

Brussels, 14.11.2012
COM(2012) 683 final

COMMUNICATION FROM THE COMMISSION TO THE COUNCIL

Assessment of action taken by Spain

**in response to the Council Recommendation of 10 July 2012 with a view to bringing an
end to the situation of excessive government deficit**

{SWD(2012) 390 final}

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1. EXCESSIVE DEFICIT PROCEDURE: BACKGROUND

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 latest, 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 procedure.

On 2 December 2009, the Council decided, in accordance with Article 3(5) of 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. 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. The Council therefore adopted a revised recommendation under Article 126(7) TFEU (the 'revised EDP recommendation') 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 consistent with the requested improvements of the structural budget balance are 6.3% of GDP for 2012, 4.5% of GDP for 2013 and 2.8% of GDP in 2014.

The Spanish authorities were also recommended to implement the measures adopted in the 2012 budget and in the Autonomous Communities' rebalancing plans and adopt the announced multi-annual budget plan for 2013-14 by the end of July 2012, including a medium-term budgetary strategy, fully specifying the structural measures, which on the basis of the Commission services' update of the 2012 Spring Forecast, are necessary to achieve the correction of the excessive deficit by 2014. They were 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 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.

2. ASSESSMENT OF EFFECTIVE ACTION TAKEN

This assessment is based on the Commission services' 2012 Autumn 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.

According to the Commission services' 2012 Autumn Forecast, real GDP is projected to contract by 1.4% in both 2012 and 2013, before growing by 0.8% in 2014. At the time of the last Council recommendation under Article 126(7) TFEU, real GDP was expected to contract by 1.9% and 0.3% in 2012 and 2013, respectively. As the recovery was expected to come earlier and to be somewhat stronger, real GDP growth was forecast to reach +1.1% in 2014. The slightly less negative growth forecast in 2012 is mainly due to somewhat more resilient domestic demand as fiscal consolidation has had a more gradual impact than expected at the time of the last Council recommendation under Art.126(7) TFEU. Regarding 2013 and 2014, the Council recommendation was based on a no-policy change assumption, while the Commission services' 2012 Autumn Forecast also takes additional consolidation measures included in the 2013-14 budget plan and the 2013 budget into account.

In 2012, according to the Commission services' 2012 Autumn Forecast, the general government deficit is projected to decrease to 8.0% of GDP, or 7.0% of GDP excluding the effect of capital injections into banks carried out in 2012, from 9.4% of GDP in 2011 (8.9% of GDP excluding capital injections into banks carried out in 2011). This compares with the government and revised EDP recommendation target of 6.3% of GDP. Despite the projected deviation from the target, the expected decrease in the headline balance would be underpinned by a substantial improvement in the primary balance, of around 2½ percentage points (net of capital injections into banks carried out in 2012), against the background of an economy shrinking by close to 1½ percent. To compensate for the likely deviation from the deficit target and in line with the Council recommendation, on 13 July 2012 Spain adopted additional consolidation measures of around 1¼% of GDP. Together with earlier consolidation measures included in the December 2011 package, the 2012 budget bill and regional rebalancing plans, total measures of around 5¼% of GDP were adopted for 2012. However, a considerable part of these measures (more than 1½% of GDP) has not been of a permanent nature. Various tax increases were introduced only on a temporary basis or consisted in bringing forward tax payments in time. The elimination of the Christmas bonus in the public sector was also limited to 2012 only. This sizeable consolidation effort would partly be counteracted by strong revenue shortfalls linked to a less tax-rich growth composition and a stronger deterioration in the labour market, higher interest payments and higher social transfers, linked to the increase in pensions adopted in December 2011. Moreover, as in previous years, there are indications that a number of regions would again miss their budgetary targets.

Netting out cyclical factors and one-off and other temporary measures, the Commission services' 2012 Autumn Forecast foresees an improvement in the structural balance by 1.2 percentage points to -6.3% of GDP in 2012, compared with an improvement in the structural

balance of 2.7% of GDP required in the revised EDP recommendation. Correcting for the downward revision of potential output growth since the time of the last Council recommendation under Article 126(7), the estimated structural effort in 2012 would be about 0.1 percentage points higher. Moreover, the change in the structural balance was also severely affected by revenue shortfalls (i.e. relative to GDP developments using standard revenue elasticities) which amount to around 1½ percentage points of GDP. Overall, taking these revenue shortfalls into account, the estimated structural effort would further increase to around 2¾ percentage points – in line with the effort required under the Council recommendation.

For 2013, the Commission services' 2012 Autumn Forecast projects the general government deficit to decline to 6% of GDP, compared to a target of 4.5% of GDP indicated by both the government and in the revised EDP recommendation. The primary balance is expected to improve by 1.8 percentage points, net of bank recapitalisation measures, on the backdrop of the economy that is forecast to shrink by 1.4%. Following the last Council recommendation under Article 126(7) TFEU, in August 2012, the Spanish government presented a multi-annual budget plan for 2013-14. However, for 2013, the plan did not specify many new revenue measures compared to what had already been announced in the July 2012 package. The draft 2013 Budget bill presented in September contained few new measures not previously announced (e.g. extension of the wealth tax by one year). In total, the budgetary impact of discretionary measures in 2013 is expected to be about 1¼% of GDP on the expenditure side and about 1% of GDP on the revenue side. The expected budget deviation of 1½% of GDP in 2013 is partly explained by the worse starting position carried over from the previous year. However, the 2013 budget bill is also based on optimistic macroeconomic assumptions, forecasting real GDP to contract by only 0.5 % and employment to stabilise. This implies a clear risk of revenues once again underperforming and social transfers overshooting. In addition, the draft budget law also seems to underestimate the increase in social benefits, including pensions and unemployment benefits. For the regions, the main consolidation measures in 2013 are the cuts in health and education included in the 2013-14 Budget Plan. There is, however, no information currently available on the actual implementation in regional budgets of these planned measures.

According to the Commission services' 2012 Autumn Forecast, the structural deficit is projected to further narrow by 2.3 percentage points and to reach 4.0% of GDP in 2013, broadly in line with the last Council recommendation under Article 126(7) TFEU which requires a structural improvement of 2.5% of GDP. Correcting for the change in estimated potential output growth between the projections underlying the revised EDP recommendations and the Commission services' 2012 Autumn Forecast, the structural effort would be around 0.1-0.2 percentage points higher.

For 2014, the Commission services' 2012 Autumn Forecast foresees an improvement in the economic outlook with real GDP growth returning to positive territory. This would not be sufficient to achieve a further narrowing of the headline deficit, which is expected to widen to 6.4% of GDP compared to a target of 2.8% of GDP. Apart from the base effect, the expected deviation mainly reflects the expiry of temporary measures taken in previous years, the fact that planned consolidation measures for 2014 were not sufficiently specified in the multi-annual budget plan announced in August and therefore could not be included in the Commission services' forecast, and that the composition of economic growth would continue to be tax-poor, with tax revenues not rising in full proportion to nominal GDP. Interest payments would also keep rising due to a higher debt stock.

The structural deficit is projected to deteriorate by 1.3 percentage points in 2014, compared to a recommended improvement of 1.9% of GDP. Correcting for the change in estimated potential growth between the projections underlying the last Council recommendation under Article 126(7) TFEU and the Commission services' 2012 Autumn Forecast, the estimated structural effort in 2014 would be around 0.1-0.2 percentage points higher. This leaves the structural effort about 3 percentage points short of the level required by the Council recommendation. Adjusting for unexpected revenue shortfalls would probably decrease this gap further, as some revenues are not following the growth path implied by nominal GDP growth. However, given that so far little or very few measures for 2014 have been specified, a complete assessment of effective action for 2014 at this stage is not possible.

In the Council recommendation under Article 126(7) of July 2012, Spain was also asked to strictly apply the new provisions of the Budgetary Stability Law (BSL) regarding transparency and control of budget execution and to establish an independent fiscal institution to provide analysis, advice, and monitor fiscal policy as well as to monitor adherence to the budgetary targets for all levels of the general government. Regarding the BSL, improvements have been made, in particular, on reporting of fiscal data for regional governments, which represent a step forward in achieving higher fiscal transparency. However, given the challenge of introducing new reporting procedures across regional administrations, a sound track record regarding the quality and consistency of reporting remains to be achieved. Critically, implementation of the preventive and corrective arm of the Budget Stability Law appears to be insufficient. No official early warning mechanism or corrective action has been triggered so far, even though several Autonomous Communities are clearly at risk of not meeting their fiscal targets in 2012. As regards the establishment of an independent fiscal institution, on 27 September the Spanish government took a decision to establish such an institution. Its remit and governing structure is currently being defined. The institution is to be created in 2013, once the relevant organic law has been adopted.

3. 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 amounting to around 5¼% of GDP in 2012 and to 2¼% of GDP in 2013. 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. However, in 2012 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 were not effectively implemented. This could lead to renewed budgetary slippages at the regional level. For 2013, there are clear risks to achieving the nominal targets stemming partly from an optimistic macroeconomic scenario underlying the 2013 Budget bill and optimistic projections for social security.

As regards 2014, it appears that Spain has not taken sufficient measures yet 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. Therefore, there is still a need to specify additional, permanent measures for 2014.

In view of the above assessment, while effective action has been taken for 2012 and 2013, the measures for 2014 fall short of the revised EDP recommendation. Based on this knife-edge assessment, the Commission considers that no further steps in the excessive deficit procedure of Spain are needed at present. The Commission will continue to closely monitor budgetary developments in Spain in accordance with the Stability and Growth Pact.

Furthermore, as regards fiscal governance, 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. Finally, it would be important to proceed with the establishment of the fiscal council as planned and to ensure its full institutional and financial independence.

Comparison of key macroeconomic and budgetary projections

		2009	2010	2011	2012	2013	2014
Real GDP (% change)	COM AF 12	-3.7	-0.3	0.4	-1.4	-1.4	0.8
	COM SF 12	-3.7	-0.1	0.7	-1.9	-0.3	1.1
	SP	-3.7	-0.1	0.7	-1.7	0.2	1.8
Output gap ¹ (% of potential GDP)	COM AF 12	-4.2	-4.8	-4.2	-4.6	-4.8	-2.7
	COM SF 12	-4.3	-4.8	-4.2	-5.3	-4.7	-2.8
	SP	-	-	-3.8	-4.3	-3.8	-2.1
General government balance ³ (% of GDP)	COM AF 12	-11.2	-9.7	-9.4	-8.0	-6.0	-6.4
	COM SF 12	-11.2	-9.3	-8.9	-6.3	-6.1	-6.4
	SP	-	-	-8.5	-5.3	-3.0	-1.1
Primary balance (% of GDP)	COM AF 12	-7.7	-7.0	-5.0	-2.2	-2.5	-2.1
	COM SF 12	-9.4	-7.4	-6.5	-3.1	-2.8	-3.1
	SP	-	-	-6.1	-2.2	0.2	2.0
Cyclically-adjusted balance ¹ (% of GDP)	COM AF 12	-9.4	-7.6	-7.6	-6.0	-4.0	-5.3
	COM SF 12	-9.3	-7.3	-6.9	-4.1	-4.1	-5.1
	SP	-	-	-6.9	-3.4	-1.4	-0.2
Structural balance ² (% of GDP)	COM AF 12	-8.7	-7.6	-7.5	-6.3	-4.0	-5.3
	COM SF 12	-8.7	-7.3	-7.0	-4.3	-4.1	-5.1
	SP	-	-	-7.3	-4.4	-2.2	-0.2
Government gross debt ³ (% of GDP)	COM AF 12	53.9	-61.5	69.3	86.1	92.7	97.1
	COM SF 12	53.9	-61.2	68.5	80.9	86.8	91.8
	SP	-	-	68.5	79.8	82.3	81.5

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.

³ The financial sector assistance programme for bank recapitalization put in place on 23 July 2012 has not yet had any impact on the general government debt and deficit forecast for 2012-14.

Source: COM AF12- Commission services' 2012 autumn forecast; COM SF12 - Commission services' updated 2012 spring forecast; SP – Stability Programme April 2012