Spain´s draft 2015 General Budget: Balancing constraints and credibility

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The government´s 2014 deficit targets and 2015 draft budget proposal are largely viewed as credible. Nonetheless, uncertainties regarding economic conditions, together with major challenges at the regional level, will be key determinants for meeting fiscal consolidation goals.

The deficit targets outlined in the 2015 draft budget are perceived as being generally realistic. Meeting these targets will require the balancing of three main factors: external commitments, political commitments and risks. On the internal political front, the adjustment strategy to be executed is largely expenditure based. Still, projected increases in revenues must be compatible with the promised tax cuts to be implemented in the run up to general elections in 2015. As regards other factors, while the macroeconomic assumptions that underpin the budgetary proposal are largely in line with consensus estimates, the risk of worse than anticipated performance at the European level could jeopardize Spain´s consolidation efforts. Moreover, the government´s forecasts for the deficit overestimate expenditure on items such as debt service as well as unemployment benefits, while potentially overestimating social security revenues. Furthermore, the ultimate response of revenues to tax reform remains to be seen. Where there is overall agreement is on the fact that the major challenge to fiscal consolidation is at the regional level, where recent performance by the regions as a whole reflects slippage from agreed-upon targets, likely requiring compensation by other government subsectors.

Introduction

The content and credibility of the draft 2015 General State Budget (PGE-2015 in its Spanish initials) depend on the conjunction of three vectors: external commitments, internal/political commitments and finally exogenous and endogenous risks.

Firstly, Spain has made a commitment to the European authorities and the financial markets to continue efforts to reduce the deficit. The government´s borrowing requirement in 2015 is 4.2% of GDP, in line with the recommendations of the Council of the European Union, and the path established in Spain’s Stability Programme. This path has been defined for the general government as a whole, and for each subsector (Ministry of Finance and Public Administration, 2014b).

Secondly, Spain must meet the internal and political commitments that determine the way

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in which the deficit is intended to be reduced in 2015 and subsequent years. Fundamentally, this entails reducing the weight of public expenditure as a share of GDP. The ability to effectively implement proposed tax cuts depends on economic conditions and their subsequent impact on tax revenues, both in absolute terms and as a percentage of GDP. This is combined with the always uncertain outcome of the fight against tax evasion.

Thirdly, the country faces both exogenous and endogenous risks which will have an impact on year-end 2014, and consequently, will serve as the point of reference for consolidation in the year ahead. Main risks include: i) the international economic situation, which shapes the government's macroeconomic framework; ii) the elasticity of the various taxes to growth in the tax base in a scenario of fiscal reform; and finally, iii) how the autonomous regions perform in 2015.

The aim of this article is to analyse the draft 2015 General State Budget by focusing on the three vectors referred to above, as well as to assess proposed 2015 budget implementation in order to ultimately determine whether or not next year´s budget is credible.

Constraints on the 2015 budget

Tables 1 and 2 set out the main budgetary objectives for the Spanish general government as a whole over the period 2014-2017. These figures represent the main inputs and assumptions of the 2015 budget proposal. In particular, the central government and social security system budgets, the objective scope of the PGE-2015, dovetail to produce these balances.

Table 1

Forecast change in the deficit and its main components for 2014-2017
(Figures as a percentage of GDP)

	2014	2015	2016	2017
Total public deficit	-5.5	-4.2	-2.8	-1.1
Interest	3.5	3.6	3.7	3.8
Primary deficit (–) or surplus (+)	-2.0	-0.6	0.9	2.7
Non-financial income	38.5	38.8	38.9	39.0
Non-financial expenses	44.0	43.0	41.7	40.1

Note: The expenditure and deficit figures exclude the one-off cost of the financial reform.

Source: Ministry of Finance and Public Administration, 2014b.

Table 2

Change in the deficit over the period 2014-2017: Kingdom of Spain Stability Plan
(Figures as a percentage of GDP)

	2014	2015	2016	2017
Central government	-3.5	-2.9	-2.2	-1.1
Autonomous regions	-1.0	-0.7	-0.3	0.0
Local authorities	0.0	0.0	0.0	0.0
Social security system	-1.0	-0.6	-0.3	0.0
TOTAL	-5.5	-4.2	-2.8	-1.1

Source: Ministry of Finance and Public Administration, 2014b.

The probability of a deviation from the targets is greater in a country as decentralised as Spain, in which subnational treasuries manage half of the total public resources. However, in the subnational context, it is necessary to draw a clear distinction between the local and regional levels. On the whole, Spain's local authorities have not had significant deficit or debt problems in the recent past. In fact, debt aggregates have moderated substantially upon excluding certain large municipal authorities with significant liabilities, such as Madrid. If we add the fact that a significant share of municipal spending immediately prior to the crisis was on services that were not legally mandatory, it is easy to see how local authorities have rapidly switched to posting budget surpluses and thus contribute to reining in the overall public sector deficit.

The autonomous regions are in a very different situation. Deficits and rising debt-to-GDP ratios have been the norm, even in the past decade, when nominal GDP was growing rapidly. Their spending includes basic items for the welfare state, characterised by their being on an expansionary trend that is hard to hold back, either because of their high income elasticity (health spending), or the application of expensive reforms (education), and new laws (such as the law on long-term care). Cut-backs at the regional level are therefore more difficult, particularly when they take place repeatedly. In real terms, regional spending underwent an average cumulative cut-back of 20% between 2009 and 2012 (Lago-Peñas and Fernández, 2013). Meanwhile, the adjustment on the income side has accounted for less than a tenth of the overall adjustment as most regions chose not to raise taxes to close the spending gap. Moreover, the 2015 regional elections are encouraging promises of tax cuts rather than increases.

The 2015 budget is not only subject to the external restrictions alluded to in the introduction above. Internally, the central government elected in 2011 has opted for a formula primarily based on spending cuts to close the deficit. Broadly speaking, four fifths has come from reducing public expenditure as a share of GDP and one fifth from an increase in revenues. This increase must also be compatible with the promised tax cuts that will start to be implemented in the run up to the general elections in 2015.

Ideological reasons undoubtedly weigh more heavily than technical ones in the choice of deficit reduction measures. Although there is recent empirical evidence that recessions tend to be softer and shorter when consolidation is based on spending cuts, the exact composition of the adjustment can be extremely important (de Mello, 2013). By contrast, the cuts in Spain have tended to be relatively unselective and have fallen most heavily on items that are fundamental for long-term economic growth (R&D, education, etc.). Finally, there are no precise estimates on the effect of the chosen combination in the extraordinary increase in inequality in Spain since the crisis broke out. According to a recent Eurostat report using 2012 data, Spain is the second most unequal country in the European Union after Latvia.

Risks for year-end 2014

The figures for year-end 2014 are crucial, because they are a proxy for the credibility of the fiscal consolidation process and because they will define the starting point for meeting the objectives in 2015. Any excess deficit over the planned 5.5% of GDP will mean an additional consolidation effort in 2015, and vice versa.

The execution data available to date and various projection exercises reveal the existence of factors that point in opposing directions. The general government ended the first half of 2014 with a deficit of approximately 3.43% of GDP, half a point lower than the previous year, in which the deficit ultimately reached 6.6% of GDP.[2] The figures

[2] The change in methodology from SEC-95 to SEC-2010 raised 2013 GDP and reduced the deficit-to-GDP ratio from 6.6% to 6.3%. The reduction in terms of GDP between 2013 and 2014 is just 8 tenths of a point.

available up until August, which do not include local authorities, show the same trend: 4.26% of GDP in 2014 compared with 4.64% of GDP in 2013. The Bank of Spain considers achieving the 2014 deficit target to be feasible, but this means stepping up the pace of the adjustment in the second half of the year (Bank of Spain, 2014). The Independent Fiscal Responsibility Authority (AIReF, 2014b) has expressed a similar opinion, considering the target for the general government as a whole to be achievable.

At the autonomous region´s level, looking at both 2013 results as well as data through the end of August, doubts remain over whether or not the regions will meet their deficit targets. The regions reached the limit for the year as a whole by the end of August (1.01%). Taking into account that traditionally, the last quarter of each budget year raises the regional deficit, as well as the fact that most regions will hold elections in May 2015, there will be a need for other subsectors to compensate for the likely slippage at the regional level. The central government is already attempting to making an additional effort, while the social security fund's figures are slightly worse than in 2013 and the local authorities have a slight surplus, similar to that accumulated the previous year. Specifically, the AIReF (2014b) estimates that the regional deficit could end the year at 1.5% of GDP, i.e. at the same level as in 2013.

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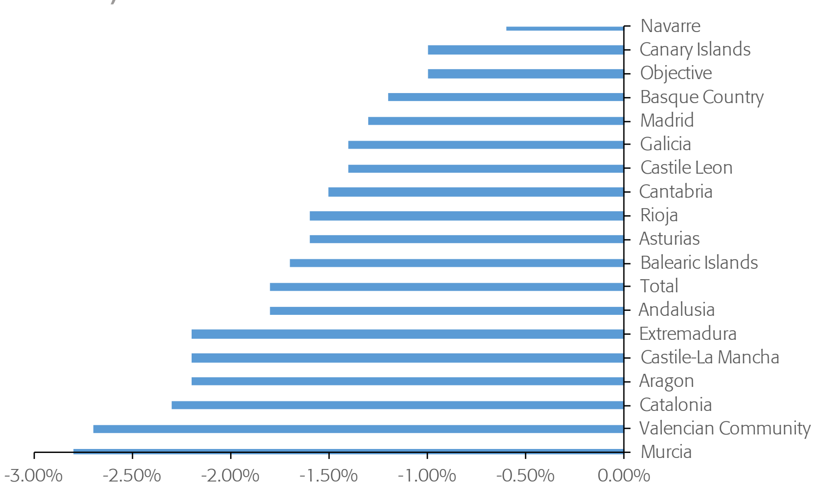
Fedea's projections (Conde-Ruiz *et al.*, 2014) raise this figure to 1.8% of GDP, which would not just mean a stagnation in the fiscal consolidation process at the regional level, but a return to 2012 figures. Exhibit 1 represents these simulations for each of the autonomous regions, clearly depicting the heterogeneity across the regions. The three biggest deviations (Murcia, Valencian Community, and Catalonia) correspond to

Exhibit 1

Autonomous Regions' deficit forecasts for 2014
(As a percentage of GDP)



Note: Synthetic deficit taken into account.
Source: Conde-Ruiz et al. *(2014).*

the three regions that have failed to meet the deficit targets systematically since 2011. Moreover, the large relative size of the latter two pushes the average upwards for the regions as a whole.

In short, the 2014 deficit target is perceived as being generally realistic, thanks to better than expected improvements in central government expenses and income. However, it is a matter of concern that we may be witnessing a step backwards that worsens the figures for the aggregate Spanish public sector in 2014, following the progress in fiscal consolidation at the regional level in 2013, and this raises serious doubts about the regions' ability to achieve a 0.7% deficit in 2015, and puts them back under the international analysts' spotlight (Lago-Peñas, 2014).

Assessing 2015 budget credibility in the context of risks

The macroeconomic scenario included in the 2015 budget fits, overall, with the average October 2014 forecasts of independent experts (the consensus of analysts in the Funcas Panel for September 2014), the Bank of Spain (2014), and the AIReF's in-depth analysis (2014a). Moreover, they are in line with the estimates by the International Monetary Fund (IMF) and the European Central Bank. Nevertheless, it is true that in recent weeks, the uncertainty and concern over stagnation in the European Union[3] has grown, which could significantly affect the Spanish economy's external demand through both the reduction in exports of goods and flows of tourists. On the other hand, the expansionary effect of the tax cuts due to come into effect in 2015, and the improved financial conditions, may play a compensating role, by stimulating internal demand (Laborda, 2014). In any event, if the European economy were to be headed for a lengthy stagnation, the risk that the Spanish economy would again record an external deficit would be large, with all of the negative consequences for sustainability, difficulties achieving GDP growth and the subsequent increase in public deficit forecasts for 2016.

Having said that, the only point on which the government's forecasts can be described as being somewhat optimistic is precisely in the case of the public deficit. Compared with the 2015 budget's objective of 4.2% of GDP, the Funcas panel of experts arrived at an average of 4.7% of GDP, in line with the IMF's July 2014 estimate. In September, the OECD forecast 4.5% of GDP.[4] For its part, AIRef (2014b) has opted to take a cautious line. It considers the deficit target to be very demanding, requiring strict adherence to the budgets, and the revenue scenario to be very ambitious, although feasible if the scenario of the cyclical recovery of the economy is confirmed.

Looking closer at the details of the budget reveals expense and income items that generate doubts about the deficit, both on the upside and the downside. We will first look at those which may be overestimating the imbalance between income and expenses in the 2015 budget, and then we will review those that would lead to an underestimation.

Debt interest and unemployment benefits could be overestimated by as much as 8 billion euros (Laborda, 2014). In the former case, the drastic cut in the risk premium is reducing the average cost of debt, and the combination of falling unemployment and the exhaustion of benefits is providing a cushion, offsetting other items.

[3] The Bank of Spain (2014) warns that: "the risks of a downward deviation from this core scenario have increased in recent months due to the worsening prospects for the world economy, in particular in the euro area." The IMF's estimate of the likelihood of a recession in the euro area in the next nine months rose from 20% in April to almost 40% in October 2014 (*World Economic Outlook*, October 2014).

[4] By contrast, BBVA Research's analysts take a much more optimistic view (Cardoso, 2014). They consider that, thanks to the stronger economic recovery and the falling debt interest bill, the deficit could even dip below 4% at the end of 2015.

By contrast, anticipated income from social security contributions is giving rise to considerable doubts. Strong expected growth centres mainly on the new system of direct settlement of social security contributions based on billing by the social security system (CRETA) and the value of compensation in kind being taken into account at full value on the basis of assessment. Overall, Laborda (2014) indicates that the social security deficit could be 9 billion euros higher than forecast. On top of this are the inflated tax revenue estimates, particularly in the case of VAT, of 3.3 billion euros. In total, 12.3 billion euros which, net of savings from latent expenses, would increase the consolidated deficit of the social security system and central government by 4.3 billion euros (0.4% of GDP). AIReF (2014b) is somewhat less pessimistic. In the case of taxes, it does not detect significant deviations with respect to the results of the projections derived from quantitative models. Only for social security contributions does it flag the presence of uncertainties as to whether they will be met, given the scale of budgetary growth. In practice, the budget may grow even further, as execution so far in 2014 suggests it is likely that 2014 will end below the initial budget. In any event, it warns that it has not attempted to quantify the impact of the management measures and the full inclusion of benefits in kind (as it "lacks the capacity to do so") and ends up accepting that, if the central government's forecasts are met, the social security fund's accounts could balance. What appears clear, as the government concedes in the 2015 budget, is that the fiscal reform currently underway will drain resources from the public treasury and make it difficult to square the accounts in 2015 and 2016.

Where there is a broad consensus among analysts is that the regions are the main source of risk. The way budget implementation has progressed so far in 2014 has set off alarm bells and again turned the spotlight on this level of government in the discussions about fiscal consolidation. But the situation today is different from that just two years ago. The legislative framework on budgetary stability passed in 2012 is now very strict and equips the central government with mechanisms and tools with which to rein in regional finances externally (Lago-Peñas, 2013). Specifically, the design, execution, monitoring and control over this stability has been recentralised, expanding the information obligations regarding budget management and enabling control missions' full powers to review the regions' fiscal management. Targets have been set unilaterally by the central government, with zero margin for negotiation, and capacity to demand application of spending cuts and tax increases deemed appropriate. In short, enforcement mechanisms have been introduced, in the form of penalties, exclusion from financing lines and access to credit, and even the suspension of autonomous government. Therefore, unlike the situation in 2012, the adoption of further legislative measures to ensure fiscal stability is no longer an option.

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An immediate alternative is to utilise these legal possibilities more fully, stepping up the intervention and control by the central government yet further. One advantage of this approach is that it could allow attention to be focused on those regions in which non-compliance is greatest, without further penalising those that are complying. In any event, this second route would represent a further ratcheting up of the pressure on the *de facto* federal system that exists in Spain. And it should not be overlooked that Catalonia, whose autonomy is a particularly politically sensitive topic, is among the regions that systematically fail to meet their targets.

The third route is to consider the centrality of the services the autonomous regions provide and the succession of deep cuts they have suffered since 2009 –exceeding those of the central government– in order to discuss the vertical balance of resources and the deficit targets between levels of government. In this case, the reform to the regional financing system needs to be sped up. A reform should allow the autonomous regions to access more fiscal resources while at the same time solving some of the system's problems. In parallel, and in a non-exclusive way, the distribution of the deficit targets between the levels of government based on their share of total spending could be explored. This would lead to a quota for the autonomous regions of at least a third of the total. It would mean doubling the target for 2015 (1.4% *vs* 0.7%).

Concluding remarks

The reduction in Spain's public deficit envisaged in the 2015 budget requires four conditions to be met. First, that 2014 ends without significant upward deviation of the deficit from the forecast (5.5% of GDP). Second, that macroeconomic developments in 2015 do not differ substantially from the forecast macroeconomic framework. Third, the forecast performance of social security contributions is close to the high increase projected, which is a genuine challenge. And fourth, that the autonomous regions' deficit is contained or its ceiling is raised at the cost of the central government. For their part, the doubts that might arise from the use of high income elasticities in the case of the system's main taxes would be entirely offset with the certainty that there are spending items (debt interest and unemployment benefits) that would conclude the fiscal year with a relatively low execution rate.

Thus, the central government has to work on three fronts: press for expansionary measures at the European level to reduce the risk of recession in the EU; ensure that the regional deficit does not come to be viewed as an out-of-control risk factor again; and finally, watch closely the implementation of budget management measures that may result in a reduction in expenditure or substantial increase in income – in particular, the reforms under way in the Spanish public administration and the system for collection of social security contributions.

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