Will improved economic conditions bring fiscal stability?

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The latest update of Spain´s Stability Programme contains relevant changes to the central government´s forecasts for economic and fiscal variables. The programme is largely viewed as achievable but ambitious, with the greatest risks of non-compliance on the expenditure side.

The latest update of Spain´s Stability Programme for the period 2015-2018 reflects more ambitious expenditure reduction efforts and a more favourable macroeconomic scenario for the first two years of the period than in the previous version. However, the following period, from 2017-2018, is characterized by greater uncertainty over the ability to execute deficit reduction plans due to the disappearance of favourable external shocks, the current output gap, and uncertainty surrounding upcoming general elections. The updated programme reflects a fiscal adjustment centred mainly on expenditure reduction through an increase in the denominator, the drop in items such as debt interest and unemployment payments, and the virtual freezing of expenditures on most items. On the whole, the government´s proposed deficit figures are more optimistic than those published by international organizations and institutions for 2015-2016. Nevertheless, there is consensus that the fiscal consolidation path adopted by the government is feasible, although ambitious and subject to considerable risks related to effective execution of planned expenditure measures and the fiscal performance of the social security system and the autonomous regions. Finally, expenditure cuts should be applied with careful consideration given to minimizing their potential negative impact on the provision of public services.

Introduction

The update of Spain´s Stability Programme (Ministry of Finance and Public Administration, 2015) envisions substantial changes to the central government´s forecasts for economic and fiscal variables. This paper critically assesses the new scenario. Firstly, it analyses the macroeconomic framework outlined to 2018. It subsequently evaluates how this fits in with the evolution of public revenues and expenditure, in light of the discretionary measures envisaged in the document itself, which affect both sides of the budget. Finally, it examines the fiscal implications between now and 2018 on the management of public services and their quality, taking a comparative view relative to other European Union countries.

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The new macroeconomic scenario

The stability programme update includes a macroeconomic framework for the four-year period from 2015 to 2018, summarised in Table 1. For analytical purposes, two two-year periods can be distinguished. For 2015-2016, various estimates are available from international organisations and private analysts. In general, the central government outlook is in line with the OECD, IMF, and European Commission forecasts and the FUNCAS consensus forecasts panel (Table 2). Indeed, FUNCAS' latest estimates indicate higher real GDP growth (3.3% in 2015 and 3.0% in 2016). The international economic situation appears to be more favourable now than just six months ago. The Spanish economy is also supported by low oil prices, depreciation of the euro, the European Central Bank's expansionary monetary policy, and the cut in personal income tax (IMF, 2015).

This scenario is in contrast to the period from 2017-2018, when the majority of the favourable shocks referenced above will no longer apply; forecasts become more uncertain; and political will and government targets become more important relative to the strictly technical components of the forecast calculations. In this regard, the solution the central government has opted for is understandable. The severe recession experienced by the Spanish economy during the five-year period from 2009-2014 now requires a sustained period of economic expansion to: normalise employment indicators; substantially reduce public debt and external debt ratios (as percentages of GDP), and help meet fiscal consolidation aims. Having to choose between prudence and ambition, the Spanish government has opted for the latter in an effort to stimulate recovery in the very short term by improving expectations. However, the deficit reduction plans for 2017-2018 are subject to much greater uncertainty over their effective execution. They essentially depend on whether the favourable economic climate continues, despite the disappearance of the aforementioned exogenous positive shocks and the current output

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Table 1
Macroeconomic outlook

	2014	2015	2016	2017	2018
1. Real GDP	1.4	2.9	2.9	3.0	3.0
2. Nominal GDP. Billion euros	0.9	3.6	3.8	4.2	4.6
Components of real GDP					
3. Private national final consumption expenditure (*)	2.4	3.3	2.9	2.7	2.5
4. General government final consumption expenditure	0.1	0.1	0.1	1.0	1.5
5. Gross fixed capital formation	3.4	6.3	5.8	5.9	5.9
6. Changes in inventories (% GDP)	0.2	0.0	0.0	0.0	0.0
7. Exports of goods and services	4.2	5.4	6.0	5.8	5.7
8. Imports of goods and services	7.6	6.7	6.4	6.3	6.2

Note: (*)Comprises households and NPISHs (non-profit institutions serving households).
Source: The author, based on Ministry of Finance and Public Administration (2014 and 2015).

gap (Fernández-Sánchez, 2015; AIReF, 2015). Furthermore, general elections are due to be held in late 2015, which could lead to a change of government and, consequently, possible modifications to the strategy of fiscal consolidation for the rest of the decade.

Table 2

Real GDP growth outlook for Spain. International organisations and FUNCAS

	2015	2016
European Commission (May 2015)	2.8	2.6
IMF (June 2015)	3.1	2.5
OECD (June 2015)	2.9	2.8
Bank of Spain (June 2015)	3.1	2.7
FUNCAS (July 2015)	3.3	3.0
FUNCAS consensus (July 2015)	3.1	2.7

Source: The author.

The new paths for public income and expenditure

Table 3 shows two paths of public expenditure and non-financial income expressed as a percentage of GDP. The path forecast by the current 2015-2018 Programme and the one found in the 2014-2017 Stability Programme. The public deficit that would arise if the government failed to carry out envisaged income and expenditure adjustment measures is also included in the new stability programme document.

The table allows several comparisons to be made. The first centres on the effect of the government´s planned discretionary measures. For the period as a whole, the forecast drop in the public deficit is 5.4 points of GDP, of which 31%

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would be a direct consequence of the government's measures and the remaining 69% associated with the improvement in economic conditions and other factors that are expected to have a greater impact on expenditure than on revenues. Exhibit 1 shows the breakdown of the fiscal adjustment. The automatic component of the adjustment centres basically on the expenditure ratio. While revenues stabilise at 38% of GDP, disbursements would fall

Table 3

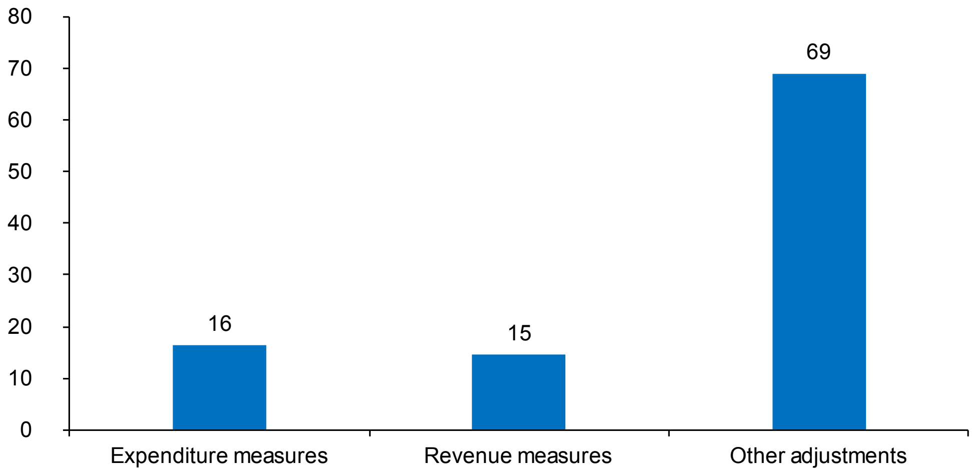
Expenditure, revenue and deficit forecasts 2014-2018

		2014	2015	2016	2017	2018
2015-2018 Stability programme	Total revenue	37.8	37.8	37.8	38.0	38.1
	Total expenditure	43.5	42.0	40.6	39.5	38.4
	Balance	-5.7	-4.2	-2.8	-1.4	-0.3
	Balance without measures	-5.7	-4.8	-3.9	-3.0	-2.0
2014-2017 Stability programme	Total revenue	38.5	38.8	38.9	39.0	
	Total expenditure	44.0	43.0	41.7	40.1	
	Balance	-5.5	-4.2	-2.8	-1.1	

Source: The author, based on Ministry of Finance and Public Administration (2014 and 2015).

Exhibit 1

Percentage breakdown of budgetary adjustment 2015-2018



Source: Bank of Spain.

nearly four points over the 2015-2018 period as a result of the increase in the denominator, the drop in expenditure items such as debt interest payments or unemployment benefits, and the virtual freezing of expenditure on most items, as we shall see in the following section.

Also of interest is a comparison of the budgetary stability programme update itself to the previous programme. Although the deficit targets for 2015 and 2016 are identical, there is a significant change in the path of public spending and revenue. The reference for the latter drops from 39% to 38%, while spending intensifies its fall to stand one point below the percentage forecast in the 2014-2017 programme for 2015 and to come to reach slightly above 38% in 2018. The change on the spending side can be explained by the fact that faster economic growth is anticipated to have a greater impact on the relevant items than forecast last year and intensifies the ratio's drop. On the revenues side, the new path could be anticipating new tax cuts over and above those already approved.[2] These cuts would cancel out the effect generated by a tax system that is elastic to GDP growth; and the commitment to strengthening the fight against tax evasion. Indeed, AIReF (2015) classes the revenue forecasts to 2018 as very prudent, above all in the case of direct taxes, bearing in mind the pattern of cyclical recovery in tax collection.

Finally, the forecast deficit for 2017 has been increased by three tenths from the previous version of the stability programme, entirely as a result of reduced public revenues. This relaxation of fiscal consolidation contrasts with the significant improvement of the macroeconomic picture.

The government´s proposed public deficit figures for 2015-2016 are more optimistic than those published by international organisations and institutions. The recent FUNCAS forecast[3] situates the public deficit at 4.6% of GDP in 2015 and 3.4% in 2016, figures 4 and 6 tenths of a percent higher than those in the 2015-2018 stability programme. The FUNCAS consensus forecasts panel published in July 2015 reports

[2] Bankia also takes this view (2015).

[3] http://www.funcas.es/prensa/NotasPrensa.aspx?file=170

slightly lower figures, but higher than those of the government: 4.4% and 3.2% For its part, the European Commission considers that the deficit will stand at 4.5% and 3.5% for 2015 and 2016, respectively (European Commission, 2015).

Particularly illustrative is AIReF's disaggregated analysis of the period 2015-2018 as a whole (2015). AIReF takes the view that the deficit reduction is achievable but ambitious. It is on the spending side that it sees the risks of non-compliance, particularly as regards the adoption of budget policy measures and decisions. Summarising:

- The measures envisaged in the Program (not replacing all workers who retire) will not be sufficient to produce the forecast drop in the employee compensation budget item (-1.3% of GDP).

- AIReF expresses some doubts about the effectiveness of the spending rationalisation measures adopted in the framework of the Commission for the Reform of the Public Administration (CORA in its Spanish initials) and the new health-spending rationalisation instrument (currently at the approval stage) in bringing down intermediate consumption and transfers in kind on the scale forecast (-1% of GDP).

- Gross fixed capital formation would be situated at historic lows (2% of GDP), which could cause a problem given the deferral of investments previously committed to during the crisis years.

- In comparison with the adjustment that took place in 1995-1999, on a relatively similar scale, there are various elements that make the current adjustment more demanding and harder to apply. Nominal GDP growth will be much lower (an annual average rate of 6.7% *vs* 4.0%), public revenues previously helped the adjustment substantially more than now forecast (1.3% *vs* 0.4% of GDP), the cut in public investment in 1995-1999 was much greater than that for 2015-2018 (-1.2% *vs* 0.3%), due to the starting point being much higher. And the same is true of the reduction in the interest burden (-1.5% *vs* -0.8%). All this increases the relevance of uncertainty over the impact of measures affecting employee compensation, intermediate consumption, and transfers in kind mentioned above, which are a central pillar of the current process of fiscal consolidation.

- Finally, from an institutional perspective, the biggest risks are at the social security system and regional government levels.

The recent European Commission evaluation (European Commission, 2015) basically agrees with AIReF's conclusions, but is less detailed. The Commission insists that the consolidation strategy is based in particular on a substantial and sustained improvement in the economic situation, neglecting the risks that increase over the medium-longer term, which can be construed as an implicit criticism. It also considers that the improvement in the structural deficit is insufficient and that there is no guarantee that the savings envisaged up to 2018 will materialise, given the lack of detail on some of the measures announced.

Finally, the International Monetary Fund (IMF, 2015) again refers to the need to provide greater detail over the measures announced, and focuses its attention on the regional level of government and the challenges it poses for fiscal consolidation. Firstly, it points to the existence of scope for savings and for the introduction of co-payments for health and education. Secondly, it advocates reforming regional financing so as to bolster the autonomous regions' capacity and incentives to consolidate their accounts. Thirdly, it recommends improving supervision and control over fulfilment of fiscal objectives. And fourthly, it suggests exploring the idea of setting asymmetrical regional deficit targets, depending on structural differences in capacities and needs for adjustment[4].

[4] For more on reforms at the regional level in Spain, see Lago-Peñas (2015).

In short, the fiscal consolidation horizon to 2018 in Spain is seen as feasible but ambitious and subject to considerable risks. Firstly, because it is particularly dependent on GDP growth and correction of the wide output gap that opened up over the period 2009-2013. Although the outlook is very good, some of the drivers benefiting the Spanish economy today could start to lose momentum in 2016. Secondly, because consolidation does not focus on increasing public revenues but is based on adjustments to employee compensation, intermediate consumption, and investment to a much larger degree than in Spain's previous fiscal consolidation efforts (1995-1999). Thirdly, because a large part of the measures announced under the spending headings referred to are not clearly defined and the savings are uncertain. And fourthly, because concerns over the autonomous regions have re-emerged with the deviations in the execution of the 2014 budget in a sizeable number of regions. There is undoubtedly still much to be done.

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Further reflections on 2018 fiscal targets

Table 4 compares real spending in per capita terms in 2013 and 2018 from a functional perspective. Data are given in terms of GDP and the cumulative percentage variation in real GDP and per capita terms, which are virtually the same in nominal and absolute terms, because the variation in the GDP deflator and the population cancel one another out.[5] The cut in general public services stands out, linked to public administration reform and the forecast drop in debt

Table 4

Structure of expenditure by functions in 2013 and 2018

	Expenditure/ GDP 2013(*) (1)	Expenditure/ GDP 2018 (2)	(1)-(2)	Change in real per capita expenditure as a cumulative percentage
General public services	6.9	5.5	-1.3	-7.1
Defence	0.9	0.8	-0.1	1.2
Public order and security	2.0	1.7	-0.3	-1.7
Economic affairs	4.0	3.7	-0.3	6.7
Environmental protection	0.8	0.7	-0.1	-2.9
Housing and community services	0.5	0.4	-0.1	-2.3
Health	6.0	5.3	-0.8	0.6
Recreational, cultural and religious activities	1.1	1.0	-0.2	-0.7
Education	4.0	3.7	-0.4	4.0
Social protection	17.6	15.7	-1.9	2.7
Total expenditure	**43.8**	**38.4**	**-5.4**	**0.9**

Note: (*)The 2013 figure does not include financial aid to the banks.

Source: Ministry of Finance and Public Administration (2015).

[5] Specifically, for 2014 to 2018, the series forecast by the Ministry for the public consumption deflator is: -0.9%; 0.0%; 0.1%; 0.7%; and, 0.7%. The cumulative variation would be 0.6%. According to National Statistics Institute (INE) forecasts, in 2018, Spain's population will be 46,237,861, which represents a change of -0.8% from the population in 2013 (46,593,236).

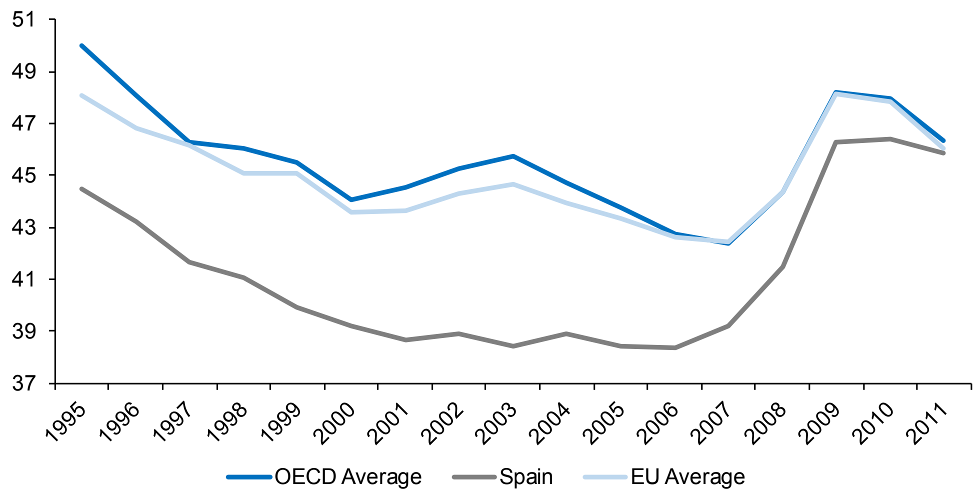
service payments; and public health spending, which will contract substantially in GDP terms and stagnate in absolute terms. Social protection spending will also drop significantly, mainly due to the expected reduction in unemployment benefits. Finally, education emerges as one of the most expansionary categories of public expenditure, but loses four tenth of its weight in GDP terms.

What are the implications of the foregoing? Firstly, the government's targets situate public expenditure at the minima reached during the last decade, such that the 38.4% announced should not be seen as an anomaly in historical terms (Exhibit 2). Nevertheless, it is true that returning to this level will probably lead again to a wide gap (of around four percentage points) with respect to the average for OECD and EU countries.

Table 5 shows the preceding public expenditure series broken down by functions. Looked at in conjunction with Table 4, the outlook for spending on education, health, and economic affairs is particularly striking. An investment of 3.7% of GDP in education would put Spain near the bottom of the table in both the EU and the OECD. Bearing in mind that there is also empirical evidence suggesting that resources are used less efficiently than in other countries (Lago-Peñas and Martínez-Vázquez, 2015), the picture is bleak and inconsistent with the importance the European Commission attaches to investment in education. In the case of health spending, on the other hand, studies suggest resources are being used highly efficiently, but the plans for 2018 entail a spending freeze in current terms and a notable gap with comparable countries. Finally, the disbursement on economic affairs is at historic lows. This heading includes significant items such as R&D spending and infrastructure investment. In the case of R&D, Spain's negative differential is well known. The progress made in the last decade was largely lost as a result of the cuts. Conversely, Spain has been strongly committed to public investment since the eighties, enabling it to make up for historical deficits, but unfortunately has also engaged in many projects with doubtful social returns. Consequently, the internal distribution of expenditure on economic affairs over the next four years should emphasise intangible (R&D) over physical investments, and unquestionably be more selective in what it does through a more

Exhibit 2

Total public expenditure as a percentage of GDP in Spain, the OECD, and the EU, 1995-2011



Sources: Lago-Peñas and Martínez-Vázquez (2015) based on OECD National Accounts at a Glance *(2014), Eurostat* General Government Expenditure by Function *(2015).*

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Table 5

Public expenditure: Total and by functions as a percentage of GDP. Averages for period 1995-2011

Percentage

	Total expenditure	General public services	Defence	Public order and security	Economic affairs	Environmental protection	Housing and community services	Health	Recreational activities, culture and religion	Education	Social protection
OECD	45.6	6.8	1.7	1.7	4.9	0.7	0.9	6.2	1.3	5.7	15.9
Spain	41.2	5.6	1.1	1.9	5.0	0.9	1.0	5.6	1.4	4.5	14.0
European Union	45.1	6.7	1.5	1.8	5.0	0.7	0.3	5.8	1.2	5.5	15.9

Sources: Lago-Peñas and Martínez-Vázquez (2015) based on OECD National Accounts at a Glance *(2014), Eurostat* General Government Expenditure by Function *(2015).*

widespread use of ex-ante analysis of social rates of return. Given that when it comes to public resources, austerity continues to dominate the horizon, it should be taken more seriously so that fiscal consolidation has the lowest possible cost in terms of quality of public services delivered to businesses and the public.

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