National Reform Program for 2013: Fiscal consolidation and stimulating growth

Sara Baliña[1]

New measures seek to strike a balance between stimulating economic growth and cleaning up public accounts.

The Spanish government unveiled, within the framework of the Stability and Growth Program for 2013-2016, the National Reform Program for the current year. The main policy lines were mostly already known, as they were included in the previous version or they had been announced beforehand. Delays in the implementation of some reforms, such as those related to rationalizing the public administration, and the need to further develop the details of other policies already in force, such as public pensions or labor reform, mean that the key elements of the 2013 Program are an extension of those from last year.

Introduction

The recommendations made by the European Commission in its review of Spain's compliance with the excessive deficit procedure criteria are reflected in the main components of the National Reform Program (henceforth, the NRP). The fact is that, even more than in previous years, the nature of the NRP should be understood in the context of an economic policy strategy defined by Europe. Since they were decided in mid-2012 to prioritize the implementation of structural reforms in economies with sizable macroeconomic disequilibria and weak growth perspectives in exchange for flexibility in public deficit targets, national reform programs began to acquire greater relative weight in the economic policy road map of peripheral euro area countries.

In the case of Spain, the upward revision of the public deficit targets of the next three years, which means putting off until 2016 the objective of 3% of GDP, does not lighten the burden of the fiscal consolidation measures in the NRP, although it does ease potential impact on the economic cycle of the reduction in current public expenditure and acknowledges the need to introduce changes in the fiscal structure. Further planned modifications in the labor law and the pension system are postponed ─with no timetable yet available─ until the completion of an assessment report on the impact of the 2012 labor law reform in the former case, and until the announcement of conclusions by an independent committee of experts in the latter case.

With regard to stimulating economic activity, the NRP tackles two main aspects: improving financing channels to the private sector and strengthening support for entrepreneurs, in addition to the liberalization of some services, the simplification of administrative procedures and the guarantee of a unified market.

[1] Partner of A.F.I. - Analistas Financieros Internacionales, S.A.

Given that the NRP for 2013 is unfolding in a context of fiscal consolidation that is less aggressive than in 2012 and within a substantially more adverse scenario of economic forecasts envisaged in the Stability Program, this article shall be structured as follows. First, it will set forth the new growth scenario for the 2013-16 period, emphasizing aspects that may impact the NRP, as well as the main implications of the revised public deficit path for the same period. Second, the NRP's more substantive measures will be analyzed and, specifically, those where implementation is planned for within the next 12 months. Lastly, the article will conclude with the estimated impact of the NRP in terms of economic growth and job creation, and it will identify the focal points of risk that may limit its impact.

Macroeconomic scenario and fiscal consolidation path for 2013-16

One of the most outstanding elements of the updated Stability Program was the sharp downward revision of growth forecasts, not only for 2013 (-1.3%) but also going forward. GDP will grow by barely 0.5% in 2014 and will stay below 1.5% until 2016, according to the government's scenario. The 2013-14 Budget Plan issued last summer and used as the basis for the General State Budget of this year, envisaged a drop in GDP of 0.5% for 2013 and growth of 1.2% for 2014.

The downward revision of the government's growth forecasts, which are now in line with the forecasts of leading international organizations and the private consensus of Spanish analysts, is accompanied by a substantial change in the composition of GDP. Slippage of internal demand may last until 2015, weighed down by the practical stagnation of household consumption and the persistent contraction of public consumption (less intense in the latter case in 2013 and 2014 than in the previous scenario but still present and elevated in both years). The expected delay in the recovery of investment in capital expenditure is symptomatic of the extent to which the fiscal consolidation can neutralize, in the short term,

Table 1

Macroeconomic forecasts of the Spanish government and of the European Commission for the Spanish economy

			Government		European Commission	
Annual average (%)	2011	2012	2013	2014	2013	2014
GDP	**0.4**	**-1.4**	**-1.3**	**0.5**	**-1.5**	**0.9**
Households consumption	-0.8	-2.2	-2.5	0.0	-3.1	-0.1
Public consumption	-0.5	-3.7	-4.4	-3.1	-3.7	-0.4
Gross fixed capital investment	-5.3	-9.2	-7.1	-0.9	-5.8	0.1
Domestic demand[1]	**-1.9**	**-4.0**	**-3.7**	**-0.8**	**-4.0**	**-0.4**
Exports	7.7	3.1	4.1	5.9	0.0	4.7
Imports	-0.8	-5.0	-3.7	2.6	-4.0	2.0
External demand[1]	**2.3**	**2.6**	**2.4**	**1.3**	**2.6**	**0.0**
Employment growth	-1.9	-4.5	-3.4	-0.4	0.0	0.0
Unemployment rate, %	21.6	25.0	27.1	26.7	27.0	26.4
Public deficit (%GDP)	-9.4	-10.6	-6.3	-5.5	-6.5	-7.0

[1] Contribution to GDP growth.

Sources: Afi, Ministry of Economy and European Commission.

the positive effects on growth of the structural reforms. After accumulating an adjustment of more than 40% since the onset of the crisis, capital expenditures are not expected to grow until 2015, and then at barely 2%.

The persistent tightening of internal spending is reflected in labor market numbers. We must add the employment loss that may take place in the first quarter of 2014 to the job destruction anticipated for 2013 –approximately 400,000 people. With a pace of job creation below 1% year on year until 2016, the unemployment rate will stay above 25% until then. The structural component of unemployment may then represent 60% of the total.

The recessive nature of the scenario of domestic demand forecast for the period explains the need to adjust the fiscal consolidation path to the cyclical conjuncture of the economy. The public deficit ended 2012 at 7.1% of GDP, excluding state aid for the banking sector, in which case the deficit would be 10.6%. In spite of the failure to meet the target of 6.3% of GDP, it does represent a reduction of 1.8% of GDP on 2011, with a cut in the structural component of the deficit of approximately 2.5 points.

For 2013, the flexible fiscal strategy carries a deficit target for Spain of 6.3% of GDP, which is the same as for 2012 and nearly two points above that stipulated in the previous Stability Program. Therefore, this year, the deficit is to be reined in by barely eight decimal points, and distributed among the administrations as follows: the central administration must reduce its imbalance by four decimal points, to 3.8% of GDP; the regions must reduce by six decimal points to 1.2%; local authorities must achieve balanced budgets and the Social Security system's expected imbalance will increase from 1% of GDP at 2012 year end to 1.4% in 2013.

In the case of the regions, it remains to be seen how the aggregate target will be distributed among them, as individual deficit targets for regions will be set in accordance with past adjustments and with the capacity to continue making adjustments going forward. If the aggregate deficit target of 1.2% were equally applied to all the regions, as has been the case to date, Valencia and Murcia would have to reduce their deficit by two points, while six regions could increase it relative to the 2012 year-end result.

The fact that both the central administration and the regions have to make smaller consolidation efforts than in 2012 reduces, for now, the risks of further hikes in the two taxes with the greatest revenue-generating power: VAT and income tax.

The fact is that both the central administration and the regions have to make smaller consolidation efforts than in 2012.

Further adjustments to avoid deviation from the 6.3% deficit target in 2013 should, in principle, be more limited, bearing in mind that 38 billion euros of fiscal consolidation measures have already been approved pursuant to the Stability Program, and pending regions' restating of their budgets with new deficit targets.

Indeed, the updated Stability Program makes practically no change in the total amount of fiscal adjustments for 2013 that had been established prior to the easing of the deficit targets and the revision of the government's growth forecasts (in total, measures amounting to nearly 4% of GDP to reduce the deficit by eight decimal points). The new items in the program are found mainly in two aspects:

- The bleaker growth forecast has not resulted in a reduction in the estimated volume of tax revenue for the year. The gross impact of the tax measures in force and those that may be adopted on environmental taxation is estimated at nearly 17 billion euros, or 1.6% of GDP. The cyclical downturn and, specifically, the slide in domestic demand, leaves the net increase in revenue at approximately 7 billion euros. The extension to 2015 of the hikes in corporate income tax, income tax and property tax that were to be temporary for 2012 and 2013 reveals the need to consolidate the increased revenue, as their repeal in 2014-15 could seriously jeopardize the fiscal consolidation path from 2013. For 2014, the public deficit target is 5.5% of GDP and, for 2015, 4.1%.

- The planned cutback in wage-earner remuneration is reduced by half. The difference with the cutback in the previous plan of roughly 2 billion euros will be covered by larger reductions in general ministry expenditures and by improving management of active and passive employment policies, according to the Stability Program.

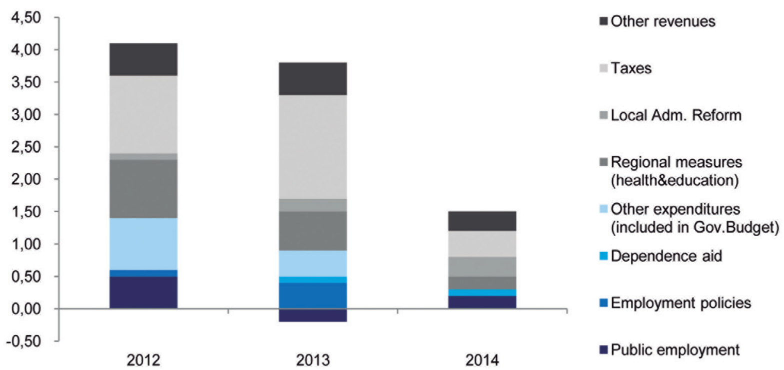
With regard to revenue forecasts, tax collection data up to March of this year disclose the difficulties for meeting the forecasts in the Stability Program, excluding the effect of tax refunds. In spite of the tax hikes in effect in the early months of the year that did not exist a year ago, total tax collections have recorded a minimal increase of 800 million euros; moreover, the increase is accounted for in full by the VAT.

The revision of environmental taxation, with the possible creation of new taxes (“green taxes”), the modification of special taxes (likely those levied on alcohol and tobacco), both in the fiscal

The revision of environmental taxation and the modification of special taxes, though yet to be detailed, may help bolster revenues in the final stretch of the year and respond to one of the European Commission's main recommendations on taxes: a shift of taxation from labor towards consumption with the largest negative externalities.

Exhibit 1

Impact of fiscal consolidation measures in 2013-16 Stability Program of Spain (% GDP). Differential effects relative to the previous year



% GDP	2012	2013	2014
Consolidation measures	4.2	3.6	1.6
Deficit reduction	1.8	0.7	0.8
Difference	2.4	2.9	0.8

Sources: Afi, Ministry of Economy and Competitiveness (2013-16 Stability Program).

SEFO - Spanish Economic and Financial Outlook Vol. 2, N.º 3 (May 2013)

discipline chapter of the NRP but yet to be detailed, may help bolster revenues in the final stretch of the year and respond to one of the European Commission's main recommendations on taxes: a shift of taxation from labor towards consumption with the largest negative externalities. It should be noted that Spain is among the countries with the lowest environmental tax burden. According to EUROSTAT data for 2011, environmental tax collection[2] in Spain amounts to 1.6% of GDP, far from Denmark's 4.1% (Denmark is a pioneer in such taxes) or the average of 2.4% for the EU-27.

Another of the planned, yet unspecified tax changes in the NRP is the modification of the corporate income tax for large enterprises, i.e., those with an annual turnover greater than 20 million euros, which is oriented towards increasing the base of the tax. The primary reason the main corporate income tax rate of small enterprises is substantially higher than of large enterprises lies, above all, in the tax adjustments applied to the book result and not so much to deductions (for R+D, reinvestment of profits, donations, etc.) that apply to the payable tax. In fact, the budget for tax benefits of corporate income tax for 2013 amounts to only 3 billion euros.

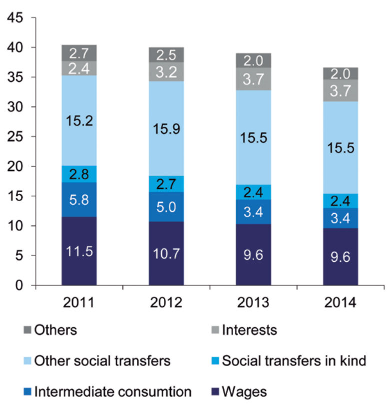
On the expenditure side, the upward revision of wage-earner remuneration as against the previous version of the Stability Program should, in theory, rein in the pace of destruction of public employment anticipated for 2013 and 2014. Then, this component of public consumption should fall from 10.7% of GDP in 2012 to 9.6% in 2014 (-1.1 points). Lastly, and in spite of the elimination of the December bonus payment for civil servants, in 2012 such remuneration amounted to 11.1% of GDP. For 2014, the new program envisages a correction to 10.4% of GDP, which in 2013 should amount to barely two decimal points.

Bearing in mind the distribution of public employees by monthly salary ranking and assuming no further wage reductions, if the Stability Program's forecast comes true, job destruction in 2013 could be lower than or similar to that of 2012 (-220,000 people). It must be recalled that only in the first quarter of

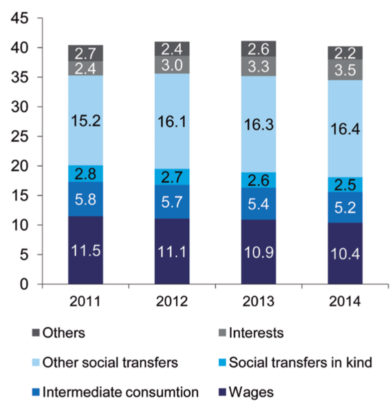
Exhibits 2 and 3

Current public expenditure in Spain. Breakdown by main items (% of GDP)

Updated 2013-16 Stability Program



Prior to easing of public deficit targets



Sources: Afi, Ministry of Economy and Competitiveness (2013-16 Stability Program).

[2] Environmental taxation in Spain includes the following: (i) energy taxes (special tax and hydrocarbons and special tax on electricity), ii) taxes on transport (special tax on certain modes of transport and tax on mechanical traction vehicles) and iii) regional taxes on pollution, waste deposits and sea emissions.

this year, the number of public wage earners fell by 70,000. Equally significant is the upward revision in expenditure in intermediate consumption.

Therefore, aggregate current public expenditure of public administrations will amount to 40% of GDP in 2014, as against the 36.6% set in the plan prior to the updating of the deficit targets. This is why public consumption may lose ground more persistently yet more moderately until 2015.

Principal structural reforms: Growth stimulus and fiscal consolidation

Table 2 summarizes the main components of the NRP for 2013. Given that each encompasses a broad spectrum of decisions, herein we shall address those which affect key areas of public finance and which may be decisive for a medium-term recovery of the Spanish economy. The benchmark will be decisions whose implementation is to occur within a horizon of approximately twelve months.

- **Bolstering of budgetary supervision, transparency and discipline.** An independent fiscal responsibility authority will be responsible for analyzing, advising and controlling the budgetary policy of all administrations; approval of a law for transparency, public information access and good governance, and development of a plan to eradicate late payments in the public sector. The latter issue is highly significant in the present, for even though the supplier payment fund and the regional liquidity fund have helped reduce the volume of administrations' commercial debt, there is a risk that delays in payments to suppliers will generate significant liquidity pressures in enterprise sectors most reliant on public services. The NRP envisages a third phase of the supplier payment plan to clear away the full volume of outstanding invoices in regional administrations.

- **Development of reform of public administrations** (a law for local administration rationalization and sustainability), with the objective of reducing the number of local authorities, clarify their powers and order their organizational structure, with a view to eliminating redundancies. Work on this reform began in 2012, but difficulties in expediting its implementation shifts to 2014-15 the bulk of the public savings it might generate. Specifically, the NRP estimates the cumulative savings in the two years at 8 billion euros.

- **Definition and regulation of the sustainability factor of the public sector pensions system.** The reform that came into force on January 1st, 2013 introduced a sustainability factor based on life expectancy trends, in order to maintain proportionality between contributions and benefits. Hence, from 2027, the fundamental parameters of the system will be revised every five years to detect differences between trends in life expectancy at the age of 67 of the population in the year of revision, and life expectancy at the age of 67 in 2027. However, the reform does not define how the sustainability factor will function, and the European Commission has urged Spain to specify the factor as soon as possible and to significantly bring forward its coming into force.

The government has created an experts' committee to prepare a report on the sustainability factor to be submitted to Parliament by May 31st, and, thus, allow the Toledo Pact Commission to prepare recommendations in June and July for a regulation of the factor. Its approval is envisaged for the third quarter of this year.

The experts' committee will have to specify which system parameters will be automatically adjusted in accordance with life expectancy: retirement age (the longer the life expectancy, the later the legal retirement age); the number of years to pay into the system (the longer the

Table 2

Main components of National Reform Program of 2013 for Spain

2013 National Reform Program
1. Public accounts reorganization: fiscal consolidation and Social Security
* Creation of an independent fiscal responsibility authority
* Transparency law, access to public information and good governance
* Measures against public NPL
* Review of taxation with european convergence criteria, especially environmental taxation
* Sustainability factor adjustment
2. Public Administration Reform
* Streamlining law and Local Government sustainability
* Public Administration Reform Report, before June 30
3. New Annual Plan for Employment Policy 2013 and Multi-Year Strategy for employment activation 2014-2016
* Promotion of public/private partnerships to facilitate the placement of jobseekers
* Entrepreneurship and youth employment strategy: 3,500 euro million (2013 to 2016)
4. Entrepreneur Support Law and Internalization
* Special VAT regime , tax incentives
* Development of alternative financing arrangements to bank (Alternative Market of Fixed Income)
* Support to entrepreneurial initiative : training measures, risk and costs reduction, streamlining of procedures
5. De indexation Spanish Economy Law
* Replacing the CPI by another index when updating rates, fees and other concepts in General Government contracts
6. Market Unit Warranty and Rationalization Plan Regulations
* Elimination of red tape, freedom of establishment and free movement
7. Services Law and professional associations
* Expansion of the list of municipal license exempt activities
* Restrictions on access to a profession by professional qualification criteria, only by law
* The access to a professional activity will enable to exercise throughout all territory (no additional requirements)
8. Good Corporate Governance and Corporate Social Responsibility
* Strenghthening the role of the shareholder in the company
* Code of Practice, remuneration policies, access conditions for governing bodies

Sources: Afi, Ministry of Economy and Competitiveness.

life expectancy, the more years of payments will be required to accede to retirement or receive 100% of the base pension), and the amount of the initial pension (the longer the life expectancy, the lower the retirement pension).

It cannot be ruled out that the sustainability factor will be applied to the initial pension of newly retired people from the entry into force of the reform, and not from 2027 as initially anticipated. The factor may be linked not only to demographic factors, but also to economic variables to narrow the gap between payments into the system and benefits in recessive phases of the economic cycle.

- **Labor law reform and employment policies**. In the NRP, further changes in labor law will depend on a prior assessment of the impact of the 2012 reform on key variables of the labor market. The assessment report to be prepared by the Ministry of Labor will be reviewed by an independent body by July of this year. Hence, any other modifications in terms of dismissal costs, access to unemployment benefits and so on may arise from this study's conclusions. The essence of the new active employment strategy lies in the following: promotion of active employment policies, improvement of collaboration between regional public employment services, enhancement of public-private partnerships and stronger links with passive policies. These general policy outlines have been present in employment policy practically since the onset of the crisis, with unsatisfactory results so far in terms of the placement percentage of public employment services and the low probability of a transition from unemployment to a job for many long-term unemployed. This is, without a doubt, one of the aspects that needs greater support in employment and which constitutes the focal point for the recommendations made by leading international organizations.

- **Creation of a favorable environment for entrepreneurship** (a law for entrepreneur support and internationalization, with the objective of enactment by 2014), based largely on the strengthening of tax incentives. The most significant are the following:

  i. A 20% income tax deduction for individual cash contributions to company start-ups. The private investor (or business angel) will be entitled to an exemption for capital gains from the sale of the stake if the proceeds are reinvested in another start-up.

  ii. A deduction of up to 10% of reinvested earnings from corporate income tax for enterprises with turnover of less than 10 million euros. They will also be allowed to recover deductions for R+D they had not been entitled to in previous years (in the present context of losses or very small profits, many enterprises would not be entitled to them).

  iii. From January 1st, 2014, SMEs and the self-employed with a business volume of less than 2 million euros could apply the cash criteria to the VAT to relieve possible cash flow problems.

Other measures would seek to strengthen lines of financing for small and medium-sized enterprises, provide greater liquidity to ICO (Spain's official credit institute) lines, issue securities in an alternative stock exchange, etc., as an alternative to traditional bank financing.

Impact of planned structural reforms on growth and employment

The impact of the foregoing structural reforms on growth and employment will be highly reliant on the response of internal spending to the fiscal adjustment yet to be tackled, and which, in view of the phase of the cycle in which the Spanish economy now stands, means deeper cutbacks of current public expenditure and more thorough rationalization of the system's public entitlements and services. The NRP quantifies the short and long-term effects of the main components of the reform. Specifically, the largest impacts result from the reforms within the process of fiscal consolidation, the supply of liquidity to territorial authorities, the labor law reform now in force and the law for a guaranteed unified market.

The contractionary effects of the fiscal consolidation measures are significant in the short term (i.e., one year). The NRP itself estimates that it may slice somewhat more than 2.5 points from growth, and nearly 2% of employment. In the long term —and over a horizon of ten years— the positive impact would be felt, mainly, in the labor market, with an increase of 9% in employment (somewhat less than half the employment destroyed since the start of the crisis). The improvement in the funding instruments for regions and local authorities would have an equivalent impact on GDP and employment in the short and long term of roughly one point of growth in both cases.

With regard to the labor law reform, the transfer of impacts is defined in terms of "less deterioration": that is, if the labor law reform had not taken place, the fall in GDP and employment would be greater in the short term, but most of all in the long term. This is because, looking ahead one year and, in the absence of expectations of recovery in demand, broader labor market flexibility would facilitate dismissals, particularly in certain sectors. In the long term, in contrast, it should lay the basis for improving hiring and provide enterprises greater room for maneuver in adjusting labor conditions to the economic cycle. However, in so far as these initial assumptions need not come to fruition and the labor law reform may be subject to further modifications, the amount of the estimated impact should be taken with caution (in the long term, employment would increase by 10% compared to a scenario in which the reform had not been undertaken).

Lastly, the law for a guaranteed unified market, which seeks to ensure the free movement of goods and provision of services throughout Spanish territory by reducing administrative red tape, could increase GDP by between 1% and 1.5% in both the short and long term. The expected impact of the measures to stimulate entrepreneurship would fall short of 0.5% in both GDP and employment.