has started but is limited by the caretaker nature of the government. The Draft Budgetary Plan includes savings on social transfers and subsidies, assuming the implementation of recommendations from the relevant spending review (See Section 3 for further details). On 14 December 2018, Spain's Council of Ministers commissioned AIReF to carry out four additional spending reviews, focusing on pharmaceutical and equipment expenditure in hospitals, investments in public infrastructure, tax expenditure and hiring incentives. They are expected to yield first results in early 2020. As reported in Section 3, the Draft Budgetary Plan already incorporates EUR 500 million of higher social contributions in 2020 that would stem from the implementation of an ongoing review of hiring incentives.

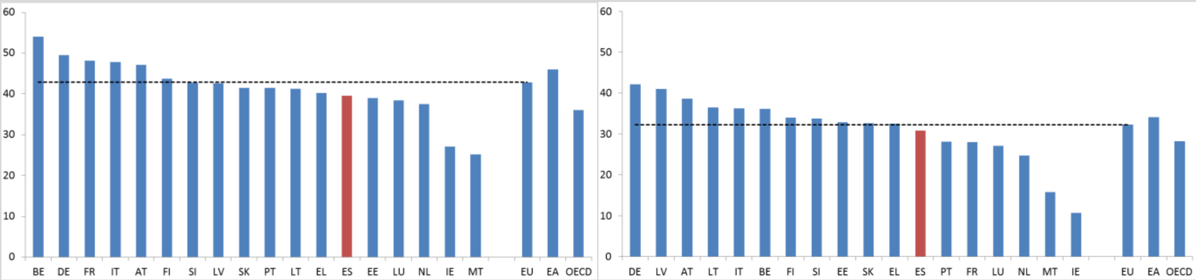
9 As noted in previous assessments of the DBP, Spain's expenditure rule could be strengthened by broadening its scope (to include the general government), by calling on non-compliant public administrations to make up for spending slippages after their occurrence and by setting the reference rate of growth of eligible expenditure in due consideration of whether Spain has reached the medium-term budgetary objective or not.

Box 4 – 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 (left) and at low wage (right) – 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.

Being of a no-policy-change nature, Spain's Draft Budgetary Plan does not contain any new measures that affect the tax wedge on labour.

6. OVERALL CONCLUSION

Based on the Commission 2019 autumn forecast the structural improvement in 2019 and 2020 falls short of the minimum linear structural adjustment to ensure sufficient progress towards compliance with the debt criterion.

Following an overall assessment of the Draft Budgetary Plan, the projected structural adjustment points to a risk of significant deviation from the recommended adjustment path to Spain's medium term objective. This follows from both the expenditure benchmark and the structural effort indicators for both 2019 and 2020. This assessment is broadly confirmed following an overall assessment based on the Commission 2019 autumn forecast.