COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 11 November 2009

SPAIN - Commission assessment in relation to the Commission recommendation for a Council recommendation under Article104 (7) of the Treaty[1]

1. THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION

Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the deficit as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn in 2008/09. Several factors are at play. First, the economic downturn brings about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December. The Plan explicated that the stimulus should be timely, targeted and temporary and differentiated across Member States to reflect their different positions in terms of public finance sustainability and competitiveness and should be reversed when economic conditions improve. Finally, several countries have taken measures to stabilise the financial sector, some of which have impacted on the debt position or constitute a risk of higher deficits and debt in the future[2], although some of the costs of the government support could be recouped in the future.

The Stability and Growth Pact requires the Commission to initiate the excessive deficit procedure (EDP) whenever the deficit of a Member State exceeds the 3% of GDP reference value. The amendments to the Stability and Growth Pact in 2005 aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation, and thereby ensuring long-term sustainability of public finances.

2. PREVIOUS STEPS IN THE EXCESSIVE DEFICIT PROCEDURE

Article 104 of the Treaty lays down an excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 “on speeding up and clarifying the

[1] Excerpt from the explanatory memorandum of the Commission recommendation for a Council recommendation adopted by the Commission on 11.11.2009.

[2] See the Eurostat decision of 15 July 2009 on the statistical recording of public interventions to support financial institutions and financial markets during the financial crisis, Eurostat News Release No 103/2009.

implementation of the excessive deficit procedure"[3], which is part of the Stability and Growth Pact.

On the basis of the budgetary data included in the January 2009 update of the stability programme of Spain and taking into account the Commission services' January 2009 interim forecast, the Commission adopted a report under Article 104(3) for Spain on 18 February 2009.[4]

Subsequently, and in accordance with Article 104(4), the Economic and Financial Committee formulated an opinion on the Commission report on 27 February 2009.

On 24 March 2009 the Commission, having taken into account its report under Article 104(3) and the opinion of the Economic and Financial Committee under Article 104(4), addressed to the Council, in accordance with Article 104(5), its opinion that an excessive deficit existed in Spain.

Subsequently, acting upon a recommendation by the Commission, the Council decided on 27 April 2009 that an excessive deficit existed in Spain in accordance with Article 104(6), and, also on a recommendation by the Commission, it addressed recommendations to Spain in accordance with Article 104(7) with a view to bringing an end to the situation of an excessive government deficit by 2012. In its recommendations, the Council established a deadline of 27 October 2009 for effective action to be taken.

Regulation (EC) No 1467/97, Article 3(5), states that if effective action has been taken in compliance with a recommendation under Article 104(7) and unexpected adverse economic events with major unfavourable consequences for government finances occur after the adoption of that recommendation, the Council may decide, on a recommendation from the Commission, to adopt a revised recommendation under Article 104(7). To this end, the Commission has assessed recent macro-economic and budgetary developments as well as effective action taken by Spain.

3. RECENT MACRO-ECONOMIC AND BUDGETARY DEVELOPMENTS

According to Article 3(5) of Council Regulation (EC) No 1467/97, the occurrence of unexpected adverse economic events with major unfavourable budgetary effects shall be assessed against the economic forecast underlying the initial Council recommendation, adopted on 27 April 2009.

Table 1: Comparison of GDP growth and government balance projections

		2008	2009	2010	2011
GDP (% change, volume terms)	COM January 09 forecast	1.2	-2.0	-0.2	n.a.
	COM autumn 09 forecast	0.9	-3.7	-0.8	1.0

3 OJ L 209, 2.8.1997, p. 6. Account is also taken of the Opinion of the Economic and Financial Committee on the "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005, available at http://ec.europa.eu/economy_finance/other_pages/other_pages12638_en.htm.

4 All EDP-related documents for Spain can be found at the following website: http://ec.europa.eu/economy_finance/netstartsearch/pdfsearch/pdf.cfm?mode=_m2.

GDP (% change, nominal terms)	COM January 09 forecast	4.6	0.9	1.8	n.a.
	COM autumn 09 forecast	3.4	-3.6	-0.3	2.4
General government balance (% of GDP)	COM January 09 forecast	-3.4	-6.2	-5.7	n.a.
	COM autumn 09 forecast	-4.1	-11.2	-10.1	-9.3

According to the Commission services' January 2009 interim forecast – which was underlying the Council recommendation under Article 104(7) – Spain's GDP was projected to decline in 2009 by 2% in volume terms and again in 2010 by 0.2%. That was expected to be the result of a retrenchment in all demand components, barring government consumption. In nominal terms, GDP was expected to expand by 0.9% and by 1.8% in 2009 and 2010 respectively. Against this economic backdrop and reflecting sizeable stimulus measures taken in the course of 2008 with an impact in 2009 amounting to a total slightly above 2% of GDP, Spain's general government balance was then projected at a deficit of 6.2% of GDP in 2009 and of 5.7% of GDP in 2010. This would follow an estimated deficit of 3.4% of GDP in 2008, which was later revised to 4.1% of GDP due to a downward revision of government revenue and, to a lesser extent, an upward revision of expenditure.

The current financial and economic crisis has heavily affected the Spanish economy and the recessive economic outlook has aggravated quickly in late 2008 and in the course of 2009. Spain's weaknesses over the developing crisis reflect mainly the reversal of the continuous domestic demand expansion of over a decade, which was associated with high indebtedness of the private sector, large external deficits and debt, an oversized housing sector compared with the euro area average and fast rising asset prices, notably of real estate assets.

The Commission services' autumn 2009 forecast projects GDP to decline in volume terms by 3.7% and 0.8% in 2009 and 2010 respectively (Table 1). This downward revision from the Commission services' January 2009 interim forecast results from a markedly bleaker outlook for every private demand component. For instance, in the autumn forecast, investment and exports are expected to decline by around 15½% and 13% respectively, which in both cases represent a downward revision of some 10 pps. from the January interim forecast. At the same time, household consumption is now projected to shrink by 5¼%, which represents an additional fall of some 3 pps. when compared with the January interim forecast. In addition, the GDP deflator is now also expected to be significantly lower than before as the result of lower consumer prices inflation and deflation in investment items. In all, GDP is now projected to decline by 3.6% in nominal terms in 2009, compared to an expected increase by 0.9% in the January interim forecast. In 2010, nominal GDP is now forecast to recede further by 0.3% rather than to expand by 1.8% as projected in the January forecast.

Spain's fiscal outlook worsened visibly in the course of 2009 dramatically reflecting the sharper-than-expected fall in economic activity. Notably, the 2009 general government deficit is projected at 11.2% of GDP in the Commission services' autumn 2009 forecast, which is considerably worse than the deficit of 6.2% projected in the Commission services' January 2009 interim forecast. Various factors have contributed to such revisions. As mentioned above, the 2008 deficit outturn was 0.7 pps. of GDP higher than estimated in the January interim forecast. Furthermore, revenue developments have turned out sharply worse than expected, with the fall of some 11½% in nominal terms projected in the autumn forecast being clearly worse than the quasi-stagnation assumed in the January interim forecast. This seems to be the combined result of a sharper-than-expected fall in nominal GDP; of an even stronger shrinking of the tax-rich domestic demand; and of a rather strong sensitivity of tax proceeds to the falls in all major tax bases such as nominal GDP, private consumption or asset transactions. All in all, tax proceeds are reflecting the fall in activity in a much stronger way than the consideration of average tax elasticities would have suggested. Taking also into account the dampening effect of a lower nominal GDP level, the revenue-to-GDP ratio is foreseen to be 2¾ pps. lower in the autumn forecast than in the January interim forecast. Finally, the developments on nominal government expenditure in 2009 projected in the January interim forecast have been broadly confirmed in the autumn forecast, which means that the downturn has not led to an unexpected sizeable increase in the level of government spending. Yet given the lower-than-expected nominal GDP level, the expenditure-to-GDP ratio is now expected to be higher than in January by some 2½ pps.

The revision in the fiscal deficit outlook for 2010 to 10.1% of GDP in the Commission services' autumn 2009 forecast from 5.7% of GDP in the Commission services' January 2009 interim forecast reflects mainly the base effect coming from the worse 2009 fiscal scenario. The 2010 deficit forecast, as described in more detail below, incorporates deficit-reducing discretionary fiscal measures from the draft 2010 Budget Law, which taken at face value would amount to a total slightly over 1¾ % of GDP.

Overall, it can be concluded that, assessed against the economic forecast underlying the initial Council recommendation, adopted on 27 April 2009, unexpected adverse economic events with major unfavourable budgetary effects have occurred in Spain.

4. ASSESSMENT OF EFFECTIVE ACTION TAKEN

According to Regulation (EC) No 1467/97[5] and the revised Code of Conduct[6] a Member State should be considered to have taken effective action if it has acted in compliance with the 104(7) recommendation. 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 improvement of its cyclically adjusted balance, net of one-off and other temporary measures, initially recommended by the Council. In case the observed adjustment proves to be lower than recommended, a careful analysis of the reasons for the shortfall should be made. In case of a multi-annual adjustment, the Code of Conduct specifies that the assessment should mainly focus on the measures taken in order to ensure an adequate fiscal adjustment in the year following the identification of the excessive deficit.

The Council in its recommendations under Article 104(7) of 27 April 2009, established a deadline of 27 October 2009 for the Spanish government to take effective action to implement the measures that will be necessary to progress towards the correction of the excessive deficit, against the background of the economic outlook in the Commission services' January 2009 interim forecast. In particular, it required Spain to "after implementing the budgetary plans outlined in the January 2009 update of the stability programme, implement the necessary efforts to bring the deficit below the reference value by 2012; to this end, implement an average annual fiscal effort of at least 1¼% of GDP, as planned in the January 2009 update of the stability programme, starting consolidation in 2010." In addition, the Council recommended that "To limit risks to the adjustment, Spain should stick to the binding nature of its medium-term budgetary framework as well as closely monitor adherence to the budgetary targets for the various levels of the government sector throughout the year." and

5 OJ L 209, 2.8.1997, p. 6.

6 "Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes", endorsed by the ECOFIN Council of 11 October 2005.

that "The Spanish authorities should report on progress made in the implementation of these recommendations in a separate chapter in the updates of the Spanish stability programme which will be prepared between 2009 and 2012".

For 2009, the general government deficit is projected at 11.2% of GDP in the Commission services' autumn 2009 forecast, which is markedly worse than the deficits of 5.8% of GDP planned in the January 2009 update of the stability programme of Spain and of 6.2% projected in the Commission services' January 2009 interim forecast. According to the draft 2010 Budget Law published in late September 2009 by the Spanish authorities, the deficit would attain 9.5% of GDP in 2009. The difference between this deficit estimate and the Commission autumn forecast is explained mainly by higher government expenditure, namely of social transfers, in the latter.

The fiscal plans outlined in the January 2009 update of the stability programme of Spain included sizeable deficit-increasing stimulus measures adopted in the course of 2008 in the context of the progressively acute deterioration in economic conditions. Discretionary measures adopted after the publication of the stability programme and the Council recommendation under Article 104(7) have improved the 2009 fiscal balance by less than 0.1% of GDP. They include expansionary measures to temporarily provide for transfers to the unemployed who have lost their unemployment benefits, incentivise car scrappage and support to the car industry, costing a total of 0.14% of GDP, which are being more than compensated by consolidation measures consisting of a permanent increase in taxes on alcohol and tobacco yielding 0.07% of GDP and a reduction in Ministries' working spending worth 0.14% of GDP. Thus, the worse-than-expected fiscal deterioration in 2009 is not due to the adoption of sizeable discretionary measures after the issuance of the Council recommendation to end the situation of an excessive government deficit.

The economic downturn has been sharper than expected in the Commission services' January 2009 interim forecast and has affected heavily Spanish public finances. In particular, as described above, tax revenue is now projected to fall by some 11½% in nominal terms, which is visibly worse than the fall in the major macroeconomic tax bases (e.g., nominal GDP or private consumption).

In turn, the level of nominal government expenditure foreseen in the Commission services' autumn 2009 forecast largely corresponds to the level implicit in the January 2009 update of the Spanish stability programme. However, as explained above, the expenditure-to-GDP ratio is now expected to be higher by some 2½ pps. on account of the lower nominal GDP level in 2009.

As for 2010, the draft 2010 Budget Law published by the Spanish authorities in late September 2009 targets a general government deficit of 8.1% of GDP. It includes a number of discretionary measures on both the revenue and expenditure side. Concerning revenue, the draft Budget includes hikes in VAT rates as of July 2010, with the normal rate going up to 18% from 16% and the reduced one to 8% from 7%; and increases of personal income taxes. On the expenditure side, the draft 2010 Budget Law incorporates almost ½% of GDP (€ 5 000 millions) of investment by local government – essentially extending into 2010 a similar stimulus measure originally adopted only for 2009 in the context of the EERP. Furthermore, the 2010 deficit developments reflect the withdrawal of a number of temporary stimulus measures implemented in 2008 and mainly 2009, various of which in the context of the EERP, which would ceteris paribus yield an improvement on the fiscal balance equivalent to around 1½% of GDP. In all, the combined impact of the withdrawal of the temporary stimulus measures on the one hand and of the new discretionary measures presented in the draft 2010 Budget Law on the other hand could yield an improvement of the fiscal balance by some 1¾% of GDP in 2010. In parallel, expenditure moderation is expected to come from annual updates of wages and pensions in 2010, which are announced to be lower than those recorded in recent years. In particular, government wages will be augmented by 0.3% and pensions will be up by 1% from their 2009 levels (the so-called minimum pensions will go up by more though).

According to the Commission services' autumn 2009 forecast – after assessing the draft 2010 Budget Law – the general government deficit is projected to represent 10.1% of GDP in 2010. The difference between this fiscal outlook and the deficit target of 8.1% of GDP presented in the draft 2010 Budget Law is explained, first, by the base effect coming from a higher 2009 government deficit expected in the Commission forecast and, second, by a more negative macroeconomic scenario in the Commission forecast and its subsequent impact on public finances, notably on government expenditure developments. In structural terms, and according to the Commission autumn forecast, the government balance would improve by around ¾% of GDP next year. This possible shortfall from the average annual fiscal effort of at least 1¼% of GDP between 2010 and 2012 as requested under Article 104(7) has to be seen against the backdrop of a rising interest burden and economic developments that are expected to continue to be more adverse than assumed at the time the Council issued its original recommendation. Yet on the basis of current information few consolidation measures have been announced beyond 2010 – apart from the withdrawal in 2011 of some temporary measures and the increases in VAT rates in mid-2010 that have an additional budgetary impact in 2011 – which would require further action in 2011 and 2012.

Overall, taking into account economic developments compared to the outlook in the Commission services' January 2009 interim forecast, it can be concluded that Spain has taken effective action as required by the Council recommendation of 27 April 2009.

5. RECOMMENDATIONS TO END THE EXCESSIVE DEFICIT SITUATION

According to Article 3(4) of Council Regulation (EC) No 1467/97, the Council recommendation under Article 104(7) has to establish a deadline of six months at most for effective action to be taken by the Member State concerned Article 3(4) of the Regulation specifies that the Council has to recommend that the Member State achieves a "minimum annual improvement of at least 0.5% of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation".

Since the Spanish authorities are considered to have taken effective action in compliance with the Council recommendations of 27 April 2009 under Article 104(7) and unexpected adverse economic events with major unfavourable consequences for government finances can be considered to have occurred in Spain, a revised recommendation for Spain is justified.

The substantial deterioration in the budgetary position resulting from the worse-than-expected economic downturn, and the weaker overall position of the economy than envisaged when the earlier Council recommendation was framed suggest that a new deadline for correction of the excessive deficit in Spain by 2013 is appropriate. Given the marked deterioration in the fiscal outlook since the original Council recommendation under Article 104(7), an average annual structural budgetary adjustment in excess of the originally recommended minimum of 1¼% of

GDP is needed between 2010 and 2013 in order to bring the headline government deficit below the 3% of GDP reference value by 2013. This correction would represent an average annual structural budgetary adjustment of 1¾% of GDP over the period 2010-2013.

After recording surpluses between 2005 and 2007, the general government balance deteriorated markedly in 2008, with a deficit of 4.1% of GDP. According to the Commission services' autumn 2009 forecast, the government deficit is projected at 11.2% of GDP in 2009 and at 10.1% of GDP in 2010. On the basis of unchanged policies, and with GDP growing already by 1% in volume terms, the deficit is expected to decline to 9.3% of GDP in 2011. In structural terms, this would represent deficits of around 9¼% and 8½% and 8% of GDP in 2009, 2010 and 2011 respectively.

Thus, a credible and sustained adjustment path would require the Spanish authorities to implement the deficit reducing measures in 2010 as planned in draft 2010 Budget Law; ensure an average annual structural budgetary adjustment of 1¾% of GDP over the period 2010-2013[7], which should also contribute to halting the rapid rise of the government gross debt ratio, which is forecast to breach the reference value; specify the measures that are necessary to achieve the correction of the excessive deficit by 2013 cyclical conditions permitting and accelerate the reduction of the deficit if economic or budgetary conditions turn out better than currently expected.

According to the Commission services' autumn 2009 forecast, the general government debt is projected to come at 54.3% of GDP in 2009 after 39.7% in 2008. Although it is currently still below the 60% of GDP reference value, it is expected to increase further in 2010 and 2011 to 66% and 74% of GDP respectively. The correction of the excessive deficit should also contribute to halting the rapid rise in the gross government debt ratio.

In order to limit risks to the required medium-term fiscal adjustment, Spain should stick to the enforceable nature of its medium-term budgetary framework, extending its horizon if needed, as well as closely monitor adherence to the budgetary targets throughout the year for all the levels of the general government sector.

On the basis of the budgetary position of 2009 projected in the Commission services' spring 2009 forecast and the projected increases in age-related expenditure, Spain has a sustainability gap that is clearly above the EU average. This means that to put public finances on a sustainable path, Spain should improve its structural primary balance in a substantial and durable manner. Besides the weak initial budgetary position in 2009, Spain faces a long-term cost of ageing that is also clearly above the EU average, mainly as the result of a projected

[7] In line with the initial recommendations under Article 104(7) issued by the Council on 27 April 2009, where due consideration was given to the special circumstances and the EERP framework, an average annual structural budgetary adjustment is recommended. As in the initial recommendations the required adjustment should take into account the fiscal room for manoeuvre. This is assessed on the basis of all factors relevant for achieving the fiscal policy objectives, starting with the level of the general government deficit and gross debt as well as other indicators, such as the current account position, the level of contingent liabilities of the financial sector, interest payments, risk premia and the expected change in age-related expenditure in the medium term. In particular, in the case of Spain due consideration was given to the size of the required budgetary correction, the expected change in age-related expenditure and the large external imbalances. In calculating the average annual adjustment, the 2011 deficit in the Commission services' autumn 2009 forecast is taken as the starting point. The total structural adjustment needed to reach the nominal deficit target of 3% by the deadline is then calculated by assuming a gradual closure of the output gap by 2015.

high increase in pension expenditure as a share of GDP over the coming decades. Therefore, to limit the risk to the long-term sustainability of public finances as defined by the Commission Communication[8] on 'Long-term sustainability of public finances for a recovering economy' and endorsed by the ECOFIN Council[9] on 10 November 2009, Spain should implement the necessary reforms to its old-age pension and health-care systems to contain and reduce the budgetary costs of ageing populations.

Enhanced surveillance under the EDP, which seems necessary in view also of the deadline for the correction of the excessive deficit, will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy to ensure the correction of the excessive deficit. In this context, a separate chapter in the updates of the Spanish stability programme which will be prepared between now and 2013 could usefully be devoted to this issue.

In general, budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of the public finances, for instance to enhance the efficiency and effectiveness of public spending. In addition, Spain should reinforce the growth potential of the economy, notably by addressing the labour market functioning to tackle the very high levels of unemployment and reduce labour market segmentation; ensure the effective implementation of education reforms; and improve competition in product markets, notably in services.

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8 Available at: http://ec.europa.eu/economy_finance/publications/publication15996_en.pdf

9 Available at: http://www.consilium.europa.eu/uedocs/cms_data/docs/pressdata/en/ecofin/111025.pdf.

Table 2: Comparison of key macroeconomic and budgetary projections

		2007	2008	2009	2010	2011
GDP (% change, volume terms)	COM autumn 09 forecast	3.6	0.9	-3.7	-0.8	1.0
	Draft 2010 Budget Law	n.a.	0.9	-3.6	-0.3	n.a.
	SP January 09	3.7	1.2	-1.6	1.2	2.6
Output gap[1] (% of potential GDP)	COM autumn 09 forecast[2]	1.5	0.8	-2.8	-3.6	-2.6
	SP January 09 [3]	1.4	0.3	-2.7	-3.7	-3.6
General government balance (% of GDP)	COM autumn 09 forecast	1.9	-4.1	-11.2	-10.1	-9.3
	Draft 2010 Budget Law	1.9	-4.0	-9.5	-8.1	-5.2
	SP January 09	2.2	-3.4	-5.8	-4.8	-3.9
Primary balance (% of GDP)	COM autumn 09 forecast	3.5	-2.5	-9.4	-7.6	-6.3
	SP January 09	3.8	-1.9	-4.1	-2.9	-1.9
Cyclically-adjusted balance[1] (% of GDP)	COM autumn 09 forecast	1.2	-4.4	-10.0	-8.5	-8.1
	SP January 09	1.6	-3.5	-4.6	-3.2	-2.3
Structural balance[4] (% of GDP)	COM autumn 09 forecast	1.2	-4.1	-9.3	-8.5	-8.1
	SP January 09	1.6	-3.5	-4.7	-3.4	-2.8
Government gross debt (% of GDP)	COM autumn 09 forecast	36.1	39.7	54.3	66.3	74.0
	SP January 09	36.2	39.5	47.3	51.6	53.7

Notes:

[1] Output gaps and cyclically-adjusted balances from the programmes as recalculated by Commission services on the basis of the information in the stability programme.

[2] Based on estimated potential growth of 2.7%, 1.6%, -0.1%, 0.0% and 0.0% respectively in the period 2007-2011.

[3] Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission services on the basis of the information in the programme.

[4] Cyclically-adjusted balance excluding one-off and other temporary measures. No one-offs are included in the most recent programme. One-off and other temporary measures are below ½% of GDP in 2008 and above ½% in 2009, all deficit increasing, are included

Source:
Stability programme update of January 2009 (SP); Draft 2010 Budget Law; Commission services' autumn 2009 forecasts (COM); Commission services' calculations.