

THE REFORM OF THE FISCAL FRAMEWORK IN SPAIN: CONSTITUTIONAL LIMITS  
AND THE NEW PUBLIC SPENDING GROWTH RULE

## THE REFORM OF THE FISCAL FRAMEWORK IN SPAIN: CONSTITUTIONAL LIMITS AND THE NEW PUBLIC SPENDING GROWTH RULE

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### Introduction

In the last two decades the developed countries have significantly modified the framework in which fiscal policy operates. In particular, they have adopted fiscal rules setting explicit caps on the deficit or public debt and/or on certain budgetary items so as to ensure the sustainability of public finances. The empirical evidence available broadly confirms that fiscal rules may prove effective in obtaining and maintaining budgetary discipline [Debrun et al. (2008) and European Commission (2009)]. Moreover, it is found that their presence increases the likelihood of fiscal consolidations being successful, which is particularly important in circumstances such as those at present, in which the deterioration in public finances brought about during the economic crisis must be corrected [IMF (2009)]. The same literature emphasises, however, that the design of fiscal rules largely influences their effectiveness. Aspects such as their definition, control and application mechanisms, and the procedure for correction in the event of deviations, are crucial for attaining the objectives laid down [Bohn and Inman (1996) and Ayusi-i-Casals et al. (2009)].

Establishing fiscal rules that make it obligatory to maintain healthy public finances is all the more important in a monetary union since, as has been seen in the case of the sovereign debt crisis affecting the euro area since early 2010, one member's inappropriate fiscal policies may have adverse repercussions for the other members and generate union-wide tensions. Insofar as the financial markets do not always act as a deterrent to these policies, it becomes necessary to set fiscal controls on the Member States, obliging them to internalise the effect of their decisions on the union as a whole.

It is this very reasoning that prompted the inclusion in the Treaty on European Union of limits on the members' deficits and public debt, which were complemented by the Stability and Growth Pact (SGP). However, the economic crisis has highlighted the problems of the workings of the SGP, which was incapable of promoting a sustained fiscal consolidation during the economic upturn. This meant that the crisis led to an unprecedented deterioration in most European countries' fiscal position and outlook, which in some cases began to be perceived as unsustainable.

The economic policy response to the euro area's sovereign debt crisis is far-reaching and includes, among other aspects, a revision of the EU economic governance framework. In addition to the need to create crisis-management mechanisms, the strong interrelatedness of macroeconomic, fiscal and financial problems has revealed the need for wider and more intense economic policy coordination in the monetary union, which has taken specific form in the design of a new framework for the monitoring of macroeconomic imbalances and of competitiveness [ECB (2011) and Caballero et al. (2011)].

On the fiscal front, a reform of the SGP aimed at strengthening its implementation is pending approval. Among other aspects, the reform acknowledges the importance of an appropriate definition of fiscal frameworks not only at the European level, but also at the national level; accordingly, the Member States are asked to meet minimum requirements in respect of their fiscal frameworks so that these may contribute more effectively to attaining budgetary stability. In the same respect, the Euro Plus Pact entered

into by the euro area Heads of State and Government on March 2011 included the commitment by members to transpose into national legislation the EU budgetary rules established in the SGP.

Spain already had budgetary stability legislation (BSL) setting limits on the deficit that all tiers of government may incur. Nonetheless, it has been decided to reinforce this framework further to the approval in September 2011 of a reform of the Constitution that incorporates into the constitutional text the deficit and debt limits set at European level. Previously, in July 2011, a public spending growth rule was introduced for central government and for the biggest municipal councils. Under this rule, the rate of increase of public spending may not annually exceed the economy's nominal medium-term growth rate.

This article analyses these changes. The following section briefly describes the reform of the SGP. The third section analyses the constitutional reform. Section 4 describes the spending rule and illustrates its functioning through a simulation of how such a rule would have worked during the expansion period. Section 5 draws conclusions.

## The reform of the Stability and Growth Pact

The framework of fiscal rules in Spain is firstly defined by the content of the constituent Treaty of the European Union and of the SGP. This framework defines quantitative limits on the deficit and public debt, a compliance oversight and control mechanism (which is known as the preventive arm of the SGP) and a procedure so that countries may correct deviations should they arise (the corrective arm of the SGP).

As regards the limits, the budget deficit is required not to exceed 3% of GDP, and public debt to remain below 60% of GDP. Further, under the preventive arm, budget balances should be “close to equilibrium or in surplus” in the medium term, a clause that has been interpreted as the need to attain and maintain a structural budget balance in equilibrium (the so-called “medium-term target”). The medium-term targets are specific to each country and depend, among other factors, on the level of public debt, on potential growth and on implicit liabilities, in particular those derived from population ageing on public finances. Currently, for the euro area countries, these targets stand, in respect of the structural budget balance, at between -0.5% of GDP (in Germany, Ireland, the Netherlands and Portugal) and a surplus of 0.5% (in Belgium, Luxembourg and Finland). In Spain's case, according to the methodology for calculating the medium-term targets agreed upon by the Ecofin in July 2009 [European Commission (2010)], the structural deficit may rise to around 0.5%, and the updated Stability Programme 2009-2010 set this target as a structural balance in equilibrium (see Table 1).<sup>1</sup>

The preventive arm of the SGP comprises the periodic monitoring of national public finances by the Commission and the Council on the basis of the Stability and Convergence Programmes submitted annually by the Member States. Under these oversight arrangements, the attainment of medium-term targets and the pattern of approach to them are evaluated. The corrective arm establishes a so-called “excessive deficit” procedure for cases in which the margins are exceeded. This includes the setting of timeframes for correction, the failure to comply with which may lead to various “reputational” or financial sanctions.

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<sup>1</sup> Each Member State presents its own medium-term budgetary targets in its stability or convergence programme. This may not exceed the target derived from the agreed calculation methodology, and it is assessed by the Ecofin Council. These targets are revised when a significant structural reform is made and, in any event, every four years.

## BUDGET BALANCE AND PUBLIC DEBT IN THE EURO AREA COUNTRIES

TABLE 1

% of GDP

	Medium-term objectives (a)	Structural balance			Actual balance			Public debt		
		1999	2007	2010	1999	2007	2010	1999	2007	2010
Belgium	0.5	-1.4	-1.4	-2.8	-0.6	-0.3	-4.1	113.7	84.2	96.8
Germany	-0.5	-1.6	-0.5	-2.2	-1.5	0.3	-3.3	60.9	64.9	83.2
Estonia	0.0	-1.8	-1.0	2.5	-3.5	2.5	0.1	6.0	3.7	6.6
Ireland	-0.5	1.3	-1.8	-30.3	2.7	0.1	-32.4	48.5	25.0	96.2
Greece	0.0	-3.4	-7.5	-8.2	-3.1	-6.4	-10.5	94.0	105.4	142.8
Spain	0.0	-2.0	1.3	-7.0	-1.4	1.9	-9.2	62.3	36.1	60.1
France	0.0	-2.4	-3.7	-5.1	-1.8	-2.7	-7.0	58.8	63.9	81.7
Italy	0.0	-1.6	-3.0	-2.9	-1.7	-1.5	-4.6	113.7	103.6	119.0
Cyprus	0.0	-4.4	2.7	-4.6	-4.3	3.4	-5.3	51.8	58.3	60.8
Luxembourg	0.5	2.1	1.9	0.1	3.4	3.7	-1.7	6.4	6.7	18.4
Malta	0.0	-8.4	-2.1	-3.5	-7.7	-2.4	-3.6	57.1	62.0	68.0
Netherlands	-0.5	-0.5	-0.9	-3.8	0.4	0.2	-5.4	61.1	45.3	62.7
Austria	0.0	-3.0	-2.0	-3.7	-2.3	-0.9	-4.6	67.2	60.7	72.3
Portugal	-0.5	-3.7	-3.4	-8.8	-2.7	-3.1	-9.1	49.6	68.3	93.0
Slovenia	0.0	-3.4	-2.9	-3.0	-3.0	-0.1	-5.6	24.3	23.1	38.0
Slovakia	0.0	-6.7	-3.6	-7.4	-7.4	-1.8	-7.9	47.8	29.6	41.0
Finland	0.5	0.3	2.6	0.2	1.6	5.2	-2.5	45.7	35.2	48.4

SOURCES: European Commission (2010) and AMECO.

a The medium-term objectives are set in structural balance terms.

The experience of the past decade has nevertheless revealed problems with the workings of the SGP, which was not capable of promoting the consolidation of public finances during the expansionary phase (see Table 1). The structural deficit in 2007, the year prior to the economic crisis, stood at  $-1.7\%$  of GDP in the euro area, a very similar figure to that observed in 1999, when the third phase of EMU began, meaning that only five of the countries today making up the euro area had achieved their medium-term targets (Germany, Spain, Cyprus, Luxembourg and Finland). Also in 2007, eight countries had a public debt ratio above 60%. Departing from this starting point, which was subsequently compounded by the impact of the economic crisis on public finances and on growth prospects, there was a highly significant deterioration in the budgetary situation in most European countries during the crisis.

Against the background of the ongoing reform of the European governance framework, the strengthening of the SGP is, therefore, of crucial importance [European Commission (2011)]. The reform that is pending approval<sup>2</sup> firstly envisages reinforcing the preventive arm with the inclusion of spending developments in the evaluation of countries' compliance with medium-term budgetary targets. As a result, the growth rate of public spending should not exceed medium-term GDP growth unless it is accompanied by discretionary increases in public revenue. It is sought hereby to prevent, as occurred before the crisis in some countries, a highly favourable trend in public revenue, associ-

<sup>2</sup> After a series of meetings between May and September 2011, the European Parliament and the Council reached an agreement on 14 September on governance reform. The Parliament plans to adopt this at its plenary session from 26 to 29 September, and the Council intends to do so on 4 October 2011.

% of GDP	1998 Debt	2007 Debt	
		Actual	Simulation
Belgium	117.4	84.2	83.1
Germany	60.3	64.9	59.9
Estonia	5.5	3.7	3.7
Ireland	53.6	25.0	25.0
Greece	94.5	105.4	79.0
Spain	64.1	36.1	36.1
France	59.4	63.9	60.2
Italy	114.9	103.6	91.3
Cyprus	58.6	58.3	48.7
Luxembourg	7.1	6.7	6.7
Malta	53.4	62.0	49.7
Netherlands	65.7	45.3	45.3
Austria	64.8	60.7	57.2
Portugal	50.4	68.3	62.5
Slovenia	23.3	23.1	23.1
Slovakia	34.5	29.6	29.6
Finland	48.4	35.2	35.2

SOURCES: AMECO and Banco de España.

a This table compares the actual debt ratio of the euro area countries in 1998 and 2007 (columns 2 and 3, respectively) with a simulation based on the debt-reduction proposal in the reformed SGP (column 4). In the simulation, a debt ratio greater than the reference value in year  $t$  is reduced in  $t+1$  by 1/20th of the difference between its level and 60%. If the annual reduction observed in the debt ratio were greater than 1/20th in a year, the reduction observed in that year would be maintained.

ated with exceptional factors such as an excessive growth of financial and real estate assets, from allowing likewise excessive public spending growth. Indeed, it can be verified that strict compliance with this rule would have led to a much healthier situation in most European countries during the decade prior to the economic crisis [Banco de España (2011)].

Secondly, it is sought to strengthen the public debt criterion, given that it had largely been ignored in the past and in light of the absence of quantitative criteria for the evaluation of its rate of reduction. The reform will require Member States with a level of debt of over 60% of GDP to move more quickly towards their medium-term budgetary targets. Further, Member States with debt ratios that exceed the reference value of 60% of GDP will be subject to the application of the excessive deficit procedure, unless the rate of decline of debt over a given period is considered satisfactory.

The Commission has proposed using a numerical criterion to evaluate whether a country's public debt ratio is diminishing at a satisfactory rate. In the three years prior to the assessment, the ratio should have fallen on average by one-twentieth of the amount by which it differs from the reference value of 60%. Table 2 presents a simulation of the dynamics of the public debt/GDP ratio between 1998 and 2007 in the euro area countries, under the assumption that this criterion had been applicable. While in terms of the area as a whole the impact would have been limited, its application would have had a very significant effect on the countries with bigger public debt/GDP ratios. Specifically, Greece and Italy would have reduced this ratio to below 100% in 2007, a level close to 20 pp and 10 pp, respectively, below their actual values. In the case of Belgium, however, the simulations show that the effort made was greater than that required by the rule.

Thirdly, new reporting obligations and new financial sanctions are included for the euro area countries. These will be applicable beforehand and more gradually, and their approval will be more automatic.

Finally, national budgetary frameworks should adjust to a set of minimum requirements relating to public accounting and statistics systems, numerical fiscal rules, forecasting systems, effective medium-term budgetary targets, and the coverage of all general government sub-sectors. Beyond these minimum requirements, the use of top-down budgeting processes will also be promoted, along with the role of fiscal councils, which will be entrusted with providing independent analyses, assessments and projections regarding national fiscal policy matters.

Along the same lines, the Euro Plus Pact, signed in April 2011 by the euro area Heads of State and Government to strengthen economic policy coordination in favour of competitiveness and convergence, highlights as one of its essential objectives the need for the Member States to transpose the EU budgetary rules laid down in the SGP into national legislation. In this respect, it is stressed that, although the Member States may select the specific national legal instrument used to bring about this transposition, they must ensure this instrument is sufficiently and soundly binding and durable (e.g. a constitutional or framework law). The exact formulation of the rule will also be decided by each country, although budgetary discipline must be ensured both at the national level and at other regional and local levels.

It is in this connection that the recent reform of the budgetary framework in Spain is being undertaken. In fact, the national budgetary framework has been defined since 2001 by the BSL, which was subsequently amended in 2006. This legislation sets limits on the deficit that all levels of government may incur. Likewise, it details a procedure for setting and monitoring targets, along with the consequences, if any, in the event of non-compliance (see Box 1 on the content of this legislation). The reforms approved in recent months reinforce this framework with the incorporation of the fiscal limits into our Constitution, along with the introduction of a public spending rule linked to medium-term economic growth. These changes are analysed in detail below.

## The constitutional reform

### CONTENT

The reform enshrines in the Constitution the obligation for all levels of government to adjust their conduct to the principle of budgetary stability. Specifically, it establishes that the State and regional governments may not incur a structural deficit that exceeds the margins, if any, established by the European Union. Local governments, for their part, must keep their budget in balance.

In the case of public debt, its weight in relation to GDP may not exceed the reference value established in the Treaty on European Union, i.e. 60%, and absolute priority is granted to the payment of interest charges and of principal on public debt over other budgetary commitments.

The limits on the structural deficit and the volume of public debt may only be exceeded in the event of natural disasters, economic recession or exceptional emergency situations beyond the control of the State and which considerably impair the financial situation or the economic or social sustainability of the State. An absolute majority in Parliament would be required in this situation.

The details on these exceptions, the way in which deviations should be corrected and the accountability of each level of government should such deviations occur, the definition of the mechanisms providing for compliance with the limit on debt and the methodology for

The budgetary stability legislation (BSL) in Spain sets limits on the deficit that may be incurred by all levels of government and public-sector corporate entities. It likewise details a procedure for setting targets and monitoring them, along with the consequences, if any, of these not being met.

Specifically, under the BSL, central government and the regional governments are, along with large municipalities at the local government level<sup>1</sup>, obliged to submit a public finances outturn that is in balance over the course of the business cycle. If economic growth of less than 2% is projected<sup>2</sup>, the deficit these levels of government may incur shall not exceed 1% of GDP<sup>3</sup>. If economic growth is between 2% and 3%, general government must show a budget in balance and, if growth exceeds 3%, a surplus must be run. Moreover, an additional 0.5% can be added to these limits to finance increases in investment, including that earmarked for research, development and innovation.<sup>4</sup> All other municipalities should always show a budget in balance or in surplus. The stability target of the Social Security system shall be set having regard to medium- and long-term population and economic developments.

Given the high fiscal decentralisation in Spain, in which the regional and local governments are responsible for a large share of public revenue and spending policies, Spanish regulations establish additional requirements for them. In the case of regional governments, the organic law on funding governing them sets limits on their debt capacity. Specifically, it allows regional governments to enter into credit operations maturing at less than one year to cover temporary cash needs but, for operations maturing at over one year, funds must be earmarked exclusively to investment spending and, moreover, the total amount of the annual repayments may not exceed 25% of the regional government's current revenue. As regards credit operations abroad and public debt issues, prior authorisation from the State is required. Similar limits exist in the case of local government.

In addition to the extension of the fiscal rules to the lower tiers of government, the BSL has a clause that says that the State shall not take responsibility for the financing of the deficits or public debt of the lower levels of government. This clause, similar to that

at the European level, seeks to prevent the cost of inappropriate fiscal behaviour in one region from feeding through to others or to central government, and it is essential so that capital markets maintain a significant disciplining effect on the basis of discrimination between the risk premia on the debt of the different levels of government.

Turning to the target-setting procedure, a report is first drawn up assessing the cyclical phase for the following three years.<sup>5</sup> On this basis, the BSL obliges the government to set, first, the budgetary stability target for the three following years in the first half of each year, both for the general government sector as a whole and for each of the agents comprising it<sup>6</sup>; and, second, the State spending limit. Both must be approved by Parliament. Once approved, the individual fiscal target for each regional government is set by means of bilateral negotiations between the Ministry of Economy and Finance and the representatives of each regional government on the Fiscal and Financial Policy Council.

As to the monitoring procedure, the Ministry of Economy and Finance is required to submit a report to the government before 1 October each year on the degree of compliance with the targets, and on real cyclical developments during the year and deviations from the initial forecast. Should a risk of non-compliance be discerned, a warning may be made to the government agent responsible. If such non-compliance involves a bigger-than-targeted deficit, the level of government in question is also required to draw up an economic and financial rebalancing plan over a maximum term of three years.

Lastly, it is stipulated that, if a deviation from targets prompts a breach of the SGP, the tier of government involved shall assume the attendant proportion of the responsibilities that should arise from the breach. In addition, in the case of the regional governments and municipalities, compliance shall be taken into account in the State's authorisation of credit operations and debt issues. Specifically, if the failure to meet the stability target takes the form of a greater-than-targeted deficit, all the regional government's debt operations shall require State authorisation.<sup>7</sup>

1 Specifically, those that are provincial or regional capitals, or that have a population equal to or higher than 75,000 inhabitants.

2 These growth thresholds that determine the possibility of attaining a budget in deficit, in balance or in surplus are set, for a period of three years, by the Council of Ministers, on the proposal of the Minister of Economy and Finance and further to a report by the Council of Fiscal and Financial Policy of the Regional Governments and the National Local Government Board.

3 Breaking down into a ceiling of 0.2% of GDP for central government, 0.75% of GDP for the regional governments as a whole and 0.05% of GDP for large municipalities.

4 This additional 0.5% of GDP breaks down into 0.2% of GDP for central government, 0.25% of GDP for the regional governments as a whole and 0.05% for the above-mentioned municipalities.

5 This report is drafted by the Ministry of Economy and Finance, following consultation with the National Statistics Institute and with the Banco de España on the cyclical position of the Spanish economy, and taking into account the projections of the European Central Bank and of the European Commission.

6 The Ministry of Economy and Finance is also entrusted with formulating the proposed stability target for the regional governments as a whole and for local governments. This proposal follows prior reports by the Fiscal and Financial Policy Council and the National Local Government Board, respectively, before being approved by the Government.

7 However, if the regional government had submitted the economic and financial plan to the Fiscal and Financial Policy Council and the measures contained therein had been declared suitable by the Council, State authorisation for short-term credit operations that are not deemed to be external financing would not be required.

	Types of fiscal rule			
	Spending	Revenue	Balance	Debt
Political commitments	9	6	4	3
Coalition agreements	2	1	1	2
Legal	14	3	13	7
International treaties			41	47
Constitution			4	3
<b>TOTAL</b>	<b>25</b>	<b>10</b>	<b>63</b>	<b>62</b>

SOURCE: IMF (2009), Fiscal rules: Anchoring expectations for sustainable public finances.

a The totals for some columns may give rise to a number higher than the total number of countries with rules, since several rules are applied simultaneously in many countries.

calculating the structural deficit shall be established in an implementing organic law that shall be approved before 30 June 2012.

The reform shall enter into force as of the day of its publication in the Official State Gazette, accepting the structural deficit limits, which shall be applicable from 2020.

#### ANALYSIS OF THE REFORM

##### Constitutional rank

The main novelty of the reform in relation to the pre-existing fiscal framework is the incorporation into the Constitution of the deficit and public debt limits set at the European level. In this respect, the economic literature stresses that a higher legal order may improve the effectiveness of the rule, arguing that this hampers the capacity of the particular government in power to eliminate or amend it, given that this normally requires broader Parliamentary majorities. Moreover, constitutional rank gives the rule supremacy over other legislation drawn up by national parliaments, meaning that such legislation must be drafted in a manner compatible with the fiscal limits included in the rule.

The empirical evidence available on this issue is scant and not sufficiently conclusive, given that very few countries have incorporated their fiscal rule into the Constitution (see Table 3). For the EU, Iara and Wolf (2010) find that the greater the rank of the legislation in which fiscal limits are set, the more effective they are. Yet for the United States, in contrast, it does not seem that the incorporation into the Constitution in certain States has given rise to significant effects in terms of budgetary discipline [Hou and Smith (2010)].<sup>3</sup>

In Spain's case, the high degree of fiscal decentralisation prevailing may be an additional argument in favour of constitutional rank, since it makes it easier for the requirement to be made of all levels of government, and in particular the regional and local governments. Indeed, the Spanish constitutional rule covers, as did the budgetary stability legislation, all tiers of government, mentioning explicitly central government, the regional governments and the local governments.<sup>4</sup>

<sup>3</sup> The evidence for the United States is, in principle, sounder than that available for the EU, since it is based on long periods of time (1978-2004) in which there are more observations with fiscal rules incorporated into the Constitution of the Federated States.

<sup>4</sup> In the case of Social Security Funds, the implementing organic law will have to detail what is understood by budgetary stability. It should be recalled that the BSL establishes that the stability target for the Social Security system should be set having regard to medium- and long-term population and economic projections. It would have been an option to include this definition in the Constitution, which would have given constitutional cover to the need to ensure the sustainability of the pensions system in the medium and long term on the basis of the population and macroeconomic projections available.



As to the choice of the target variable for the rule, the reform refers to the budget deficit in structural terms<sup>5</sup>, but it does not set an explicit numerical limit as is the case, for example, in the German constitution, but refers rather to the margins established by the European Union. As indicated in the previous section, the main limit on the structural deficit existing at the European level is that included in the preventive arm of the SGP, which establishes the need to attain the medium-term target, which in Spain's case was defined by the 2009-2010 Stability Programme as a structural balance in equilibrium. In any event, the size of this target depends on the level of public debt, potential growth and implicit liabilities. And a structural surplus might indeed be required if the country were to have, for instance, a high public debt/GDP ratio or if medium- and long-term growth prospects were to worsen. The reference to the European Union could be understood along the lines that, were Spain to find itself in these circumstances, the constitutional requirement might come to entail the requirement of a structural surplus. Furthermore, it can add greater flexibility to the setting of targets, aligning them automatically to European agreements.

In any event, the political agreement accompanying the constitutional reform establishes that the limits on the structural deficit will be set in an organic law and will be 0.4% of GDP (0.26% corresponding to the State and 0.14% to the regional governments), a figure slightly above the medium-term target set in the 2009-2010 Stability Programme, but which observes the figure defined according to the calculation methodology agreed upon. This figure is similar to that set in the reform of the German constitution, which places it at 0.35% of GDP for the annual cyclically adjusted central government deficit, while in the case of the federal *Länder*, it is 0%. In Spain's case, the setting of the numerical ceiling and its distribution between State and regional government under the law involves allowing these limits to be amended, like any organic law, by an absolute Parliamentary majority, compared with the three-fifths figure that amendment of the Constitution requires.<sup>6</sup>

The definition of the limit in respect of the structural deficit adds a practical difficulty, since this variable is not observable and must be estimated.<sup>7</sup> Specifically, the calculation of the structural deficit is obtained as the difference between the observed deficit and the cyclical deficit<sup>8</sup>, and the latter is calculated by applying the public revenue and spending elasticities to the deviation, or output gap, between actual GDP and potential or trend GDP. However, estimates of the output gap and of the elasticity of public revenue and spending are not free from controversy, given that there are different methods available in the economic literature that also show different results. The reform stipulates that it will be the implementing organic law that determines "the methodology and procedure for the calculation of the structural deficit". It would be advisable to choose a method that were readily replicable and one that could be made available to all analysts. In the case of the German constitutional reform, it was decided, for example, to apply the same method currently used in the European Union, developed jointly by the European Commission and the Member States.

In the case of the output gap it should moreover be taken into account that the estimates require macroeconomic projections and are frequently subject to revision following the inclusion of new available information or data arising from forecasting errors, which may also

5 The constitutional text makes no reference to the actual deficit. In any event, the 3% ceiling in the EU Treaty remains applicable.

6 In this respect, the political agreement accompanying the constitutional reform indicates that "the limits relating to the structural deficit, and the path for attaining the debt target in 2020, may be subject to revision in 2015 and in 2018, on the initiative of any of the parties subscribing to this agreement".

7 Nor was the arrangement established under the stability law free from problems, given that it necessarily involved setting the thresholds determined by the surplus, equilibrium or deficit requirement.

8 The calculation of the structural balance further requires adjusting the latter for temporary or exceptional factors.

alter the calculations of the structural deficit. It is therefore necessary to establish the treatment of these revisions.<sup>9</sup> Generally, calculations of the structural deficit should be based on prudent estimates of the economy's potential output growth, estimates that avoid viewing as structural improvements in the budget deficit those that are merely cyclical.

The main advantage of using the deficit in structural terms is that it allows the stabilising role of fiscal policy to be maintained (see Chart 1).<sup>10</sup> In fact, the cyclical component of the deficit diminishes (increases) in periods of economic expansion (recession), given that public revenue tends to grow (diminish) and public spending to fall (increase) simply due to the operation of the automatic stabilisers, generating a stabilising effect on the economy. The constitutional limits would allow for countercyclical discretionary fiscal policy conduct, beyond that derived from the automatic stabilisers, but that would call for the attainment of structural surpluses in economic boom times.

Setting the limit in terms of the structural deficit offers some advantages over the current BSL, which establishes the need for a surplus, a balanced budget or a deficit in terms of real GDP growth thresholds. In particular, these thresholds create undesirable elements of discontinuity. For instance, a growth forecast of 1.9% enabled a deficit of up to 1% to be budgeted (without including the productive investment deficit), whereas, if growth one-tenth of a point higher is projected, a budget in balance would have to be provided for. Furthermore, there was no direct relationship between growth above the threshold set on the amount of the surplus, meaning that it could not be ensured that a continuous period of expansion would materialise in a sizeable surplus (a surplus of 0.1% of GDP was sufficient to comply with the rule). Conversely, the new definition requires that, in times of economic boom, the entire portion relating to the cyclical balance should be saved and this, moreover, will be proportionate to the economic expansion (see Chart 1).

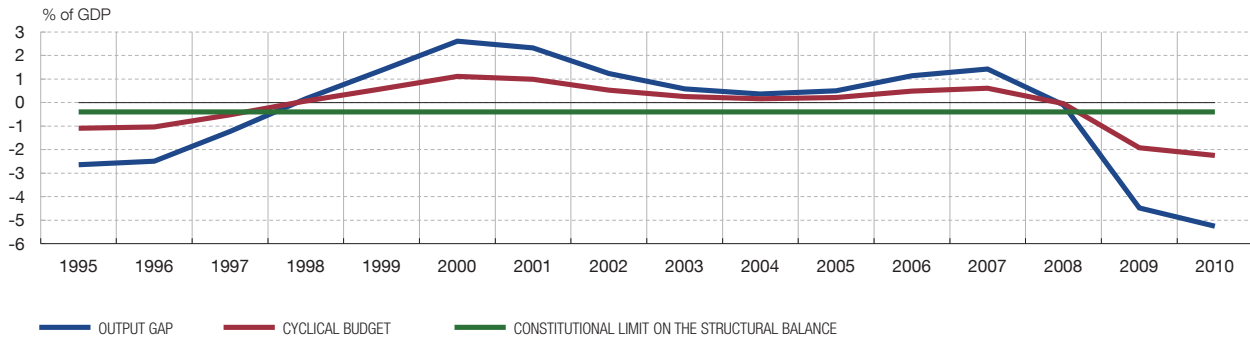
Generally, it could be said that the new rule will require higher surpluses than those arising from the BSL in expansion periods. For example, on the basis of an elasticity of the deficit with respect to the output gap of 0.4, in a situation of a positive output gap to an order equivalent to 3% of GDP, the fiscal surplus will have to be at least 0.8%, while in the case of the BSL, a surplus of 0.1% would suffice (provided that real GDP growth exceeded 3%). Moreover, the ceiling of 1.5% for the total deficit under the current BSL is eliminated, giving more headroom in periods of recession. For example, if a negative output gap of 5% of GDP is reached, the new arrangement would allow a deficit of up to 2.4% of GDP.

Another difference between the new rule and the BSL is that the new structural limits cannot be altered by the presence of investment spending. There are arguments that warrant leaving public investment outside the definition of the rule (in application of what is known as the "golden rule"), which are based above all on the fact that there is evidence showing that this type of expenditure may exert positive effects on growth in the long run. However,

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9 In the case of the German constitutional rule, the ex post result of the structural balance is adjusted for the error in the projection of real GDP. In the case of the Swiss constitutional rule, however, when a deviation from the limit in the rule arises as a result of a forecasting error, this is included in full in a notional account.

10 In the case of local governments, the ceiling is set in terms of the observed deficit. This is the criterion that was also adhered to by the BSL, although in this case the biggest municipal councils were actually allowed to run a deficit of 0.5% of GDP when economic growth was less than 2%. Local government revenue may show something of a cyclical response in its behaviour, given that they have a share in State tax revenue (depending on how the latter trends) and, in the case of the large municipalities, a percentage of personal income tax, VAT and excise duties are transferred to them. Accordingly, compliance with the limits set in the Constitution will mean that these municipalities will have to attain a structural surplus in periods of expansion, allowing them to offset the adverse impact on revenue-raising capacity in economic slowdowns, without having to apply compensatory adjustment measures.



SOURCE: AMECO.

excluding investment spending also poses problems. Firstly, not all investment spending is necessarily productive. Secondly, there is expenditure classified as current that may have even greater effects on long-term productivity (for example, education spending). Further, the accounting distinction between current and capital expenditure is not always easy, whereby excluding investment spending may generate incentives to record current expenditure in this latter group. Indeed, some countries that had “golden rules” in the past, such as the United Kingdom and Germany, have recently scrapped them.

The limit on public debt

The reform establishes an explicit limit on public debt, further reinforcing the commitment to budgetary discipline. Public debt is, in fact, the key variable for measuring the sustainability of public finances; and, given that the need to meet the debt criterion in the Stability Pact has in the past been subject to a milder interpretation than in the case of the deficit, the introduction of a constitutional limit may confer operability on the European requirement in Spain’s case. Moreover, this prevents those budgetary transactions that are not accounted for in the budget deficit, but which do give rise to an increase in borrowing needs, from remaining outside the scope of the rule.

The Constitution further establishes that the procedure for reducing the public debt/GDP ratio if it exceeds the European ceiling will be detailed in the implementing organic law. This procedure should adhere, at least, to the arrangements laid down in the new reform of the Stability Pact for the reduction of excess debt above 60% of GDP.

As to the priority given to the payment of the interest and principal on public debt over other expenditure, this may prove particularly significant in circumstances such as the present in which the markets are most sensitive to the possibilities of sovereign debt default.

The possibility of deviations from the limits

Broadly, establishing exceptions to compliance with fiscal limits is considered to be desirable and can reinforce the credibility of compliance, provided these exceptions are clearly defined. In the case of constitutional reform, the definition of these exceptions and the need for Parliamentary approval of the circumstances giving rise to the exceptionality are very similar, for example, to those of the German constitution, the sole difference being that, in Spain’s case, explicit mention is made among the exceptions of “economic recession”. In this respect, it should be recalled that the Treaty on European Union states that deficits above 3% are not considered “excessive” provided that the failure to comply is of scant significance, temporary and due to exceptional circumstances, such as a serious economic recession for instance. Following the 2005 reform of the SGP, a serious recession

sion is defined as a negative year-on-year growth rate of real GDP or a cumulative loss of output over a prolonged period of very low real GDP growth relative to potential growth. Moreover, it is important that the organic law should make clearly explicit the temporary path that should be followed to place the deficit once more within the established limits, once the deviations have come about.

The Spanish constitutional reform does not explicitly consider the treatment of the potential deviations that may come about. In this respect, the German constitutional rule, like Switzerland's, includes in its implementing legislation a mechanism whereby any ex post deviation from the structural balance target (positive or negative) is accumulated in a notional account. In Switzerland's case, the government must take adjustment measures if this account has a negative balance exceeding 6% of expenditure (i.e. around 0.6 pp of GDP), placing it below this limit in the following three years. In Germany's case, adjustment measures must be taken as soon as the notional account reaches 1%, but only if economic conditions allow.<sup>11</sup>

Monitoring, control and compliance mechanisms

The economic literature stresses that to ensure the success of fiscal rules, it is vital to have the appropriate monitoring and control mechanisms, and the capacity to impose or encourage compliance. In Spain's case, these procedures should also be laid down in the implementing organic law of the constitutional text. In relation to monitoring the rule, it is particularly important that the mechanisms set in place should allow early identification, within the fiscal year, of the risks to meeting the budgetary targets.

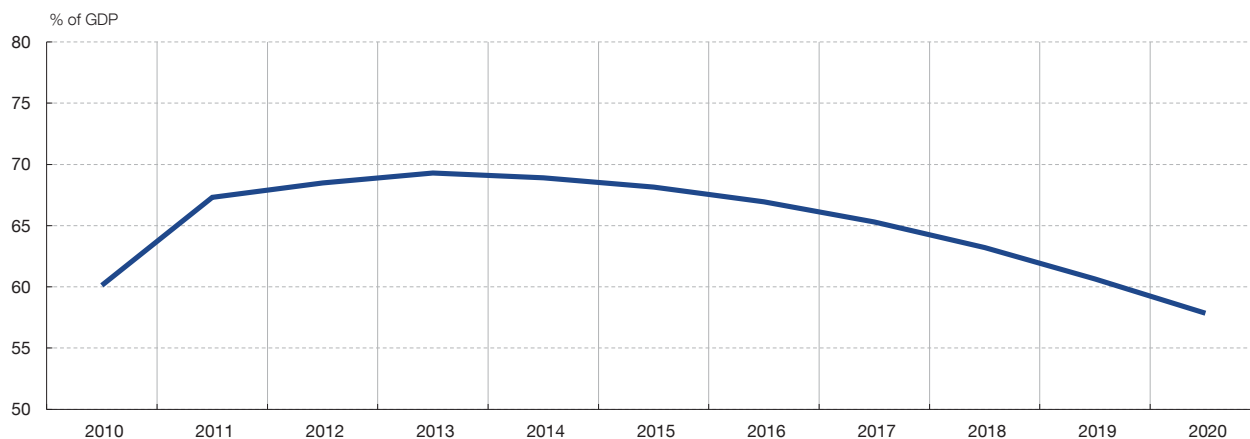
As to the mechanisms for encouraging or forcing through compliance, the constitutional reform indicates that the implementing organic law should regulate the responsibility of each government level in the event of non-compliance with the budgetary stability targets, which might be interpreted as the possibility of including sanctions. Sanctions are, in fact, a mechanism that could encourage compliance. However, the evidence shows that it is not easy to define them in a manner that makes their application credible, as the case of the SGP demonstrated. In this respect, and as indicated in the second section, the reform of the Pact includes the proposal whereby sanctions should be decided beforehand and more automatically so that their applicability is enhanced. A further instrument that might prove very effective would be clauses providing for the automatic adjustment of specific revenue and expenditure items in the event of the established fiscal targets failing to be met.<sup>12</sup>

Transitory period

Finally, as regards the entry into force of the rule, the definition of a transitory procedure would be reasonable given the high budget deficit levels prevailing at the time of approval of the constitutional reform. The transitory period is somewhat longer in Spain's case than was set in Germany, at least in the case of central government. That might be warranted by the different starting position in terms of the budget deficit, although the extension to 2020 in the case of limits on the structural deficit might prove more than accommodating. It should be borne in mind that the latest Stability Programme set an overall general government structural deficit of 1.9% in 2014, whereby, if this target is met, attaining a structural deficit of 0.4% in 2020 will entail a limited fiscal effort.

11 The control account may not exceed 1.5% of GDP and, moreover, deviations during the year may not exceed 3% of budgetary revenue. In the year after this increase in the control account of above 1%, the deficit must be reduced by the amount by which it exceeds 1%, but not by an amount in excess of 0.35%. This obligation is only applicable to the years in which there is a positive output gap or the negative output gap is diminishing.

12 The content of single additional provision 2 of the constitutional reform may give rise to the introduction of these mechanisms in the implementing organic law, indicating that "this law shall envisage the mechanisms that allow compliance with the debt limit referred to in article 135.3".



SOURCE: Banco de España.

The political agreement accompanying the constitutional reform indicates, moreover, a 60% ceiling on public debt as a target to be met in 2020. Chart 2 illustrates how this ratio might be attained on the basis of a series of assumptions.<sup>13</sup> Evidently, under harsher macroeconomic scenarios the fiscal adjustment needed to place public debt at 60% in 2020 will be greater. Even under the macroeconomic scenario simulated, a greater adjustment of the structural deficit, that were to anticipate the time at which the constitutional limit were reached, would allow a swifter reduction in the public debt ratio, meaning that room for manoeuvre would be gained to face potentially adverse situations without the risk of breaching the 60% ceiling again.

### The new spending rule

Before the constitutional reform, in July 2011, a ceiling on public spending growth was introduced into the national budgetary framework with a definition very similar to that included in the preventive arm of the SGP. This spending rule, now in force, is a very useful complement to the constitutional debt and deficit margins. Indeed, the experience in some other developed countries shows that the most successful fiscal frameworks are those that combine the budget deficit rule with explicit limits on public spending [IMF (2009) and Ljungman (2008)]. The usefulness of the latter is that it is directed at the habitual source of budget deficits. Specifically, the ex ante setting of a maximum amount of spending adds discipline to the budgeting for each spending unit, and these units thus have less leeway to exert upward pressure through their individual demands. Moreover, ex post this enables the increase in revenue in better-than-expected cyclical situations to be saved and, if the rule is well-defined and transparent, the spending components that generate deviations can be identified.

Defining a spending rule is not, however, free from difficulty and the definition may impair its effectiveness. Specifically, among the different elements that make up its definition, the choice of the variable that acts as a reference for setting boundaries on its permitted course is one of

<sup>13</sup> In particular, strict compliance with the macroeconomic and fiscal projections in the latest Stability Programme is assumed. That would entail placing the budget deficit at 2.1% of GDP and the public debt ratio at 68.9% in 2014. Subsequently, an annual 0.3% adjustment of the structural deficit is assumed, taking it to 0.4% in 2020 as established by the reform. Under the assumption of a zero contribution to the change in debt of the difference between GDP growth and the implicit interest rate on debt, a deficit-debt adjustment of 0.5% of GDP per annum and a trajectory that would see the output gap close in 2015 to subsequently turn positive and reached 2% in 2020, the public debt/GDP ratio would stand below 60% in 2020.

the most important. In principle, given that public revenue shows approximately unit elasticity with respect to nominal GDP, a growth in spending linked to this variable would ensure, if the starting point is a budgetary position in balance, that this position were maintained in the future. Evidently, if the starting point is a budget deficit, resuming a balanced budget will require spending growth below nominal growth until such equilibrium is attained.

However, to avoid procyclical behaviour in public spending, selecting annual GDP growth as a reference should be avoided, replacing it instead with a measure of the economy's potential growth. Under the rule approved in Spain, the annual increase in spending may not exceed the increase in real GDP over the medium term, which is defined, for each year, as the average of the real GDP growth rates envisaged in the Stability Programme for the current year and the three following years and those recorded in the five previous years, i.e. as an average of growth rates over nine years, which may be considered as an approximation to potential growth.<sup>14</sup> In any event, given that the constitutional reform will also require the estimation of this variable for the calculation of the structural deficit, its definition in the spending rule should desirably be compatible with the methodology used in the estimation.

As to the nominal component of GDP to be taken as a reference, in principle the annual growth of the GDP deflator could be used. Nonetheless, that might allow very high spending increases as a result of the existence of likewise very high inflation. To avoid this problem, some limit could be set on the increase in the deflator incorporated into the rule (e.g. that compatible with the ECB's definition of price stability). Along the same lines, it has been decided in the case of the rule approved to set growth in the GDP deflator of 1.75% as a reference, which would add a disciplining element to the future course of public spending.

The rule likewise states that the permitted growth in spending should be adjusted for the estimated impact of planned discretionary tax measures; as a result, when regulatory changes involving increases (reductions) in revenue are approved, the limit on spending increases (falls) by the equivalent amount. This adjustment is fully warranted in that it accommodates growth in spending to changes in revenue and prevents fiscal imbalances from arising further to the approval, for example, of tax cuts not accompanied by equivalent cuts in spending. However, it should be taken into account that estimating the impact of tax changes on revenue is not straightforward and *ex ante* estimates may differ greatly from actual results. Accordingly, it would be advisable periodically to conduct an *ex post* analysis and to adjust spending growth to the potential deviations that may arise.

As regards the spending components subject to the limit, it has been decided, firstly, to exclude interest payments, which is justified by the fact that this variable is beyond the control of the fiscal authority, at least in the short run. Further, non-discretionary expenditure on unemployment benefits is excluded, which will prevent any procyclical bias in the application of the rule.<sup>15</sup> However, this exclusion runs the risk of leaving out rises in expenditure derived from a structural increase in unemployment, which will not be corrected with cyclical developments.

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14 Some problems may be encountered with this definition. Specifically, the five years backwards that are taken may not be representative of potential growth if a structural change takes place. Moreover, taking projections for the current year and three ahead may cause added problems given that it is a stylised fact in the literature that it is difficult to capture changes in the business cycle. Further, the use of projections may cause some risk of excessive growth in spending if the projections prove optimistic.

15 For instance, in an economic slowdown there would be an increase in spending on unemployment benefits. If the rule is applied to this definition of spending, that would mean that, to ensure compliance, other spending items would have to be adjusted to compensate for the total spending growth exceeding that set in the rule, causing a procyclical bias therein.

As to the tiers of government to which the limit is applicable, central government and its agencies are included along with local governments that participate in the transfer of State taxes. In the case of the regional governments, the government has proposed in the Fiscal and Financial Policy Council the adoption by all regions of the spending rule. Given the weight of the regional governments in public spending in Spain, the extension to them is crucial if effective control over spending is to be achieved.

In respect of Social Security Funds, their exclusion essentially involves leaving spending on pensions out of the rule (in addition to the above-mentioned unemployment benefits). That would be consistent with the need to maintain a long-term perspective in the financing of these benefits. The annual growth of this item is largely predetermined by the parameters of the system and demographic developments, meaning it would be difficult to restrict its trajectory annually. In any event, to ensure the financial equilibrium of the pensions system in the long run, a regular estimate is needed of future spending requirements and the adaptation of the parameters of the system, in particular through the sustainability factor incorporated into the recently approved pensions reform.

Finally, the monitoring and correction mechanisms are, once again, a crucial element for ensuring the rule's effectiveness. Spanish regulations establish that, before 1 October each year, the Minister of Economy and Finance shall submit to the government a report on the degree of compliance with the spending rule for the preceding year. In the event of non-compliance, it is established that the level of general government responsible will adopt exceptional and immediately applicable measures to ensure a return to the approved spending path. It would perhaps be useful also to introduce some criterion to be applied in the course of the year so that, if deviations are anticipated, they may be corrected in the current fiscal year. Moreover, given that this rule is a complement to the multi-year budgetary stability targets, it might be worthwhile setting spending targets for the same years for which deficit targets are determined, making it necessary to adopt a multi-year perspective in expenditure budgeting that may prove most appropriate for rationalising such expenditure.

Table 4 illustrates how a rule such as that approved in Spain would have worked in the 1998-2010 period. Specifically, it shows spending growth and the budget deficit that would have arisen had a similar rule been applied in each year of the period 1998-2010. In this connection, the fiscal figures for 1997 are taken and public spending growth equal to the economy's nominal growth in the medium term is set.<sup>16</sup> The rule is applied to total general government public spending less the interest burden on public debt and less social benefits (essentially relating to unemployment and pensions). Hence an attempt is made to replicate the working of the rule which, as indicated, excludes these components. Under these assumptions, however, it is assumed that the rule applies to the spending of the regional governments and to all local governments.

Clearly, strict compliance with the rule would have led to a much healthier public finances situation during the decade prior to the economic crisis, allowing in particular the extraordinary revenue arising from the real estate boom to be saved. Indeed, the growth of public spending in the 1998-2007 period was significantly higher in Spain than would have been

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<sup>16</sup> Medium-term growth is calculated for each year as the arithmetic mean of the real GDP growth of the five previous years and of the forecasts for that year and for the three following years included in the Stability Programme (for that year). Added to this real growth is a deflator of 1.75%, equivalent to that set by the rule. Finally, this limit increases/falls by the amount of the discretionary tax measures in each year.

	Observed data				Growth of spending allowed by the rule and components				Outcome of the application of the rule	
	Total public spending growth (1)	Real GDP growth (2)	GDP deflator growth (3)	Budget balance (% of GDP) (4)	Average growth of real medium-term GDP in accordance with the rule (5)	GDP deflator growth allowed by the rule (6)	Contribution of the discretionary revenue-side measures to the growth of public spending allowed by the rule (7)	Discretionary revenue-side measures (% of GDP) (8)	Total public spending growth allowed by the rule (9)	Budget balance as a result of the application of the rule (% of GDP) (10)
1998	5.6	4.5	2.5	-3.2	2.9	1.75	-1.0	0.0	3.7	-2.4
1999	4.4	4.7	2.6	-1.4	3.3	1.75	-5.9	-1.7	-0.9	0.5
2000	6.6	5.0	3.5	-1.0	3.5	1.75	0.0	-0.2	5.2	0.9
2001	6.7	3.6	4.2	-0.7	3.8	1.75	0.0	0.0	5.6	1.4
2002	7.8	2.7	4.3	-0.5	3.7	1.75	0.7	0.1	6.1	2.0
2003	6.0	3.1	4.1	-0.2	3.6	1.75	-2.6	-0.6	2.7	3.1
2004	8.8	3.3	4.0	-0.4	3.5	1.75	0.1	-0.2	5.3	3.8
2005	6.8	3.6	4.3	1.0	3.3	1.75	0.8	0.1	5.9	5.2
2006	8.2	4.0	4.1	2.0	3.2	1.75	1.0	0.0	6.0	6.9
2007	9.2	3.6	3.3	1.9	3.3	1.75	-0.7	-0.4	4.4	8.0
2008	8.8	0.9	2.4	-4.2	3.3	1.75	-2.3	-1.4	2.8	3.4
2009	7.4	-3.7	0.6	-11.1	2.2	1.75	2.2	-0.6	6.2	-3.2
2010	-0.1	-0.1	1.0	-9.2	1.8	1.75	4.8	1.4	8.3	-3.2
Average (1998-2007)	7.0	3.8	3.7	-0.2	3.4	1.75	-0.8	-0.3	4.4	2.9
Average (2008-2010)	5.4	-1.0	1.3	-8.2	2.4	1.75	1.6	-0.2	5.8	-1.0
Average (1998-2010)	6.6	2.7	3.2	-2.1	3.2	1.75	-0.2	-0.3	4.7	2.0

SOURCES: ECB and AMECO.

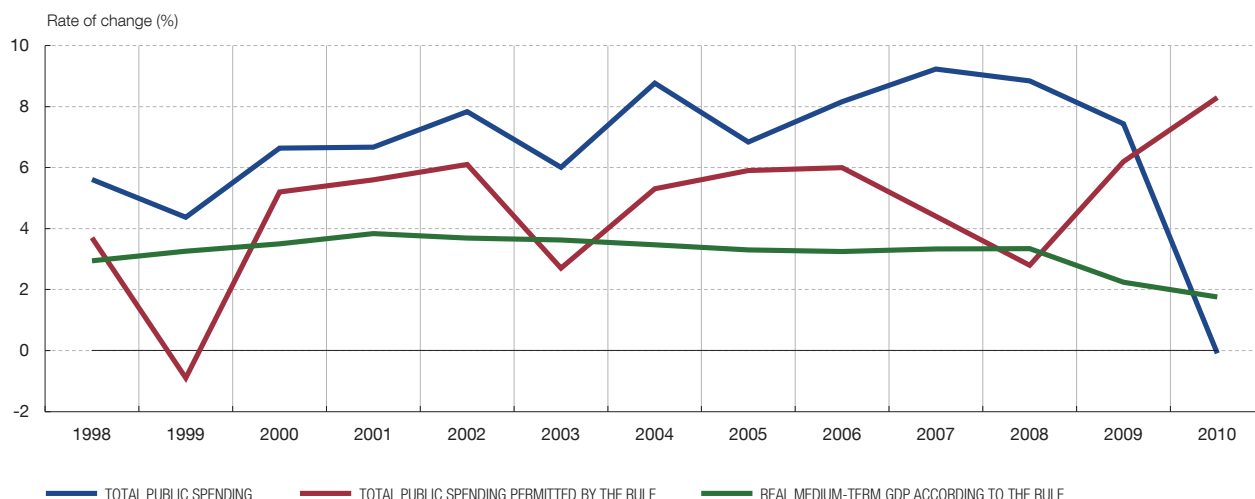
the case with the application of the rule (7% in annual average terms, compared with 4.4%, respectively) (see Chart 3). In the economic crisis period it would, however, have allowed for slightly higher growth than that observed. In terms of the budget balance, a far greater surplus than that actually posted would have been achieved in 2007, the year prior to the crisis.<sup>17</sup> The rule would not have prevented a highly significant deterioration in the budget balance during the crisis but, given the starting situation, the budget deficit would have been significantly below the actual figure recorded.

## Conclusions

The economic crisis and, in particular, the events that unfolded further to the Greek fiscal crisis and spread to other countries have highlighted the weaknesses of the European governance framework. In the fiscal arena, the strong deterioration in the budgetary position and outlook in most European countries has its roots in various factors, such as the cyclical downturn, the repercussions of the restructuring of the financial system and the revision of the medium-term growth outlook for European economies. However, it is also clear that the European fiscal framework had not been capable of sustainably redressing public finances during the economic upturn in such a way as to provide sufficient leeway to tackle the recession.

<sup>17</sup> This estimate of the impact on the budget balance reflects the direct effect of the spending rule and the second-round effects arising from the possible impact of this lower growth in spending on GDP growth. The estimate draws on a simulation made with the Banco de España Quarterly Macroeconomic Model (MTBE).





SOURCES: ECB and AMECO.

As part of the European governance framework reform under way, it is therefore crucial to reinforce the Stability and Growth Pact so as to improve its implementation and effectiveness. The reform pending approval does indeed amend several aspects of the workings of the Pact, including most notably recognition of the importance of improving national fiscal frameworks so that they may contribute to achieving budgetary stability.

Against this background, it has been decided to strengthen the budgetary framework in Spain by building into the constitutional text the limits on the budget deficit and the public debt ratio established at the European level, extending them to all government levels. The raising of these limits to constitutional rank should give rise to a greater degree of compliance with such limits, insofar as the latter would be more difficult to alter and the other laws approved should be compatible with them. At the same time, the definition of the limit on the budget deficit in structural terms, though it poses certain measurement problems, allows the fiscal stability target to be compatible with the maintenance of a stabilising role in the application of fiscal policy through the automatic stabilisers.

The effectiveness of fiscal rules depends, in any event, on setting the appropriate rule-control and compliance procedures in place. In the constitutional reform, these matters are addressed in an organic law. It is therefore vital that this law should define these procedures in such a way that the risks to attaining the targets may be identified in time and that the corrective measures preventing such risks from materialising be adopted. Furthermore, the law should clearly and strictly specify exceptions, making explicit the time path that should be followed in order to reposition the fiscal variables within the limits set when deviations occur. Finally, the appropriate mechanisms to assist in compliance with targets should also be incorporated, including here the setting of sanctions and/or the laying down of clauses for the automatic adjustment of specific revenue and expenditure items should the specific fiscal targets established not have been met.

The national budgetary framework has also been strengthened by the introduction of a public spending rule which, broadly, limits its annual increase to the economy's nominal growth in the medium term. The strict application of this limit, combined with the constitutional rule, may prove useful for ensuring fiscal discipline in the future. Indeed, a counter-

factual exercise of how a spending rule such as that approved would have worked in Spain in the 1998-2010 period shows that strict compliance with such a rule would have led to a much healthier public finances situation during the decade prior to the economic crisis. This is because it would have made it possible for the extraordinary revenue arising from the real estate expansion to have been saved, meaning that the surplus prior to the crisis would have been higher and the budget deficit would not have reached the levels observed during the crisis. In any event, for a rule of these characteristics to be effective, its application to the regional governments should be ensured.