Deficit reduction in Spain: Uncertainty persists

Charged with bringing down a high structural deficit, Spain's new government has proposed a revised roadmap for fiscal consolidation. However, given the current political climate, receiving the necessary support remains a challenge.

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Abstract Spain's fiscal outlook is far from clear. With a structural deficit incompatible with fiscal stability and substantially higher than those seen in the EU, the fiscal landscape is undoubtedly one of the Spanish economy's biggest weaknesses. Facing the very real possibility of interest rate hikes, international financial market tensions and lower economic growth, the PSOE government has recently proposed a new fiscal strategy that includes upward revisions to the deficit targets for 2019–2021. Additionally, receiving Parliamentary support for the recently presented 2019 GSB will be difficult and the revenue estimates included in the project to achieve an ambitious 1.3% of GDP target initially agreed upon with the EU will too be difficult to achieve. [1]

Introduction

In 2018, Spain deviated significantly from its Stability Programme target, albeit in line

> "Facing a difficult political landscape, the new government opted to take an alternative approach to deficit reduction."

with revised estimates provided when the General State Budget for 2018 (2018-GSB) was approved. In April, the since departed Partido Popular (PP) government presented an updated version of the 2018–2021 Stability Programme, with a deficit target of 2.2% of GDP for 2018. [2] With the previous year's budget rolled over, the PP also worked to negotiate a 2018-GSB that required the support of other parties with seats in the Lower House.

Over the course of those negotiations, expenditure and tax concessions were added that gradually made meeting the deficit target an increasingly tough proposition (Lago-Peñas, 2018). Just when that process was in the final stages, a no-confidence vote ousted the PP from power in June, putting Spain's socialist party, the PSOE, into government with an even fewer number of seats in the Lower House than held by the PP.

The new government opted to take an alternative approach. First, it accepted the draft 2018-GSB it had inherited, assuming it would garner ample support in the House, as it had been drafted and supported by the parties now in opposition and the timing of the entire process was significantly off track. Second, it notified the European Commission that it would miss the deficit target initially agreed for 2018 because the budget dynamics it inherited would require sharp and swift adjustment and do considerable harm to growth in Spain. Although the Commission has not been explicit about this, all signs suggest the rationale of the new government has been accepted and that ending the year with a deficit of less than 3% will be sufficient to avoid a fine. [3] The even more complicated fiscal situation in other countries has undoubtedly helped (Conde-Ruíz, García and Rubio-Ramirez, 2018). Finally, the PSOE decided to focus on the 2019-GSB, in which it could crystallise its own programme and agreement with its main political ally (Podemos).

This new fiscal strategy, which includes upward revision of deficit targets for 2019–2021, was presented in July (Ministry of Finance, 2018a) and was rapidly dismissed by the leaders of the PP and Ciudadanos, which between them have a majority in the Senate and must approve the change. This legal requirement has created a barrier that the government has not been able to surmount, despite several attempts to rewrite the law to this end.

As of January 2019, nothing has changed. Today we are looking at two different deficit target roadmaps: one approved in April 2018 and still in effect today, and another proposed by the current government that received majority support in the Lower House on December 20th, 2018. According to the government, this proposal would have been acceptable to the European Commission, but it was formally rejected by the Senate on December 27th.

Outlook for the end of 2018

The budget outturn figures to October 31st show a significant deficit reduction (Exhibit 1). Leaving local authorities aside, the deficit to end October stood at 1.07% of GDP, compared to 1.7% in the first ten months of 2017, a reduction of 0.63 percentage points of GDP. Meanwhile the figures for local authorities (to September 30th) point to a slightly smaller surplus in 2018 than in the same period of 2017: 0.36% *versus* 0.47%. Putting all the data together, by the last quarter of the year, the deficit was running half a point lower year-on-year, sufficient to meet the revised target, but not the original deficit target of 2.2%.

Projections compiled by various public and private institutions for the year show an unusual degree of consensus and are in line with the figures above. As of January, the Funcas consensus deficit forecast (Funcas, 2019), the Spanish supervisory institutions (AIReF, 2018b and Bank of Spain, 2018) and the international institutions (IMF, 2018; OECD, 2018; European Commission, 2018a) are all expecting a deficit of 2.7% of Spanish GDP in 2018.

One positive takeaway is that regional and local governments have ceased to be a problem. Although international analysts have highlighted the impact of the decentralised government structure on the delivery of fiscal targets in the past, both regional and local governments are set to meet their original targets for 2018 and, combined, may generate a small surplus (~0.1pp) that will partially mitigate the shortfalls anticipated at the central government and Social Security levels. Despite sharp growth in employment in recent years, Social Security has been unable to generate a surplus.

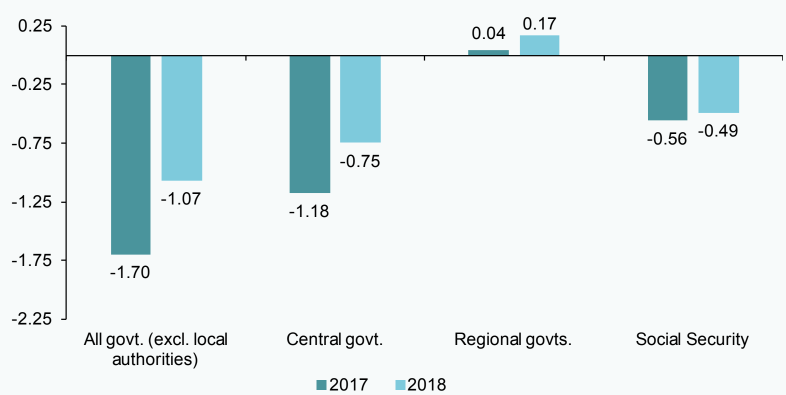
Returning to aggregate numbers, Exhibit 2 shows one of the main effects of the developments of 2018. Aside from the cycle's positive impact on public accounts, the structural deficit has not notably declined, returning once again to over 3%. In fact, the trend since 2015 clearly shows the deficit correction effort of recent years has been driven exclusively by the economic situation. The structural deficit remains at levels clearly incompatible with fiscal stability and the necessary reduction in public borrowings – currently around 100% of GDP. The contrast with the overall trend in the European Union is evident, with the EU's structural deficit substantially lower (around 1%) and dropping over the last five years. The fiscal landscape is without a doubt one of the Spanish economy's biggest weaknesses, with interest rate hikes, international financial market tensions and lower economic growth all plausible scenarios.

Political consensus would be valuable and useful on three fronts. First, there is a pressing need to reform the Spanish tax system to generate higher, more efficient and more

Exhibit 1

Government deficit (-) / surplus (+) to October 31st for 2017 and 2018

Percentage of GDP



Source: Author based on Ministry of Finance report (2018b).

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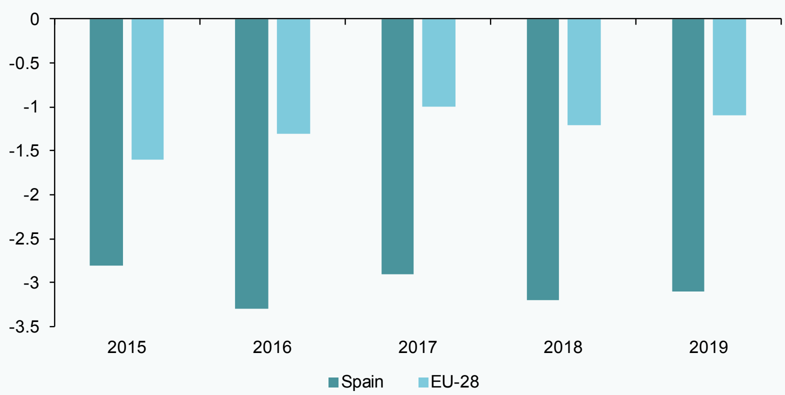
Exhibit 2 **Estimated (cyclically-adjusted) structural budget balances, 2015-2019**

Percentage of GDP



Source: Author, based on European Commission figures (2018a).

equitable tax revenue, as well as eliminate all manner of tax breaks and reduce fraud. Second, reconfiguring the structural income and expense structure of Social Security in light of the recent analysis of sustainability issues by the AIReF, Spain's independent fiscal institution (IFI) (AIReF, 2019). Lastly, performing a widespread and rigorous assessment of the social return on spending to reconsider programmes with fewer benefits for society, projects with a negative social surplus and current expenditure. The spending review being conducted by the AIReF (http://www.airef.es/es/spending-review/), as mandated by the central government, is a step in the right direction, but is clearly insufficient given the major institutional and cultural shortcomings of evaluating public policies in Spain (Albi and Onrubia, 2016).

An uncertain future

The Spanish government presented a budgetary plan for 2019 in October of last year that aims to meet a deficit target of 1.8% and has been examined by the European Commission (2018b) and the AIReF (2018a). The response from the European Commission can be described as moderately pessimistic. It acknowledges that the plan implies a downward adjustment to the budget imbalance, but calls it insufficient. The Commission is forecasting a deficit of 2.1% in 2019 (0.3pp above the government target) shaped mainly by a revenue shortfall. Specifically, the Commission views as overly optimistic the forecasts for tax receipts from new taxes on financial transactions and certain digital services (the so-called Google tax), the impact of adopting best international practices for the control of tax fraud and the positive impact of the planned increase in the Social Security earnings cap. In total, it expects tax revenue to come in 0.2pp of GDP below the government's forecasts. It also believes the various promises and new initiatives in pensions, education, R&D and social policy will cost Spain 0.1pp more than forecast. The Commission warns of the risk of non-compliance and the scant progress that has been made in reducing the structural deficit.

The AIReF (2018a) is more generous in its assessment, considering the delivery of the 2019 target feasible (but not probable). It assigns a probability of 48% to meeting the target, which is halfway between its 60% threshold for qualifying an event as probable and 40% as improbable. This greater optimism is partly due to the fact that the AIReF assessment includes the increase in the Social Security earnings cap, a new development that was not in the draft sent to Brussels and which is estimated to generate an additional 0.1pp of revenue (between 1 and 1.1 billion euros).

Starting with revenue, the estimates compiled by Spain's IFI separate the government's forecasts into three main areas: the new tax on certain digital services; the effort to stamp out fraud; and the forecast increase in receipts from the wealth tax. The AIReF is forecasting revenue from the digital services tax of a maximum of 968 million euros, compared to the government's forecast of 1.2 billion euros. As for the gains from tighter control over tax fraud, the institution is forecasting revenue of between 200 and 270 million euros, well below the 500 million euros in the budgetary plan. Finally, the 339 million euros of additional revenue from wealth taxes estimated by the government is not factored in because it is entirely up to the regional governments to determine what wealth tax rates to apply.

In sum, the shortfall detected by the AIReF would be offset by the increase in the Social Security cap, with the 7.18 billion euros of additional revenue included in the budgetary draft falling within the IFI's confidence interval of between 6.07 and 7.7 billion euros. On the spending side, the AIReF endorses the government's figures except for the estimated cost of restating pensions, the increase in the minimum and non-contributory pensions and the elimination of co-payments for the most vulnerable pensioners. Compared to the budgetary draft estimate of 2.53 billion euros, the AIReF estimates additional expenditure of 2.89 billion euros, 361 million more than the government.

In short, the government's budgetary plan for 2019 is thought to be close to being able to meet a deficit target of 1.8%. With certain adjustments, such as those introduced since its initial presentation, it is already on target within a reasonable level of confidence. However, as the AIReF explicitly states in its report, "there is little margin for accommodating potential deviations in the estimated impact of the measures announced", and less margin still to head into budget negotiations. As we saw with the 2018-GSB, this tends to result in higher spending commitments and lower revenue collection forecasts. In recent weeks, the situation has become even more complicated. On January 11th, the government presented its draft 2019-GSB in which it assumes that until the Senate opposition to the new roadmap is resolved, 1.3% is the deficit to be targeted. And that requires squeezing out an addition 6.2 billion euros (0.5pp of GDP).

The draft 2019-GSB shows the extreme difficulty of reconciling three objectives. First, the expenditure and revenue projections must be proven technically feasible. Second, the accounts must sufficiently reflect the commitments made to increase spending

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> Although the challenge is formidable, the government has a few elements in its favour.

and tax collection with the parties to the left of the PSOE and which are already featured in the budgetary plan. Third, as noted above, the government must carve out additional room for financial manoeuvring to secure the support it needs to get the draft through parliament.

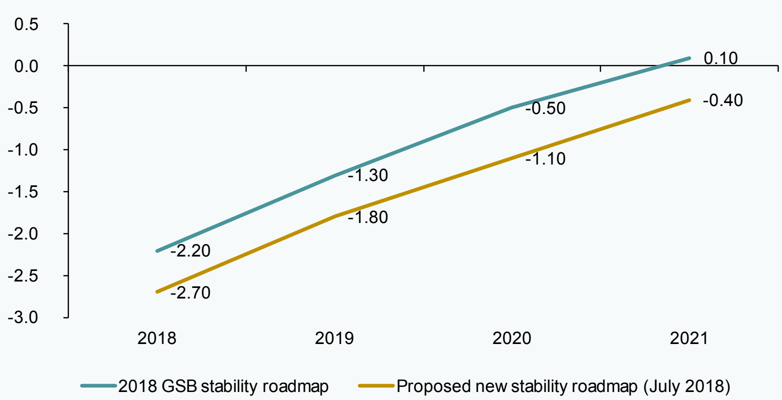
Essentially, what the government has opted to do is maintain its original budgetary plan without introducing additional measures with a significant impact on either revenue or spending. Of the 0.5pp of additional deficit-cutting required, 0.2pp must be delivered by the regional governments according to the Stability Programme. The plan assumes that the remaining 0.3pp would be offset via higher tax revenue elasticity. Based on forecast real and nominal GDP growth of 2.2% and 3.8%, respectively, the draft 2019-GSB models growth in tax receipts of over 10%. In comparison with preliminary estimates for tax collection in 2018, corporate income tax is expected to increase by 13.7%, VAT by 11.7% and the so-called special duties by 11.8%. Even considering the impact of the increases in taxation contemplated in the budgetary plan, these figures are very high in light of past experience and available studies. Against this backdrop, delivery of the revenue forecasts, while feasible in the budgetary plan, looks improbable in the 2019-GSB. On the spending side, meanwhile, the negotiations will likely only exert upward pressure.

At this juncture, the probability of passing the AIReF's and the European Commission's budget feasibility tests and simultaneously garnering majority support in the Lower House is low, unless the Senate's opposition to resetting the deficit roadmap can be surmounted in the weeks to come. The resistance displayed by the Partido Popular to date makes this improbable. As shown in Exhibit 3, the new roadmap is similar to that approved by the last government, except for a one-time difference of 0.5pp in 2018 as a

Exhibit 3

Budget deficit (-) and surplus (+) targets, 2018-2021

Percentage of GDP



Source: Author, based on Ministry of Finance report (2018a).

result of the 2018-GSB, which was essentially drawn up and negotiated by the PP. [4]

What the new government wants to do is to treat that deviation as a step change, and adjust the deficit between 2019 and 2021 at exactly the same pace as originally planned. Therefore, it is foreseeable that the PP will oppose the 2019-GSB because it implies a different mix of expenditure and revenue than it pursued consistently while in government.

Notes

[1] The author would like to thank Fernanda Martínez and Alejandro Domínguez (GEN) for their assistance and Carlos Cuerpo and Javier Pérez for their input.

[2] In keeping with the targets made public in July 2017.

[3] The Commission's recent assessment of the budgetary plan for 2019 endorses this expectation (European Commission, 2018b). Having noted the certain deviation from target, the Commission states: "however, at 2.7% of GDP, the headline deficit is forecast to be below the Treaty reference value of 3.0% in 2018, in line with the deadline set by the Council".

[4] The European Commission (European Commission, 2018a: 103) itself reaches a similar conclusion: "The somewhat slower pace of deficit reduction is due to measures included in the 2018 budget law, namely the higher revaluation of pensions, the pay hike for public employees and, to a lesser extent, the tax cut for low-income earners."

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