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COMMISSION STAFF WORKING DOCUMENT

Analysis of the draft budgetary plan of SPAIN

Accompanying the document

COMMISSION OPINION

on the draft budgetary plan of SPAIN

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1. INTRODUCTION

Spain has submitted its Draft Budgetary Plan (DBP) for 2015 on 15 October 2014 in compliance with Regulation (EU) No 473/2013 of the Two-Pack. Spain is currently subject to the corrective arm of the Pact. The Council opened the Excessive Deficit Procedure for Spain on 27 April 2009. According to the 21 June 2013 Council recommendation, the country is recommended to correct the excessive deficit by 2016.

Section 2 of this document presents the macroeconomic outlook underlying the DBP and provides an assessment based on the Commission forecast. The following section presents the recent and planned fiscal developments, according to the DBP, including an analysis of risks to their achievement based on the Commission forecast. In particular, it also includes an assessment of the measures underpinning the DBP. Section 4 assesses the recent and planned fiscal developments in 2014-2015 (also taking into account the risks to their achievement) against the obligations stemming from the Stability and Growth Pact. Section 5 provides an analysis of implementation of fiscal structural reforms in response to the latest country-specific recommendations adopted by the Council on 8 July 2014, including those to reduce the tax wedge. Section 6 summarises the main conclusions of the present document.

2. MACROECONOMIC DEVELOPMENTS UNDERLYING THE DRAFT BUDGETARY PLAN

The DBP is based on a macroeconomic scenario of accelerating economic activity. Thus, after contracting by 1.2% in 2013, the DBP foresees real GDP to grow by 1.3% and 2.0% in 2014 and 2015, respectively. In contrast to the preceding six years, internal demand is expected to contribute positively to growth as from 2014 and to be the driving force behind the recovery, with net external demand actually detracting from growth in 2014 and only contributing marginally in 2015. The DBP foresees a strengthening of private consumption and investment in equipment, driven by growing employment, improving confidence, better financial conditions and the effects of the reduction in personal income tax. The slight upward revision of real GDP growth in 2014 compared with the Stability Programme (from 1.2% to 1.3%) hides a more significant reassessment of the driving factors behind growth. In fact, the DBP forecasts growth to be fully driven by domestic demand, as compared with a more even contribution from domestic and net external demand in the Stability Programme. The same pattern holds for 2015, albeit to a lesser extent. Employment is expected to continue expanding, with the annual growth rate rising from 0.7% in 2014 to 1.4% in 2015.

The macroeconomic scenario in the DBP for 2015 appears somewhat more benign compared with the Commission 2014 autumn forecast. Real GDP growth in 2015 is expected to be about 0.3 pp. stronger. As a reflection of this, employment is also projected to grow slightly faster in 2015 compared with the Commission forecast. Risks to the Commission's growth forecast appear skewed to the downside and are mainly related to the external sector, should in particular the recovery in the euro area turn out slower than expected.

Box 1. The macro economic forecast underpinning the budget in Spain

The macroeconomic forecasts underpinning the 2015 draft budgetary plan have been endorsed by Spain's independent fiscal institution –*Autoridad Independiente de Responsabilidad Fiscal -AIReF*.

The authority was created in law in November 2013 (Organic Law 6/2013 of 14 November) and it was operational at the time of writing, with its staffing in the process of completion.

AIReF's independence is grounded by adequate legal provisions. Its freedom to communicate and right to access to information needed to carry out its duties in due time are also foreseen in the law. However, implementing legislation to spell out AIReF's right to access information was pending at the cut-off date of this report.

On 26 September 2014, AIReF endorsed the government's macroeconomic forecast underpinning the 2015 draft budget as "probable"; the corresponding report was published on AIReF's website[1]. AIReF has pointed out downward risks to the official macroeconomic forecasts, in particular, the impact of lower euro area growth on the Spanish economy.

On 15 October, AIReF published another report assessing the government's budgetary targets for budget balance, expenditure and debt contained in the 2015 draft budget. In particular, the 2015 budget balance target of 4.2% is described as "very challenging" and "requiring a strict implementation of the presented Budget".

Both AiReF assessments are referred to in the DBP.

AIReF's mandate is broad, thus allowing it to play a relevant role in Spain's budgetary processes. It is required, among others, to issue reports to assess the Stability Programme, the DBP, the compliance of general government budget performance with numerical fiscal rules, the regions' economic and financial plans and to give advice on the activation of the correction mechanisms set out in Spain's Oganic Law on Budgetary Stability and Financial Sustainability.

[1] http://www.airef.es/es/contenidos/informes/27-informe-sobre-previsiones-macroeconomicas-del-proyecto-de-pp-gg-del-estado

Table 1. Comparison of macroeconomic developments and forecasts

	2013	2014			2015		
	COM	SP	DBP	COM	SP	DBP	COM
Real GDP (% change)	-1.2	1.2	1.3	1.2	1.8	2.0	1.7
Private consumption (% change)	-2.3	1.4	2.0	2.0	1.8	2.1	2.0
Gross fixed capital formation (% change)	-5.1	0.5	1.5	1.1	3.0	4.5	4.2
Exports of goods and services (% change)	4.3	5.0	3.6	3.8	6.1	5.2	4.9
Imports of goods and services (% change)	-0.5	3.6	4.4	4.8	5.0	5.0	5.1
Contributions to real GDP growth:							
- Final domestic demand	-2.6	0.7	1.4	1.4	1.2	1.8	1.6
- Change in inventories	0.0	0.0	0.0	0.0	0.0	0.0	0.0
- Net exports	1.4	0.6	-0.1	-0.2	0.5	0.2	0.1
Output gap[1]	-7.5	-6.6	-5.9	-6.0	-4.8	-3.6	-4.1
Employment (% change)	-2.6	0.9	0.9	0.9	1.5	1.7	1.4
Unemployment rate (%)	26.1	24.9	24.7	24.8	23.3	22.9	23.5
Labour productivity (% change)	2.1	0.3	0.6	0.6	0.2	0.7	0.6
HICP inflation (%)	1.5	n.a.	n.a.	-0.1	n.a.	n.a.	0.5
GDP deflator (% change)	0.7	0.5	0.1	-0.3	0.8	0.6	1.0
Comp. of employees (per head, % change)	1.7	0.2	0.8	0.5	0.6	1.0	0.9
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	2.1	2.0	1.5	1.0	2.4	1.7	1.2

Note:

[1]In percent of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source :

Stability programme 2014 (SP); Draft Budgetary Plan 2015 (DBP); Commission 2014 autumn forecast (COM); Commission calculations.

3. RECENT AND PLANNED FISCAL DEVELOPMENTS

3.1. Deficit developments

The DBP expects the general government deficit to shrink from 6.8% of GDP in 2013 to 5.5% of GDP in 2014, equal to the Stability Programme target, although starting from a slightly better-than-expected deficit outcome (by 0.3% of GDP) in 2013 (see Table 2) on accounts of the ESA 2010 statistical revision. This is broadly in line with the Commission 2014 autumn forecast (which foresees a deficit of 5.6% of GDP), also as regards individual revenue and expenditure categories. Although there are risks underlying both the Commission and the DBP's forecast for 2014, in particular if expenditure restraint at regional level does not materialise as expected, there is apparently some margin, albeit limited, to the 2014 EDP target of 5.8% of GDP.

For 2015, the DBP targets a general government deficit of 4.2% of GDP. The deficit reduction in 2015 is planned to be achieved by a combination of expenditure restraint and higher revenues. The expenditure-to-GDP ratio is projected to fall by 1.0% of GDP, reflecting mainly lower compensation of employees, social payments and intermediate consumption, while interest expenditure is still rising. In spite of the planned cuts in corporate and personal income tax rates, the revenue-to-GDP ratio is forecast to increase by 0.4% of GDP, on the back of higher revenues mainly from taxes on production and imports, reflecting an improved macroeconomic outlook. This pattern is very similar to the one presented in the Stability Programme.

The Commission 2014 autumn forecast foresees a general government deficit of 4.6% of GDP in 2015, 0.4% of GDP higher than the DBP. This essentially reflects a slightly worse starting position and a more prudent view on expenditure restraint, in particular at the regional and local level, as well as a different assessment of the impact of some revenue measures, namely the planned tax reform. There are additional risks to the budgetary targets, in particular related to contingent liabilities in the energy sector and implementation risks in view of the upcoming elections.

In the DBP, the structural deficit[2] is expected to decrease by 0.3% of potential GDP and reach 2.0% in 2014, which is 0.2% of potential GDP. lower than in the Stability Programme. In 2015, the DBP forecasts the structural deficit in Spain to remain broadly unchanged at 2.0%, 0.1% of potential GDP less compared to the Stability Programme. The Commission 2014 autumn forecast estimates the structural deficit to decrease by 0.2% of potential GDP and reach 2.2% in 2014, and to widen by 0.2% of potential GDP. to 2.3% in 2015.

[2] As recalculated by the Commission on the basis of the information provided in the DBP, using the commonly agreed methodology. Note that in the case of Spain, structural balances recalculated by the Commission on the basis of the DBP scenario shows significant differences with the structural balances taken from the DBP at face value. In particular, the structural balance figures reported in the programme are -0.6% and -0.5% for 2014 and 2015, respectively.

Table 2. Composition of the budgetary adjustment

(% of GDP)	2013	2014			2015			Change: 2013-2015
	COM	SP	DBP	COM	SP	DBP	COM	DBP
Revenue	**37.5**	**38.5**	***38.0***	**38.3**	**38.8**	***38.4***	**38.4**	**0.9**
of which:								
- Taxes on production and imports	11.0	11.4	*11.3*	11.3	11.8	*11.6*	11.6	0.6
- Current taxes on income, wealth, etc.	10.0	10.8	*10.3*	10.3	10.8	*10.3*	10.3	0.3
- Capital taxes	0.5	0.5	*0.5*	0.5	0.5	*0.5*	0.5	0.0
- Social contributions	12.2	12.6	*12.2*	12.2	12.5	*12.1*	12.1	-0.1
- Other (residual)	3.8	3.2	*3.7*	3.9	3.2	*3.9*	3.9	0.1
Expenditure	**44.3**	**44.0**	**43.6**	**43.9**	**43.0**	**42.6**	**43.1**	**-1.7**
of which:								
- Primary expenditure	41.0	40.5	40.3	40.5	39.4	39.2	39.7	-1.8
of which:								
Compensation of employees	10.9	11.0	10.8	10.8	10.6	10.4	10.5	-0.5
Intermediate consumption	5.3	5.4	5.3	5.3	5.1	5.1	5.3	-0.3
Social payments	18.9	19.2	18.7	18.8	18.8	18.3	18.5	-0.6
Subsidies	1.0	1.2	1.1	1.1	1.1	1.0	1.0	0.0
Gross fixed capital formation	2.1	1.6	2.2	2.1	1.6	2.1	2.1	0.0
Other (residual)	2.8	2.1	2.2	2.4	2.2	2.3	2.3	-0.5
- Interest expenditure	3.3	3.5	3.3	3.3	3.6	3.4	3.4	0.1
General government balance (GGB)	**-6.8**	**-5.5**	**-5.5**	**-5.6**	**-4.2**	**-4.2**	**-4.6**	**2.6**
Primary balance	**-3.5**	**-2.0**	**-2.2**	**-2.3**	**-0.6**	**-0.8**	**-1.2**	**2.7**
One-off and other temporary	-0.4	-0.2	-0.4	-0.2	0.0	-0.2	-0.1	0.2
GGB excl. one-offs	**-6.4**	**-5.3**	**-5.1**	**-5.4**	**-4.2**	**-4.0**	**-4.5**	**2.4**
Output gap[1]	-7.5	-6.6	-5.9	-6.0	-4.8	-3.6	-4.1	3.9
Cyclically-adjusted balance[1]	-2.8	-2.3	-2.4	-2.4	-1.9	-2.2	-2.4	0.5
Structural balance (SB)[2]	**-2.3**	**-2.2**	**-2.0**	**-2.2**	**-1.9**	**-2.0**	**-2.3**	**0.3**
Structural primary balance[2]	0.9	1.3	1.4	1.2	1.7	1.3	1.0	0.4

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source :

Stability programme 2014 (SP); Draft Budgetary Plan 2015 (DBP); Commission 2014 autumn forecast (COM); Commission calculations.

3.2. Debt developments

The DBP foresees the debt-to-GDP ratio to reach 97.6% of GDP in 2014 (a downward revision of almost 2% of GDP compared with the Stability Programme, mainly driven by an upward revision of nominal GDP resulting from the changeover to the ESA 2010 accounting methodology). The upward trend in gross debt is set to continue in 2015, with the debt ratio rising to 100.3% of GDP. Compared to the Stability Programme, the DBP foresees a considerably smaller increase in the debt ratio for 2014, mainly on account of lower stock-flow adjustments (by more than 2% of GDP). As regards 2015, the revision in the planned increase in the debt-to-GDP ratio compared to the Stability Programme can also be mainly attributed to a higher contribution of the stock-flow adjustment. The DBP does not provide a breakdown of the various components of the stock-flow adjustment and of their respective revisions.

Compared with the DBP, the Commission 2014 autumn forecast projects slightly higher debt levels, which mainly reflect differences in inflation in 2014 and a somewhat higher primary deficit in 2015. The Commission forecast foresees the debt-to-GDP ratio to reach 98.1% in 2014 and 101.2% in 2015, about 1% of GDP higher than in the DBP.

Table 3. Debt developments

(% of GDP)	2013	2014			2015		
		SP	DBP	COM	SP	DBP	COM
Gross debt ratio[1]	**92.1**	**99.5**	**97.6**	**98.1**	**101.7**	**100.3**	**101.2**
Change in the ratio	7.6	5.6	5.5	6.0	2.2	2.7	3.0
Contributions[2] :							
1. Primary balance	**3.5**	**2.0**	**2.2**	**2.3**	**0.6**	**0.8**	**1.2**
2. “Snow-ball” effect	**3.7**	**1.9**	**2.0**	**2.5**	**1.1**	**0.9**	**0.7**
Of which:							
Interest expenditure	3.3	3.5	3.3	3.3	3.6	3.4	3.4
Growth effect	1.0	-1.1	-1.2	-1.1	-1.7	-1.9	-1.7
Inflation effect	-0.6	-0.4	-0.1	0.3	-0.8	-0.6	-1.0
3. Stock-flow adjustment	**0.4**	**1.7**	**1.2**	**1.3**	**0.6**	**1.1**	**1.1**
Of which:							
Cash/accruals difference		n.a.	n.a.		n.a.	n.a.	
Net accumulation of financial		n.a.	n.a.		n.a.	n.a.	
of which privatisation proceeds		n.a.	n.a.		n.a	n.a.	
Valuation effect & residual		n.a.	n.a.		n.a.	n.a.	

Notes:

[1] End of period.

[2] The snow-ball effect captures the impact of interest expenditure on accumulated debt, as well as the impact of real GDP growth and inflation on the debt ratio (through the denominator). The stock-flow adjustment includes differences in cash and accrual accounting, accumulation of financial assets and valuation and other residual

Source :

Stability programme 2014 (SP); Draft Budgetary Plan 2015 (DBP); Commission 2014 autumn forecast (COM); Commission calculations.

3.3. Measures underpinning the draft budgetary plan

The DBP reports a consolidation effect resulting from discretionary measures of 1.5% and 1% of GDP in 2014 and 2015 respectively (see Table 4). In 2014, almost two thirds of this effect stems from expenditure-based measures, where savings are expected from a restrictive public sector hiring policy, various measures at the regional level and planned savings from the local administration reform. On the revenue side, the consolidation reflect higher corporate taxes as well as higher regional and local taxes (including local property tax). In 2015, more than two thirds of the planned measures are stemming from the expenditure side, with measures at regional and, above all, local level figuring prominently. On the revenue side, higher environmental taxes and further tax measures at regional and local level are planned to more than outweigh the impact of the tax reform, including the lowering of personal income tax rates (see Section 5).

Table 4. Main discretionary measures reported in the DBP[3]

A. Discretionary measures taken by General Government - revenue side

Components	Budgetary impact (% GDP) (as reported by the authorities)	
	2014	**2015**
Taxes on production and	0.1	0.4
Current taxes on income, wealth,	0.3	-0.3
Capital taxes	0.0	0.0
Social contributions	0.1	0.1
Property Income	n.a.	n.a.
Other	0.0	0.0
Total	0.5	0.3

Note:
The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that revenue increases as a consequence of this measure.
Source: Draft Budgetary Plan 2015

B. Discretionary measures taken by general Government- expenditure side

Components	Budgetary impact (% GDP) (as reported by the authorities)	
	2014	**2015**
Compensation of employees	-0.2	-0.2
Intermediate consumption	-0.1	-0.3
Social payments	-0.2	-0.1
Interest Expenditure	0.0	0.0
Subsidies	0.0	0.0
Gross fixed capital formation	-0.3	0.0
Capital transfers	n.a.	n.a.
Other	0.0	0.0
Total	-0.9	-0.7

Note:
The budgetary impact in the table is the aggregated impact of measures as reported in the DBP, i.e. by the national authorities. A positive sign implies that expenditure increases as a consequence of this measure.
Source: Draft Budgetary Plan 2015

[3] The table reports the cumulative annual budgetary impact of main discretionary measures. The DBP reports also the incremental annual impact, however, not according to the ESA 95 breakdown.

The Commission 2014 autumn forecast takes into account consolidation measures of about 1.25% of GDP in 2014 and about 0.5% of GDP in 2015, as some of the measures, notably at regional and local government level, carry implementation risks, also in light of the track record in 2013. Moreover, the net cost of the tax reform could also be somewhat higher than planned. However, fiscal consolidation measures planned in both 2014 and 2015 in the DBP mostly do not rely on one-offs. The previous reliance on reductions in investment expenditure seems to have come to an end, and the focus achieving efficiency gains in public spending at various levels of government makes the overall consolidation strategy more growth-friendly.

4. COMPLIANCE WITH THE PROVISIONS OF THE STABILITY AND GROWTH PACT

For 2014, the DBP projects the headline deficit to decrease to 5.5% of GDP, below the EDP headline target of 5.8% of GDP. According to the Commission 2014 autumn forecast, the general government deficit of Spain is expected to reach 5.6% of GDP in 2014, below the headline target for that year recommended under the EDP. However, while the EDP recommendation requires Spain to achieve an improvement in the structural balance of 0.8% of GDP in 2014, the DBP foresees an improvement of only 0.3% of GDP as recalculated using the commonly agreed methodology. The Commission 2014 autumn forecast points to an expected improvement in the structural balance of 0.2% of GDP, more than half a percentage point less than what was required.

Accounting for revisions in the potential output growth estimate and unexpected revenue windfalls/shortfalls since the time of the EDP recommendation, the estimated corrected change in the structural balance amounts to -0.5% of GDP in 2014, i.e. 1.3% of GDP. below the effort required in the EDP recommendation[4]. In cumulative terms over 2013-2014, Spain is expected to achieve an improvement in the uncorrected structural balance of almost 1.5% of GDP, which is below the cumulative target of 1.9% of GDP. In the same period, the cumulated corrected improvement in the structural balance is estimated at 0.5% of GDP, 1.4% of GDP below the recommended effort. However, it is worth noting that specifically at the turning point of the cycle, developments in the structural balance for Spain may tend to underestimate the true fiscal effort. In particular, at this stage of the cycle, estimates of the potential growth seem to bottom-out at still negative values, while real GDP growth returns firmly into positive territory, thus possibly leading to some overestimation of the cyclical component of fiscal consolidation.

The latest EDP recommendation required Spain to adopt additional measures in 2014 of around 2% of GDP. However, according to a bottom-up assessment which estimates the size the fiscal effort for 2014 on the basis of the additional discretionary revenue measures and the expenditure developments under the control of the government between the EDP scenario and the Commission 2014 autumn forecast, Spain is expected to record an effort of 1.2% of GDP in 2014, which is 0.8% of GDP lower than what was required. However, the exclusion of unemployment benefit payments related to the evolution of the number of unemployed from the usual metric for the bottom-up effort may in the case of Spain lead to some underestimation of the fiscal effort. In particular, measures taken specifically to target (unwarranted) access to the unemployment benefit system may have contributed to fiscal consolidation, although not showing in this particular metric for fiscal effort. Also, long-term unemployed leaving the unemployment benefit system and turning to social assistance schemes may further reduce the effort as measured by this metric. In cumulative terms over

[4] Most of the difference between the uncorrected and corrected structural balance is due to the impact of revisions in potential output growth compared to that underlying the growth scenario in the recommendation.

2013-2014, the fiscal effort based on this method amounts to 1.3% of GDP, against a required effort of 2% of GDP.

Box 2. Council recommendations addressed to Spain

On 21 June 2013, the Council recommended Spain under Article 126(7) of the Treaty to correct its excessive deficit by 2016. To this end:

- Spain should put an end to the present excessive deficit situation by 2016.

- 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, based on the Commission services' 2013 spring forecast extended to 2016, 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.

- 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.

- 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 Council Regulation (EC) No 1467/97, to report in detail the consolidation strategy that is envisaged to achieve the targets.

Furthermore, the Spanish authorities should (i) 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 EU fiscal rules, (ii) undertake concrete steps to rein in the increasing structural deficit in the social security system, and (iii) give a greater emphasis to the growth friendliness of the consolidation, including by conducting systematic reviews of expenditure and the tax system.

On 8 July 2014, the Council also addressed recommendations to Spain in the context of the European Semester. In particular, in the area of public finances the Council recommended to Spain to:

- ensure that the new independent fiscal authority becomes fully operational as soon as possible

- ensure a full implementation of the preventive, corrective and enforcement measures in the Budgetary Stability Organic Law at all levels of government, including on the elimination of public sector commercial arrears.

- carry out by February 2015 a systematic review of expenditure at all levels of government to underpin the efficiency and quality of public spending going forward.

- continue increasing the cost-effectiveness of the healthcare sector, in particular by further rationalising pharmaceutical spending, including in hospitals and strengthening coordination across types of care, while maintaining accessibility for vulnerable groups.

- adopt by the end of 2014 a comprehensive tax reform to make the tax system simpler and more conducive to growth and job creation, preservation of the environment and stability of revenues.

For 2015, the headline balance forecast in the DBP is in line with the EDP target of 4.2% of GDP. However, the achievement of the planned headline deficit target may be subject to risks. In particular, according to the Commission 2014 autumn forecast, the general government deficit is forecast to stand at 4.6% of GDP in 2015, almost 0.5% of GDP higher than the EDP target.

The latest EDP recommendation requires Spain to achieve an improvement of the structural balance of 0.8% of GDP in 2015. However, the DBP foresees no change in the structural balance as recalculated using the commonly agreed methodology. In turn, the Commission 2014 autumn forecast projects the structural deficit to deteriorate by 0.2% of GDP in 2015. Correcting for the change in the estimated potential growth between the projections underlying the revised EDP recommendation and the 2014 autumn forecast, as well as revenue windfalls/shortfalls, the estimated change in the structural balance would still remain at -0.2% of GDP. This is below the recommended structural effort by 1% of GDP.

On a cumulative basis over 2013-2015, the estimated shortfall amounts to 1.4% of GDP when measured against the uncorrected balance, and to 2.4% of GDP when corrected. This shortfall is even larger when also including 2015.

Finally, the bottom-up estimate of the fiscal effort in 2015 is close to zero. This falls short of the target of about 1% of GDP of measures deemed necessary in 2015 to reach the structural targets spelled out in the EDP recommendation, leading to an underperformance of 1.6% of GDP in cumulative terms over 2013-2015.

The DBP also confirms the headline deficit target for 2016 at 2.8% of GDP, in line with the EDP target. However, considering inter alia that not all consolidation measures presented in the DBP were sufficiently specified to be included in the Commission 2014 autumn forecast, the latter foresees the general government deficit to narrow by only 0.7% of GDP to 3.9% in 2016. Therefore, the risks to achieving the EDP 2016 headline deficit target at this stage are high given the insufficient amount of measures currently specified for 2015 and 2016.

The latest EDP recommendation requires Spain to achieve a structural fiscal consolidation of 1.2% of GDP in 2016. However, according to the Commission 2014 autumn forecast, neither the uncorrected nor the corrected change in the structural balance is projected to achieve this target. Given the shortfalls in previous years, this holds also on a cumulative basis.

Table 5. Compliance with the EDP recommendation

(% of GDP)	2013	2014		2015	
	COM	DBP	COM	DBP	COM
Headline balance					
Headline budget balance	-6.8	-5.5	-5.6	-4.2	-4.6
EDP requirement on the budget balance	-6.5	-5.8		-4.2	
Fiscal effort - change in the structural balance					
Change in the structural balance[1]	1.3	0.4	0.2	-0.1	-0.2
Cumulative change[2]	1.3	1.7	1.5	1.6	1.3
Required change from the EDP recommendation	1.1	0.8		0.8	
Cumulative required change from the EDP recommendation	1.1	1.9		2.7	
Fiscal effort - adjusted change in the structural balance					
Adjusted change in the structural balance[3]	1.0	-	-0.5	-	-0.2
of which: *correction due to change in potential GDP estimation (α)*	-0.3	-	-0.4	-	0.0
correction due to revenue windfalls/shortfalls (β)	0.0	-	0.3	-	0.1
Cumulative adjusted change [2]	1.0	-	0.5	-	0.3
Required change from the EDP recommendation	1.1	0.8		0.8	
Cumulative required change from the EDP recommendation	1.1	1.9		2.7	
Fiscal effort - calculated on the basis of measures (bottom-up approach)					
Fiscal effort (bottom-up)[4]	0.1	-	1.2	-	0.1
Cumulative fiscal effort (bottom-up)[2]	0.1	-	1.3	-	1.4
Requirement from the EDP recommendation	0.0	2.0		1.0	
Cumulative requirement from the EDP recommendation	0.0	2.0		3.0	

Notes

[1]Structural balance = cyclically-adjusted government balance excluding one-off measures. Structural balance based on DBP are recalculated by Commission on the basis of the Draft Budgetary Plan scenario using the commonly agreed methodology. Change compared to t-1.

[2] Cumulated since the latest EDP recommendation.

3 Change in the structural balance corrected for unanticipated revenue windfalls/shortfalls and changes in potential growth compared to the scenario underpinning the EDP recommendations.

[4]The estimated budgetary impact of the additional fiscal effort delivered on the basis of the discretionary revenue measures and the expenditure developments under the control of the government between the baseline scenario underpinning the EDP recommendation and the current forecast.

Source :

Draft Budgetary Plan 2015 (DBP), Commission 2014 autumn forecast (COM), Commission calculations

5. IMPLEMENTATION OF FISCAL-STRUCTURAL REFORMS

Spain has made some progress to comply with the 2014 fiscal structural Country-Specific Recommendations (CSRs). Spain's independent fiscal authority (AIReF) is now operational. However, the implementation of Spain's stability law on non-compliant regional governments has been weaker than in 2013. At the time of writing, an expert group had submitted review proposals on main spending items, but no agreement had been reached on their implementation at central and regional government levels. Last, the tax reform, while providing some simplification to the tax system, is not revenue neutral, and might therefore make fiscal consolidation more difficult. Specifically:

- AIReF has issued various reports and opinions, including on the 2015 macroeconomic and budgetary forecasts (see box 1), despite having been staffed only recently. However, implementing legislation to spell out information submission procedures and data needed by AIReF to carry out its duties was pending at the time of writing. Moreover, contrary to the common principles on national fiscal correction mechanisms, AIReF's law does not mandate the government to publish its explanations should it resolve to ignore AIReF's advice, this being an area for improvement.
- Despite visible deterioration in regional public finances throughout 2014, no preventive measures foreseen in Spain's Stability Law had been applied up until end-October on regions at risk of non-compliance. In addition, compared with last year, the adoption of corrective measures is going at a much slower pace, with only one of six regional Economic and Financial Plans having been approved. Slippages in the regional budget outcome will carry on to 2015, thus making it difficult to comply with an even more demanding deficit target.
- Spain's stability law was amended in December 2013 to ensure that all general government subsectors comply with the 30 day average payment period for commercial debt, in accordance with applicable EU legislation. To that end, the amendments mandate all administrative bodies to publish periodically their average payment period on their website and set out a procedure to monitor compliance by the ministry of finance. The first average payment period data calculated according to a standard methodology was published at the end of October 2014, with a varying degree of compliance at sub-central government level. The publication launches the legal procedure to ensure compliance with the abovementioned target.
- Following the 2014 CSR on spending reviews, the government created on 26 June 2014 of a taskforce looking into expenditure reduction in Spain's regions. To be effective, measures have to be agreed at the meeting of the Financial and Fiscal Policy Council (a forum gathering representatives from the regions and central government's finance departments), and then be legislated. At the time of writing, measures had been identified but no agreement to have them adopted had taken place.
- On 1 August, the government approved the draft tax reform proposal which is to be adopted by parliament by the end of 2014. The tax reform focuses on cuts in personal and corporate income taxes and is therefore not as comprehensive or ambitious as it could have been. It is a partially missed opportunity to simplify significantly and fix shortcomings in the tax system and to sustainably lower labour taxation by shifting the tax burden to indirect taxes (consumption or environmental) or recurrent property taxes. Positive elements of the reform are some reduction of the labour tax wedge, however with a short-run impact mainly on disposable income (and hence consumption and imports) rather than on labour costs (and thus employment), measures to broaden the corporate tax base and reduce the debt bias, and limited measures to reduce tax fraud. Not being revenue neutral (the ex-ante cost is estimated by the government at 0.9% of GDP), the reform might make fiscal consolidation more difficult.

Last, the DBP makes explicit reference to other non-fiscal CSRs. Measures in the DBP seem to contribute to compliance with the abovementioned CSR.

Box 3. Addressing the tax wedge

The tax burden on labour in the euro area is relatively high, which weighs on economic activity and employment. Against this background, the Eurogroup has expressed its commitment to effectively reduce the tax burden on labour. It will take stock of Member States' plans for reductions of the tax burden when discussing the draft budgetary plans.

In the context of the European Semester, Spain was issued the recommendation to "adopt by the end of 2014 a comprehensive tax reform to make the tax system simpler and more conducive to growth and job creation, preservation of the environment and stability of revenues. To that end, shift revenues towards less distortive taxes, such as consumption, environmental (e.g. on motor fuels) and recurrent property taxes; remove inefficient personal and corporate income tax expenditures; consider lowering employers' social security contributions, in particular for low-wage jobs".

The tax wedge in Spain is somewhat below the EU average. Revenues from employers' social security contributions are relatively high. The tax wedge for a single person without children earning 50% of the average wage was 32.1% compared to an EU average of 34% in 2013, for 67% of the average wage it was 37.2% (EU average: 37.7%) and for the average wage it was 40.7% (EU average: 41.1%). Revenues from employers' social security contributions amounted to 8.4% of GDP in 2012. The Spanish employment rate in 2013 was 58.6% against a 68.4% EU average.

The Draft Budgetary Plan contains measures to reduce the tax wedge. A permanent reduction of personal income tax rates forms part of the government's tax reform, which is also integrated in the consolidation plan as presented in the DBP. The tax reform itself is not fully financed, but the DBP foresees other offsetting measures on the revenue and expenditure side. The cut should also be seen against the background of the personal income tax and VAT hikes that were introduced in 2012 as part of the effort to consolidate public finances. The cut in personal income tax will be introduced in two stages, the first part taking effect in January 2015 and the second a year later. In addition a temporary reduction in social contributions on new contracts was available between February and December 2014.

The measures decrease the tax wedge for most income categories, and could have a positive effect on employment. However, their impact could have been larger had they focused more on cutting labour costs by lowering social contributions.

6. OVERALL CONCLUSION

Based on the Commission 2014 autumn forecast, the headline budgetary deficit is expected to decrease to 5.6% of GDP in 2014 and to drop further to 4.6% of GDP in 2015. For 2015, the Draft Budgetary Plan is based on somewhat favourable growth assumptions and includes measures which are not yet fully specified, posing some risks to meeting the headline target. The improvement in the structural balance falls short of the efforts required by the Council in both 2014 and 2015, regarding both the uncorrected and the corrected change in the structural balance. Compared to the baseline scenario in the EDP recommendation, based on bottom-up calculations, in 2014 the planned consolidation is underpinned by additional consolidation measures of around 1.2% of GDP and in 2015 the bottom-up method indicates almost no further effort. Therefore, for both 2014 and 2015, the amount of additional measures specified in the Draft Budgetary Plan falls short of what was deemed necessary to reach the structural targets spelled out in the EDP recommendation. For 2016, Spain has not yet taken the additional measures necessary to underpin the EDP headline deficit targets.

Spain has made some progress to address its fiscal structural CSRs. While the independent fiscal institution is now operational, the adoption of corrective measures on regional governments having not complied with deficit targets has gone at a much slower pace than in 2013. Moreover, the draft tax reform, while providing some simplification to the tax system, it is not revenue neutral and may render fiscal consolidation more difficult.