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COMMUNICATION FROM THE COMMISSION

Assessment of action taken by Portugal and Spain

in response to the Council decisions of 8 August 2016 giving notice to take measures for the deficit reduction judged necessary in order to remedy the situation of excessive deficit

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1. INTRODUCTION

On 8 August 2016, the Council adopted decisions under Article 126(9) of the Treaty on the Functioning of the European Union (TFEU), giving notice to Portugal and Spain to take measures for the deficit reduction judged necessary in order to remedy the situation of excessive deficit.

Portugal was given notice to put an end to the excessive deficit situation by 2016 by reducing the general government deficit to 2.5% of GDP this year. Such a target excluded the impact of the direct effect of potential bank support. Based on the Commission 2016 spring forecast, which underpinned the Council decision, this was considered consistent with an unchanged structural balance with respect to 2015. The Council also decided that Portugal should use all windfall gains to accelerate the deficit and debt reduction. Moreover, Portugal was required to adopt and fully implement consolidation measures for the amount of 0.25% of GDP in 2016 in addition to the savings included in the Commission 2016 spring forecast. This notably implied fully implementing the consolidation measures incorporated in the 2016 Budget, including the additional expenditure control in the procurement of goods and services highlighted in the Stability Programme, and complementing those savings with further measures of a structural nature to achieve the required fiscal effort. Finally, in order to ensure a durable improvement of public finances, the Council requested Portugal to strictly implement the Budget Framework Law and the Commitment Control Law and further improve revenue collection and expenditure control. Portugal was requested to present a clear schedule and implement steps to fully clear arrears and improve efficiency in the health care system, to reduce the reliance of the pension system on budget transfers, and to ensure fiscal savings in the restructuring of State-owned enterprises (SOEs).

Spain was given notice to put an end to the excessive deficit situation by 2018 by reducing the general government deficit to 4.6% of GDP in 2016, to 3.1% of GDP in 2017 and 2.2% of GDP in 2018. Based on the updated Commission 2016 spring forecast underpinning the Council decision, this was considered consistent with a deterioration of the structural balance by 0.4% of GDP in 2016 and improvements by 0.5% of GDP in both 2017 and 2018. The Council also decided that Spain should use all windfall gains to accelerate the deficit and debt reduction, and should adopt and fully implement consolidation measures for the amount of 0.5% of GDP in both 2017 and 2018 in addition to the savings included in the updated Commission 2016 spring forecast. Finally, the Council required Spain to adopt measures to strengthen its fiscal framework, in particular with a view to increasing the automaticity of mechanisms to prevent and correct deviations from the budgetary targets and to strengthening the contribution of the Stability Law's spending rule to public finance sustainability. It also required the Spanish government to set up a consistent framework to ensure transparency and coordination of public procurement policy across all contracting authorities and entities, including appropriate ex-ante and ex-post control mechanisms to ensure efficiency and legal compliance.

In accordance with Article 3(4a) of Council Regulation (EC) No 1467/97, the Council established the deadline of 15 October 2016 for Portugal and Spain to report in detail on action taken in response to the Council decision. A report to the Council and the Commission highlighting the fiscal policy measures taken to achieve the targets set by the Council was submitted by Spain on 15 October 2016 and a report was submitted by Portugal on 17 October 2016.

The Commission has examined the budgetary strategies of Portugal and Spain based on the information included in the reports on action taken in order to assess whether both Member States have complied with the Council decisions of 8 August 2016.

Box 1: Methodology for assessing effective action

According to Regulation (EC) No 1467/97 and the Code of Conduct[1], a Member State should be considered to have taken effective action if it has acted in compliance with either the Council recommendation under Article 126(7) of the TFEU or the Council decision to give notice under Article 126(9). The Code of Conduct states that the assessment of effective action should in particular take into account whether the Member State concerned has achieved the annual budgetary targets and the underlying improvement of its cyclically-adjusted balance, net of one-off and other temporary measures, as recommended by the Council.

The methodology to assess effective action[2] requires, firstly, verifying whether the Member State is compliant with the headline deficit target and the underlying improvement in the structural balance required in the Council recommendation or decision to give notice. If this is the case, the procedure is held in abeyance.

If the Member State fails or is at risk of failing to meet the headline deficit target or the required improvement in the structural balance, a careful analysis of the reasons for such a shortfall is undertaken. The careful analysis aimed at assessing whether the Member State has acted in compliance with the Council recommendation or decision to give notice builds on two complementary fiscal effort measures: (i) the 'top-down' method, which measures the change in the structural balance adjusted for the revision of potential output growth, revenue windfalls/shortfalls and unexpected events compared to the baseline scenario underpinning the Council recommendation or decision to give notice; and (ii) the 'bottom-up' method, which estimates the budgetary impact of the individual discretionary fiscal measures implemented and the developments in expenditure under the control of the government compared to the baseline scenario underpinning the Council recommendation or decision to give notice. The careful analysis is also complemented by other relevant qualitative considerations allowing the Commission to provide a qualified judgment on whether the Member State has taken enough policy actions to comply with the Council recommendation or decision to give notice

If the careful analysis indicates that the Member State concerned has delivered on its policy commitments, the assessment will conclude that effective action has been taken. If the careful analysis shows that policy commitments have not been delivered and the headline deficit targets are expected to be missed, the assessment will conclude that effective action has not been taken. However, if the headline deficit targets are expected to be met, the procedure should be held in abeyance.

[1] "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", available at: http://ec.europa.eu/economy_finance/economic_governance/sgp/index_en.htm .

[2] As endorsed by the Council on 20 June 2014: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/143293.pdf.

2. ASSESSMENT OF ACTION TAKEN BY PORTUGAL

2.1. Measures included in the report on action taken and updated budgetary projections

As explained in the report on action taken submitted by Portugal on 17 October 2016, Portugal implemented a freeze of EUR 445 million (¼% of GDP) in intermediate consumption in response to the Council decision to give notice of 8 August 2016. This measure is expected to partially offset the deficit-increasing factors presented in the document. The report plans a general government deficit of 2.4% of GDP in 2016, which is 0.2% of GDP above the 2016 Stability Programme target. The difference stems mostly from the worsening of the macroeconomic outlook compared to the 2016 Stability Programme, which contributes to the downward revision of tax revenue projections. On the expenditure side, two one-off factors are also expected to increase the general government deficit (one related to Oitante — the asset management vehicle created in the framework of the Banif resolution —, and the other related to the cancellation of two concessions).

2.2. Assessment of action taken

The Commission 2016 autumn forecast projects a general government deficit of 2.7% of GDP in 2016, above the required deficit target of 2.5% of GDP but below the Treaty reference value of 3% of GDP. Half of the divergence as compared to the 2.4% of GDP included in the report on action taken stems from a less optimistic macroeconomic scenario in the Commission 2016 autumn forecast, resulting in lower tax revenue projections. The remaining discrepancy results from some larger expenditure pressures in the Commission 2016 autumn forecast than in the report on action taken, notably regarding compensation of employees and intermediate consumption.

Table 1: Comparison of budgetary projections

% of GDP	Headline budget balance	Adjustment in the structural balance
	2016	2016
Commission 2016 autumn forecast	-2.7%	-0.1%
Report on action taken / DBP 2017*	-2.4%	0.0%
Baseline scenario (2016 spring forecast)**	-2.7%	-0.2%
EDP target	-2.5%	0.0%

Notes:

*Structural balances based on the DBP are recalculated by Commission on the basis of the DBP scenario using the commonly agreed methodology.

** Scenario underpinning the Council Decision of 8 August 2016

The required fiscal effort of an unchanged structural balance is not projected to be met as the Commission 2016 autumn forecast projects a slight deterioration by 0.1% of GDP. This is better than the 0.2% of GDP deterioration projected in the Commission 2016 spring forecast underpinning the Council decision to give notice because of the downward revision of the macroeconomic outlook and the ensuing impact on the cyclical adjustment.

As provided in the methodology for assessing effective action (see Box 1), this situation calls for a careful analysis of the fiscal effort based on the adjusted change in the structural balance ('top-down' method) and on the amount of measures taken ('bottom-up' method).

Based on the 'top-down' method to assess fiscal effort, the adjusted change in the structural balance is estimated at 0.4% of GDP. Moreover, based on the 'bottom-up' method, the fiscal effort of 0.3% of GDP seems to be broadly in line with what was deemed necessary to comply with the Council decision to give notice (0.25% of GDP). This mainly reflects the requested freezing of intermediate consumption — with a structural budgetary impact of close to ¼% of GDP — taken in response to the Council decision to give notice and duly reported in the report under analysis.

Table 2: Comparison between the adjusted change in the structural balance and the 'bottom-up' fiscal effort, based on the Commission 2016 autumn forecast

% of GDP	Adjusted change in the structural balance	Bottom-up effort
	2016	2016
Commission 2016 autumn forecast	0,4%	0,3%
Baseline scenario (2016 spring forecast)*	-0,2%	0,0%
EDP target	0,0%	0,25%

* Scenario underpinning the Council Decision of 8 August 2016

Overall, while the headline deficit target is not projected to be met in 2016, the Commission 2016 autumn forecast still expects a timely correction of the excessive deficit. Moreover, the Commission forecast projects the excessive deficit to be corrected in a durable manner as the headline deficit is forecast to remain below the Treaty reference value of 3% of GDP, further decreasing to 2.2% of GDP in 2017 and moderately increasing to 2.4% of GDP in 2018. Finally, the required fiscal effort is expected to be achieved in 2016 on the basis of both the adjusted change in the structural balance and the 'bottom-up' method to assess fiscal effort. However, the timing and magnitude of a potential deficit impact of the planned recapitalisation of Caixa Geral de Depósitos (CGD) are not yet known. This represents a risk to the timely and durable correction of the excessive deficit.

2.3. Assessment of action taken as regards fiscal-structural measures

As regards the measures required by the Council to ensure a durable improvement of public finances, the report on action taken highlights containment of non-financial debt in the central administration and increases in available funds to clear arrears in the health sector. The report also refers to the approval of operating rules for the new Budgetary Framework Law's implementation unit. Moreover, a spending review has started, covering for the time being health and education sectors, as well as public procurement and state-owned enterprises (SOEs), with a planned cumulative impact of EUR 238 million in savings until 2019, of which EUR 75 million in 2017. Regarding the sustainability of the pension system, the report points to the planned allocation of the revenue of a new progressive tax on real estate assets to the social security's Financial Stabilisation Fund (expected to yield EUR 160 million in 2017) in the Draft Budget for 2017. This is being presented by the government as a way to address the reliance on standard budgetary transfers. However, the expenditure side of the

sustainability of the pension system remains unaddressed. Finally, the report on action taken refers to a refocus of SOEs' restructuring plan as ongoing, without referring to specific progress in this area.

3. ASSESSMENT OF ACTION TAKEN BY SPAIN

3.1. Measures included in the report on action taken and updated budgetary projections

In light of the caretaker nature of the government, the report on action taken submitted by Spain on 15 October 2016 focuses on measures adopted with the aim of ensuring compliance with the intermediate budgetary targets for 2016.

In particular, the report highlights the following two new fiscal policy measures adopted in response to the Council decision of 8 August 2016: firstly, the decision to bring forward the closing date of the 2016 fiscal year and secondly, Royal Decree Law 2/2016, which raises the amount of corporate income tax (CIT) instalment payments. The former is a budget-management strategy to help to rein in expenditure in 2016, with planned savings amounting to EUR 1 billion (0.1% of GDP). The latter was adopted by the Spanish government and ratified by the parliament on 20 October 2016 with a view to offsetting an anticipated 0.6% of GDP shortfall in CIT revenues in 2016, resulting from the expiry on 1 January 2016 of transitory measures governing CIT instalment payments. Among other things, the measure reintroduces and increases minimum CIT instalment payments, broadening their coverage to a larger number of companies. According to the report, in addition to compensating for the above-mentioned shortfall in CIT revenue, the measure has a further 0.2% of GDP net positive impact on the 2016 headline balance, with the deficit planned to reach 4.6% in 2016. This measure however does not bring any improvement to Spain's structural balance.[3]

In view of the caretaker nature of the government until the deadline of 15 October set by the Council for the submission of the report, and consistently with the no-policy-change projections presented in the DBP for 2017, the report on action taken does not present any new fiscal policy measures for 2017, which would be necessary to ensure compliance with the 2017 and 2018 headline deficit and structural targets. It only highlights the continued impact of measures already adopted in 2016 or before. On this basis, the planned deficit for 2017 in the DBP is 3.6% of GDP, 0.5 percentage points above the headline deficit target set by the Council for that year.

As regards the measures required by the Council decision of 8 August 2016 to strengthen Spain's fiscal and public procurement policy frameworks, the report provides information on the implementation of the relevant provisions in the national fiscal framework − namely, the Stability Law − in 2016 and on the two legislative proposals put forward by the Spanish government to strengthen supervision of public procurement, which are now awaiting parliamentary approval.[4]

[3] The expiration of on 1 January 2016 of transitory measures governing CIT instalment payments as well as the Royal Decree Law 2/2016 setting new minimum payments do not introduce any changes to the overall tax burden for corporations, but only affect the timing of the tax liabilities and payments. Therefore, the Commission considers their impact to be of a one-off nature.

[4] For further details, see the Staff Working Document accompanying this Communication and the Commission Opinion on the Draft Budgetary Plan for 2017 of Spain.

3.2. Assessment of action taken

The Commission 2016 autumn forecast expects a headline deficit of 4.6% of GDP, in line with the deficit target in the Council notice. In particular, in the first half of 2016, Spain's general government deficit barely changed, despite strong economic growth. Available monthly data for August and September for some subsectors of general government confirmed this picture. Whereas expenditure has grown in line with expectations, revenue has been weighed down by significant shortfalls in income tax revenue. This is especially the case for CIT following the entry into force of the second leg of the CIT tax reform and the abolition of the minimum CIT instalment payments, which came into effect in January 2016. The Royal Decree Law 2/2016 that was adopted on 20 October 2016 more than offsets the impact of the latter.

In the absence of a budget for 2017, the deficit is then expected to narrow to 3.8% of GDP in 2017 and to 3.2% of GDP in 2018. This is mostly on account of a positive macroeconomic outlook (supporting tax revenue and helping to keep social transfers under control) and decreasing interest payments in a low interest rate environment. However, the expected deficit outcome for both years remains above the headline deficit targets set by the Council and a timely correction by 2018 is currently not projected.

While the Council decision of 8 August 2016 requires Spain to limit the deterioration of the structural balance to at most 0.4% of GDP in 2016, the Commission 2016 autumn forecast points to a decline in the structural balance by 1.0% of GDP, 0.6 percentage points below what was requested. For 2017 and 2018, the Council decision of 8 August 2016 requires Spain to achieve an improvement in the structural balance of 0.5% of GDP in 2017. In contrast, the Commission 2016 autumn forecast projects no change in the structural deficit for 2017 and 2018.

Table 3: Comparison of budgetary projections

% of GDP	Headline budget balance			Change in the structural balance		
	2016	2017	2018	2016	2017	2018
Commission 2016 autumn forecast	-4.6%	-3.8%	-3.2%	-1.0%	0.0%	0.0%
Commission 2016 July forecast *	-4.6%	-3.3%	-2.7%	-0.4%	-0.1%	0.0%
Report on action taken / 2017 Draft Budgetary Plan	-4.6%	-3.6%	na	-0.7%	-0.1%	na
EDP target	-4.6%	-3.1%	-2.2%	-0.4%	0.5%	0.5%

Notes:

Structural balances based on the Draft Budgetary Plan are recalculated by Commission using the commonly agreed methodology.

* Scenario underpinning the Council Decision of 8 August 2016

As provided in the methodology for assessing effective action (see Box 1), this situation calls for a careful analysis of the fiscal effort based on the adjusted change in the structural balance ('top-down' method) and on the amount of measures taken ('bottom-up' method).

Table 4: Comparison between the adjusted change in the structural balance and the 'bottom-up' fiscal effort based on the Commission 2016 autumn forecast

% of GDP	Adjusted change in the structural balance			Bottom-up effort		
	2016	2017	2018	2016	2017	2018
Commission 2016 autumn forecast	-0.5%	0.2%	0.0%	-0.1%	0.3%	0.0%
EDP target	-0.4%	0.5%	0.5%	0.0%	0.5%	0.5%

Regarding 2016, the careful analysis shows that there is a risk of underperforming the required fiscal effort based on both metrics. In particular, according to the 'top-down' method, the estimated adjusted change in the structural balance is projected to be of -0.5% of GDP in 2016, marginally missing the -0.4% of GDP target required by the Council. A similar picture emerges based on the 'bottom-up' method, which projects the net impact of (structural) revenue measures and expenditure developments under the control of the government to have a net expansionary impact of 0.1% of GDP, compared to the zero impact required by the Council.

As regards 2017, while acknowledging the no-policy-change nature of these projections, the careful analysis reveals that in the absence of further measures the fiscal effort would fall short of the level required by the Council by 0.3% of GDP based on the 'top-down' method, while the 'bottom-up' estimate would point to a shortfall of 0.2% in that year. This would translate into a cumulative shortfall over 2016-2017 of 0.3% of GDP on the basis of both the 'bottom-up' and 'top-down' metrics. Lastly, for 2018, and also on account of the no-policy-change nature of these projections, the 'top-down' estimate projects no fiscal effort in 2018 and a cumulative shortfall of 0.8% of GDP compared to the target required by the Council. Similarly, the 'bottom-up' estimate shows no fiscal effort in 2018. This is below the target of 0.5% of GDP of measures deemed necessary in 2018 to reach the structural targets spelled out in the Council decision to give notice, leading to an underperformance of 0.9% of GDP in cumulative terms over 2016-2018.[5]

3.3. Assessment of action taken as regards fiscal-structural measures

The Spanish government has put forward some measures in response to the Council decision, which however fall short of its requirements.

While the Spanish authorities provided detailed information on the implementation of the preventive and corrective mechanisms of the Stability Law throughout 2016, they have so far not presented proposals to amend that law so as to make the application of those mechanisms automatic. Moreover, in the absence of appropriate implementing legislation, the application of the Stability Law's spending rule remains unclear and can be subject to interpretations that undermine its contribution to fiscal discipline.

As for the planned measures to strengthen Spain's public procurement policy framework, the reported measures can go some way in improving some public procurement practices in

[5] In a letter addressed to Vice-President Dombrovskis and Commissioner Moscovici dated 8 November 2016, the Spanish Minister of Economy, Industry and Competitiveness, announced that the Spanish government will submit an updated DBP within the next coming weeks. According to the letter, this updated budget would ensure compliance with the 2017 headline deficit target of 3.1% of GDP in 2017 and the structural effort requirement of 0.5% of GDP.

Spain, but overall they do not address the need for a consistent framework that ensures sufficient transparency and coordination of public procurement across all contracting authorities and entities. Furthermore, the report does not spell out clear objectives for public procurement, instruments for action and a timeline for their adoption and implementation.

4. CONCLUSIONS

The reports on action taken submitted by Portugal on 17 October 2016 and Spain on 15 October 2016 provide details on the measures underpinning both Member States' budgetary strategies.

Regarding Portugal, based on the information available, the general government deficit is expected to reach 2.7% of GDP in 2016, below the 3% of GDP reference value of the Treaty but above the target required by the Council on 8 August 2016. A careful analysis based on the Commission 2016 autumn forecast suggests that Portugal has delivered the fiscal effort deemed necessary to comply with the Council decision of 8 August 2016. According to the methodology for assessing effective action, as Portugal is compliant with the fiscal effort requested by the Council decision of 8 August 2016, the Commission considers that Portugal has taken effective action in response to the Council decision of 8 August 2016 and, therefore, that the procedure should be kept in abeyance at this stage. Given the potential deficit-increasing impact of the CGD recapitalisation, a timely and durable correction of the excessive deficit is however not yet ensured. The Commission also invites the authorities to further pursue the implementation of the fiscal-structural measures requested by the Council in the decision to give notice of 8 August 2016.

Regarding Spain, the authorities have confirmed their commitment to ensure a correction of the excessive deficit as required by the Council. However, given the caretaker nature of the government on the 15 October 2016 deadline set by the Council, the report on action taken focuses on the measures adopted with the aim of delivering compliance with the 2016 intermediate deficit target, while presenting no-policy-change projections for 2017. Overall, according to the Commission 2016 autumn forecast, the headline deficit is expected to decrease to 4.6% of GDP in 2016, in line with the target, while there is a risk that the fiscal effort may fall somewhat short of the requirements. On the basis of the projected achievement of the required headline deficit target in 2016, the excessive deficit procedure should be kept in abeyance at this stage. At the same time, the targets for 2017 and 2018 are currently not projected to be met on a no-policy-change basis, indicating that there are risks to the timely correction of the excessive deficit. The Commission expects Spain to submit an updated Draft Budgetary Plan for 2017 to the Commission and the Eurogroup showing compliance with the requirements set out in the Council decision of 8 August 2016, in principle at least one month before the 2017 Budget Law is adopted in parliament. The updated Draft Budgetary Plan will also have to include information on the actions being taken in response to the Council requirements to strengthen Spain's fiscal and public procurement policy frameworks, in accordance with Article 1(5) and (6) of the Council decision to give notice of 8 August 2016. The Commission will re-examine compliance with the requirements set out in the above-mentioned Council decision on the basis of the information in the updated Draft Budgetary Plan.