Spain´s public finances: Present situation and future outlook

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Spain is currently in the midst of a fiscal rebalancing process as part of its efforts to minimize the negative effects of the economic crisis. The greatest challenges for meeting deficit targets in 2014 will be for the autonomous regions and social security.

In response to the economic crisis affecting Spain since 2008, authorities have been forced to carry out a fiscal rebalancing in order to ensure the sustainability of public finances over the medium and long term. Although this process of fiscal consolidation has been uneven across the different levels of the public administration, major consolidation efforts are being made to bring the overall deficit below 3% by 2016. This fiscal effort is being directly reflected in the improved access of the State and of the autonomous regions to financial markets in 2013.

Determinants of the present situation

Spanish public finances are in the midst of a rebalancing process in an effort to alleviate the deep economic crisis Spain has been facing since 2008. The deteriorating position of public accounts, which posted a deficit of 11.2% of GDP in 2009, and the increase of public debt from 42% of GDP in 2008 to 90% of GDP as of June 2013, has forced authorities to undertake major fiscal consolidation efforts to ensure the sustainability of public finances in the medium and long term.

Since 2010, when the previous government adopted a harsh package of measures to reduce expenditures (freezing the largest pensions and cutting the wages of civil servants, among others), the introduction of new measures aimed at curtailing the public deficit has been constant.

However, weak macroeconomic conditions, which directly impact tax revenues, coupled with structural problems of the Spanish economy, such as the aging of the population and the elevated level of structural unemployment, have prevented these fiscal measures from accomplishing the same degree of fiscal consolidation.

The macroeconomic situation is reflected in public accounts mainly in the following four ways:

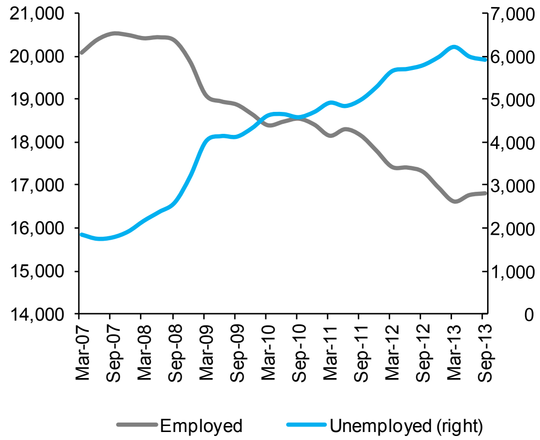
- Steep decline in non-financial revenue of all public authorities (-13.4% in 2012 from 2007), as regulatory changes have been insufficient to increase revenue in recent years.
- Constant increase in non-financial expenses.[2] Expenditure in 2012 was 19.2% greater than the aggregate volume spent by public authorities in 2007.

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

[2] Total expenditure, excluding financial assets and liabilities (Chapters 8 and 9 of the budget's economic classification). These are excluded because they are no longer part of the deficit calculation under the European System of Accounts (SEC 95).

Exhibit 1

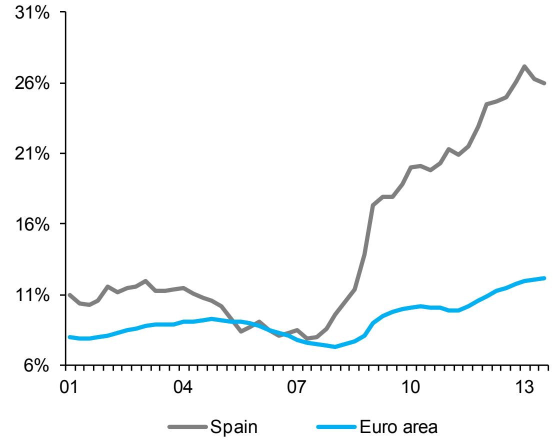
Social security registration and registered unemployment in Spain (thousands of people)



Sources: Social Security and AFI.

Exhibit 2

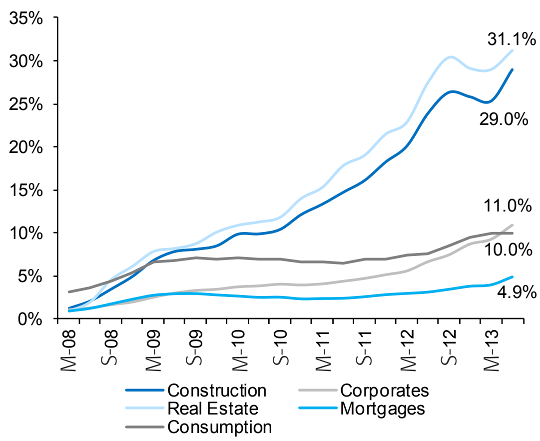
Unemployment in Spain and in the eurozone



Sources: Eurostat, INE, AFI.

Exhibit 3

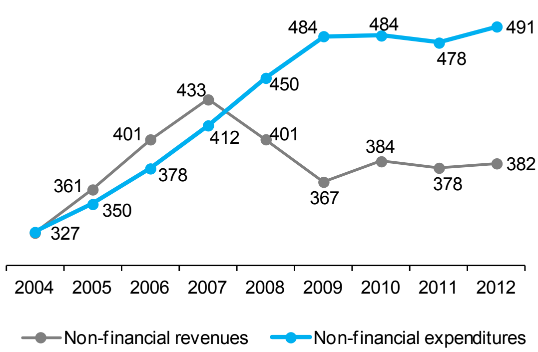
Non-performing loan rate by business segment in Spain



Sources: Bank of Spain and AFI.

Exhibit 4

Aggregate non-financial revenue and expenditure of all Spanish public authorities (billions of euros)



Source: General Comptroller of the State Administration (IGAE).

- Deterioration in solvency and non performing loan rates. The economic recession and the heavy presence of financial institutions in the development and construction sector led to a significant impairment in their levels of solvency and non-performing loan rates. These acute systemic risks forced the Spanish state to channel European financial aid to institutions in the weakest position.

Table 1
Cyclical and structural balance of Spanish public authorities (percentage of GDP)[3]

	2012	2013	2014	2015	2016
Total Balance Public Administration	-6.85	-6.50	-5.80	-4.20	-2.80
Cyclical Balance	-2.58	-2.80	-2.24	-1.55	-0.73
Structural Balance	-4.27	-3.71	-3.56	-2.65	-2.07

Source: Bank of Spain and own elaboration.

Such aid, as of August 2013, has amounted to a public deficit of 47.05 billion euros, which is 4.7% of Spanish GDP.

- Furthermore, as a result of the shortage of equity and difficulties in gaining access to financing, the period of payment to suppliers was considerably increased. With the aim of solving this problem, the government created the supplier payment funding mechanism, which has allowed for the refinancing of 28.5 billion euros of commercial debt through long-term loans, and which the government itself expects will allow for payment of additional invoices amounting to 14 billion euros.

Absorbing such imbalances must necessarily entail the adoption of structural reforms, as the structural deficit will account for a larger proportion than the cyclical deficit in 2013 (see Table 1).

Even though the government has already carried out a reform of the pension system, it is considered insufficient on its own and further reforms are necessary, particularly of the Spanish tax system, which the government intends to enact at some point in 2014.

In any event, even though the structural deficit methodology helps to better identify the weaknesses of public finances, compliance with the Excessive Deficit Protocol is still used to measure stability targets in accordance with the financing capacity or necessity elaborated in accordance with SEC95 methodology. Hence, it will be used to analyze herein the evolution of Spanish public finances in 2013 and the perspectives for 2014.

Need for consolidation and evolution of the public deficit in 2013

The consolidation requirements in Spain for 2013 have been defined by the upward revision of the deficit target announced in late May. Hence, the country has been granted a two-year extension to correct its excessive deficit, which means bringing

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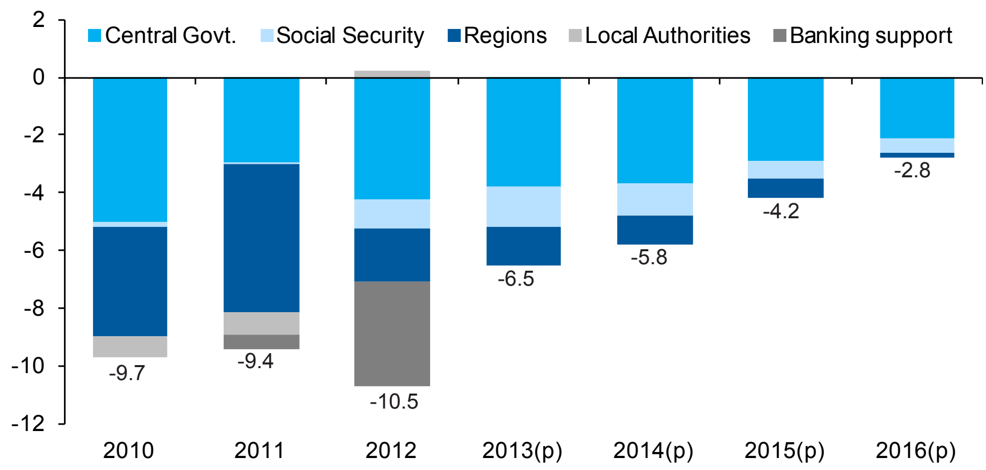
[3] Taking into account the effective deficit targets set by the EU and the output gap levels estimated by the Bank of Spain for the same period. Estimates are the result of the application of methodology approved by the Methodological Development Order of the Budgetary Stability and Financial Sustainability Organic Law 2/2012, of April 27th, on calculation of trend forecasts of revenue and expenditure and the benchmark rate of the Spanish economy. The value of public finance cyclical sensitivity of 0.43 is applied - the level that has been used by Spanish authorities in calculating cyclical and structural balances.

Exhibit 5

Deficit consolidation path in Spain



Source: Ministry of Finance and Public Administrations.

it below 3% of GDP by 2016. In exchange, the European Commission (EC) demanded specific details of the consolidation measures contained in the 2013 Stability Program, in an attempt to ensure compliance by said year.

Consequently, the effort required of Spain in 2013 is limited to a bit more than three tenths of one percent of GDP, from 6.85% of GDP down to 6.5% of GDP (see Exhibit 5). This aggregate target for the entire administration, in view of the high degree of administrative decentralization in Spain, is subdivided into four individual targets for each of the administrative sub-sectors (i.e., central government, autonomous regions, social security and local authorities).

Central government

The central government, comprising the administration and its autonomous bodies, has a deficit target in 2013 of 3.8% of GDP. Although this may have appeared somewhat lacking in ambition at first, as the initial figures for year-end 2012 signaled a deficit of 3.83% of GDP when the target was announced, successive revisions of the 2012 figure edged it upwards to 4.24% of GDP.[4] Thus, consolidation for 2013 amounts to more than four tenths of one percent of GDP, a feasible target that, nevertheless, depends on an improvement in non-financial revenues, especially taxes, in the form of tax hikes.

The deficit in the year to August[5] amounted to 4.09% of GDP for the central government, which is still above the target, albeit on a downward path compared to previous months. Total aggregate collections in the main taxes[6] [income tax, Value Added Tax (VAT) and corporate income tax] have been uneven.

While VAT grew to September by 12.2% in year-to-year comparable terms, driven by tax hikes,

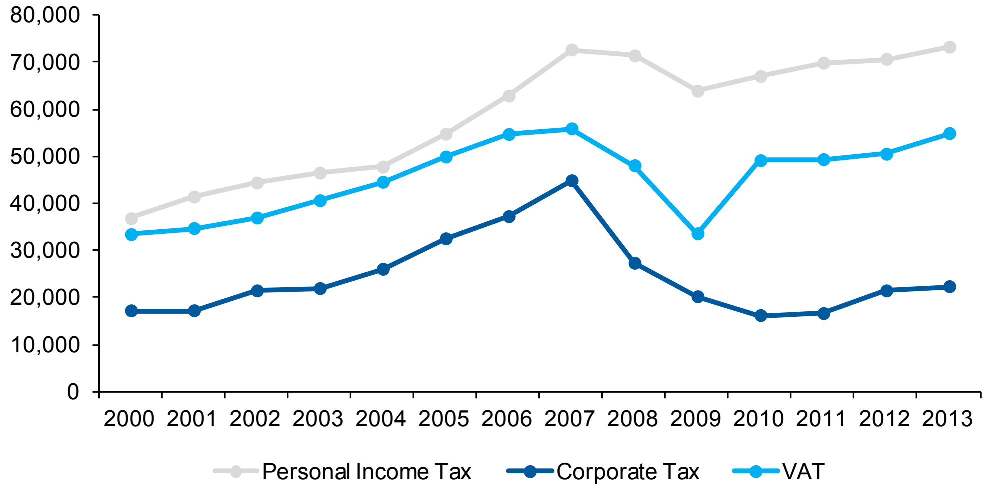
[4] According to the latest submission to Eurostat in October 2013.

[5] Latest available figure as of date of article.

[6] Tax collection figures to September are available.

Exhibit 6

Collections in main taxes and expected volumes
(millions of euros)



Source: Spanish Tax Agency.

Table 2

Tax collections and expected levels

	Sept-13 (billion €)	% Change yoy	% Change yoy Expected (*)
Income tax	51.693	-1.3%	1.9%
Corporate tax	9.81	-6.1%	-1.2%
VAT	40.618	12.2%	5.8%

Source: Spanish Tax Agency and Draft State Budgets for 2014. (*) 2013 Settlement advance from 2012 collection.

the income tax continues to fall despite the maintenance of the rate hike enacted in 2012. Corporate income tax declined by 6.1% due to the increase in refunds early in the year and the decrease in the gross differential tax (due to lower company profits). The final stretch of the year will account for the bulk of corporate income tax collections, when we learn if this tax finally reached the volume expected by the State that implies a stagnation from 2012. In any event,

In spite of the cutbacks planned for the most discretionary expenditure items, the high degree of inflexibility of certain budgetary items that carry great weight (such as interest, unemployment and transfers to social security) made it impossible to undertake an aggregate reduction of expenditure.

attaining budgeted revenues will depend on economic momentum in the last quarter.

With regard to non-financial expenditure, the State budgeted year-on-year growth of 6.2% for 2013. In spite of the cutbacks planned for the most discretionary expenditure items (non-financial ministry expenditure has been cut by 9.4% compared with the initial 2012 budget), the high degree of inflexibility of certain budgetary items that carry great weight (such as interest, unemployment and transfers to social security) made it impossible to undertake an aggregate reduction of expenditure.

Even so, data on budgetary execution by the central government to September showed a more positive evolution in expenditure than budgeted (4.9% year-on-year in September), due mainly to lower interest expenses. As against a forecast of more than 38.6 billion euros for interest, the State had recorded 21.2 billion euros. This will almost certainly allow for savings in this item of at least five tenths of one percent of GDP, which could offset the also more-than-likely shortfall in revenue from tax collections.

All in all, the central government is not expected to end 2013 with an elevated deviation from the target of 3.8% of GDP. If it does deviate, it will be about two tenths of one percent of GDP.

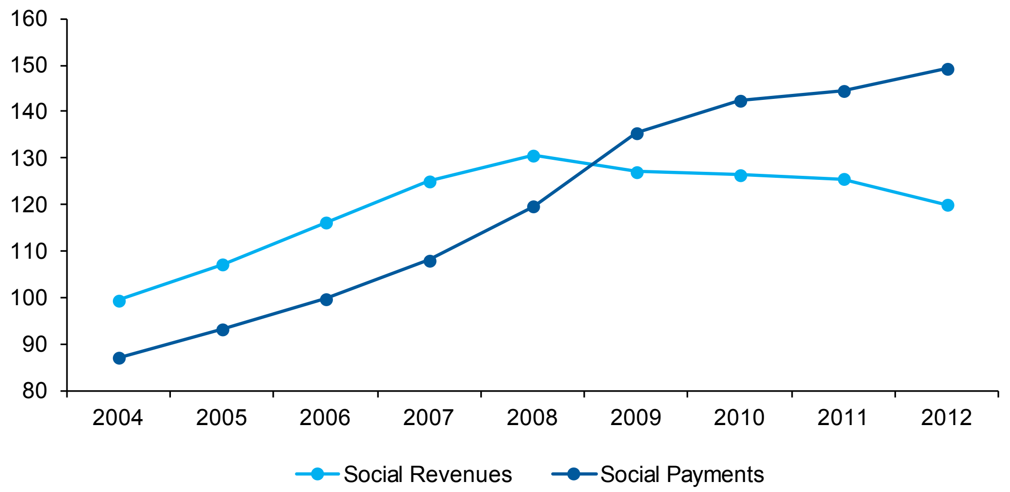
Social security[7]

The revenue base of Spanish social security has sharply contracted throughout the economic crisis. Social payments, the main source of funds, were 10.6 billion euros lower at year-end 2012 than at year-end 2008. In addition, two further factors are driving the deficits observed since 2010: increasing unemployment benefits and the aging of the Spanish population, with ever increasing average pensions. These two factors

Exhibit 7

Revenue and social payments

(billions of euros)



Source: General Comptroller of the State Administration (IGAE).

[7] The deficit in terms of the national accounting system also includes the social security system (pensions), the Spanish public employment service and the wage guarantee fund.

mean that expenditure in social benefits in 2012 was 24.7% higher than in 2008.

In addition to the economic crisis, two further factors are driving the deficits of Spanish Social Security since 2010: increasing unemployment benefits and the aging of the Spanish population, with ever larger average pensions.

Given the minimal improvement in the economic cycle, this pattern has governed social security accounts in 2013. Even though the government initially budgeted on the basis of a scenario of equilibrium after the European Commission eased the budgetary consolidation path in May, the deficit target of the social security system was set at 1.4% of GDP.

In spite of this additional margin, until August, the State sought to put off the entry into deficit of social security by speeding up the pace of annual transfers to the system. In fact, following the practical depletion of transfers, August was the first month of the year to record a deficit (-0.18% of GDP).

This depletion of transfers will result in a more-than-proportional increase of the social security deficit in the final stretch of the year, and it may reach the envisaged 1.4% of GDP. The deficit will have been due mainly to deviations from budgeted figures in social payments (8 billion euros), contributory pensions (2.2 billion euros) and in unemployment benefits (3.3 billion euros).

Autonomous regions

The regions, which were the main focal point of tension and doubt as regards the sustainability

Table 3

Deficit performance of the regions
(% GDP)

Deficit	Dec-12	Aug-13	2013 Target	Margin for 2013
Andalusia	-2.09	-0.75	-1.58	-0.83
Aragon	-1.45	-0.94	-1.30	-0.36
Asturias	-1.03	0.34	-1.06	-1.40
Balearic Islands	-1.82	0.29	-1.40	-1.69
Canary Islands	-1.10	-0.11	-1.20	-1.09
Cantabria	-1.51	-0.36	-1.13	-0.77
Castile-La Mancha	-1.57	-0.84	-1.30	-0.46
Castile- Leon	-1.40	-0.54	-1.27	-0.73
Catalonia	-2.21	-1.06	-1.58	-0.52
Extremadura	-1.03	-0.86	-1.00	-0.14
Galicia	-1.29	-0.74	-1.20	-0.46
Rioja	-1.17	0.04	-1.06	-1.10
Madrid	-1.07	-0.91	-1.07	-0.16
Murcia	-3.17	-1.43	-1.59	-0.16
Navarre	-1.74	-2.55	-1.20	1.35
Basque Country	-1.46	-0.69	-1.20	-0.51
Valencia	-3.69	-0.76	-1.60	-0.84
TOTAL	**-1.84**	**-0.79**	**-1.30**	**-0.51**

Source: General Comptroller of the State Administration (IGAE).

of Spanish public finances in 2011, made a substantial consolidation effort in 2012, closing the year with a deficit of 1.84% of GDP.[8] However, the highly mixed picture among the regions, which was pre-existing, but which was exacerbated during the economic crisis, meant that the distance between the most balanced regions and those which showed the steepest imbalances was more than 2.5% of GDP. While regions like Valencia and Murcia more than doubled the target of 1.5% of GDP, nine of the seventeen regions had a smaller deficit than allowed. Indeed, four regions (Asturias, the Canary Islands, Extremadura and Madrid) ended the year with a deficit of about 1% of GDP.

The highly mixed picture among the regions, which was pre-existing, sharpened in the economic crisis, which meant that the distance between the most balanced regions and those which showed the steepest imbalances was more than 2.5% of GDP.

This situation led the Ministry of Finance and Public Administrations to set different deficit targets for different regions for the first time since the stability regulations were enacted. In spite of this, meeting the aggregate target set for the regions requires substantial measures in the field of expenditure, as revenue will not constitute a significant further source of funds. The majority of the regions' revenues are comprised of state transfers under the regional funding system, which, in 2013, will grow by only 1.2% on 2012.

To August, the regions posted a deficit measured by the national accounting system of 0.79% of GDP. The good performance was due to a reduction of public expenditure (mainly through current transfers to other public authorities and intermediate consumption). If this pace of growth is sustained, the figure would imply meeting the target of 1.3% of GDP. Although it is, in principle, a positive figure, it must be recalled that the difficulty in allocating adjustments of national accounting to the regional budgets on a monthly basis means that some figures are not representative. In fact, three regions continued to run a surplus with four months left in the year: Asturias, Balearic Islands and La Rioja.

This factor should be borne in mind, along with the low degree of success in planned asset sales (only 11% of projected sales had been realized by August) as the combination of these factors could generate a deviation from the target of two tenths of one percent of GDP. Assuming this larger deficit cannot be offset with further expenditure cutbacks, the deficit would end the year at about 1.5% of GDP, versus the ceiling of 1.3% of GDP. In any event, mixed results among regions are to be anticipated, with most of the seventeen regions expected to meet the target, in contrast to the high deficits of a minority.

Local authorities

Local authorities were not only the sole sub-sector to meet their stability target in 2012 of 0.0% of GDP, but they beat the target and ran a surplus of 0.22% of GDP. This positive situation places them in a comfortable position to meet the target in 2013, which is again a balanced budget.[9] The property tax hike in 2012, along with the clearing away of overdue invoices owed to suppliers, was the basis of this good result.

For 2013, maintenance of the property tax hike, along with a more-than-likely curtailment of expenditure based on the adjustment plans[10] prepared in order to gain access to the supplier payment mechanism, should enable compliance with the target and even generate a small surplus[11]

[8] According to latest submission to Eurostat in October 2013.

[9] Financing requirement in terms of SEC 95 of 0.0% of GDP.

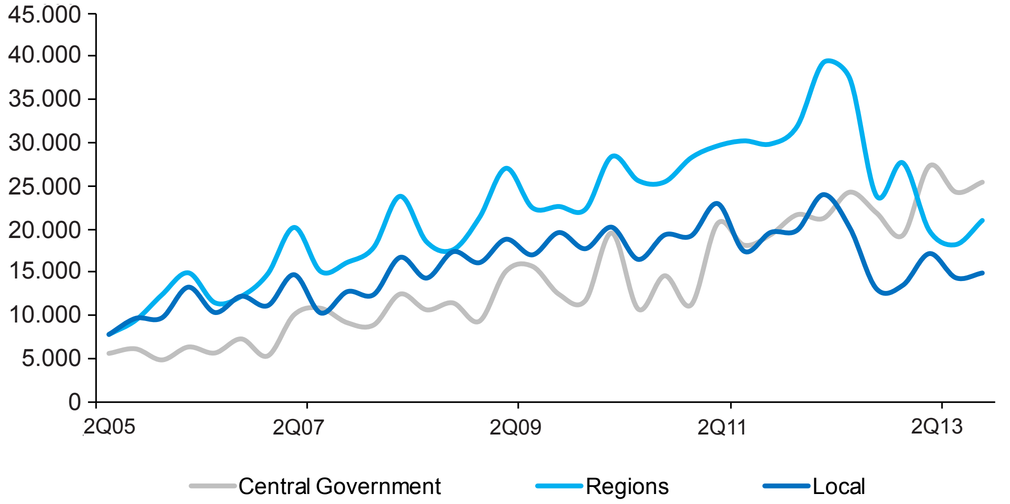
[10] These measures are equivalent to 0.14% of GDP (with no public employment measures).

[11] At June 2013, the latest available figure as of the writing of this article, the surplus stood at 0.19% of GDP.

Exhibit 8

Evolution of accounts pending payment

(billions of euros)



Source: Bank of Spain.

that could cover the deviations of the central government and the regions.

Perspectives for 2014

In 2014, the aggregate consolidation burden of all public authorities amounts to seven tenths of one percent of GDP, with the aim of bringing down the deficit from 6.5% of GDP to 5.8% of GDP. The allocation by authorities of this burden is uneven, as it is null for local authorities, one tenth of one percent for the central government and three tenths for the regions and social security. Accordingly, the biggest difficulties in meeting the target will be found in the last two sub-sectors, which we will analyze below.

Central government

The minimal consolidation burden required of the State has eased the pressure to boost non-financial revenue. Hence, the upturn in the economic cycle is expected to be sufficient to increase such revenue by 1.2% relative to 2013.

This performance means that if the GDP growth forecasts are met (0.7% according to the government), budgeted tax revenues would be feasible, and only at risk due to any further deviation beyond that announced in the end-of-year forecast of 2013.

Table 4

Impact of tax changes

(billions of euros)

	2013	2014
Income tax	3.430	0.083
Corporate tax	0.152	2.920
Environmental taxes	1.889	0.054
VAT	8.429	0.117
Special taxes	2.422	0.434
Others	-0.366	.050
TOTAL	**15.956**	**3.658**

Source: Ministry of Finance and Public Administration.

The State's non-financial expenditure remains practically as budgeted in 2013. The increase in allocations to the public employment service and of budgetary financing of the electricity tariff deficit, which amounts to 5.5 billion euros, means the adjustment will be focused on ministry expenditure, over which the State has a margin of discretion. Allocations for regions and local authorities are also reduced.

Social security

Due to the deficits run by social security, the social security reserve fund has been used to pay pensions since 2010. As of July 2013, when the most recent disbursement was made from the fund, it had a volume of 59.307 billion euros. At the current rate of disbursements, the fund will be depleted in 2019. This unsustainability in the medium-term (falling payments into the system) and long-term (aging population) of the social security system has forced the government to undertake a reform of the pension system.

The main novelties are the delinking of pensions from CPI – with the introduction of a revalorization index whose main determining factors are the revenue and expenditure of the social security system and the annual rate of change in the number of contributory pension– and a sustainability factor that will enter into force in 2019. This sustainability factor will be determined by life expectancy upon entering retirement age.

To these factors we must add that, since January, the legal retirement age is being progressively increased, to 67 by the year 2027.

In the social security budgets prepared for 2014, the impact of this reform is already taken into account, with pensions increasing only by 0.25%. This allowed for reducing the 2014 deficit target from the 1.4% of GDP of the previous year to 1.1% of GDP. Nevertheless, there may be difficulties in meeting this target, as the budget envisages payments into the social security system of 102.8 billion euros, implying that the increase necessary to attain the amount budgeted for 2014 would be 5 billion euros. Although the maximum contribution base will be increased by five percentage points –given that this group accounts only for 4% of total contributors and no significant increases are anticipated in either employment or in nominal wages– it will be difficult for the government's forecast to be met.

On the expenditure side, contributory pensions, amounting to 112.1 billion euros, show significant growth as against the amount budgeted for this year (+5.4%). This is mainly due to the growth in the number of pensioners and the increase in the average pension, as the increase is to be limited to 0.25%.

Hence, with a reduction in state contributions, the sharp increase in contributory pensions and the difficulties in attaining envisaged social security contributions, meeting the social security target in 2014 may require measures beyond those set out in the State budget.

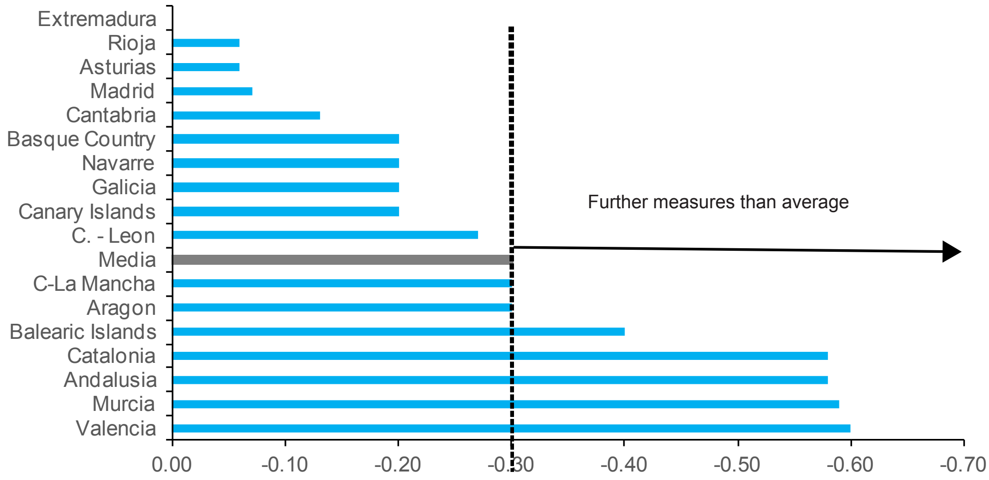
Autonomous regions

In 2014, the regions must reduce their average deficit by a bit more than three tenths of one percent of GDP, from 1.3% of GDP to 1.0% of GDP. Thus, the central authorities and social security must undertake a larger fiscal consolidation burden. To this greater aggregate effort we must add the additional pressure that will be generated in regions where the objective was higher than the average regional deficit: Catalonia, Andalusia, Murcia and Valencia must reduce their deficits by double the regional average (see Exhibit 9). Consequently, the regions required to bear a larger burden may again be asked to meet a separate deficit target in 2014.

As of the date of this article, fourteen of the seventeen regions had submitted their draft budgets for 2014. An analysis of the data therein

Exhibit 9

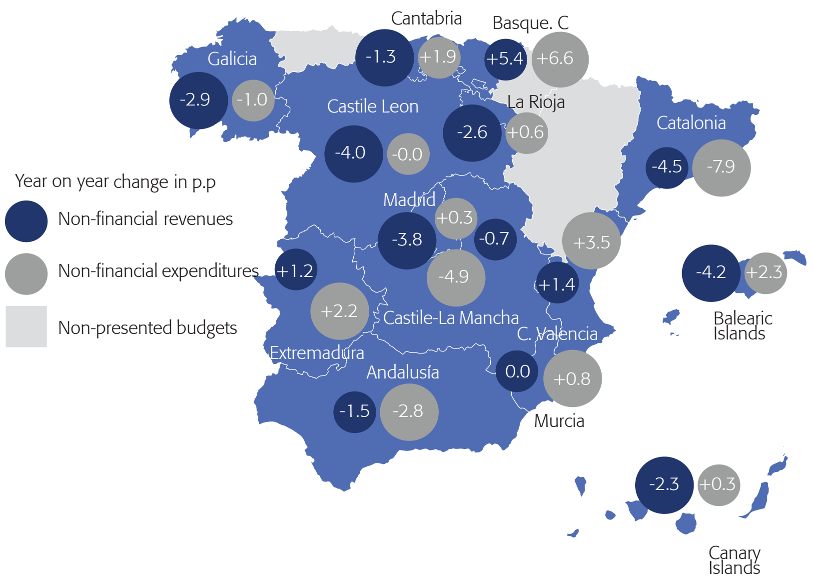
Consolidation burden in 2014



Source: Ministry of Finance and Public Administration and own elaboration.

Exhibit 10

Year-on-year change in autonomous regions' non-financial revenue and expenditure (initial 2014 budgets *vs*. 2013)



Source: Own elaboration.

shows that the regions will have to take further measures to meet the already demanding targets, as their revenue from the regional financing system will be reduced by an average of 2.5% relative to 2013. With a view to compensating for this decline, budgets envisage revenue from properties and from asset sales that will be difficult to attain. The aggregate of these amounts –except for the three other regions that have yet to submit budgets– comes to 4.7 billion euros, when aggregate revenue from these items of all regions barely amounted to 1.47 billion euros.

Even so, the weakness of revenues is forcing regions – in contrast to the State – to reduce their expenditures. In aggregate, the budgets envisage a reduction in total non-financial expenditure of 1.4%. The main items allowing for this reduction are staff costs (-1.3%), thus meaning that the destruction of public employment will continue and, once again, there will be cutbacks in capital expenditure (-11%), which now account for only 9.2% of non-financial expenditure.

Local authorities

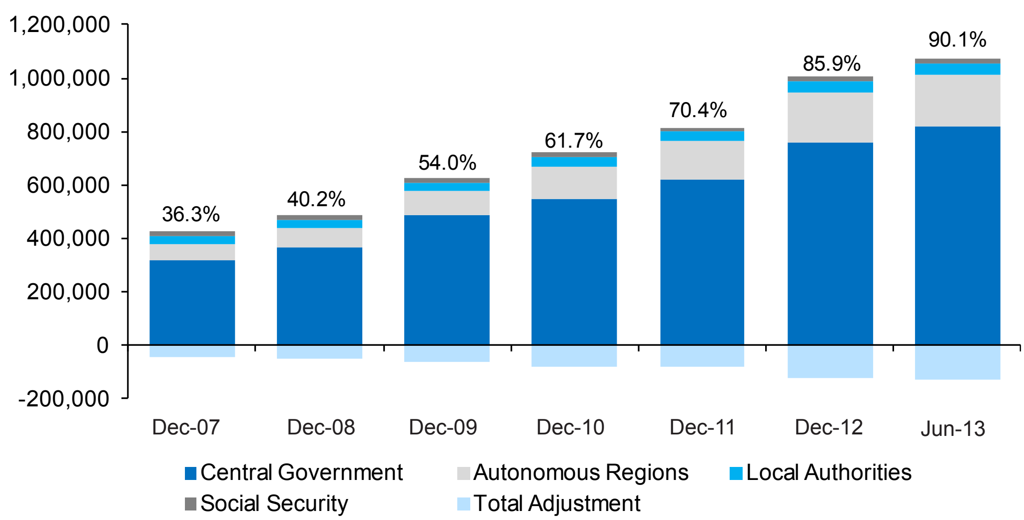
Local authorities must maintain in 2014 the balanced budget that was required of them in 2013. We anticipate they will meet the target owing to the across-the-board maintenance of the property tax hike, which was mandatory in 2012 and 2013 but voluntary thereafter, and due to the spending cutbacks related to the reform of the local sector, which is currently before parliament, for which the government estimates an impact of 1.146 billion euros in 2014.

Impact on debt level

The deficits generated during the economic crisis have logically been reflected in debt levels. As of June 2013, the debt of public authorities was more than double the existing stock at year-end 2008 (see Exhibit 11), standing at 90.1% of GDP. Far from being a ceiling, this level will continue to rise because Spanish public authorities will continue to run deficits until at least 2016.[12]

Exhibit 11

Debt by authority (millions of euros) and debt-to-GDP ratio



Source: Bank of Spain.

[12] According to government forecasts, the public debt-to-GDP ratio at year-end 2014 will reach 98.9% of GDP.

Public debt will continue to grow at least until 2016, albeit at a slower pace than in recent years, due to the lower anticipated deficits.

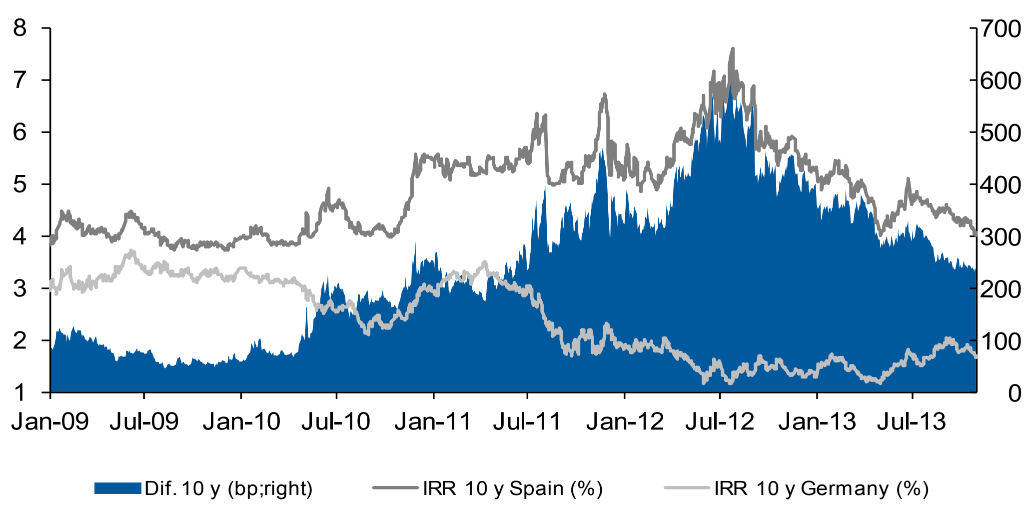
Therefore, we should recall that although the Spanish state committed to achieving a public debt-to-GDP ratio of 60% by 2020 in the Budgetary Stability and Financial Sustainability Organic Law, it will most likely be unable to meet the target. In fact, S1, the medium-term sustainability indicator used by the European Union, indicates that a primary structural balance of +5.3% of GDP until 2020 would be necessary in order to return the debt ratio to 60% of GDP by 2030. The average primary balance of the Spanish economy in the 2000-2008 period, at the time of the biggest boom, only reached 1.5%.

In any event, with the financial markets having stabilized, public authorities are finding it easier to cover their funding needs in 2013, and at a lower cost. The Treasury, the body which issues the debt for the central government, had covered some 80% of its net funding needs for the year by October 2013, where it was also assisted by the strong presence of foreign investors in debt auctions.

Nine autonomous regions[13] have joined the regional liquidity fund created by the State, which is enabling them to cover both debt maturities and new funding needs[14] without having to turn to the markets on an individual basis. The eight other regions have managed to quickly cover their debt servicing needs at a far lower cost than in recent years, due to the relative normalization of financial markets.

Exhibit 12

IRR of 10-year Spanish and German debt (%), sovereign spread at term (bp)

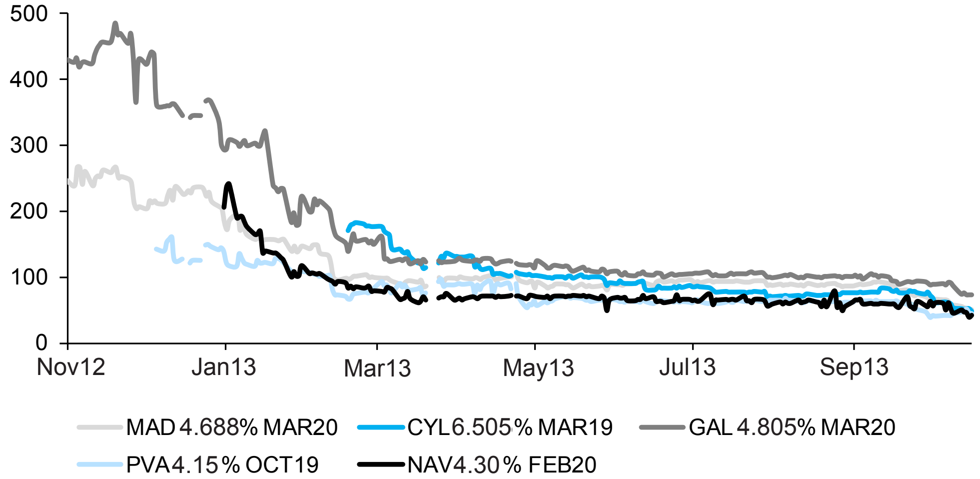


Sources: Reuters, AFI.

[13] Andalusia, Catalonia, Valencia, Asturias, Canary Islands, Balearic Islands, Murcia, Castile-La Mancha and Cantabria.

[14] The regional liquidity fund allows for covering maturities of securities, of loans granted by European institutions of which Spain is a member in transactions that cannot be refinanced or novated by the autonomous regions and for meeting additional public deficit finance necessities.

Exhibit 13
Regional spreads in secondary market against Treasury



Source: Bloomberg.

Nevertheless, it is important to emphasize that the regional liquidity fund that emerged in 2012 as a temporary liquidity mechanism to offset the inability of some regions to fund themselves at reasonable prices, has been extended to at least 2014.