THE NEW BUDGETARY STABILITY LAW

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Introduction

In September 2011 it was decided to reinforce the prevailing framework of budgetary rules in Spain with the approval of a constitutional reform. The reform enshrines in the Constitution the obligation for all tiers of general government to adjust their conduct to the principle of budgetary stability.[1] Subsequently, on 27 April 2012, the Organic Law of Budgetary Stability and Financial Sustainability (LEP by its Spanish abbreviation) implementing this constitutional reform was approved, replacing the stability laws in force. The LEP made significant amendments to the definitions of and the mechanisms for determining the deficit, debt and public spending limits applicable to the different levels of government, along with changes in correction procedures and mechanisms in the event of slippage.

The new budgetary rules and their legal place in the Constitution respond to a tendency observed in the other European countries, and reflected in various reforms recently introduced into the institutional architecture of the monetary union.[2] Indeed, the economic policy response to the sovereign debt crisis in the euro area is broad-based and includes, among other aspects, a review of the EU's economic governance framework. The budgetary area has seen the approval, firstly, of a reform of the Stability and Growth Pact (SGP) aimed at reinforcing its implementation, which includes an amendment of its preventive arm with the incorporation of spending developments into the assessment of the countries' compliance with medium-term budgetary objectives, the strengthening of the public debt criterion, and the introduction of new reporting obligations and financial sanctions for euro area countries which will be applied earlier than at present and more gradually, and whose approval will be more automatic. The reform also acknowledges the importance of an appropriate definition of the fiscal frameworks not only at the European level but also domestically; accordingly, Member States are bound to comply with a series of minimum requirements in their budgetary frameworks in order to contribute more effectively to achieving budgetary stability. Further, in the Treaty on Stability, Coordination and Governance (TSCG), an inter-governmental agreement signed by the European Council on 2 March 2012, the countries undertake to maintain their structural balance in equilibrium and to pass through this commitment to their domestic legal systems and, preferably, to their Constitutions.

It is against this background that the reform of the budgetary framework in Spain, which this article analyses in detail, has taken place. In this connection, the following section reviews and analyses the quantitative caps on the deficit, debt and public spending laid down in the new framework, while the third section examines those cases in which the law allows slippage from these thresholds. The reform includes a transitory period running to 2020 in which to move gradually towards the reduction of the deficit and of debt from the current levels to below the limits set. The provisions relating to this transitory period are analysed in the fourth section. The article concludes with a box that summarises the procedures for setting objectives and for monitoring and controlling their fulfilment in accordance with the LEP. The final section draws conclusions.

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1 See Hernández de Cos (2011).

2 See Caballero *et al* (2011).

Quantitative caps on the deficit, debt and public spending

The Law on Budgetary Stability and Financial Sustainability sets three types of restrictions on general government conduct: they may not run a budget deficit in structural terms; public spending growth shall, at most, be that of the economy's nominal potential growth; and the public debt/GDP ratio may not exceed 60%. These limits are described and analysed below.

THE CAP ON THE BUDGET DEFICIT IN STRUCTURAL TERMS

The LEP sets a cap on the budget deficit defined in structural terms as opposed to applying it on the basis of the actual deficit as was the case in previous budgetary stability laws. Specifically, it establishes that the State and regional governments (RG) may not incur a structural deficit.[3] This criterion does not apply, however, to local government (LG) and Social Security Funds, which shall maintain a budgetary position in equilibrium or in surplus, and not only in terms of the related structural balance.[4]

The estimate of the structural deficit is obtained as the difference between the actual deficit and the cyclical deficit,[5] with the latter being calculated through the application of the elasticities of public revenue and public spending to the difference, or output gap, between actual GDP and potential or trend GDP. Various methods are available in the economic literature to estimate the output gap and elasticity of public revenue and public spending. The Law has opted to apply the method currently used in the European Union, i.e. the cyclically adjusted deficit, net of exceptional and temporary measures, developed jointly by the European Commission and the Member States.[6] Specifically, this method draws on the estimation of potential GDP based on a production function, which requires that each of its components (employment, capital and total factor productivity) be assessed in terms of their potential values[7] [8]. As

3 It should be recalled that TSCG rules set a cap on the structural deficit of 0.5% of GDP, although a structural deficit of, at most, 1% of GDP is allowed if the public debt/GDP ratio is significantly below 60% of GDP and the risks to the sustainability of public finances in the long run are low. The preventive arm of the SGP establishes the need to attain the medium-term objectives (MTO), which are also defined in terms of the structural deficit. In its Stability or Convergence Programme, each Member State presents its own medium-term budgetary objective, which may not exceed that derived from the agreed methodology for calculating it, and this is assessed by the Ecofin. These objectives are revised when a major structural reform is undertaken and, in any event, every four years. In Spain's case, according to the methodology for calculating the medium-term objectives agreed by Ecofin in July 2009 [European Commission (2010)], the structural deficit may rise to around 0.5%, although the updated 2009-2010 Stability Programme set this objective as a structural balance in equilibrium, which was maintained in subsequent Stability Programmes.

4 In the case of LG, the previous stability law allowed the bigger municipal councils to run a deficit of up to 0.05% of GDP when economic growth was less than 2%. In this respect, it should be borne in mind that LG revenues may show a certain cyclical response given that they have a share in the State's tax receipts (which depend on the business cycle) and, in the case of the major municipal councils, they are assigned a percentage of personal income tax, VAT and excise duties. Accordingly, compliance with the limits set in terms of the actual zero budget balance will apply to these LG entities, which will be obliged to attain a structural surplus in expansions, enabling them to offset the adverse impact on tax revenue at times of slowdown without having to apply compensatory adjustment measures.

5 Calculation of the structural balance also requires that this balance be adjusted for temporary or exceptional factors.

6 See Denis *et al* (2006) and Ministerial Order ECC/2741/2012 of 20 December 2012 on the methodological implementation of Organic Law 2/2012 of 27 April 2012 on Budgetary Stability and Financial Sustainability relative to the calculation of the trend forecasts of revenue and expenditure and of the Spanish economy's reference rate.

7 In the case of the stock of capital, it is estimated on the basis of a dynamic capital accumulation equation in which the capital for the period is equal to gross investment plus the capital of the previous period and less depreciation. As to potential employment, this is estimated on the basis of the working-age population (15-64), the potential participation rate, the number of potential hours worked per employee and the NAWRU (non-accelerating wage rate of unemployment). Both the participation rate and the number of potential hours are obtained by applying the Hodrick-Prescott (HP) filter to the series observed (or forecast). The NAWRU is estimated as the non-observable component of a Phillips curve that includes the acceleration in the share of wages in GDP, labour productivity and the terms of trade (defined as the difference between the growth rate of the GDP deflator and that of private consumption) as regressors. The weights of the labour and capital factors are set at 0.65 and 0.35. Finally, potential TFP is obtained as an estimate of the trend of the annual residual of GDP once the contribution of labour and capital is stripped out.

8 The sample period of the estimate runs from 1980 up to six years following the current year (t) and estimation is with annual data. This span is necessary in order to avoid the problem of the sensitivity of the Hodrick-Prescott filter to the information available at the extremes of the sample. For the extension of the series, macroeconomic forecasts from the Ministry of Economy and Competitiveness for the period from t to t+3, while the series of hours worked, participation rates and TFP are extended between t+4 and t+6 by means of the application of ARIMA models. As to the population projections, INE short-term estimates are used.

The new Budgetary Stability Law establishes a very detailed procedure for the annual setting of budgetary objectives for the overall general government sector and its agents. Further, it details the mechanisms for the monitoring of the fulfilment of these objectives, it establishes significant improvements in terms of transparency of public finances and it provides for a set of instruments to prevent slippage or to redress it should it arise. This box details the main aspects of the new legislation in relation to these issues.

1 Procedure for setting budgetary objectives and their monitoring

— Before 1 April each year (t), the Ministry of Financial Affairs and Public Administration (MHAP) shall make a proposal for the setting of the stability and public debt objectives for the three following years both for the general government sector and for its sub-sectors. The proposal shall be forwarded to the Fiscal and Financial Policy Council (CPFF) and the National Local Government Council (CNAL), which shall have 15 days to issue a report on the matter.[1]

— Following the report by the CPFF and the CNAL, the government shall set the stability objectives, including the State spending limit, in the first half of the year (t). The resolution of the Council of Ministers shall be sent to Parliament for its approval.

— Once the objectives for each sub-sector have been approved, MHAP shall propose the individual objectives for each RG to the CPFF, and the latter shall then issue a report within 15 days. Subsequently, the government will approve the objectives for each RG.

— The preparation of the draft budgets of all general government tiers will accommodate themselves to these objectives. In particular, the RG and LG shall approve their spending limits, before 1 August, and send the essential outlines of their next budgets, before 1 October, to MHAP, which shall report on how suited they are to the objectives before 15 October.

— In the first quarter of the following year (t+1), MHAP shall report to the government on the degree of compliance with the stability and public debt objectives in the initial general government budget and on compliance with the spending rule in the same initial budget for the case of CG and the RG.

— Before 1 October in the following year (t+1), MHAP shall submit a report to the Government on the degree of compliance with the rules in the previous year (t), which will also include a forecast on compliance in the current year.

1 The proposal shall be accompanied by a report assessing the economic situation over the time horizon for the setting of the objectives. The report shall be drafted by the Ministry for Economic Affairs and Competitiveness (MEC), further to consultation with the Banco de España, and bearing in mind the forecasts of the European Central Bank and of the EC.

2 Improved transparency

— The budgets of all general government tiers should include exact information so as to relate the balance of revenue and spending in the budget to net lending or net borrowing according to the European System of Accounts (ESA).

— Minimum reporting requirements are laid down for RG and LG, including most notably monthly outturns of RG revenue and spending, and quarterly outturns in the case of LG, along with all the information needed to calculate the budget outturn in terms of national accounts.[2] Thus, from June 2012, the IGAE began to regularly publish quarterly accounts of all the general government sub-sectors in terms of ESA 95. Also, since October 2012, MHAP has been regularly publishing RG monthly accounts in terms of budgetary accounts and, since March 2013, RG and Social Security monthly accounts in terms of national accounts.

3 Non-compliance prevention mechanisms

— The Government shall warn RG or LG if they perceive a risk of the stability, debt or spending rule objective not being met. After this warning, the responsible level of government shall take measures within one month to redress the situation. Should it not do so, or if MHAP considers the measures are not sufficient, some of the coercive measures envisaged in the Law shall be imposed.

— An automatic prevention system is established when debt stands above 95% of the limits set in the Law.[3] In this case, the only debt operations allowed will be treasury-related ones.

— For the case of the Social Security sub-sector, if the Government projects a pensions system deficit in the long run, it must automatically revise the sustainability factor envisaged in Law 27/2011 of 1 August 2011 on the updating, reform and modernisation of the Social Security system.

4 Non-compliance correction mechanisms

— The Law states that the level of government which exceeds its public debt limit may not enter into net debt operations. Likewise, if the budgetary stability or public debt objectives are not met, all RG debt operations and all LG long-term operations will require State authorisation.[4 5]

2 Ministerial Order HAP/2105/2012 of 1 October 2012 implementing the reporting obligations envisaged in Organic Law 2/2012 of 27 April 2012 on Budgetary Stability and Financial Sustainability.

3 In the transition period to 2020 the percentage considered shall be 100%.

4 Or, if appropriate, of the RG that has financial stewardship of the LG.

5 Moreover, in the case of the RG, if one of these objectives or the spending rule is not fulfilled, a mandatory and binding report by MHAP will be needed for the granting of subsidies or the signing of agreements by CG with the RG in question.

— When, in normal circumstances, CG, RG or LG fail to meet the budgetary stability, public debt or spending rule objectives, they shall draw up a Financial Economic Plan (FEP) providing for the correction of the slippage within 1 year. If the exceptional circumstances envisaged in the Law occur, the emergence of slippage will require the submission of rebalancing plans (RP) that include the paths envisaged to attain once more the budgetary stability or public debt objective.[6] In that case, the Law sets no deadline for correction.

— MHAP shall report quarterly on the monitoring of all ongoing FEP and RP. If, in any report, slippage in the application of the measures were to be verified, the level of government responsible shall be required to correct it. If, in the following quarterly report, it is verified that the measures of the plan have not been complied with and that this may lead to non-compliance with the stability objective, MHAP may impose the coercive measures envisaged in the Law.

— In the event of non-compliance with the FEP or RP, the LEP stipulates the obligation for the level of government responsible to approve, within 15 days from the non-compliance occurring, the non-use of appropriations to ensure compliance with the objective. In parallel, a sanction shall be established, consisting of the obligation to set aside a remunerated deposit at the Banco de España equivalent to 0.2% of its GDP.[7] Should the pertinent corrective measures not have been applied within three months, the deposit will cease to generate interest and if, following a second three-month period, non-compliance persists, the Government, on the proposal of MHAP, may resolve that the deposit be converted into a fine. If, after a further three-month period following the setting of the fine, the necessary measures have still not been adopted, the Government may resolve to send a delegation of experts who will have to submit a proposal of mandatory measures.

— In the case of the RG, if the resolution on the non-use of appropriations were not adopted, or if the obligatory deposit were not set aside or the measures proposed by the above-mentioned delegation of experts were not accepted, the Government would require the president of the RG to see through the measure that has not been carried out. If this requirement is not met, the Government, with the approval by absolute majority of the Senate, shall adopt the measures necessary to ensure forcible execution by the RG. A similar procedure is envisaged for LG. In this case, persistent non-compliance may lead to the dissolution of the local government bodies responsible.

6 Both FEP and RP shall be drawn up within one month from the time non-compliance is noted or exceptional circumstances discerned, respectively, and their implementation shall take no longer than three months. In the case of CG, the plans shall be drawn up by the Government (on the proposal of MHAP) and sent to Parliament for approval. If they are rejected, the Government will have one month to submit a new plan. In the case of the RG, the plans formulated by them shall be sent to the CPFF and, if they are not considered appropriate, the CPFF shall call on the RG to submit a new plan. If a plan is not submitted within the specified period or is rejected again, MHAP may impose the coercive measures set out in the draft legislation.

7 Moreover, like the previous regulations, the draft law establishes that if sanctions are applicable to Spain under European regulations, the portion applicable to them shall be transferred to the levels of government responsible.

to the elasticities of the fiscal variables with respect to the cycle, these are estimated for personal income tax, corporate income tax, indirect taxes and social security contributions in the case of revenue; and for unemployment benefits and other primary expenditure in the case of spending (see Table 1).[9] The aggregate sensitivity of the budget balance to the business cycle can be obtained as the weighted sum of these elasticities of public revenue and spending, where the weights are those of the various revenue and spending items as a proportion of nominal GDP. Assuming a constant revenue and spending structure, the European Commission sets this cyclical sensitivity of the Spanish budget balance at a value slightly higher than 0.4. The cyclical component of the deficit in each year is thus obtained by multiplying this sensitivity by the output gap (expressed as a percentage of potential GDP). Finally, as earlier mentioned, the cyclically adjusted component of the deficit is obtained as the difference between the actual budget balance and its estimated cyclical component.

From the standpoint of fiscal policy design, the main advantage of setting the budget deficit cap in structural terms is that it enables its stabilising character to be preserved. In

9 See European Commission (2005).

ELASTICITIES OF PUBLIC SPENDING AND REVENUE **TABLE 1**

	Elasticities [1]	Weights of revenue/spending in GDP (average 1995-2012) [2]	Cyclical sensitivities [3] = [1] x [2] / 100
Total taxes and social security contributions	1.08	33.8	0.36
Personal income tax	1.92	7.0	0.13
Corporate income tax	1.15	2.9	0.03
Indirect taxes	1.00	10.9	0.11
Social security contributions	0.68	13.0	0.09
Total current primary expenditure	-0.16		
Unemployment insurance	-3.30	1.8	-0.06
Other primary expenditure	-0.03	31.7	-0.01
General government cyclical sensitivity			**0.43**

SOURCES: IGAE (National Audit Office) and Ministerial Order ECC/2741/2012 of 20 December 2012.

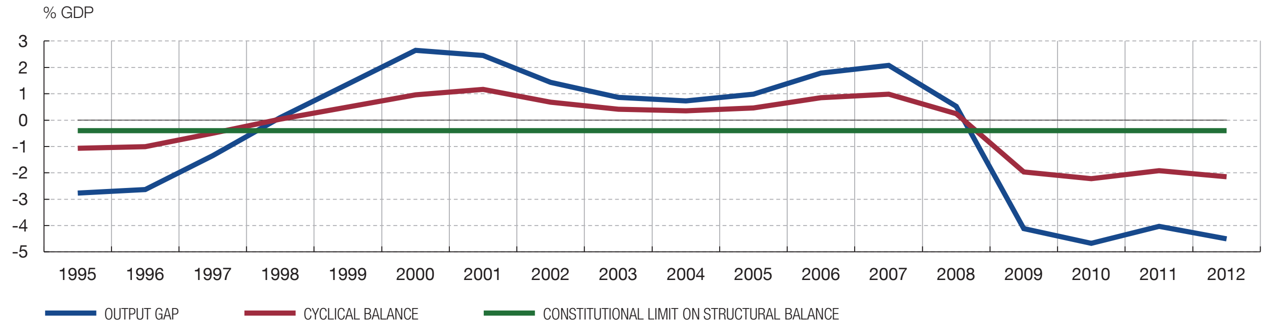
fact, the cyclical component of the deficit falls (increases) in periods of economic expansion (recession), given that public revenue tends to grow (diminish) and public spending to fall (increase) simply as a result of the operation of the automatic stabilisers, generating a stabilising effect on the economy. Insofar as the caps on the structural deficit do not affect the course of the cyclical component of the deficit, a rule thus defined allows for the free play of these automatic stabilisers. Moreover, it might allow fiscal policy to play a countercyclical discretionary role, beyond that derived from the automatic stabilisers, but that would call for structural surpluses to be attained in economic boom periods. Hence, on the basis of the estimates of the general government cyclical balances made by the European Commission for the 1995-2012 period, a hypothetical application of the zero structural deficit rule would have been consistent with oscillations in the general government balance ranging from a maximum deficit of 2.2% of GDP in 2010 to a surplus of 1.1% of GDP in 2000 (see Chart 1).

The main practical difficulty in defining the budget deficit cap in structural terms arises from the fact that this variable is not observable and has to be estimated, with the economic literature, as stated, providing different methods that offer likewise different results. The advantage of deciding to use the reference methodology provided by the European Commission is that it is known to and can be readily replicated by analysts, and it avoids the discrepancies that might arise between the national rule and that established at the European level by the application of a different methodology, which makes it easier to monitor the public finances situation from the standpoint of compliance with Community commitments. In any event, it should be borne in mind that estimates of the structural deficit are frequently subject to revision, whether this be due to the incorporation of fresh (budgetary or macroeconomic) information or to potential forecasting errors, given that these estimates require the use of macroeconomic projections.[10] The new LEP does not establish differentiated treatment in the event of structural deficit revisions arising, something which

10 In this respect, Kempkes (2012), using data for the OECD countries, finds evidence that there is a significant bias for the output gaps estimated in real time to be more negative than those estimated using final data. The scale of the bias is between -0.6% and -0.5% of potential GDP on average in all countries and periods, meaning that the use of estimated output gaps in real time would have enabled governments to record higher budget deficits than those that would have arisen from an estimate based on the use of final data. The results also show that the source of these biases would be due, above all, to systematic errors in the macroeconomic projections and not so much to the method for estimating potential output.

OUTPUT GAP, CYCLICAL BUDGET BALANCE AND CONSTITUTIONAL RULE

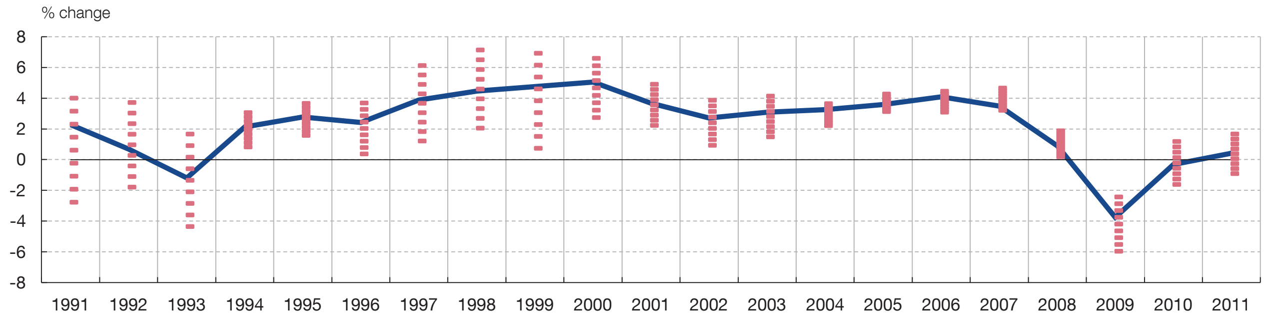
CHART 1



SOURCE: AMECO (updated 22 February 2013).

OVERALL SPANISH GDP GROWTH AND REGIONAL HETEROGENEITY

CHART 2



SOURCES: Spanish Regional Accounts and Banco de España. The broken vertical lines highlight the distance between the maximum and minimum growth in a specific year of the 17 Regional Governments.

does occur in the fiscal rules applied in some countries.[11] Furthermore, setting a limit on the structural deficit that is applicable not only to the State but also to the RG raises the question of the estimation of this structural balance at the level of each tier of government. In this respect, and as stipulated under the new stability law, Ministerial Order ECC/2741/2012 of 20 December 2012 details the methodology for distributing the estimated overall general government structural deficit among the different agents. Specifically, it was opted to use the same output gap measure for all general government levels and the State, namely that resulting from the application of the above-mentioned methodology at the European level. This decision is warranted by two types of argument. On one hand, the difficulty entailed by estimating an output gap measure which differs across RG and which, in turn, is compatible with the aggregate measure used in the context of the SGP. On the other, it is argued that the cyclical synchrony between the RG is very high, despite the fact that the dispersion of the RGs' real GDP growth rates may, some years, be high, which might in the odd case pose practical implementation problems for the principle of a single output gap (see Chart 2).[12]

It has also been opted to use the same value of the revenue and expenditure elasticities for the State and all the RG (see Table 1). In turn, the cyclical sensitivities of each level of

11 In the case of the German constitutional rule, the ex post result of the structural balance is adjusted for the error in the real GDP forecast. In the case of the Swiss constitutional rule, however, when there is a deviation from the rule limit derived from a projection error, this is included in its entirety in a notional account, which only requires adjusting if it exceeds a specific threshold.

12 For instance, in 2009, although real GDP for the economy as a whole contracted by 3.7%, the extremes stood between the declines of 6% for the Valencia region and of 2.4% for the Madrid region.

DISTRIBUTION OF THE CYCLICAL BALANCE ACROSS THE GENERAL GOVERNMENT SUB-SECTORS TABLE 2

	Output gap in 2011 (a)	Elasticities	Estimated weights as a percentage of 2011 nominal GDP			Simulated distribution of the cyclical component		
			Central Government and Social Security	Regional Govern-ment	Local Govern-ment	Central Government and Social Security	Regional Govern-ment	Local Govern-ment
	[1]	[2]	[3]	[4]	[5]	[6] = [1] x [2] x [3]	[7] = [1] x [2] x [4]	[8] = [1] x [2] x [5]
Total revenue						**-0.88**	**-0.40**	**-0.12**
Personal income tax	-4%	1.92	3.79	3.17	0.47	-0.29	-0.24	-0.04
Corporate income tax	-4%	1.15	1.74	0.02	0.11	-0.08	0.00	-0.01
Indirect taxes	-4%	1.00	3.89	3.95	2.03	-0.16	-0.16	-0.08
Social security contributions	-4%	0.68	13.09	0.05	0.03	-0.36	0.00	0.00
Total current primary expenditure						**-0.40**	**-0.02**	**-0.01**
Unemployment insurance	-4%	-3.30	2.81	0.00	0.00	-0.37	0.00	0.00
Other primary expenditure	-4%	-0.03	26.94	17.27	6.77	-0.03	-0.02	-0.01
Residual (other revenue)						**0.04**	**0.04**	**0.04**
Cyclical balance						**-1.25**	**-0.39**	**-0.09**

SOURCES: INE (SNA annexed tables), IGAE (National Audit Office), European Commission and Banco de España.

a European Commission's 2013 Winter Report.

government are obtained as the weights of the various revenues and expenditures that are considered cyclical (as a percentage of national GDP) multiplied by the related elasticities. Thus, when calculating structural balances, the only factor that can determine differences in the impact of the cycle across governments is the presence of discrepancies in the weights of public revenue and spending. In particular, governments in whose accounts the most cycle-sensitive items account for most weight, as may be the case with, for example, unemployment spending, social security contributions or personal income tax, will have a comparatively bigger cyclical balance[13]. For the purposes of the distribution of the cyclical balance the Social Security System is integrated into Central Government (CG) since, as the ministerial order indicates, unemployment benefits – a markedly cyclical expenditure item – may be financed interchangeably by contributions, taxes or debt.

Table 2 presents an exercise of how the distribution of the cyclical balance across the general government sub-sectors would have been in 2011 applying the above-mentioned methodology. Here use is made of the output gap estimate for that year made by the EC in its 2013 Winter Report[14], the elasticities of public revenues and expenditure in Table 1, and approximate weights of the share by agent in revenue and expenditure based on IGAE (National Audit Office) data.[15] As was to be expected, the CG aggregate would account for some 70% of the total for the cyclical balance, owing to the effect of the Social Security System (in both its revenue and expenditure facets), while the RG would be assigned 25% and LG the remaining 5%.

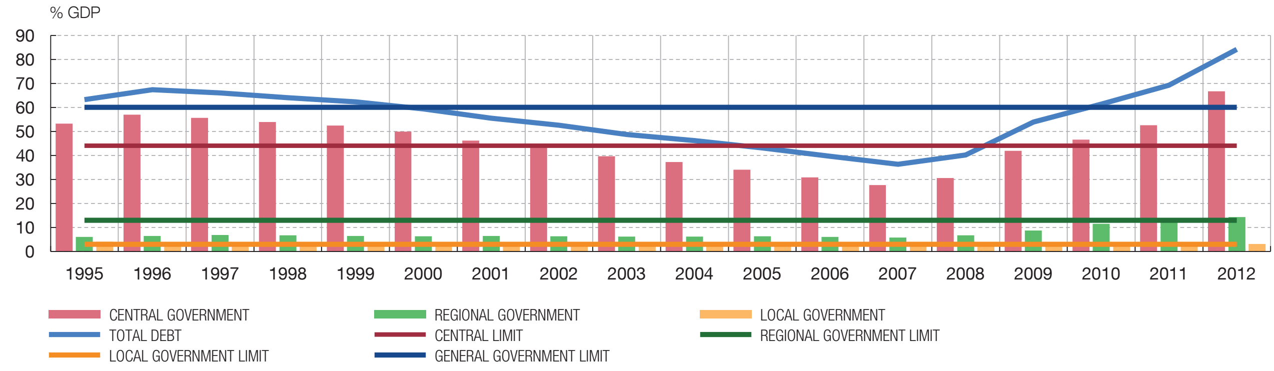
13 In the case of the RG, it should further be borne in mind that some receive transfers from the Guarantee Fund, the changes in which over time are linked to State tax revenues, which include State takings for personal income tax, VAT and excise duties. The elasticity in respect of the output gap of this basket of taxes is estimated at 1.4.

14 See European Commission (2013).

15 The heading "Other" has been included to ensure consistency with the cyclical balance that would arise from the habitual aggregate approximation which is calculated multiplying the sensitivity of general government to the business cycle (0.43) by the output gap. The distribution of the remainder across the sub-sectors has been carried out using the weights in other revenue of the various general government sectors.

PUBLIC DEBT AND LIMITS

CHART 3



SOURCE: Banco de España. Consolidated public debt by General Government sub-sector.

THE CAP ON PUBLIC DEBT

The LEP stipulates that the weight of overall general government debt in GDP may not exceed 60% as from 2020. This explicit cap on public debt was not envisaged in previous stability laws and further reinforces the commitment to budgetary discipline, given that it is the key variable for measuring the sustainability of public finances. Indeed, one of the main objectives of the reform of the SGP approved in 2011 is to strengthen the operationality of the cap set on this variable. Setting a limit on the level of public debt also prevents budgetary operations that are not recorded in the budget deficit but that generate an increase in borrowing needs from remaining outside the scope of the rule. The rule also gives absolute priority to the payment of public debt interest and capital expenses over other budgetary commitments, which may prove especially important for dispelling potential doubts over the situation of public finances at times of financial instability or deteriorating confidence.

The LEP establishes the means of distributing the cap of 60% of GDP across the general government sub-sectors. A figure of 44% of GDP corresponds to CG, 13% to the RG as a whole (this limit is also applied to each of them in respect of their regional GDP) and 3% to LG, a very similar distribution to that observed at end-2011, when CG amassed around 75% of the overall general government debt. Arguably, in principle, CG should have greater scope for indebtedness, as established under the law, so as to be better placed to respond to the shocks affecting the country as a whole, and to help smooth the idiosyncratic shocks of each territory or group of territories. Further, their greater accessibility to international markets to raise financing might justify a higher threshold.

Chart 3 plots the debt for each sub-sector in recent years, and the debt caps set. CG and LG can be seen to have exceeded the LEP cap in most of the years, with the exception of the periods 2002-2009 and 2001-2008, respectively. The RG, for their part, only exceeded it in 2011 and 2012.

In relation to the foregoing and as under the previous legislation, the LEP stipulates that CG may not assume the debt commitments of the RG or LG, nor that of the public corporations reporting to them, and nor may the RG assume LG commitments. This is what is known as the non-bailout clause, and its wording in the LEP is very similar to that in the Treaty on European Union for relations between Member States. In a country as decentralised as Spain, this clause is crucial in seeking to prevent the costs of inappropriate fiscal behaviour at one level of government from passing through to the other tiers, and it is vital so that the capital markets may maintain a disciplining effect based on discrimination among the risk premia on the debt of the different levels of government.

In any event, the LEP also states that RG and LG may apply to the State for access to exceptional liquidity support measures. To do this, the RG in question has to agree on an adjustment plan with the Ministry of Financial Affairs and Public Administration (MHAP) that ensures fulfilment of the stability objectives. This plan shall be public and include an approval, start-up and surveillance timetable. Compliance with the timetable will determine the tranche-by-tranche disbursement of the financial aid. Moreover, the RG must accept the specific monitoring and reporting conditions.[16] In this respect, the Government has launched various support mechanisms for RG and LG in 2012 and 2013 so as to provide for the refinancing of their prior debts or for payment to trade creditors.

THE SPENDING RULE

The LEP stipulates that the State, RG and LG shall annually approve a non-financial expenditure cap. Specifically, it states that the annual increase in spending (by the State, the RG and LG) may not exceed the medium-term GDP growth reference rate set by the Ministry for Economic Affairs and Competitiveness (MEC), in keeping also with the European Commission's methodology. In this respect, the ministerial order approved in December 2012 states that the medium-term growth of real GDP shall be calculated as the mean of the estimates of the potential growth of real GDP over the last five years, the estimate for the current year and the projections for the following four years. Approximating the spending cap reference value as a measure of the changes in GDP over 10 years prevents the rule from giving rise to procyclical behaviour by public spending.

To arrive at the nominal potential GDP acting as a reference, the LEP opts to use the (actual or forecast) annual growth of the GDP deflator, with a maximum of 2%. This limit on the increase in the deflator adds a disciplining element to the future course of public spending, preventing very high increases in expenditure due to excessive price growth.

The rule further establishes that the permitted increase in spending should be adjusted for the estimated impact of the planned discretionary tax measures, so that when regulatory changes entailing permanent increases (reductions) in revenues are approved, the spending cap may increase (must fall) by the equivalent amount. This adjustment is fully justified in order to accommodate the growth in spending to developments in revenue and to prevent fiscal imbalances from arising owing to the approval, for example, of tax cuts not accompanied by equivalent reductions in spending. However, it should be borne in mind 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 ex post analyses and to accommodate the growth in spending to the potential slippage that may arise.

As regards the spending components subject to the cap, it has firstly been opted to exclude interest payments. This can be justified since this variable lies beyond the control of the tax authority, at least in the short term. Moreover, despite the fact that the rule is not applied to Social Security Funds, non-discretionary spending on unemployment benefits is also excluded. This exclusion will prevent a procyclical bias being generated in public spending derived from the application of the rule.[17] Finally, also excluded is the portion of expenditure financed with specifically earmarked funds from the European Union or from

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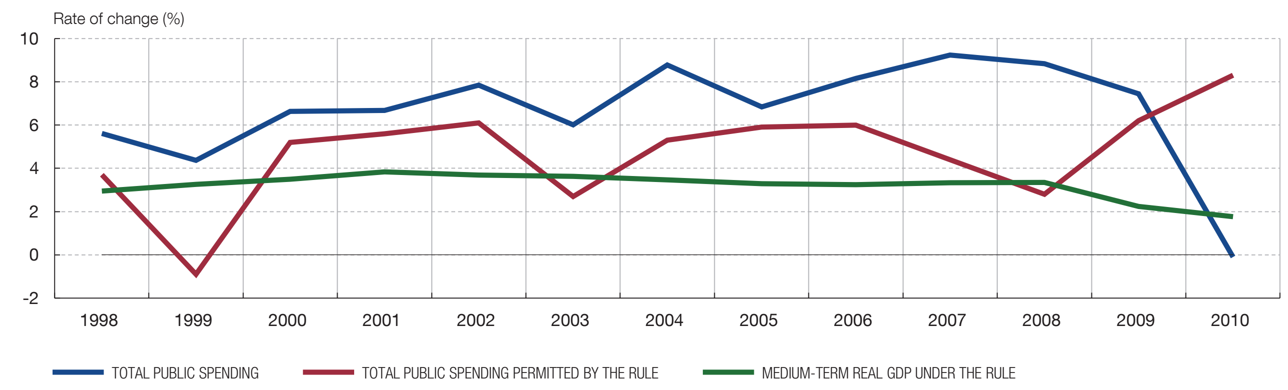
16 In particular, information should be reported quarterly to MHAP on public guarantees received and credit lines arranged, trade debt incurred, derivatives transactions and any other contingent liability.

17 For example, in an economic slowdown there would be an increase in unemployment benefit spending. If the rule were applied to this definition of spending, that would mean that, to ensure its fulfilment, other spending items would have to be adjusted to offset the growth of total spending above that set under the rule, giving rise to procyclical bias in spending.

PUBLIC SPENDING: ACTUAL AND PERMITTED BY THE RULE

CHART 4



SOURCE: Hernández de Cos (2011).

other public administrations and State transfers to the RG and LG linked to financing arrangements. The exclusion of these items, with the exception of transfers between general government sub-sectors, is equivalent to that incorporated into the 2011 SGP reform.[18]

The extension to the RG and LG of this rule, which did not exist under the previous legislation, is particularly important for achieving effective control over spending given the major responsibilities exercised by these governments in Spain. As regards Social Security Funds, their exclusion essentially entails leaving pension spending (in addition to the aforementioned unemployment benefits) out of the rule, which 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 determined by the parameters of the system and demographic developments, whereby it would be difficult to annually restrict its growth.

Chart 4 offers a counterfactual exercise of how the spending rule would have worked had it been applied in the past. As can be seen, its application in the period of expansion from 1999 to 2007 would have substantially restricted the permitted annual spending, such that significant room for manoeuvre could have been generated that would have restricted the deterioration in public finances from 2009. Moreover, the spending rule is a most useful complement to the structural deficit rule since, in periods of economic expansion marked, for instance, by an expansion in the real estate market, the habitual calculations of the structural balance identify the public revenues usually accompanying these episodes as a structural – as opposed to a purely cyclical – improvement. The spending rule allows, however, for the disciplining of the trend of this item at such times, facilitating the saving on extraordinary revenues.

The exceptions to the rules: the possibility of slippage in respect of the caps

Broadly, establishing exceptions to compliance with fiscal limits is understood to be desirable and can reinforce the credibility of their fulfilment, provided they are clearly defined. In this respect, the new Stability Law stipulates that the State and the regional governments may incur structural deficits and exceed the public debt caps in exceptional circumstances, such as natural disasters, serious economic recessions (defined in keeping with European regulations, and where, moreover, a real negative rate of change in GDP according to annual national accounts must be posted) or exceptional emergencies[19], approved

18 In the case of the SGP, the public investment considered for the assessment of the rule is allowed not to be the annual figure but a four-year average, in order to prevent the volatility of this variable, especially in small countries.

19 Exceptional emergency situations are understood as those beyond the control of the general government sectors and which considerably impair their financial position or their economic or social sustainability.

by an absolute majority in Parliament. Social Security Funds may post a structural deficit in accordance with the purposes and conditions of the Social Security Reserve Fund regulations[20], while LG must constantly maintain a balanced budget or run a surplus.

The definition of serious economic recession included in the law is somewhat more restrictive than that in the SGP, given that, as indicated, it requires that a real negative GDP growth rate be recorded.[21] Specifically, in the case of the SGP it is stipulated that deficits over 3% are not considered "excessive", provided that the failure to comply is of scant significance, temporary and due to exceptional circumstances. The latter include unusual circumstances over which the Member State has no control and which bear significantly on the financial position of the general government sectors, or a serious economic recession.[22] Following the reform of the SGP in 2005, the latter situation is defined as a negative annual real GDP growth rate or a cumulative loss in output over a prolonged period of very low real GDP growth in relation to potential growth. For its part, the TSCG retains the same escape clauses as the SGP, but in relation to the structural deficit target.

In the case of structural reforms with long-term budgetary effects, the LEP allows for an overall general government structural deficit of up to 0.4% of nominal GDP. The LEP defers to the European agreements for the definition of which structural reforms allow such slippage. In this case, the SGP also allows temporary slippage from the medium-term objectives if there are significant structural reforms with positive long-term budgetary effects[23], although the SGP places no limit on the scale of the slippage permitted; accordingly, the Organic Law is once again more restrictive.

Transition period

As indicated in the introduction, the LEP stipulates a transition period running from the entry into force of the law until 2020, the first year in which the aforementioned structural deficit and public debt caps will be applicable. During that period, the reduction in the structural deficit shall be at least 0.8% of GDP in annual average terms (with the distribution between State and RG based on the structural deficit percentages recorded as at 1 January 2012). The public debt ratio shall be reduced at the rate necessary to place it below 60% in 2020[24 25]. These limits shall not be applicable in exceptional situations. Further, the pace of reduction of public debt and of the structural deficit shall be reviewed in 2015 and 2018.

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20 In this latter case the maximum structural deficit allowed for CG shall be lessened by the amount equivalent to the Social Security deficit.

21 Regarding the definition of "serious economic recession", it should be clarified whether the annual GDP in question is the national output, in which case the clause will be uniformly and symmetrically activated for all the general government sectors concerned, or whether, conversely, the potential divergences between GDP for Spain as a whole and GDP for a particular RG may lead to an asymmetrical and non-uniform application of the escape clause. In this respect, while it is true on average that the presence of negative annual GDP rates of change at the national level are usually accompanied by rates of the same sign for each RG, this has not always been the case. In 2010, for example, the rate of change of real national GDP was -0.1%, while for six RGs the related rates were positive or zero. Positive changes in national GDP between 1990 and 1992 were accompanied by negative rates being posted by an average of three RGs per year, something similar to what happened in the 1982-1986 period, in which two RGs per annum on average posted negative rates as opposed to positive rates for real aggregate GDP.

22 It shall be considered temporary when the Commission's budgetary projections indicate that the deficit will be below the reference value at the end of the unusual circumstances or the serious economic recession.

23 The SGP refers explicitly to the case of pension reforms that entail introducing a system based on several pillars and that include an obligatory "fully funded" pillar.

24 The change in the annual non-financial spending by each tier of government may not exceed the real GDP growth rate of the Spanish economy. Moreover, whenever the real GDP growth rate exceeds 2% per annum or employment is generated with growth of at least 2% per annum, the public debt/GDP ratio would have to fall by at least 2 pp of GDP.

25 However, if in 2020 public debt does not exceed 60% of GDP, a particular tier of government may exceed its specific debt limit provided that it meets the structural deficit criteria. In any event, the related tier of government shall reduce its debt over the maximum period established by the SGP taking 2012 as the initial year (i.e. approximately 20 years).

It should further be borne in mind that, given that the budget deficit exceeds 3% at present and that Spain is subject to the SGP's Excessive Deficit Procedure, the Spanish authorities must also comply with the recommendations of the European Council associated with this Procedure, which set structural balance adjustments of a specific amount[26]. Subsequently, once the budget deficit stands below 3% of GDP, the SGP requirements also establish an approximation to the medium-term objective, defined as a structural balance close to zero, entailing a minimum adjustment of 0.5% of the structural deficit, which must exceed 0.5% if the debt is above 60%, as is the case of Spain at present. Lastly, regarding the approximation of the public debt/GDP ratio to 60%, the current SGP stipulates an annual pace of reduction of 1/20 on average over the last three years the deficit is excessive.

Conclusions

The new Budgetary Stability Law has marked a substantial step forward in updating the framework of budgetary rules applicable to Spanish general government conduct. It includes a significant set of institutional elements identified by the European Commission as "best practices" in terms of legal appropriateness (enshrinement in the Constitution), the setting of quantitative limits on the structural budget deficit, debt targets, a public spending rule, escape clauses set in the law, surveillance and control procedures for meeting objectives, transparency and explicit inclusion of the cross-government non-bailout principle.

In particular, the application of the Stability Law has already entailed an improvement in terms of the transparency of general government conduct, with the regular publication of the RG and LG budget outturns. This improvement is particularly significant given that the shortcomings in the availability of information on these tiers of government previously prevented budgetary slippage being detected in time and delayed the activation of mechanisms ensuring that objectives were met. As a result of the application of the Law, the information in both the State and RG budgets should be improved, so that the underlying assumptions for the revenue and expenditure projections may be known and that information is at hand on these items in National Accounts terms, which is the relevant definition for the existing fiscal rules. In this respect, a single document offering a detailed view of the overall general government budgetary projections for the following year and their compatibility with the objectives set might be useful before the end of each year.

The Stability Law also includes new coercive instruments to ensure compliance with budgetary objectives by all levels of government. These include the possibility of establishing sanctions, the automatic adjustment of RG spending in specific cases of non-compliance and also the imposing of adjustment measures by CG , which RG and LG are bound to observe. These new legal mechanisms may prove most effective for ensuring discipline if rigorously applied and if the appropriate procedures for overseeing the budgetary outturn during the year are set in place.

The LEP establishes a transitory period, running to 2020, in order to gradually reduce the deficit and debt from their current levels and place them below the limits set for that year. During this period minimum requirements in respect of fiscal adjustments are mandatory and, along with the European Council's recommendations in the context of the Stability and Growth Pact, these will govern the pursuit of budgetary policy over the coming years. Fulfilment of the foregoing requirements will, indeed, call for a most significant and prolonged

26 For example, the European Council's Recommendations to Spain on 9 July 2012 aimed at bringing the excessive deficit situation to an end (ECOFIN 12171/12), the latest recommendations available at the time of this article going to press, established the need for an improvement in the structural balance of 2.5% of GDP in 2013 and of 1.9% of GDP in 2014.

fiscal drive in quantitative terms. In this connection it would be useful to set in place a medium-term budgetary programme containing projections for the various public revenue and spending items, based on a prudent macroeconomic scenario, and in which the various measures – and the quantification of their impact – are detailed, enabling the fiscal adjustment to be seen through under the terms laid down in the LEP and the SGP. This type of budgetary planning could be conducive to the credibility of the fiscal consolidation process, anchoring agents' expectations and providing for a far-reaching review of the different spending programmes and of the tax system in all levels of general government.

Finally, it should be recalled that the Government has announced an additional reinforcement of the national budgetary framework with the creation of an independent fiscal institution which, though still pending approval, will be tasked with fiscal policy analysis, advisory and monitoring functions to ensure government compliance with the principle of budgetary stability, and the evaluation of economic forecasts. Such institutions have proven useful in peer countries and could play a key role in entrenching the credibility of budgetary policy in Spain. For this, it is vital that the institution is given a degree of independence, effective responsibilities and resources in keeping with best international practices.

12.4.2013.

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