2012 and 2013: Two fundamental years for fiscal consolidation

Ángel Laborda and María Jesús Fernández[1]

Reaching fiscal consolidation targets is proving more difficult than expected. However, significant results have been achieved in the past year and are likely to continue in 2013.

The deterioration of Spain's public accounts and investors' loss of confidence are among the most visible effects of the economic crisis. Although there is disappointment at falling short of fiscal targets, consolidation efforts in 2012 have been significant and it is likely that the same will be true in 2013. Further acceleration of the adjustment rate, particularly if this involves additional tax increases, could seriously damage the productive fabric and the financial system, which will not help in restoring investor confidence. On the other hand, greater involvement of European institutions and additional structural reforms may not yield visible results in the short term, but will contribute to long-term sustainability of public accounts while helping to raise confidence levels.

Introduction

One of the most visible effects of Spain's current economic crisis, along with the soaring unemployment rate, is the sharp deterioration in public accounts. Spain went from a surplus of 2.4% of GDP in 2007 to a deficit of 11.2% in 2009, and by 2012 government debt had risen by around 50 percentage points of GDP. These developments, and the fear that the cost of bailing out and consolidating the financial system could considerably worsen imbalances, have led to a serious loss of confidence among investors, who have come to doubt the government's ability to meet its financial commitments. The result has been an increase in the country-risk premium and a severe financial squeeze on the economy as a whole. Against this backdrop, the response of the Spanish and European authorities was to seek to return the public accounts to financial stability and speed up compliance with the Stability and Growth Pact. In May 2010, the Council of Ministers revised the budgetary stability targets for the three years from 2011 to 2013, and set a deficit target of 6% for 2011, 4.4% for 2012, and 3% for 2013.

However, fiscal consolidation is proving more difficult than anticipated. The 2011 financial year closed with a deficit initially estimated at 8.5%. This was subsequently revised to 9% (9.4% when aid to financial institutions is included). The main reasons for this substantial deviation were the

[1] *Funcas Economy and Statistics Department.*

slippage in the autonomous regions' accounts in an election year and the deteriorating overall situation, which plunged the Spanish economy back into recession. This missed target, the high profile of the banking crisis, and the lacklustre management of the sovereign debt crisis by Europe's institutions, ended up compounding investors' loss of confidence in the Spanish economy.

With 2011 drawing to a close in an unfavourable economic context, the EU's Economic and Financial Affairs Council (ECOFIN) agreed a deficit target of 5.3% of GDP for 2012, instead of the 4.4% originally set. The general government budget was subsequently drawn up based on this figure. The new target meant cutting the deficit by more than three percentage points of GDP, in a context in which GDP was expected to contract by 1.7%, making it again over-ambitious. Consequently, this target was later revised upwards to 6.3% of GDP, and in the end, the current estimate is of a figure of 7.3%.

Although there is disappointment at falling short of the targets, significant results have been achieved in terms of fiscal consolidation in 2012 and it is likely that the same will be true in 2013. The calculations of the breakdown of the deficit suggest a correction in the structural component of between 2.5 and 3 percentage points of GDP in both 2012 and 2013. Speeding up the rate of adjustment, particularly if this requires tax increases, could seriously damage the productive fabric and the financial system, which will not help restore investors' confidence. There are other routes to restoring confidence, ranging from greater involvement by European institutions, to structural reforms to ensure the long-term sustainability of the public accounts, although the results will not be so visible in the short term.

This article examines how the public accounts progressed in 2012 and sets out the forecasts for 2013, accompanied by a brief analysis of the general economic conditions for the Spanish economy.

The macroeconomic context

2012 saw a turning point in the European debt crisis, with the announcement in July by the President of the European Central Bank that he would do whatever it took to save the euro. From this point on, the tensions in financial markets began to ease. Conditions improved further when the ECB announced its outright monetary transactions (OMT) debt purchase programme in September, the new bail-out for Greece was approved in November, and an agreement to avoid the "fiscal cliff" was struck in the United States.

The progress of the economy in the first half of 2012 was shaped by the severe credit squeeze and the uncertainty resulting from the debt crisis, which had erupted in the second half of the previous year. The European economy suffered a relapse, with zero or negative growth rates, albeit with significant differences between countries. Thus, whereas Germany managed to avoid recession, the countries of the periphery suffered a significant slowdown.

In Spain, Funcas' most recent estimates suggest GDP will contract by 1.4% over the year as a whole. This is a somewhat better result than was expected at the start of the year (Exhibit 1), and is basically explained by the improvement in the performance of exports of goods and tourism services. As in previous years, the drop in GDP came from the contraction in domestic demand, which has suffered a cumulative drop of 15% since the start of the crisis, whereas the external sector has made a positive contribution

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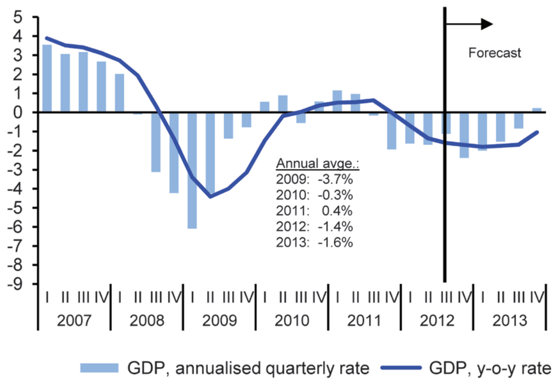
Exhibit 1

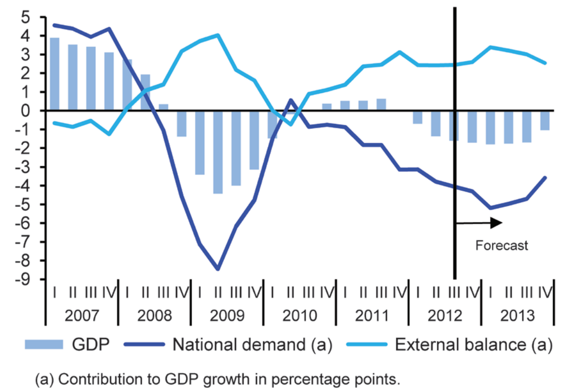
Spanish economy. Forecasts for 2012-2013

Change y-o-y in %, unless otherwise indicated

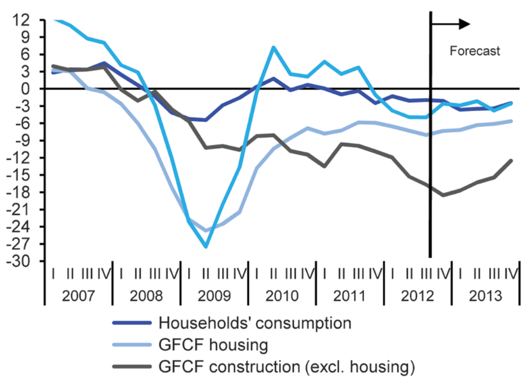
1.1 - GDP



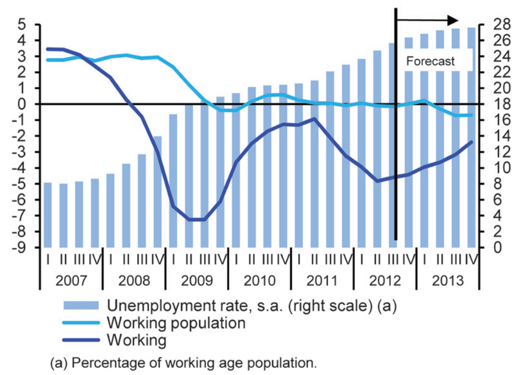
1.2 - GDP, national demand and external balance



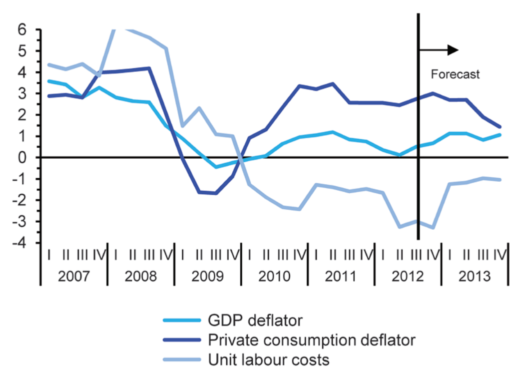
1.3 - National demand aggregates



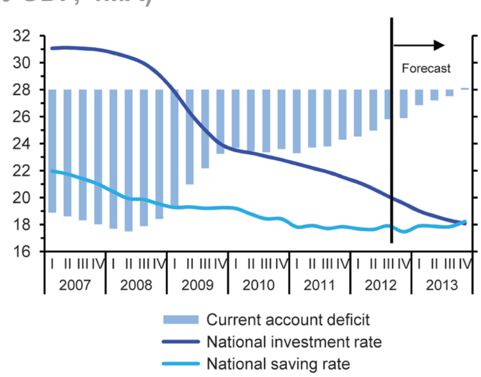
1.4 - Employment and unemployment



1.5 - Inflation



1.6 - Saving, investment and c/a deficit (% GDP, 4MA)



Sources: INE (Quarterly National Accounts) and Funcas (forecasts).

to growth. The slump in domestic demand, coupled with the increase in exports, enabled the deficit on the goods and services balance to be redressed, to the extent that it now shows a surplus for the first time since 1997.

Employment fell by 4.3% over 2012 as a whole, and the unemployment rate is likely to have ended the year at 26%. The increase in productivity deriving from sharp job losses, in conjunction with wage constraint, has led to a further drop in unit labour costs, on top of those already seen since 2010, and this had brought about a significant improvement in Spain's cost-competitiveness with respect to the rest of the euro area.

The inflation rate picked up strongly between July and October, although in the final months of the year it moderated to 2.9%. This level is high, but is entirely due to exogenous factors, such as the rising cost of energy products and the government's legislative changes aimed at curbing the deficit, such as the VAT rise, increased public charges and prices, and changes in the payment scheme for medications.

Thanks to the more favourable climate from July onwards, the return on Spanish ten-year government bonds has fallen from 6% to below 5.0% in January this year, while the risk premium has declined to 350 basis points from its high of 600 in July. Similarly, external finance has started to return and the volume of Spanish public debt held by foreign investors has begun to recover.

Nevertheless, the situation remains fragile and uncertainties abound, such that any unexpected event could shatter the stability of the last few months. Moreover, despite the recent improvement, access to international markets remains tight, and will continue to be so throughout much of 2013.

The aforementioned issues, in conjunction with the likely continuation of the adjustment to domestic demand and fiscal consolidation, implies that economic conditions will remain fairly restrictive in 2013, a year for which a drop in GDP of 1.6% is forecast. Nevertheless, the situation looks likely to improve later as the year progresses. The progress made in 2012 towards the consolidation and restructuring of Spain's troubled financial institutions helped dispel many of the uncertainties and risks hanging over the country's economy. There are now reasons to expect the current acute credit squeeze to gradually ease over the course of the year.

Progress towards the correction of the macroeconomic imbalances should make it possible to stabilise domestic demand towards the end of the year, such that its negative contribution to GDP growth will start to slacken off significantly, to the point that it will be completely offset by the positive contribution of the external sector. This will result in slightly positive GDP growth rates from this point on.

Fiscal policy in 2012

The calling of early elections in November 2011 led to a delay of six months in the submission and approval of the 2012 General State Budget (PGE-2012). This budget assumed a contraction of GDP of 1.7% in 2012, in real terms, and of 0.7% in nominal terms (Table 1). Funcas' current estimates, pending the data for the fourth quarter, suggest a drop that is three tenths of a percent smaller in real terms, but around three tenths of a percent larger in nominal terms, which is the more important variable for tax revenues. Two additional variables with a big impact on the public accounts are employment and unemployment. The budget predicted a drop in employment of 3.7% (3.8% among salaried employees), a figure that current estimates put close to 4.3% (5% among salaried employees). The unemployment rate was projected to rise from 21.6% in 2011 to 24.3%, while current estimates put it at approximately 25%. In short, although the first conclusion that can be drawn from the evolution of real GDP is that the macroeconomic context might have been slightly more favourable than foreseen in the budget

Table 1

Main forecasts for Spain 2012-2013

Average year-on-year change, as a percentage, unless otherwise stated

	2012						2013		
	Spring 2012 forecasts			Current forecasts					
	Govt. PGE-2012 (Apr. 2012)	FUNCAS (Apr. 2012)	FUNCAS forecast panel consensus (Apr. 2012)	Govt.	FUNCAS (Nov. 2012)	FUNCAS forecast panel consensus (Dec. 2012)	Govt.	FUNCAS (Nov. 2012)	FUNCAS forecast panel consensus (Dec. 2012)
Real GDP	-1.7	-1.7	-1.7	-1.5	-1.4	-1.4	-0.5	-1.6	-1.5
Private consumption	-1.4	-2.1	-1.8	-1.5	-1.8	-1.8	-1.4	-3.3	-2.3
Public consumption	-8.0	-6.6	-7.1	-4.8	-4.0	-4.3	-8.2	-4.9	-6.4
Gross fixed capital formation	-9.0	-8.1	-8.4	-9.9	-9.0	-8.3	-2.1	-7.9	-6.1
- GFCF construction	-9.9	-10.0	-10.4	--	-11.6	-11.5	--	-11.1	-8.4
- GFCF equipment	-7.3	-4.6	-6.0	--	-4.1	-6.3	--	-2.9	-3.0
DOMESTIC DEMAND	-4.4	-4.4	-4.2	-4.0	-3.8	-3.8	-2.9	-4.5	-3.9
Exports	3.5	3.3	3.1	1.6	3.2	3.3	6.0	4.5	4.7
Imports	-5.1	-5.5	-5.7	-6.7	-4.7	-4.5	-1.5	-4.6	-3.0
EXTERNAL BALANCE (1)	2.7	2.7	2.5	2.5	2.4	2.4	2.3	2.9	2.4
Nominal GDP: - € billions	1,065.4	1,065.5	--	1,050.6	1,052.9	--	1,062.9	1,046.6	--
- Change (in %)	-0.7	-0.7	--	-1.2	-1.0	--	1.2	-0.6	--
GDP deflator	1.0	1.0	--	0.3	0.4	--	1.6	1.0	--
CPI	--	2.2	1.8	--	2.5	2.4	--	2.1	2.2
Employment (nat. acc.)	-3.7	-3.6	-3.3	-4.0	-4.3	-4.2	-1.2	-3.2	-2.9
Unemp. rate (% labour force)	24.3	24.5	24.0	24.6	25.1	24.9	24.3	27.3	26.5
B.P. deficit c/a (% of GDP)	-0.9 (2)	-1.9	-1.8	-1.9	-2.1	-1.8	0.1	0.2	0.0
Govt. deficit/surplus (% GDP) (3)	-5.3	-6.2	-5.8	-6.3	-7.3	-7.2	-4.5	-5.6	-5.6
Government debt (% of GDP)	79.8	79.7	--	85.3	86.4	--	90.5	94.3	--

(1) Contribution to GDP growth in percentage points.
(2) Net borrowing vis-à-vis rest of world. In 2011 this was 0.5% of GDP less than the current account deficit.
(3) Excluding aid to financial institutions.

Sources: Ministry of Economy and Finance (PGE-2012-2013) and FUNCAS.

(and therefore with a positive effect on the general government deficit), the reality is that nominal GDP growth, the composition of that growth and the evolution of the labour market and salaries (the main basis of personal income tax) have all shown significant deviations, which has had a negative impact on the deficit.

Although the evolution of real GDP may suggest that the macroeconomic context might have been slightly more favourable than foreseen in the budget, the reality is that nominal GDP growth, its composition and evolution of the labour market and salaries have all shown significant deviations, which has had a negative impact on the deficit.

Summarising the main budgetary targets, the PGE-2012 envisages a deficit in national accounts terms of 5.3% of GDP for the general government, 3.2 percentage points (pp) of GDP less than estimated for 2011 at the time. This deficit was broken down into 3.5% of GDP for the central government, 1.5% for the autonomous regions, 0.3% for local governments, and a balanced budget for the social security funds. This amounts to a highly restrictive fiscal policy, particularly in the context of a contraction in GDP. The reasoning behind this was basically the need to satisfy the

Table 2

Taxes collected by central government: Forecast and actual (cash)

	2011-2012 budget					Execution January-November		
	Millions of euros			% variation		Millions of euros		
	Budget 2011 (A)	*Execution 2011 (B)*	*Budget 2012 (C)*	*Budget vs. budget (C/A)*	*Budget vs. execution (C/B)*	*2011*	*2012*	*% Change 2012/2011*
A.- TOTAL TAXES								
1.- Total taxes	164,278	160,890	167,797	2.1	4.3	151,110	152,727	1.1
1.1.- Direct	91,506	89,640	98,720	7.9	10.1	82,764	86,054	4.0
- Personal income tax	71,761	69,803	73,106	1.9	4.7	65,226	65,910	1.0
- Corporate income tax	16,008	16,611	19,564	22.2	17.8	14,611	17,190	17.7
- Nonresidents income tax	2,540	2,040	2,411	-5.1	18.2	1,834	1,569	-14.4
- Quotas of pension fund rights, etc.	1,197	1,186	3,639	204.0	206.8	1,093	1,385	26.7
1.2.- Indirect	72,772	71,250	69,077	-5.1	-3.0	68,346	66,673	-2.4
- VAT	48,952	49,302	47,691	-2.6	-3.3	48,126	47,216	-1.9
- Special taxes	20,825	18,983	18,426	-11.5	-2.9	17,479	16,744	-4.2
- Others	2,995	2,965	2,960	-1.2	-0.2	2,741	2,713	-1.0
B.- TAXES SHARED WITH REGIONAL AND LOCAL GOVERNMENTS (INCOME TAX, VAT AND SPECIAL TAXES)								
2.- Total	141,538	138,088	139,223	-1.6	0.8	130,831	129,870	-0.7
2.1.- Income tax	71,761	69,803	73,106	1.9	4.7	65,226	65,910	1.0
2.2.- VAT	48,952	49,302	47,691	-2.6	-3.3	48,126	47,216	-1.9
2.3.- Special taxes	20,825	18,983	18,426	-11.5	-2.9	17,479	16,744	-4.2
C.- CENTRAL GOVERNMENT SHARES OF INCOME TAX, VAT AND SPECIAL TAXES								
3.- Total	68,641	65,233	47,367	-31.0	-27.4	64,128	43,046	-32.9
3.1.- Income tax	35,494	33,544	29,232	-17.6	-12.9	32,054	24,522	-23.5
3.2.- VAT	24,968	25,355	13,633	-45.4	-46.2	26,190	14,901	-43.1
3.3.- Special taxes	8,179	6,334	4,502	-45.0	-28.9	5,884	3,623	-38.4
C.- REGIONAL AND LOCAL GOVERNMENTS SHARES OF INCOME TAX, VAT AND SPECIAL TAXES								
4.- Total	72,897	72,855	91,856	26.0	26.1	66,703	86,824	30.2
4.1.- Income tax	36,267	36,259	43,874	21.0	21.0	33,172	41,388	24.8
4.2.- VAT	23,984	23,947	34,058	42.0	42.2	21,936	32,315	47.3
4.3.- Special taxes	12,646	12,649	13,924	10.1	10.1	11,595	13,121	13.2

Sources: Ministry of Finance.

commitments made to the EU in order to make rapid progress towards fiscal consolidation and comply with the Stability and Growth Pact, and thus tackle the sovereign-debt crisis and rebuild the confidence of financial markets in the more vulnerable countries. Subsequent to the budget's approval, on July 10th, during the so-called Europe week, the ECOFIN revised the deficit target to 6.3%. This was in response to the upward revision of the deficit in 2011 and the fact that revenue was performing worse than expected. This modification was assigned to the central government, such that its deficit target was set at 4.5% of GDP.

To meet these targets, given that the tax revenue forecasts deriving from the macroeconomic situation pointed towards a significant drop, the PGE-2012 included a number of fiscal measures that, together with others already in place, represented an increase in central government tax revenues of 12.3 billion euros. Thanks to

Table 3

Central government 2012 budgetary execution up to November

	2011-2012 budget					Execution January-November		
	Millions of euros		% change	Millions of euros		Millions of euros		
	Budget 2011 (A)	Execution 2011 (B)	Budget 2012 (C)	2012 Budget vs. 2011 budget (C/A)	2012 Budget vs. 2011 execution (C/B)	2011	2012	% Change 2012/2011
A. NATIONAL ACCOUNTS								
1.- Non-financial resources	--	137,518	--	--	--	92,446	97,312	5.3
2.- Non-financial applications (expenses)	--	169,097	--	--	--	144,262	143,222	-0.7
3.- Deficit (Financing needs)	-24,388	-31,579	-36,976	--	--	-51,816	-45,910	-11.4
3.a.- Deficit as % of annual GDP	-2.3	-3.0	-3.5 (b)	-1.2 (a)	-0.5 (a)	-4.9	-4.4	0.5 (a)
3.b.- Deficit as % of annual GDP, excluding regional and local governments settlements from prev. years	-4.8	-4.6	-3.5 (b)	1.3 (a)	1.1 (a)			
B.- CASH								
4.- NON-FINANCIAL INCOME	106,020	104,331	119,233	12.5	14.3	97,396	108,318	11.2
4.1.- Taxes	91,381	88,035	75,941	-16.9	-13.7	84,407	65,903	-21.9
4.1.1.- Direct	55,239	53,381	54,846	-0.7	2.7	49,592	44,666	-9.9
- Personal income tax	35,494	33,544	29,232	-17.6	-12.9	32,054	24,522	-23.5
- Corporate income tax	16,008	16,611	19,564	22.2	17.8	14,611	17,190	17.7
- Nonresidents income tax	2,540	2,040	2,411	-5.1	18.2	1,834	1,569	-14.4
- Quotas of pension fund rights, etc.	1,197	1,186	3,639	204.0	206.8	1,093	1,385	26.7
4.1.2.- Indirect	36,142	34,654	21,095	-41.6	-39.1	34,815	21,237	-39.0
- VAT	24,968	25,355	13,633	-45.4	-46.2	26,190	14,901	-43.1
- Special taxes	8,179	6,334	4,502	-45.0	-28.9	5,884	3,623	-38.4
- Others	2,995	2,965	2,960	-1.2	-0.2	2,741	2,713	-1.0
4.2.- Non-tax income	14,639	16,296	43,292	195.7	165.7	12,989	42,415	226.5
5.- NON-FINANCIAL PAYMENTS	150,056	151,095	152,630	1.7	1.0	135,863	136,056	0.1
5.a.- Payments excluding interest	122,635	128,891	123,754	0.9	-4.0	113,908	110,519	-3.0
5.1.- Current expenses	132,406	133,835	139,950	5.7	4.6	121,935	127,174	4.3
5.1.1.- Staff costs	26,982	27,420	27,339	1.3	-0.3	23,767	23,834	0.3
5.1.2.- Purchases of goods and services	3,385	4,319	3,238	-4.3	-25.0	3,308	2,586	-21.8
5.1.3.- Interest	27,421	22,204	28,876	5.3	30.0	21,955	25,537	16.3
5.1.4. Current transfers	74,618	79,892	80,498	7.9	0.8	72,905	75,217	3.2
5.2.- Capital expenses	15,178	17,260	10,302	-32.1	-40.3	13,928	8,882	-36.2
5.2.1.- Real investments	5,817	6,895	5,280	-9.2	-23.4	5,473	4,852	-11.3
5.2.2.- Capital transfers	9,362	10,365	5,022	-46.4	-51.5	8,455	4,030	-52.3
5.3.- Contingency fund	2,472	--	2,377	-3.8	--	--	--	--
6.- CASH BALANCE (4-5)	-44,036	-46,764	-33,397	-24.2	-28.6	-38,467	-27,738	-27.9
6.a.- Deficit as % of annual GDP	-4.1	-4.4	-3.2	1.0 (a)	1.2 (a)	-3.6	-2.6	1.0 (a)
6.b.- Primary cash balance (4-5.a)	-16,615	-24,560	-4,521	-72.8	-81.6	-16,512	-2,201	-86.7

(a) Change in percentage points of GDP.

(b) This deficit target was modified to -4.5% subsequent to the approval of the PGE-2012.

Source: Ministry of Finance.

this, forecast tax revenues rose by 4.3% on the previous year (Table 2). Some of the most significant measures were a supplementary income tax rate (4.1 billion euros), a number of changes to corporate income tax (5.35 billion euros), a special tax on the fiscal regularisation of concealed income (2.5 billion euros), and other measures such as increasing the tax on tobacco products and levying court fees.

Estimates based on the data available up to November suggest that the **central government** will meet its deficit target for 2012 (Table 3). Revenues were increasing by less than initially expected, but the upward path followed in previous months will continue, bringing revenues closer to the target when December's revenue is included. This progression is the consequence of the additional measures taken in July, on top of those in the PGE-2012, basically affecting corporate income tax and value added tax (VAT). In the case of VAT, since September, the general rate has risen from 18% to 21% and the lower rate from 8% to 10%. At the same time, a series of goods and services to which the lower rate formerly applied are now subject to the full rate. The government's estimate of the impact of all the measures taken since 2011, effective in 2012, comes to 14.84 billion euros, 9.2% of total tax revenues in 2011. Based on an estimate for December, tax revenues for the year as a whole could suffer a downward deviation of around 3.65 billion euros. Nevertheless, it is foreseeable that the government might partially make up for this deviation with higher non-tax income than forecast.

The central government's payments registered near stability relative to the same period of 2011, as against forecast growth of 1% for the full year. It is foreseeable that in December these payments will moderate further due to the government's decree to eliminate public employees' Christmas bonuses.

The central government's non-financial cash balance to November registered a deficit of 27.74 billion euros, compared with 38.47 billion euros in 2011. In national accounts terms, the deficit came to 45.91 billion euros, a drop of 11.4% on the previous year. This figure represents 4.4% of the year's estimated GDP, 0.5 pp less than a year earlier. All these figures are fairly well aligned with the overall forecast for the year, making it plausible that the central government will meet its target, and it may even improve on it by a few tenths of a percent of GDP.

However, the way the **social security** system's income and expenses (excluding unemployment benefits) are evolving suggests that it will not be able to balance its budget as required. In the period up to November, non-financial income dropped by 1.4%, when it should have risen by 2% to match the budget. At the same time, expenses grew faster than forecast. Thus, adding in the estimates for December, a deficit of at least 5 billion euros looks likely. As might be expected, unemployment benefits, which are another important component of the social security funds' deficit, have also diverged from their earlier estimates. In the period to November, spending on unemployment benefits rose by 6%, compared with a forecast for the year as a whole of a reduction of 4%. Based on these data, the system's deficit can be estimated at 3.5 billion euros, making the social security funds' overall balance a deficit of 9 billion euros, or 0.85 pp of GDP.

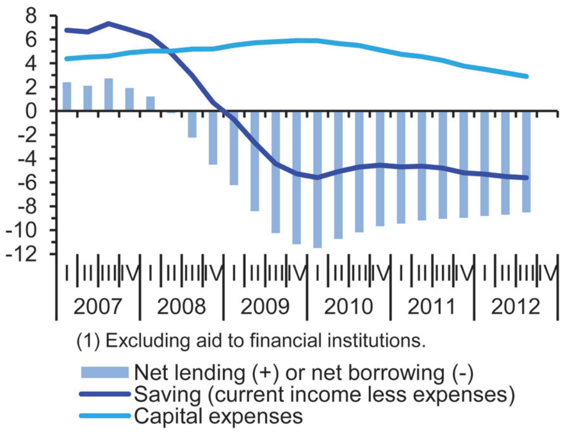
The most relevant information available for the **autonomous regions** is the estimate of their accounts (in national accounts terms) for the first three quarters of the year by the General Intervention Board of the State Administration (IGAE). These estimates show a deficit in uniform terms of 11.98 billion euros, or 1.14% of GDP, compared with 2.2% in the same period the previous year. In other words, the deficit has halved. Keeping the rate of reduction close to this for the third quarter leads to a figure of 1.9% for the year as a whole, which is 0.4 pp over the target.

Lastly, as regards the available statistical information, Exhibit 2 presents the quarterly national accounts on the progress of the total government deficit (as a percentage of GDP) up to the third quarter of 2012. The figure here was obtained as the difference between net savings and capital expenditure in terms of the moving sum over four quarters. As can be seen, savings (i.e. the difference between current revenues and current expenditures) improved slightly in 2010, but since early 2011 they have remained on a moderately downward path, ending the third quarter of 2012 with a negative figure equivalent to 5.6% of GDP. This trend is more marked in the case of capital

Exhibit 2

General government saving, investment and deficit (1)

Percentage of GDP, moving sum over four quarters

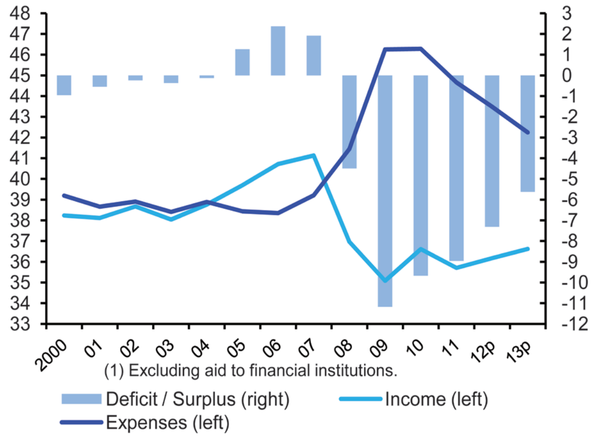


Sources: IGAE and INE.

Exhibit 3

Government income, expenses and deficit (1)

Percentage of GDP



Sources: Up to 2011, IGAE; 2012-13, FUNCAS forecasts.

expenditure, which has dropped to 2.9% of GDP (compared with 5.9% at the end of 2009). This has allowed the deficit to be reined in, albeit too slowly for it to bring the target for the year as a whole within reach. The deficit for the last four quarters up to the third quarter of this year, excluding aid for financial institutions, comes to 8.5% of GDP, just half a percentage point below that in the fourth quarter of 2011 and a long way from the target for the year as a whole of 6.3%.

Based on the foregoing data and analysis, and assuming that local governments meet their targets, the public administration as a whole could balance its 2012 budget with a deficit of 7.3% of GDP (excluding aid to financial institutions, which is valued at 1.1 pp of GDP). This figure is 1.7 pp of GDP lower than that for 2011, but 1 pp higher than the target approved by ECOFIN. The drop on the previous year would come from an increase in income of 0.5 pp of GDP and a cut in expenditures of 1.2 pp (Exhibit 3).

Table 4 shows our estimate (in national accounts terms) of the main income and expenditure items of the general government accounts. In these estimates, total income grew by a modest 0.3% in 2012, and tax revenues by 0.5%, outpacing nominal GDP growth by 1.5 pp. This implies an increase in the tax burden of 0.4 pp of GDP, partly offsetting the reduction in 2011. In the last three years, the tax burden has therefore regained 1.1 points of the 6.4 points it lost between 2008 and 2009.

On the expenditure side (excluding aid to financial institutions), a reduction of 3.6% on the previous year is envisaged. This basically derives from the drop in capital expenditures, as current expenditures fell only slightly, given that the reduction in public consumption and subsidies was offset by the increased spending on interest payments and welfare benefits. As a percentage of GDP, total expenditures shrank by 1.2 pp to 43.5%, a percentage that is 4.3 pp higher than in 2007.

Bearing in mind that the economy's growth was again below its long-term trend rate, the difference between actual and potential GDP (output gap) has once again widened. This means that the cyclical component of the public deficit has also

Table 4

General government accounts. Forecasts for 2012-2013 (Funcas)

	Billions of euros			*% y-o-y change*		*% of GDP*		
	2011 (P)	*2012 (F)*	*2013 (F)*	*2012 (F)*	*2013 (F)*	*2011 (P)*	*2012 (F)*	*2013 (F)*
1.- TOTAL RESOURCES (INCOME)	379.7	380.9	383.3	0.3	0.6	35.7	36.2	36.6
of which, tax revenues	330.5	332.0	334.8	0.5	0.8	31.1	31.5	32.0
1.1.- CURRENT INCOME	380.3	382.6	386.2	0.6	0.9	35.8	36.3	36.9
1.1.1.- Taxes on production and imports	105.0	106.0	113.2	1.0	6.8	9.9	10.1	10.8
1.1.2- Income and wealth taxes	101.6	106.9	106.7	5.2	-0.2	9.6	10.2	10.2
1.1.3.- Actual social contributions	129.0	124.9	121.4	-3.2	-2.8	12.1	11.9	11.6
1.1.4.- Other current resources	44.7	44.9	45.0	0.4	0.2	4.2	4.3	4.3
1.2.- CAPITAL INCOME (a)	-0.7	-1.7	-2.9	--	--	-0.1	-0.2	-0.3
2.- TOTAL APPLICATIONS (EXPENSES)(b)	475.0	457.7	442.1	-3.6	-3.4	44.7	43.5	42.2
2.b.- Total non-interest expenses (2 – 2.1.3)(b)	448.8	423.9	398.9	-5.6	-5.9	42.2	40.3	38.1
2.1.- CURRENT EXPENSES	435.5	431.9	425.3	-0.8	-1.5	41.0	41.0	40.6
2.1.b.- Total current expenses excl. interest (2.1 – 2.1.3)	409.4	398.1	382.1	-2.8	-4.0	38.5	37.8	36.5
2.1.1.- Remuneration of employees	123.6	118.1	112.6	-4.4	-4.7	11.6	11.2	10.8
2.1.2.- Intermediate consumption and production taxes	62.5	55.8	47.5	-10.7	-14.8	5.9	5.3	4.5
2.1.3.- Interest and other property income	26.1	33.8	43.2	29.3	27.8	2.5	3.2	4.1
2.1.4.- Social benefits	163.8	168.1	169.3	2.6	0.7	15.4	16.0	16.2
2.1.5.- Social transfers in kind	30.0	30.0	30.0	0.0	0.0	2.8	2.8	2.9
2.1.6.- Subsidies and other current transfers	29.6	26.1	22.7	-11.8	-13.0	2.8	2.5	2.2
2.2.- CAPITAL EXPENDITURES (a)	39.5	25.8	16.8	-34.6	-34.9	3.7	2.5	1.6
2.2.1.- Gross capital formation (c)	30.0	19.6	12.8	-34.6	-34.9	2.8	1.9	1.2
2.2.2.- Capital transfers (b)	9.4	6.2	4.0	-34.6	-34.9	0.9	0.6	0.4
3.- NET LENDING (+) OR BORROWING (-) (DEFICIT) (1 - 2) (b)	-95.3	-76.8	-58.8	-19.5	-23.4	-9.0	-7.3	-5.6
4.- Primary deficit/surplus (1 -2.b) (b)	-69.2	-43.0	-15.6	-37.9	-63.6	-6.5	-4.1	-1.5
5.- Aid to financial institutions	5.1	11.6	0.0					
6.- DEFICIT with aid to financial institutions	-100.4	-88.3	-58.8	-12.1	-33.4	-9.4	-8.4	-5.6
7.- Primary deficit with aid to financial institutions	-74.3	-54.5	-15.6	-26.6	-71.3	-7.0	-5.2	-1.5
MEMORANDUM ENTRY:								
8.- Gross disposable income	167.5	161.7	158.3	-3.5	-2.1	15.8	15.4	15.1
9.- Final consumption	222.7	210.9	197.3	-5.3	-6.4	20.9	20.0	18.9
10.- GROSS SAVING (8 - 9 = 1.1 - 2.1)	-55.2	-49.2	-39.1	-10.8	-20.6	-5.2	-4.7	-3.7
11.- Deficit of central government and agencies (b)	-31.4	-45.2	-36.8	43.7	-18.5	-3.0	-4.3	-3.5
12.- Deficit of Social Security funds	-0.8	-8.4	-10.5	989.7	24.2	-0.1	-0.8	-1.0
13.- Deficit of autonomous regions	-54.1	-20.0	-10.5	-63.1	-47.7	-5.1	-1.9	-1.0
14.- Local government deficit	-9.0	-3.2	-1.0	-64.7	-66.9	-0.8	-0.3	-0.1
15.- GROSS DEBT	736.5	909.8	987.0	23.5	8.5	69.3	86.4	94.3
16.- Nominal GDP mp	1063.4	1052.9	1046.6	-1.0	-0.6	--	--	--

(P) Provisional.(F) Forecast.

(a) Includes adjustment for uncertain collections.

(b) Excludes aid to financial institutions.

(c) Includes net acquisition of non-financial non-produced assets (land).

Sources: 2011, Ministry of Economy and Finance (IGAE) and INE; 2012-13, FUNCAS forecasts.

Table 5
Breakdown of government deficit

	2006	2007	2008	2009	2010	2011	2012 (F)	2013 (F)
Percentage of GDP								
1.- TOTAL DEFICIT	2.4	1.9	-4.5	-11.2	-9.7	-9.4	-8.4	-5.6
2.- Non-recurrent extraordinary expenses (a)	0.0	0.0	0.5	1.2	1.0	0.5	1.1	0.0
3.- Interest payments	1.6	1.6	1.6	1.8	1.9	2.5	3.2	4.1
4.- Recurrent primary deficit (1+2+3)	4.0	3.5	-2.4	-8.2	-6.7	-6.5	-4.1	-1.5
4.1.- Recurrent cyclical primary deficit	3.3	5.1	4.8	0.7	0.0	0.1	-1.4	-2.9
4.2.- Cyclically adjusted recurrent primary deficit STRUCTURAL PRIMARY DEFICIT) (4-4.1)	0.7	-1.6	-7.2	-8.9	-6.7	-6.6	-2.7	1.4
5.- Cyclically adjusted total primary deficit (TOTAL STRUCTURAL DEFICIT) (4.2-3)	-0.9	-3.2	-8.8	-10.6	-8.7	-9.0	-5.9	-2.7
Change on previous year in percentage points of GDP								
1.- TOTAL DEFICIT	1.1	-0.4	-6.4	-6.7	1.5	0.2	1.1	2.8
2.- Non-recurrent extraordinary expenses	0.0	0.0	0.5	0.7	-0.2	-0.5	0.6	-1.1
3.- Interest payments	-0.1	0.0	0.0	0.2	0.2	0.5	0.8	0.9
4.- Recurrent primary deficit (1+2+3)	1.0	-0.5	-5.9	-5.8	1.4	0.2	2.4	2.6
4.1.- Recurrent cyclical primary deficit	1.9	1.9	-0.3	-4.1	-0.7	0.1	-1.4	-1.6
4.2.- Cyclically adjusted recurrent primary deficit (STRUCTURAL PRIMARY DEFICIT) (4-4.1)	-0.9	-2.3	-5.6	-1.7	2.2	0.1	3.9	4.1
5.- Cyclically adjusted total primary deficit (TOTAL STRUCTURAL DEFICIT) (4.2-3)	-0.8	-2.3	-5.6	-1.8	2.0	-0.4	3.1	3.2

(a) Includes both expenses and loss of income. In 2011 and 2012 these are aid to financial institutions. (F) Forecast.(a) Includes adjustment for uncertain collections.

Sources: Author's own calculations forecasts based on data from the National Accounts up to 2011. The output gap, which is the starting point for the estimate of the cyclical component of the deficit, is obtained as the percentage difference between actual and potential GDP. the latter is extracted using the Hodrick-Prescott filter (lambda = 100).

increased, albeit much less than in the last two years. It can therefore be deduced that all the deficit reduction effort has come from a structural or discretional adjustment. Table 5 shows how the deficit breakdown has been calculated. It should be borne in mind that these figures may vary widely depending on the methodology used[2], although the differences are relatively minor when the variations in these components are analysed. And it is the components that are basically the most significant indicators when assessing the sign of budgetary policy and the fiscal consolidation effort. The drop in the total deficit estimated for 2012 is 1.7 pp of GDP, excluding support to financial institutions. Deducting the increase in interest payments from this figure yields a reduction in the primary deficit of 2.4 pp of GDP. This figure breaks down into an increase in the cyclical component of 1.4 pp and a decrease in the structural (discretional) component of 3.9 pp. Over the three years from 2010 to 2012 the structural component of the primary deficit has improved by 6.2 pp of GDP. Nevertheless, its level remains high, estimated at around 3 pp of GDP.

[2] *In the calculations given here, the output gap, which is the starting point when estimating the cyclical component of the deficit, is obtained as the percentage difference between actual (observed) and potential (trend) GDP, where the latter is obtained using the Hodrick-Prescott filter (lambda = 100).*

Forecasts for 2013

The 2013 budget

The 2013 budget (PGE-2013) forecasts a contraction in GDP of 0.5% in 2013, in real terms, and of 1.2% in nominal terms (Table 1). The real-term contraction is approximately one percentage point less than in the latest forecasts by international organisations and the consensus among private-sector analysts. Its composition shows a further significant decline in domestic demand (-2.9%), which is largely offset by the contribution of net external demand (2.3 percentage points). In the case of employment, the PGE-2013 forecasts a drop of 1.2%, which is also significantly less than envisaged by other forecasts. Average employee remuneration increases by 1.5%, with salaried employees' income rising by 0.3%. Here too, significant differences with other forecasts are apparent, as these project a drop in salaried

Table 6

Forecast government income, expenses, financing needs and debt in 2013

1.- NON-FINANCIAL INCOME

	Billions of euros		Change with respect to progress of 2012 settlement (%)	
	Govt.	Total (1)	Govt.	Total (1)
1.- Total	124.0	193.9	2.6	-9.0
2.- Taxes	104.2	174.1	37.7	3.7
2.1.- Direct	64.6	96.6	19.9	-1.5
- Pers. inc. tax	42.3	74.2	48.4	2.2
- Corp. inc. tax	19.0	19.0	-2.9	-2.9
- Others	3.4	3.4	-42.4	-42.4
2.2.- Indirect	39.6	77.5	81.6	11.0
- VAT	28.3	54.7	98.6	13.2
- Others	11.3	22.8	49.6	6.3
3.- Remainder	19.8	19.8	-56.2	-56.2
Memorandum entry:				
Nominal GDP		1062.9		1.2

2.- NON-FINANCIAL EXPENSES

	Billions of euros	Change with respect to initial 2012 budget (%)
1.- Total	162.1	6.2
2.- Current expenses	150.9	7.8
2.1.- Staff costs	27.7	1.2
2.2.- Purch. of goods and services	2.9	-12.0
2.3.- Interest	38.6	33.7
2.4.- Current transfers	81.8	1.6
3.- Capital expenses	8.6	-16.1
3.1.- Real investments	3.9	-13.9
3.2.- Capital transfers	4.7	-17.9
4.- Contingency fund	2.6	8.4
Memorandum entry:		
Current transfers, regional and local governments financing systems	35.3	-3.2
Total expenses, excluding regional and local governments financing systems	126.8	9.2
Total non-interest expenses, excluding regional and local governments financing systems	88.2	1.0

3.- FINANCIAL NEEDS (Billions of euros)

	PGE-12	PGE-13
1.- Deficit of non-financial transactions	33.4	38.1
2.- Changes in financial assets	3.4	10.0
3.- Debt repayments	149.3	159.2
4.- Total financial needs (1+2+3)	186.1	207.2

4.- GOVERNMENT DEBT

	2012	2013
1. Outstanding debt (billions)	677.9	728.8
2.- Debt according to Excessive Deficit Protocol (% of GDP)	66.1	70.2

(1) Including regional and local governments' share of income tax, VAT, and special taxes.
Sources: Ministry of the Economy and Public Treasury.

employees' income of 3%. The government expects the unemployment rate to fall to 24.3%, whereas other forecasts indicate a significant increase, to around 26.5%. The uncertainty surrounding the macroeconomic forecasts is undoubtedly high in the current context, but the overall assessment leads to the conclusion that the official figures may be sufficiently overoptimistic to have a serious impact on the budgetary forecasts.

Table 6 sets out the main **central government** income and expenditure headings included in the budget. Tax revenues, including the share of tax that corresponds to the autonomous regions and local governments, will increase by 3.7% relative to estimates for 2012. Central government tax revenues will grow by 37.7%, to 104.23 billion euros, while those destined for other levels of government will shrink by 24.1%. This difference in growth rates is due to the distortion caused in 2012 by the 2010 settlement in central government and autonomous regions' revenues, which boosted regional income above its "normal" level at the expense of central government income. This ceased to apply in 2013, causing a blip in the rate of change.

This increase in total tax income exceeds that in nominal GDP by a considerable margin, and that in domestic demand by a wider margin still. This is due to the fiscal adjustment measures adopted since December 2012, included in the PGE-2013, which will bring the treasury additional revenue of 7.22 billion euros in 2013 in net terms.

Non-tax income will fall in 2013 to 19.81 billion euros, 56.2% less, which will be largely compensated for by the sharp rise in taxes retained by the central government, and is mainly due to the same reasons, i.e. the settlement with the autonomous regions in 2012 for the 2010 financial year, which caused an anomalous increase in transfers to the regions from the central government. The overall effect of the increase in taxes and reduction in transfers for the autonomous regions is negligible, as the amount received under these two headings in 2013 (63.97 billion euros) will be practically the same as in 2012 (63.02 billion euros).

The central government's non-financial income is estimated at 124.04 billion euros, 2.6% more than in 2012. This increase looks reasonable if, despite the macroeconomic forecasts that suggest that the PGE-2013's estimates are over-optimistic, we assume that the tax-raising measures taken will produce the results the treasury expects. However, given that our estimates for the end of 2012 suggest that revenues will fall short of the budget's projections by 3.65 billion euros, the rate of variation applied to this income would lead to a figure that falls short by a similar amount in 2013.

The State's budgeted non-financial expenditures for 2013 come to 162.11 billion euros, 6.2% more than initially budgeted for 2012 (Table 6). This increase is basically due to the cost of interest (33.7%) and transfers to the social security to cover the cost of non-contributory pensions managed by the social security fund but paid for from the central government budget. Thus, expenditure assigned to ministries, excluding these latter items, has been reduced by 9.4%.

The difference between non-financial income and expenses foreseen in 2013 suggests the deficit will come to 38.06 billion euros. If the variation in financial assets of 9.96 billion euros is added to this figure, net borrowing (net issuance) comes to 48.02 billion euros. Repayments of government debt are estimated at 159.15 billion euros. From this it is possible to deduce financial needs (total issuance) of 207.17 billion euros, 21.04 billion more than initially envisaged for 2012. The outstanding government debt will rise from 677.9 billion euros in 2012 to 728.80 billion euros in 2013, or 68.6% of GDP (70.2% GDP according to Excesive Deficit Protocol).

As regards the **social security** system, its non-financial expense budget, which represents 41% of total consolidated central government expenditure, is now 125.80 billion euros, having grown by 5% compared to the initial budget in

2012. The main item, contributory pensions, will rise by 4.3%. These growth rates seem reasonable, although when they are applied to real 2012 expenditure, which is likely to exceed that budgeted, as already mentioned, they lead to an expenditure for 2013 which is also higher. Non-financial revenue is estimated at 125.69 billion euros, 4.8% more than in 2012. This is basically due to the increase in government transfers, given that the main item, namely employers' and employees' social security contributions, has increased by just 1.2%. However, this increase is not consistent with the consensus forecast of a reduction of around 3% in employees' earnings. If we add to this the fact that revenues in 2012 will be less than budgeted, the result is that 2013 revenues may be overestimated by approximately 6.5 billion euros. Although the budget foresees income and expenses being almost balanced, our forecasts suggest instead a deficit of around 9 billion euros, despite the sharp increase in transfers from the central government.

Going from public accounts in cash terms to national accounts terms, which use the accruals basis, the deficit of the central government and its agencies envisaged in the PGE-2013 rises to 40.90 billion euros, or 3.85% of GDP, the same figure as envisaged for the central government, including the social security system. The autonomous regions' deficit is projected to fall to 0.7% of GDP and local government is expected to be in equilibrium. The total deficit in 2013 for all levels of government therefore comes to 4.5% of GDP, against a target of 6.3% or our estimate of 7.3% in 2012.

Estimated public deficit in 2013

Table 4 shows the figures for Funcas' forecast of how the public accounts as a whole are expected to evolve in 2013 based on the data from the close of 2012, discussed in the previous section, and the forecasts that can be deduced from the PGE-2013. The 2013 budget expects revenues to grow by 0.6%, 1.2 pp more than Funcas' estimate of nominal GDP growth. Among the sources of revenue, taxes on production and imports show the biggest increase, explained by the increase in VAT rates and other measures already discussed. Income tax revenues remain practically unchanged, as the increase in personal income tax (due to the measures taken rather than growth in the tax base), will be offset by the drop in corporate income tax, which will shrink as a result of the increase in advance payments and other measures in 2012. Social security contributions drop by 2.8%, somewhat less than employees' earnings. As a percentage of GDP, total general government revenues could increase for the second consecutive year by around half a percentage point, to 36.6%. Nevertheless, this ratio is still 4.5 pp below its peak in 2007.

In the case of expenditures, excluding aid to financial institutions, a drop of 3.4% is foreseen, which is similar to that in 2012. This would be the third decline in a row. Excluding interest, which is set to rise to 28%, primary expenditure will fall by 5.9%. Public consumption, the main component of which is staff remunerations, will drop by 6.4%, with subsidies and other current transfers falling yet faster. However, the biggest fall is in the case of capital expenditure, down by almost 35%. Welfare benefits, which comprise the biggest expenditure category, are the only expenses showing an increase, although the rate is slower than in 2012, due to the cutbacks in unemployment benefits and other non-pension benefits. As a percentage of GDP, total expenditure will fall by 1.3 pp, a similar figure to that in 2012.

The estimates for income and expenses yield a deficit for the general government of 5.6% of GDP, 1.1 pp more than forecast by the government. This difference is partly explained by the different initial macroeconomic picture, but in particular by the deviation in 2012, which, in the absence of additional corrective measures, will spill over into 2013. In any event, as in 2012, the 1.7 pp of GDP reduction in the deficit in a further year of recession is a sign of significant fiscal consolidation. Making a bigger effort would have an excessively restrictive impact on aggregate demand growth and employment with negative consequences for the current process of consolidating the financial system, and in the long term, for the process of fiscal consolidation.

The estimates of the various deficit components (Table 5) show an improvement in the primary structural deficit (cyclically adjusted balance excluding interest payments and aid to financial institutions) of 4 pp of GDP, similar to that in 2012, making it positive for the first time in seven years. The total structural deficit would be situated below 3%. If these forecasts are met, the total structural deficit adjustment between 2012 and 2013 will have been substantial, with a reduction of around 6 pp of GDP. This would enable to slow the rate of adjustment in 2014, so as to minimise the impact on economic growth.