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Subject:	COUNCIL RECOMMENDATION with a view to bringing an end to the situation of an excessive government deficit in Spain **COMMON GUIDELINES** **Consultation deadline for Croatia: 18.6.2013**

COUNCIL RECOMMENDATION

of

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

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty on the Functioning of the European Union and in particular Article 126(7) thereof,

Having regard to the recommendation from the European Commission, Whereas:

(1) According to Article 126 of the Treaty on the Functioning of the European Union (TFEU) Member States are to avoid excessive government deficits.

(2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.

(3) 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[1] ("the Council Recommendation of 27 April 2009"), 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[2].

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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.

(4) 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 by Spain and that unexpected adverse economic events with major unfavourable consequences for government finances had occurred after the adoption of Council Recommendation of 27 April 2009. In particular, 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 decided to adopt a revised recommendation under Article 126(7) TFEU ("the Council Recommendation of 2 December 2009") to correct the excessive deficit by 2013 at the latest in a credible and sustainable manner by taking action in a medium-term framework.

(5) 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 (EDP) was therefore necessary.

(6) On 10 July 2012, the Council decided, in accordance with Article 3(5) of Regulation (EC) No 1467/97that 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 Council Recommendation of 2 December 2009. In particular, 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 ("the Council Recommendation of 10 July 2012") 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 also 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.

(7) 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 Council Recommendation of 10 July 2012 and that no further steps in the EDP were required.

(8) According to Article 3(5) of Regulation (EC) No 1467/97, the Council may decide, on a recommendation from the Commission, to adopt a revised recommendation under Article 126(7) TFEU, if effective action has been taken and unexpected adverse economic events with major unfavourable consequences for government finances occur after the adoption of the original recommendation. Under Article 3(5) of that Regulation, the occurrence of unexpected adverse economic events with major unfavourable budgetary effects is to be assessed against the economic forecast underlying the Council Recommendation.

(9) In accordance with Article 126(7) of the TFEU and Article 3 of Regulation (EC) No 1467/97, the Council is required to make recommendations to the Member State concerned with a view to bringing the situation of excessive deficit to an end within a given period. The Recommendation has to establish a maximum deadline of six months for effective action to be taken by the Member State concerned to correct the excessive deficit. Furthermore, in a recommendation to correct an excessive deficit the Council requests the achievement of annual budgetary targets which, on the basis of the forecast underpinning the recommendation, are consistent with a minimum annual improvement in the structural balance, namely, the cyclically-adjusted balance excluding one-off and other temporary measures, of at least 0,5 % of GDP as a benchmark. In accordance with Articles 9(1) and 17(2) of Regulation (EU) No 473/2013 of the European Parliament and of the Council of 21 May 2013 on common provisions for monitoring and assessing draft budgetary plans and ensuring the correction of excessive deficit of the Member States in the euro area[1], Spain should present an economic partnership programme.

[1] OJ L 140, 27.5.2013, p. 11.

(10) After a short-lived recovery in 2011 the economy has slipped back into recession, recording negative quarterly real GDP growth since the third quarter of 2011. In annual terms, GDP fell by 1,4 % in 2012. According to the Commission services' 2013 Spring Forecast, 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). At the time of the last Council recommendation, real GDP was expected to contract by 1,9 % and 0,3 % in 2012 and 2013, respectively, and to grow by 1,1 % in 2014. The less negative growth outcome in 2012 was mainly due to somewhat more resilient domestic demand possibly also due to the liquidity injected through the repayment scheme for the commercial debt accumulated by the regions and local authorities before 1 January 2012 (EUR 27,4 billion, or 2,6 % of GDP). With regards to 2013 and 2014, the Commission services' 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 deterioration in the macroeconomic outlook is partly linked to additional consolidation measures included in the 2013-14 budget plan and the 2013 budget being taken into account.

(11) According to the Commission services' 2013 spring forecast, 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 for capital transfers to banks (which are considered as one-off operations), the corresponding deficits were 7,0 % and 9,0 % of GDP in 2012 and 2011, respectively. The decrease in the headline balance corresponds to an improvement in the primary balance of 2,4 percantage points (net of capital transfers into banks), against the background of a shrinking economy and a tax-weak growth composition. The Commission services' 2013 spring forecast points to an improvement in the structural deficit of 1,8 percantage points in 2012, compared with a recommended improvement of 2,7 percentage points. Correcting for the slight downward revision of potential output since the last Council Recommendation, the estimated fiscal effort remains unchanged. However, the estimated change in the structural balance was severely affected by unexpected revenue shortfalls, which amounted to around 1,0 percentage point Overall, taking these effects into account, the adjusted fiscal effort would increase to 2,9 percentage points, above the recommended effort under the Council Recommendation of 10 July 2012. Apart from recapitalisation measures, the budgetary deviation in 2012 is linked to a combination of weaker-than-expected revenues (taking into account the impact of discretionary measures and the base effect) and higher intermediate consumption and social transfers. The less tax-rich growth composition and a stronger deterioration in the labour market implied major revenue shortfalls, in particular of direct and indirect taxes, as well as higher social expenditure. Spain adopted sizeable consolidation measures during 2012, amounting to around 4 % of GDP, including around 1½ % of GDP on the revenue side and 2½ % of GDP on the expenditure side. Those measures partly compensated also for an underlying deterioration in the structural balance due to rising interest payments and higher social transfers.

(12) For 2013, according to the Commission services' 2013 spring forecast, the government deficit is projected to decline to 6,5 % of GDP, compared to the EDP target of 4,5 % of GDP. The primary balance is expected to improve by 4,5 percentage points (0,9 percentage points net of capital transfers into banks). Following the last Council Recommendation, the Spanish government presented, in August 2012, a multi-annual budget plan for 2013-14, outlining some features of the consolidation strategy for the medium-term. In total, the budgetary impact of discretionary measures in 2013 is estimated to be about 1 % of GDP on the expenditure side and about 1½ % of GDP on the revenue side. The expected budgetary deviation of around 2 % of GDP compared with the EDP target is partly explained by the worse starting position. 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 in the Council Recommendation of 10 July 2012. The Commission services' 2013 spring forecast projects the structural deficit to further narrow by 1,1 percentage points in 2013, compared with a recommended effort of 2,5 percentage points Correcting for the change in the estimated potential growth and for higher-than expected revenue shortfalls, the estimated fiscal effort improves by 1,4 percentage points, bringing the adjusted fiscal effort to 2,5 % of GDP, in line with the recommended effort in the Council Recommendation of 10 July 2012. 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 billion. (0.,3 % of GDP) still to be adopted and implemented this year.

(13) According to the Commission services' 2013 spring forecast, for 2014, the headline deficit is expected to widen to 7,0 % of GDP compared to an EDP target of 2,8 % of GDP. The primary deficit would widen by 0,4 % of GDP. Apart from the base effect, the expected deviation mainly reflects the expiry of temporary measures taken in previous years and the fact that the planned consolidation measures for 2014 were not sufficiently specified in the August 2012 multi-annual budget plan to be included in the Commission services' forecast. Moreover, the composition of economic growth would continue to be tax-poor, with social contributions and indirect taxes not rising in full proportion to nominal GDP. Interest payments would also keep rising due to a higher debt stock. According to the Commission services' 2013 spring forecast, the structural deficit is projected to deteriorate by 1,1 percentage points, compared to a recommended improvement of 1,9 % of GDP. Correcting for the change in the estimated potential growth and unexpected revenue shortfalls, the gap increases by a further 0,2 percentage points.

(14) As regards fiscal governance, major progress has been made in the reporting of budgetary execution at sub-central government levels. However, the provisions of the Budgetary Stability Law on early warning and corrective mechanisms to limit budgetary deviations have not been fully effective and the transparency of their implementation could be enhanced. Despite progress with respect to budgetary reporting at regional level, achieving higher fiscal transparency would require more comprehensive, consistent and timely reporting, also of budgetary plans, on a consolidated general government basis in line with the European System of Accounts . The establishment of a fiscal council, with full institutional and financial independence, is still pending.

(15) General government gross debt rose to around 84 % of GDP in 2012 compared to 80,9 % of GDP projected in the updated Commission services' 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 payment of public administration arrears. 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.

(16) On 10 April 2013, the Commission concluded, based on its 2013 In-Depth Review on Spain under the Macroeconomic Imbalances Procedure[1], that Spain is experiencing excessive macroeconomic imblances. The correction of these imbalances accumulated during the boom years, and in particular the absorption of very high private and external debt levels, are having major negative consequences on economic growth, financial stability and public finances. A sustainable correction of the excessive deficit in the medium-term requires simultaneous progress on ensuring the correction of macroeconomic imbalances, supported by structural reforms to boost growth and employment creation and to reduce structural rigidities that hamper the adjustment.

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

(17) According to the Commission services' 2013 spring forecast, 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 Council Recommendation of 10 July 2012. Those 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 elasticites have led to a substantial deterioration in the budgetary position. Moreover, the economic recession has affected employment in a very negative way and unemployment has risen sharply. Considering all these factors, consistent with the rules of the Stability and Growth Pact and including the need to correct excessive macroeconomic imbalances with major unfavourable consequences for public finance, an extension of the deadline for correcting the excessive deficit in Spain by two years to 2016 appears to be justified, rather than the one-year extension that the Stability and Growth Pact foresees as a rule.

(18) 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 clearly below the reference value, in order to guarantee an effective and lasting achievement of the correction within the requested deadline.

(19) The intermediate headline deficit targets leading to the correction of the excessive deficit by 2016 are set at 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. Achieving those targets requires an annual improvement in the primary balance (net of one-off measures) of 1,3 % of GDP on average over the period 2013-16 and, on the basis of the Commission services' 2013 Spring Forecast extended to 2016, an improvement in the structural budget balance of 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. This more gradual adjustment path takes into account the current difficult economic environment and the on-going major structural transformation of the Spanish economy and will have to be supported by ambitious structural reforms. As such, it is expected to support the unwinding 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.

(20) According to the Commission services' 2013 spring forecast extended to 2016, 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 deficit target), but the budgetary plans at all levels of government will have to be strictly implemented. For the period 2014-2016, bringing the deficit below the Treaty reference value on a sustainable basis will require considerable structural fiscal measures on top of those already included in the Commission services' 2013 spring forecast. Those measures, amounting to around 2 % of GDP in 2014, 1 % of GDP in 2015, and 1½ % of GDP in 2016 should take into account the need to compensate for the negative second-round effects, negative potential output growth, as well as rising interest and social payments.

(21) 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 target is based on additional consolidation measures of around EUR 3 billion envisaged in the Programme, which still need to be fully specified.

(22) 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.

(23) 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, namely by means of 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.

(24) In view of the decentralised nature of its public finances, Spain's fiscal adjustment path should be underpinned by a credible medium-term consolidation strategy that includes (i) a detailed multi-annual budget plan with full specification of measures for 2014-16, (ii) further strengthening the effectiveness of the institutional framework (by raising further 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).

(25) In parallel to the regular reviews of the ESM Financial Assistance for the Recapitalisation of Financial Institutions in Spain[1] and as agreed in the Memorandum of Understanding signed on 23 July 2012, monitoring of progress on implementation of Spain's EDP commitments will be carried out on a quarterly basis.

(26) Spain fulfils the conditions for the extension of the deadline for correcting the excessive general government deficit as laid down in Article 3(5) of Regulation (EC) No 1467/97,

HAS ADOPTED THIS RECOMMENDATION:

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1 http://ec.europa.eu/economy_finance/assistance_eu_ms/spain/index_en.htm

(1) Spain should put an end to the present excessive deficit situation by 2016.

(2) Spain should reach a headline deficit target of 6,5 % of GDP in 2013, 5,8 % of GDP in 2014, 4,2 % of GDP in 2015, and 2,8 % of GDP in 2016, which is consistent with an improvement of the structural balance of 1,1 %, 0,8 %, 0,8 %, and 1,2 % of GDP in the years 2013-2016 respectively based on the Commission services' 2013 spring forecast extended to 2016.

(3) Spain should implement the measures adopted in the 2013 budget plans at all levels of government and stand ready to take corrective action in case of deviations from budgetary plans. The authorities should reinforce the medium-term budgetary strategy with well-specified structural measures for the years 2014-16 that are necessary to achieve the correction of the excessive deficit by 2016.

(4) The Council establishes the deadline of 1 October 2013 for the Spanish government to take effective action and, in accordance with Article 3(4a) of Regulation (EC) No 1467/97, to report in detail the consolidation strategy that is envisaged to achieve the targets.

Furthermore, Spain should:

(a) strengthen the effectiveness of the institutional framework by raising further the transparency in implementation of the Budgetary Stability Law as well as by establishing an independent fiscal council to provide analysis, advice and monitor compliance of fiscal policy with national and Union fiscal rules;

(b) undertake concrete steps to rein in the increasing structural deficit in the social security system; and

(c) give a greater emphasis to the growth friendliness of the consolidation, including by conducting systematic reviews of expenditure and the tax system.

Finally, to ensure the success of the fiscal consolidation strategy, it will be important to back the fiscal consolidation by comprehensive structural reforms, in line with the Council Recommendations addressed to Spain in the context of the European Semester and the Macroeconomic Imbalances Procedure.

This Recommendation is addressed to the Kingdom of Spain.

Done at Brussels,

For the Council
The President