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signed by Mr Jordi AYET PUIGARNAU, Director

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Analysis by the Commission services of the budgetary situation in Spain
following the adoption of the COUNCIL RECOMMENDATION to Spain of
10 July 2012 with a view to bringing an end to the situation of an excessive
government deficit
Accompanying the document Recommendation for a COUNCIL
RECOMMENDATION with a view to bringing an end to the situation of an
excessive government deficit in Spain

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COMMISSION STAFF WORKING DOCUMENT

Analysis by the Commission services of the budgetary situation in Spain following the adoption of the COUNCIL RECOMMENDATION to Spain of 10 July 2012 with a view to bringing an end to the situation of an excessive government deficit

Accompanying the document

Recommendation for a

COUNCIL RECOMMENDATION

with a view to bringing an end to the situation of an excessive government deficit in Spain

{COM(2013) 383 final}

1. INTRODUCTION

On 27 April 2009, the Council decided, in accordance with Article 104(6) of the Treaty establishing the European Community (TEC), that an excessive deficit existed in Spain and issued a recommendation to correct the excessive deficit by 2012 at the latest¹, in accordance with Article 104(7) TEC and Article 3 of Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure².

On 2 December 2009, the Council decided, in accordance with Article 3(5) of Council Regulation (EC) No 1467/97, that effective action had been taken and that unexpected adverse economic events with major unfavourable consequences for government finances had occurred after the adoption of that recommendation. Notably, the sharp deterioration in the growth outlook in the wake of the global economic and financial crisis had major negative budgetary implications. As a result, the Council adopted a revised recommendation under Article 126(7) TFEU to correct the excessive deficit by 2013 at the latest in a credible and sustainable manner by taking action in a medium-term framework.

On 15 June 2010, the Commission concluded that Spain had taken effective action in compliance with the Council recommendation of 2 December 2009 to bring its government deficit below the 3% of GDP reference value and considered that no additional step in the excessive deficit procedure was therefore necessary.

On 10 July 2012, the Council decided, in accordance with Article 3(5) of Council Regulation (EC) No 1467/97, that effective action had been taken but that unexpected adverse economic events with major unfavourable consequences for government finances had occurred after the adoption of the revised recommendation in 2009. Notably, a worsening in the growth outlook and the shift to a less tax-rich growth composition had major negative budgetary implications. The Council therefore adopted a revised recommendation under Article 126(7) TFEU and recommended Spain to correct the excessive deficit by 2014 at the latest. In order to bring the headline government deficit below the 3% of GDP reference value by 2014, Spain was recommended to deliver an improvement of the structural balance of 2.7% of GDP in 2012, 2.5% of GDP in 2013 and 1.9% of GDP in 2014, based on the Commission services' update of the 2012 Spring Forecast. The headline deficit targets were set at 6.3% of GDP for 2012, 4.5% of GDP for 2013 and 2.8% of GDP in 2014.

Spain was recommended to implement the measures adopted in the 2012 budget and in the Autonomous Communities' rebalancing plans and to adopt the announced multi-annual budget plan for 2013-14 by the end of July 2012, including a medium-term budgetary strategy, which would fully specify the structural measures necessary to achieve the correction of the excessive deficit by 2014. Spain was also recommended to adopt without delay additional measures in 2012, should risks to the budgetary plans materialise. In addition, Spain was asked to strictly apply the new provisions of the Budgetary Stability Law regarding transparency and control of budget execution. In line with the country-specific recommendations under the European Semester, the Council also asked Spain to establish an independent fiscal institution to provide analysis, advice and monitor fiscal policy, stick to the enforceable nature of its medium-term budgetary framework as well as closely monitor

¹ All documents related to the excessive deficit procedure for Spain can be found at: http://ec.europa.eu/economy_finance/economic_governance/sgp/deficit/countries/spain_en.htm

² OJ L 209, 2.8.1997, p. 6.

adherence to the budgetary targets throughout the year for all the levels of the general government sector.

On 14 November 2012, the Commission concluded, based on the Commission services' 2012 Autumn Forecast, that Spain had taken effective action in compliance with the revised Council recommendation of 10 July 2012 and that no further steps in the excessive deficit procedure were required.

2. RECENT MACRO-ECONOMIC DEVELOPMENTS

After a short-lived recovery in 2011, when real GDP increased by 0.4% thanks to strong net exports, the economy has slipped back into recession, recording negative real GDP growth since the third quarter of 2011. The recession deepened in the second half of 2012, with the contraction accelerating to 0.8% quarter-on-quarter in the last quarter of the year, partly reflecting the short-term impact of consolidation measures. In annual terms, GDP fell by 1.4% in 2012. According to the Commission services' 2013 Spring Forecast³, the recession is set to continue in 2013, with positive net exports still not able to offset the on-going contraction of domestic demand. Output is expected to stabilise only towards the end of 2013. Real GDP is thus projected to contract by 1.5% in 2013, before growing by 0.9% in 2014, under a no-policy-change assumption. As discussed in the 2013 In-Depth Review (IDR) under the Macroeconomic Imbalances Procedure⁴, the correction of large economic imbalances built up during the boom period will be a drag on growth over the medium-term. Private sector deleveraging, very high unemployment, tight financing conditions, and fiscal consolidation are weighing down on domestic demand. Net exports are therefore likely to be the only source of GDP growth over the forecast horizon, with domestic demand remaining a drag. The labour market situation is due to continue to deteriorate and the already very high unemployment is likely to increase further in the short term.

In the baseline no-policy-change scenario at the time of the revised EDP recommendation (the Commission services' updated 2012 Spring Forecast' for Spain), real GDP was projected to contract sharply in 2012 and start expanding again in the first half of 2013, yielding annual growth rates of -1.9% and -0.3% in 2012 and 2013, respectively (see Table 1). As the recovery was expected to kick in earlier, annual real GDP in 2014 was forecast to reach 1.1%. Eventually, real GDP growth in 2012 turned out less negative than foreseen in the Commission services' updated 2012 Spring Forecast. This was mainly due to somewhat more resilient domestic demand than expected at the time of the revised EDP recommendation, possibly also thanks to the liquidity injected via the repayment scheme for the commercial debt accumulated by the regions and local authorities before 1 January 2012 (EUR 27.4 bn, or 2.6% of GDP). However, compared to the Commission services' updated 2012 Spring Forecast, the 2013 Spring Forecast envisages a sharper contraction of real GDP in 2013 and a more subdued recovery in 2014. This includes a sharper drop in domestic demand in both years and a more protracted slump in employment. The worse macroeconomic outlook partly

³ The Commission services' 2013 Spring Forecast had a cut-off date of 23 April. It takes into account budgetary data for 2012 validated by Eurostat on the 22 of April 2013. For the purpose of this document, the Spring Forecast has been extended to 2016. .

⁴ http://ec.europa.eu/economy_finance/publications/occasional_paper/2013/op134_en.htm

reflects the fact that the 2013 Spring Forecast takes into account additional consolidation measures included in the 2013-14 budget plan and the 2013 budget.⁵

Table 1: Comparison of macroeconomic developments and forecasts

	2011	2012		2013			2014		
	outturn	COM SF12	COM SF13	SP 2013	COM SF12	COM SF13	SP 2013	COM SF12	COM SF13
Real GDP (% change)	0.4	-1.9	-1.4	-1.3	-0.3	-1.5	0.5	1.1	0.9
Contributions to real GDP growth:									
Domestic demand	-1.8	-4.4	-3.9	-3.7	-2.0	-4.0	-0.8	-0.1	-0.4
Changes in inventories	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net exports	2.3	2.5	2.5	2.4	1.6	2.6	1.3	1.2	1.3
Employment (% change)	-1.5	-4.0	-4.2	-3.5	-1.5	-3.4	-0.2	0.3	0.0
GDP deflator (% change)	1.0	0.9	0.1	1.4	0.6	1.6	1.4	1.4	1.0
Output gap (% of potential GDP)	-4.1	-5.4	-4.6	-4.5	-4.9	-4.6	-3.2	-3.0	-2.3
Potential output growth (% change)	-0.2	-0.8	-0.9	-1.5	-0.9	-1.4	-0.8	-0.9	-1.5

Source: COM SF12 - Commission services' updated 2012 Spring Forecast; COM SF13 - Commission services' 2013 Spring Forecast covering the period 2012-2016; SP 2013 - Stability Programme April 2013

3. ASSESSMENT OF EFFECTIVE ACTION

3.1 Background information

The current assessment of effective action is based on the Commission services' 2013 Spring Forecast. It takes into account the economic and budgetary developments since 10 July 2012, when the last Council recommendation under Article 126(7) TFEU was issued. The assessment starts by comparing the recommended fiscal effort in the Council recommendation, the apparent fiscal effort, measured by the change in structural budget balance, and the adjusted structural effort. The adjustment of the structural balance takes into account (i) the impact of revisions in potential output growth compared to that underlying the growth scenario in the Council recommendation, and (ii) the impact on revenue of revisions of the tax content of economic activity (composition of economic growth or of other windfalls/shortfalls) relative to what was assumed at the time of the recommendation. This top-down approach in the assessment is complemented by a careful analysis, including a bottom-up assessment of consolidation measures undertaken by the Spanish government.

Table 2 and 3 below present the main variables used in the assessment of effective action. Table 2 presents the baseline scenario underlying the revised July 2012 EDP recommendation. Table 3 summarises the key budgetary requirements of the revised EDP recommendation: annual nominal targets and required annual adjustments in the structural balance.

⁵ Real GDP is expected to contract less in 2013 than envisaged in the 'EDP scenario' of the revised EDP recommendation (cf. Table 3), which is due to carry-over effects from 2012 and the fact that the change in the headline and structural deficit is lower than was anticipated in the EDP scenario.

Table 2: Baseline scenario underlying the recommendation addressed to Spain in July 2012

<i>% of GDP</i>	2011	2012	2013	2014
Revenues	35.1	35.9	35.7	34.7
Current revenues	35.3	36.1	35.9	34.9
Discretionary measures with impact on current revenue (EUR bn) ⁶	9.7	9.3	-1.8	-4.7
Expenditure	44.0	42.2	41.8	41.1
Real GDP growth (%)	0.7	-1.9	-0.3	1.1
Nominal GDP growth (%)	2.1	-1.0	0.3	2.5
Potential GDP growth (%)	0.1	-0.8	-0.9	-0.9
Structural balance	-7.0	-4.3	-4.1	-5.1
General government balance	-8.9	-6.3	-6.1	-6.4
<i>p.m CAB methodology revenue elasticity</i>	1.1	1.1	1.1	1.1
<i>p.m Apparent revenue elasticity</i>		0.9	-0.2	0.5
<i>p.m Output gap (% of pot. output)</i>	-4.2	-5.3	-4.7	-2.8

Table 3: EDP scenario underlying the recommendation addressed to Spain in July 2012

<i>% of GDP</i>	2011	2012	2013	2014
Real GDP growth (%)	0.7	-1.9	-2.1	-1.1
Potential GDP growth (%)	0.1	-0.8	-0.9	-0.9
Structural balance	-7.0	-4.3	-1.8	0.1
General government balance	-8.9	-6.3	-4.5	-2.8
<i>p.m Output gap (% of pot. output)</i>	-4.2	-5.3	-6.5	-6.8

3.2 Assessment of effective action

3.2.1 Budgetary implementation in 2012

The general government deficit reached 10.6% of GDP in 2012, compared with a government and EDP target of 6.3% of GDP and a 9.4% of GDP outcome in 2011. Adjusting the figures for capital transfers to banks (which are considered as one-off operations), the corresponding deficits were 7.0% and 9.0% of GDP, respectively, implying an improvement in the general government deficit of close to 2 pps. Net of capital transfers into banks, the primary balance narrowed by 2.4 pps. from -6.5% of GDP in 2011 to around -4.1% in 2012, against the background of an economy shrinking by 1.4%. By level of government, the main consolidation effort was achieved at the regional and local level, with the regions in aggregate only missing the deficit target of 1.5% of GDP by slightly more than 0.2 pps. (although with considerable variation across regions), after recording a deficit of more than 5% of GDP in 2011. In contrast, the social security sector balance deteriorated by around 1 pp., resulting in a deficit of almost 1% of GDP.

The revised EDP recommendation of 10 July 2012 required Spain to achieve an improvement in the structural balance of 2.7 pps. in 2012. The Commission services' 2013 Spring Forecast points to an improvement in the structural deficit of 1.8 pps, (see Table 4). Accounting for the slight downward revision of potential output since the time of the revised EDP recommendation does not have a material impact on the adjusted fiscal effort in 2012. However, the estimated change in the structural balance was severely affected by revenue

⁶ Measures clearly specified and committed to by government ahead of the recommendation.

shortfalls compared with the scenario underlying the original EDP recommendation. These shortfalls amounted to around 1.0 pp. Despite additional discretionary current revenue measures of almost EUR 8 bn taken since the EDP recommendation, actual current revenues in 2012 increased by almost EUR 3 bn less than foreseen at the time. Hence, this adds up to an unexpected revenue shortfall of around EUR 11 bn compared with the EDP recommendation. Overall, taking these effects into account, the estimated adjusted change in the structural balance amounts to 2.9 pps., above the effort required under the revised EDP recommendation.

Table 4: Composition of the budgetary adjustment

	2011		2012		2013			2014		
	outturn	SP April 2012	COM SF 2012	COM SF 2013	SP April 2013	COM SF 2012	COM SF 2013	SP April 2013	COM SF 2012	COM SF 2013
	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
Revenue	35.7	35.1	35.9	36.4	37.0	35.7	36.8	36.8	34.7	35.9
<i>of which:</i>										
- Taxes on production and imports	9.9	9.8	9.9	10.2	10.8	9.8	10.7	10.8	9.8	10.6
- Current taxes on income, wealth, etc.	9.6	9.5	10.2	10.1	10.4	10.1	9.9	10.5	9.6	9.2
- Social contributions	13.2	13.0	12.8	12.9	12.5	12.6	12.8	12.3	12.3	12.5
- Other (residual)	3.1	2.9	3.0	3.2	3.2	3.2	3.4	3.2	3.0	3.6
Expenditure	45.2	43.6	42.2	47.0	43.3	41.8	43.3	42.3	41.1	42.9
<i>of which:</i>										
- Primary expenditure	42.7	41.2	39.0	44.1	40.0	38.5	40.0	38.8	37.8	39.4
<i>of which:</i>										
- Compensation of employees	11.6	11.5	10.9	11.1	10.9	10.7	11.2	10.4	10.2	10.9
- Intermediate consumption	5.9	5.4	4.9	5.7	5.4	4.6	5.4	5.2	4.6	5.4
- Social payments	18.2	18.0	18.5	18.8	18.9	18.6	19.0	18.9	18.4	19.0
- Subsidies	1.1	1.1	0.9	1.0	1.1	0.9	0.9	1.0	0.9	0.9
- Gross fixed capital formation	2.9	2.8	1.9	1.7	1.5	1.8	1.4	1.5	1.8	1.3
- Other (residual)	3.0	2.5	1.9	5.9	2.2	1.9	2.1	1.9	1.9	2.0
- Interest expenditure	2.5	2.4	3.2	3.0	3.3	3.3	3.3	3.5	3.3	3.5
General government balance (GGB)	-9.4	-8.5	-6.3	-10.6	-6.3	-6.1	-6.5	-5.5	-6.4	-7.0
Primary balance	-7.0	-6.1	-3.1	-7.7	-3.0	-2.8	-3.2	-2.0	-3.1	-3.6
One-off and other temporary measures	-0.2	0.4	0.2	-3.0	0.0	0.0	0.0	0.0	0.0	-0.4
Structural balance	-7.2	-7.3	-4.3	-5.5	-4.3	-4.1	-4.4	-3.9	-5.1	-5.5
Change in structural balance	-	-	2.9	1.8	1.2	0.2	1.1	0.4	-1.0	-1.1
Corrected change in structural balance due to revision of potential output growth ('alpha')				1.8			1.3			-0.9
Real GDP growth	0.4	0.7	-1.9	-1.4	-1.3	-0.3	-1.5	0.5	1.1	0.9
GDP deflator	1.0	1.4	0.9	0.1	1.4	0.6	1.6	1.4	1.4	1.0
Nominal GDP	1.4	2.1	-1.1	-1.3	0.2	0.3	0.1	1.9	2.5	2.0

Source: SP April 2012 - Stability Programme April 2012; SP April 2013 - Stability Programme April 2013; COM SF 2012 - Commission services' updated 2012 Spring Forecast; COM SF 2013 - Commission services' 2013 Spring Forecast covering the period 2012-2016.

Table 5: Change in structural balance corrected for revisions in potential output gap and revenue windfalls/shortfalls⁷

	Uncorrected fiscal effort (ΔS)			Corrected fiscal effort (ΔS^*)			<i>Required fiscal effort in the latest Council recommendation (R)</i>			Deadline for correction
	2012	2013	2014	2012	2013	2014	2012	2013	2014	
ES	1.8	1.1	-1.1	2.9	2.5	-1.4	2.7	2.5	1.9	2014

This analysis is confirmed by a more in-depth analysis of the budgetary developments in 2012, including a bottom-up assessment of measures taken. The improvement in the primary balance of around 2.4% of GDP in 2012 (net of capital transfers into banks) was achieved despite a sharp contraction in the economy and a very tax-weak growth composition. To compensate for likely deviations from the deficit target, Spain adopted sizeable consolidation measures during 2012 (Table 6). On the whole, total measures of around 4% of GDP were adopted for 2012, including around 1½% of GDP on the revenue side and 2½% of GDP on the expenditure side. Of the total measures, around ¾% of GDP consisted of one-off measures, and therefore did not contribute to a durable improvement in the budget balance. Moreover, part of these measures compensated an underlying deterioration in the budgetary position linked with rising interest payments and higher social spending and therefore are not reflected in an improvement in the structural balance.

In nominal terms, the government and EDP target for the headline deficit in 2012 was 6.3% of GDP. Apart from the recapitalisation measures, the deviation from the target is linked to a combination of weaker-than-expected revenues (taking into account the impact of discretionary measures and the base effect) and expenditure overruns, including higher intermediate consumption and social transfers. The less tax-rich growth composition and a stronger deterioration in the labour market implied major revenue shortfalls, notably of direct and indirect taxes, as well as higher social expenditure. As a result, despite an increase in VAT and personal and corporate income tax, current revenues remained weaker than expected at the time of the revised EDP recommendation when adjusted for the base effect. On the expenditure side, slippages of around ½ pp. occurred (net of base effects and bank recapitalisations), mainly for intermediate consumption and social payments.

Table 6: Main discretionary measures in 2012-2014 (% of GDP)

Revenue	Expenditure
2012	
<ul style="list-style-type: none"> • VAT and excise tax rate increases (0.2% of GDP) • Changes to corporate taxation (0.4% of GDP) • Personal income tax hike (0.7% of GDP) • Revenue raising measures at regional level, e.g. increase in property taxes, etc (0.2% of GDP) • Increase of fees in education and at 	<ul style="list-style-type: none"> • Cuts in public investment and other capital expenditure (1.0% of GDP) • Cuts in health and education (0.4% of GDP) • Elimination of Christmas bonus for public employees (0.4% of GDP) • Reduction of public employment (0.2% of GDP) • Unemployment benefit reform (0.2% of

⁷ Detailed calculations for these corrections are provided in the Annex.

<ul style="list-style-type: none"> central government level (0.1% of GDP) Total: 1.6% of GDP 	<ul style="list-style-type: none"> GDP) Total: 2.5% of GDP
2013	
<ul style="list-style-type: none"> VAT and excise tax rate increases (1.1% of GDP) Personal income tax hike (0.1% of GDP) Revenue raising measures at regional level (0.1% of GDP) Broadening of social security base (0.1% of GDP) Increase of fees in education and at central government level (0.1% of GDP) Total: 1.5% of GDP 	<ul style="list-style-type: none"> Cuts in health and education (0.7% of GDP) Cuts in unemployment benefits (0.4% of GDP) Freezing of public sector hiring (0.2% of GDP) Reintroduction of Christmas bonus for public employees (-0.4% of GDP) Capital transfer for covering electricity tariff deficit (-0.2% of GDP) Optimization of long-term care (0.1% of GDP) Total: 1.0% of GDP
2014	
<ul style="list-style-type: none"> Expiry of changes to corporate taxation (-0.5% of GDP) Expiry of personal income tax hike (-0.6% of GDP) Total: -1.1% of GDP⁸ 	<ul style="list-style-type: none"> Freezing of public sector hiring (0.2% of GDP) Restricting early or partial retirement (0.1% of GDP) Local administration reform (0.2% of GDP) Total: 0.5% of GDP
<p><i>Note: Negative sign denotes a deficit increasing measure. Only measures yielding more than 0.1% of GDP are listed.</i></p>	

3.2.2 Budgetary developments in 2013

According to the Commission services' 2013 Spring Forecast, the government deficit is projected to decline to 6.5% of GDP in 2013, compared to the EDP target of 4.5% of GDP. The primary balance is expected to improve by 4.5 pps. (0.9 pp. net of capital transfers into banks) (see Table 4). Despite 2013 being another year of contracting domestic demand, the full-year effect of the increase in VAT and hikes in excise duties are expected to result in slightly higher total revenues. On the expenditure side, sizeable cuts in intermediate consumption and gross fixed capital formation should offset the rise in interest expenditure, due to a higher debt stock, and social spending. There are, however, risks to this scenario, notably on the revenue side, if similar shortfalls as in 2012 were to materialise.

The Commission services' 2013 Spring Forecast projects the structural deficit to narrow by 1.1 pps. compared with a recommended effort of 2.5 pps. Correcting for the change in the estimated potential growth between the projections underlying the revised EDP recommendations and the 2013 Spring Forecast would improve the adjusted fiscal effort by

⁸ According to the 2013 update of the Stability Programme, these measures are to be extended/made permanent.

0.2 pp. Moreover, correcting for higher-than expected revenue shortfalls, the effort improves by 1.2 pps., bringing the change in the adjusted fiscal effort to 2.5% of GDP. Despite additional discretionary current revenue measures of more than EUR 17.5 bn (around 1.7% of GDP) having been taken since the EDP recommendation, actual current revenues are expected to increase by only EUR 4 bn compared with what was foreseen at the time. Hence, this adds up to an unexpected revenue shortfall of close to EUR 13 bn (1.2% of GDP) compared with the EDP recommendation. The adjusted fiscal effort is in line with the required effort according to the revised EDP recommendation.

Following the revised EDP recommendation, in August 2012, the Spanish government presented a multi-annual budget plan for 2013-14, outlining some features of the consolidation strategy for the medium-term. For 2013, the plan did not specify sizeable new revenue measures compared to what had already been announced in the July 2012 package, and which foresaw the VAT hike to have its main impact in 2013. On the expenditure side, a large share of the consolidation effort foreseen in the August plan stems from measures at the regional level (0.7% of GDP) and from changes to unemployment benefits (0.4% of GDP). To these measures, the 2013 Budget bill added a few new measures not previously announced, such as an extension of the wealth tax by one year. A number of temporary and one-off measures expiring in 2013 partly offset these consolidation measures (e.g. reintroduction of Christmas bonus, corporate income taxes). In total, the amount of discretionary measures impacting on 2013 is estimated to be about 1% of GDP on the expenditure side and about 1½% of GDP on the revenue side.

The expected deviation from the 2013 target recommended in July 2012 is forecast to reach around 2 pps at unchanged policies. This is partly explained by the worse starting position (base effect ¾% of GDP). However, the main factor behind the deviation is the unfavourable growth composition, with private consumption contracting more strongly and the labour market performing worse than expected at the time of the EDP recommendation. This has made economic activity less tax rich, with detrimental impact on the government balance. Hence, despite additional discretionary revenue measures of about 1½% of GDP, the revenue ratio is expected to rise by only ½ pp, reflecting major revenue shortfalls. Also, on the expenditure side, additional discretionary measures of 1 pps. are only expected to lead to a decrease in the expenditure ratio of about 0.1 pp. The main elements preventing a further reduction in this ratio are higher interest payments and higher social transfers due to ageing and adverse developments in the labour market.

In its 2013 Stability Programme, the Spanish government announced a general government deficit target of 6.3% of GDP for 2013, to be underpinned by additional consolidation measures of around EUR 3 bn. (0.3% of GDP) still to be adopted and implemented this year.

3.2.3 Budgetary developments in 2014

For 2014, the Commission services' 2013 Spring Forecast foresees real GDP growth of 0.9% under a no-policy change scenario. The expected return to positive economic growth and a certain stabilisation in the labour market, however, are not sufficient to achieve a further narrowing of the headline deficit, which is expected to widen to 7.0% of GDP compared to an EDP target of 2.8% of GDP. The few additional consolidation measures for 2014 specified so far (see below) are not enough to offset the expiry of temporary measures taken in previous years. The primary deficit is expected to widen by 0.4% of GDP to 3.6% in 2014. Apart from the base effect (2% of GDP), the expected deviation from the headline target mainly reflects the expiry of temporary measures and the fact that the planned consolidation measures for

2014 were not sufficiently specified in the multi-annual budget plan announced in August 2012. Moreover, the composition of economic growth continues to be tax-poor, with social contributions and indirect taxes not rising in full proportion to nominal GDP. Interest payments also keep rising due to a higher debt stock. The 2013 Stability Programme, submitted after the cut-off date of the 2013 Spring Forecast, announces an extension of the temporary measures that were to expire in 2014 (such as the changes to the corporate and personal income taxation), additional unspecified savings at regional level and under the local administration reform, which still remains to be adopted, as well as containment of expenditure growth.

The main discretionary consolidation measures with an incremental impact in 2014 are the freeze in public sector hiring (0.2% of GDP) and various measures restricting early or partial retirement (0.1% of GDP). The main discretionary measures that are expiring in 2014 are the 2012 hikes to personal income tax rates (0.6% of GDP), the 2012 changes to corporate taxation (0.5% of GDP), the temporary wealth tax (0.1% of GDP), and the hike from 15% to 21% of withholdings in the personal income tax system (0.1% of GDP). The 2013-14 Budget Plan included further consolidation measures at regional and local level of about $\frac{3}{4}$ % of GDP in the field of health and education and regarding regional and local administration consolidation. However, these were not sufficiently specified in order to be fully included in the Commission services' 2013 Spring Forecast.

The revised EDP recommendation of 10 July 2012 recommended Spain to achieve a structural fiscal consolidation of 1.9% of GDP in 2014. However, according to the Commission services' 2013 Spring Forecast, the structural deficit is projected to deteriorate by 1.1 pps. to 5.5% in 2014. Correcting for the change in the estimated potential growth between the projections underlying the revised EDP recommendations and the 2013 Spring Forecast, would improve the estimated fiscal effort in 2014 by around 0.2 pp. However, adjusting for unexpected revenue developments increases the gap by around 0.4 pp. This leaves the adjusted structural effort about $\frac{3}{4}$ pps. short of the level required by the revised EDP recommendation.

3.2.4 Public debt

General government gross debt rose to around 84% of GDP in 2012 compared to 80.9% of GDP projected in the Commission services' updated 2012 Spring Forecast. The increase in the debt ratio was due to a higher than expected deficit outcome, lower nominal GDP growth, costs of bank recapitalisation operations and the repayment of public administration arrears (see below). According to the Commission services' 2013 Spring Forecast, the debt-to-GDP ratio is expected to increase further and to exceed 95% in 2014, based on a no-policy-change scenario, thus exceeding the Treaty reference value in all years. This increase in the debt ratio is mainly driven by higher interest payments and to a lesser extent by the dynamics of the primary deficit and low nominal GDP growth. The materialisation of downside risks related to the macroeconomic scenario and the budgetary targets would imply a further increase in public debt.

Spain faces high risks to sustainability in a medium-term perspective and medium risks in the long run. Returning to a higher structural primary balance, around -0.5% of GDP as it was on average in the period 1998-2012, would help contain these risks. The 2013 reform of early retirement schemes is expected to contribute to the long-term sustainability of the social security system. However, further measures to contain age-related expenditure growth appears necessary, e.g. via the appropriate regulation of the sustainability factor foreseen by

the 2011 reform of the pension system, including by providing that the retirement age will rise in line with gains in life expectancy.

3.2.5 Budgetary framework

In the revised EDP recommendation of July 2012, Spain was also recommended to strictly apply the new provisions of the Budgetary Stability Law regarding transparency and control of budget execution. The Law and the conditionality of the Regional Liquidity Fund appear to have contributed to contain deviation of regional budget outcomes from targets.

Major progress has been made regarding a more transparent and timely reporting on budgetary execution at different levels of government in 2012. Spain has started to publish quarterly fiscal accounts for subsectors in national accounts terms, including detailed information on the regions' revenues, expenditures and fiscal balances. Consolidated quarterly accounts for the general government in national accounts terms are now published with a lag of two months. Moreover, since October 2012, monthly reports on regional public finances are published on a budget execution basis with a month and a half delay. As of March 2013, monthly regional fiscal data are published in national accounts terms with a two-month lag. Some improvements in the municipalities' fiscal reporting have also been made with a delay in reporting of maximum three months. Despite these important improvements in transparency, a sound track record regarding the quality and consistency of reporting remains to be achieved, given the challenge of introducing new reporting procedures across regional administrations. Also, the information content of the data is reduced by the lack of long time series. Finally, information on arrears (outstanding amounts and payments) is incomplete. The government has disclosed data on arrears paid through the Suppliers Payment Scheme in 2012. However, the scheme does not cover all regions and local entities and it targets invoices which remained unpaid as of 1 January 2012.

There has been limited visible progress in enforcing the preventive and corrective arm of the Budgetary Stability Law in a more transparent and timely manner. The early warning mechanism was triggered only in late December 2012 despite several Autonomous Communities being at risk of not meeting their fiscal targets already in the first half of the year. This relatively late activation puts at risk the timely correction of emerging budgetary deviations. Moreover, the implementation of the corrective mechanisms could have been more transparent. To illustrate, the publicly available assessments of the economic and financial plans do not give a detailed evaluation of measures adopted by the regions relative to the targets. Furthermore, although not required by law, the early warnings (*requerimientos*) issued at the end of 2012 could have been published in the interest of transparency and raising credibility of the implementation of the law

The Regional Liquidity Fund (RLF) set up to provide affordable financing to regions that experience funding difficulties has been extended through 2013. The provision of liquidity is subject to strengthened fiscal conditionality and supervision through continuous monitoring of the adjustment plans of each beneficiary region in order to ensure meeting the general government budget deficit target. In 2013, the participating regions will be subject to stricter monthly reporting and monitoring requirements on their cash flow position in exchange for liquidity support. The funding mechanism has been modified: contrary to 2012 when part of the funding was provided by banks, in 2013 the funding needs of the regions will be covered entirely by the central government to reduce costs. The 2012 Suppliers Payment Scheme has been extended (for the remaining EUR 2.6 bn of the original EUR 30 bn allocation), still

limited to commercial debt contracted by end-2011. As such, the scheme can increase debt but has no impact on the deficit in accruals terms.

In line with the country-specific recommendations under the European Semester, the Council also asked Spain to establish an independent fiscal institution to provide analysis, advice and monitor fiscal policy, stick to the enforceable nature of its medium-term budgetary framework as well as closely monitor adherence to the budgetary targets throughout the year for all the levels of the general government sector. On 27 September, the Spanish government decided to establish such an independent institution which was to become operational in early 2013.⁹ However, the setting-up of the council has lagged behind schedule and the government announced in the 2013 Stability Programme and National Reform Plan to aim at setting up the independent fiscal institution by end- 2013. The institution would thus not be able to play an effective role already in the 2014 budgetary planning procedure as originally foreseen.

4. PROPOSED NEW FISCAL ADJUSTMENT PATH

According to the baseline scenario, Spain will not meet the nominal budgetary targets established in the Council Recommendation of 10 July 2012. However, Spain has implemented a structural effort in 2012 and 2013 which, account taken of the unexpected adverse economic developments compared to when the Council recommendation was issued, is in line with the EDP recommendation. These unexpected adverse economic developments have entailed major unfavourable consequences for government finances. In particular, significant revenue shortfalls linked to the on-going rebalancing of the economy towards a less tax-rich growth structure and associated negative effects on revenue elasticities have led to a substantial deterioration in the budgetary position. The high magnitude of these shortfalls was not fully expected in the original EDP recommendation. At the same time, the actual decline in real GDP was less severe than expected. Yet, the economic recession has affected employment in a very negative way and unemployment has risen sharply. Together with the changing composition of GDP growth, this has had adverse effects on both the revenue and expenditure side with a shortfall of current tax revenue and social contributions as well as higher expenditure on social transfers.

As highlighted in the 2013 In-Depth Review under the Macroeconomic Imbalance Procedure, the correction of the large economic imbalances accumulated during the boom years, and in particular the absorption of very high private debt levels and the need to rebalance the economy towards a more export-led growth model, are having major negative consequences on economic growth and still entail risks for financial stability. The on-going correction of these imbalances and the associated economic recession entail a sharp and protracted worsening of public finances and have put public debt on a steep upward path. Continued, determined fiscal consolidation efforts are required to rein in the increase in public debt and to bring public finances back on a sustainable path. At the same time, it appears neither possible nor desirable to fully correct the negative impact of the adjustment of macroeconomic imbalances on public finances in the short term. A sustainable correction of the excessive deficit in the medium-term requires simultaneous progress on ensuring a smooth correction of imbalances, supported by structural reforms to boost growth and employment creation and to reduce structural rigidities that hamper the adjustment. The path of fiscal consolidation needs to reflect also possible implications for the correction of imbalances. Considering all these

⁹ This will also be required under the Treaty on stability, coordination and governance in the Economic and Monetary Union.

factors and using the flexibility foreseen in the Stability and Growth Pact, an extension of the deadline for correcting the excessive deficit in Spain appears to be warranted.

Against the background of high uncertainties regarding economic and budgetary developments, the budgetary target recommended for the final year of the correction period should be set at a level slightly below the reference value, in order to guarantee an effective and lasting achievement of the correction within the requested deadline.

According to the new EDP scenario in Table 8, granting two additional years in the correction of the excessive deficit corresponds to intermediate headline deficit targets of 6.5% of GDP for 2013, 5.8% of GDP for 2014, 4.2% of GDP for 2015, and 2.8% of GDP for 2016. The attainment of these deficit targets is consistent with an annual improvement in the primary balance (net of one-off measures) of 1.3% of GDP on average over the period 2013-16. The improvement in the structural budget balance implied by the headline targets is 1.1% of GDP in 2013, 0.8% of GDP in 2014, 0.8% of GDP in 2015, and 1.2% of GDP in 2016.¹⁰ These targets for the annual improvement in the structural budget balance take into account the need to compensate for the negative second-round effects of fiscal consolidation on public finances, through its impact on GDP growth. The more gradual adjustment path takes into account the current difficult economic environment and the on-going major structural transformation of the Spanish economy. As such, it is expected to support the correction of external and internal macroeconomic imbalances, mitigate the negative short-term impact of fiscal consolidation on economic growth, while still stabilising and reversing the upward trend in general government debt.

According to the Commission services' 2013 Spring Forecast, which is based on a no-policy change assumption, no additional measures appear needed at this stage to achieve the recommended improvement in the structural balance for 2013 (and the new 6.5% of GDP headline deficit target), but the budgetary plans at all levels of government will have to be strictly implemented. The situation will have to be monitored closely and further corrective action would have to be taken early on if deviations from budgetary plans were to materialise. For the period 2014-2016, bringing the deficit below the Treaty reference value on a sustainable basis will require implementing considerable additional structural fiscal measures, when taking into account the need to compensate for the negative second round effects, subdued growth prospects as well as rising interest and social payments. Budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of the public finances and reinforcing the growth potential of the economy. Based on current estimates, this would require an amount of permanent annual measures with an estimated budgetary impact of around 2% in 2014, 1% in 2015, and 1½% of GDP in 2016. This is based on the need to compensate for the expected deterioration in the underlying structural balance in the baseline scenario and to deliver the required structural effort in the EDP scenario.

The 2013 Stability Programme envisages an adjustment path which is broadly consistent with the correction of the excessive deficit by 2016, targeting headline deficits of 6.3% of GDP in 2013, 5.5% in 2014, 4.1% in 2015, and 2.7% in 2016. For 2013, the lower deficit target is based on additional consolidation measures of around EUR 3 bn envisaged in the programme, which, however, remain to be fully specified.

¹⁰ The required structural fiscal efforts have to be interpreted with great caution given the major uncertainties surrounding the methodological estimation of potential growth and output gaps in an economy like Spain, facing profound structural transformations.

It would be important to underpin the adjustment path by a credible medium-term consolidation strategy that includes (i) a detailed multi-annual budget plan with well-specified structural measures for the years 2014-16, (ii) further strengthening the effectiveness of the institutional framework (by raising the transparency in implementation of the Budgetary Stability Law as well as by establishing an independent fiscal council), (iii) undertaking concrete steps to rein in the mounting structural deficit in the social security system, and (iv) giving a greater emphasis to the growth friendliness of the consolidation (including by conducting systematic expenditure reviews as well as reviews of the tax system).

Table 7: Baseline scenario (Commission services' 2013 Spring Forecast)

<i>% of GDP</i>	2011	2012	2013	2014	2015	2016
Revenues	35.7	36.4	36.8	35.9	36.1	36.1
Current revenues	35.8	36.3	36.6	35.4	35.6	35.5
Discretionary measures with impact on current revenue (EUR bn) ¹¹	8.6	17.1	15.8	-11.3	2.1	0.0
Expenditure	45.2	47.0	43.3	42.9	42.2	41.6
Real GDP growth (%)	0.4	-1.4	-1.5	0.9	1.4	1.9
Nominal GDP growth (%)	1.4	-1.3	0.1	2.0	2.6	3.2
Potential GDP growth (%)	-0.2	-0.9	-1.4	-1.5	-0.1	0.6
Structural balance	-7.2	-5.5	-4.4	-5.5	-5.7	-5.9
General government balance	-9.4	-10.6	-6.5	-7.0	-6.0	-5.6
<i>p.m CAB methodology revenue elasticity</i> ¹²	1.0	1.0	1.0	1.0	1.0	1.0
<i>p.m Apparent revenue elasticity</i>		3.3	-24.4	1.0	1.1	0.9
<i>p.m Output gap (% of pot. Output)</i>	-4.1	-4.6	-4.6	-2.3	-0.8	0.6

Table 8: EDP scenario

<i>% of GDP</i>	2011	2012	2013	2014	2015	2016
Real GDP growth (%)	0.4	-1.4	-1.5	-0.5	0.7	0.9
Potential GDP growth (%)	-0.2	-0.9	-1.4	-1.5	-0.1	0.6
Structural balance	-7.2	-5.5	-4.4	-3.6	-2.8	-1.6
General government balance	-9.4	-10.6	-6.5	-5.8	-4.2	-2.8
<i>p.m Output gap (% of pot. output)</i>	-4.1	-4.6	-4.6	-3.8	-2.9	-2.6

¹¹ Measures clearly specified and committed to by government ahead of the recommendation.

¹² The standard revenue elasticity has been revised in line with the recently endorsed by EPC methodology for computing cyclically-adjusted balances.

5. CONCLUSIONS

On current information, it appears that Spain has taken effective action that represents adequate progress towards correcting the excessive deficit in 2012 and 2013 within the limits specified by the Council on 10 July 2012. In particular, Spain has adopted sizeable consolidation measures of around 4% of GDP in 2012 and of 2½% of GDP in 2013, based on bottom-up calculations. Correcting for revisions in potential output growth and for revenue shortfalls due to tax-poor growth, the estimated annual improvement of the structural balance is in line with the effort required by the Council for 2012 and 2013.

For 2014, it appears that Spain has not yet taken sufficient measures to deliver the required structural effort. The multi-annual budget plan announced in August did not present sufficiently specified measures to underpin the recommended fiscal effort. Moreover, the plan does not compensate for the expiry of temporary and one-off measures in that year. Thus, while effective action for 2012 and 2013 has been taken, the measures for 2014 fall short of the revised EDP recommendation.

As regards fiscal governance, the provisions of the Budget Stability Law with respect to the envisaged early warning and corrective mechanisms to limit deviations from the budgetary targets of the Autonomous Communities have not been implemented in a transparent and fully effective way. This could lead to renewed budgetary slippages at the regional level, especially if funding conditions ease. Despite progress being made with respect to budgetary reporting at regional level, achieving a higher degree of fiscal transparency would require more comprehensive, consistent and timely reporting on a consolidated general government basis in line with ESA95. Also, it would be important to overcome the delay in the establishment of the fiscal council and to ensure its full institutional and financial independence.

The substantial deterioration in the budgetary position resulting from significant revenue shortfalls, linked to less-tax rich growth structure and worse labour market conditions, as well as from the weaker overall position of the economy than envisaged when the earlier Council recommendation was issued, suggest that an extension of the deadline for correcting the excessive deficit is appropriate. Granting two additional years for the correction of the excessive deficit would correspond to intermediate headline deficit targets of 6.5% of GDP for 2013, 5.8% of GDP for 2014, 4.2% of GDP for 2015, and 2.8% of GDP for 2016. The underlying improvement in the structural budget balance implied by these targets is 1.1% in 2013, 0.8% in 2014, 0.8% in 2015, and 1.2% in 2016, in order to bring the headline government deficit below the 3% of GDP reference value by 2016. The structural fiscal measures needed on top of those already included in the baseline scenario of the Commission services' 2013 Spring Forecast are estimated at around 2% in 2014, 1% in 2015, and 1½% of GDP in 2016.

Table 9: Comparison of key macroeconomic and budgetary projections

		2011	2012	2013	2014	2015	2016
Real GDP (% change)	COM SF13	0.4	-1.4	-1.5	0.9	1.4	1.9
	COM SF12	0.7	-1.9	-0.3	1.1	-	-
	SP	0.7	-1.4	-1.3	0.5	0.9	1.3
Output gap ¹ (% of GDP)	COM SF13	-4.1	-4.6	-4.6	-2.3	-0.8	0.6
	COM SF12	-4.2	-5.3	-4.7	-2.8	-	-
	SP	-3.8	-4.7	-4.5	-3.2	-2.4	-1.3
General government balance (% of GDP)	COM SF13	-9.4	-10.6	-6.5	-7.0	-6.0	-5.6
	COM SF12	-8.9	-6.3	-6.1	-6.4	-	-
	SP	-8.5	-10.6	-6.3	-5.5	-4.1	-2.7
Primary balance (% of GDP)	COM SF13	-7.0	-7.7	-3.2	-3.6	-2.5	-2.1
	COM SF12	-6.5	-3.1	-2.8	-3.1	-	-
	SP	-6.1	-7.7	-3	-2	-0.5	0.9
Cyclically-adjusted balance ¹ (% of GDP)	COM SF13	-7.5	-8.4	-4.3	-5.9	-5.7	-5.9
	COM SF12	-6.9	-4.1	-4.1	-5.1	-	-
	SP	-6.9	-8.40	-4.20	-3.9	-3.0	-2.1
Structural balance ² (% of GDP)	COM SF13	-7.2	-5.5	-4.4	-5.5	-5.7	-5.9
	COM SF12	-7	-4.3	-4.1	-5.1	-	-
	SP	-7.3	-5.5	-4.3	-3.9	-3.0	-2.1
Government gross debt (% of GDP)	COM SF13	69.3	84.2	91.3	96.8	100.6	103.3
	COM SF12	68.5	80.9	86.8	91.8	-	-
	SP	68.5	84.2	91.4	96.2	99.1	99.8

Notes:
1 Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.
2 Cyclically-adjusted balance excluding one-off and other temporary measures.
Source: COM SF13- Commission services' 2013 Spring Forecast covering the period 2012-2016; COM SF12 - Commission services' updated 2012 Spring Forecast; SP – Stability Programme April 2013

Annex

**Table A1: Adjustment of apparent structural effort for the revision in potential growth
– details of calculation**

	Pot. growth assumptions underlying the July 2012 recommendation (%) (1)	Pot. growth (COM 2013 SF) (%) (2)	Forecast error (%) (3)=(2)-(1)	Structural expenditure (% of pot. GDP) (COM 2013 SF forecast) (4)	Correction coefficient (% of nominal pot. GDP) (5)=[(3) x (4)]/100
2012	-0.8	-0.9	-0.1	41.6	0.0
2013	-0.9	-1.4	-0.5	41.1	-0.2
2014	-0.9	-1.5	-0.5	41.8	-0.2

Table A2: Adjustment of apparent structural effort for the revenue shortfalls/windfalls as compared to standard elasticities – details of calculation

CAB methodology	Change in current revenues (yoy) (EUR bn)	Discretionary revenues measures (EUR bn)	Nominal growth assumptions (%)	Current revenues in t-1 (EUR bn)	Revenue gap (EUR bn)	Correction coefficient
	<i>July reco.</i> (1)	<i>July reco.</i> (2)	<i>July reco.</i> (3)	<i>July reco.</i> (4)	(5)=[(1)-(2')-ε*x (3') x (4')]-	=(5) expressed in % of nominal pot. GDP
	<i>2013 SF</i> (1')	<i>2013 SF</i> (2')	<i>2013 SF</i> (3')	<i>2013 SF</i> (4')	[(1)-(2)-ε*x (3) x (4)]	
gy	5.5	9.3	-1.0	378.4	-11.5	-1.0
revenue	-2.0	-1.8	0.3	383.9	-12.8	-1.2
elasticity	-0.2	-4.7	2.5	381.9	4.8	+0.4
ε*=1.0						
2012						
2013						
2014						