The last decade has been marked by a process of general government deficit reduction in Spain, from the peak of 11% of GDP in 2009 to 3.1% in 2017. In parallel, general government debt also began to decline slightly, in step with the economic recovery, from 2014 when the debt-to-GDP ratio peaked at 100.4%, compared with 98.3% in 2017.[1] Maintaining healthy public finances is indispensable for macroeconomic stability and the correct provision of public services, as it provides, in particular, room for manoeuvre for fiscal policy in the event of adverse shocks and reduces the vulnerability to possible changes in investor sentiment in the markets.

In this setting, on official estimates, the budgets and plans of the different general government sectors for 2018 combined should give rise to a further reduction in budgetary imbalances this year. Specifically, the official budget deficit target is 2.2% of GDP, which would be an improvement of 0.9 pp, mainly reflecting a decline in the public expenditure-to-GDP ratio. In turn, the official general government debt forecast has been set at 97% of GDP, which if met would be a decrease of 1.3 pp in public indebtedness. In this scenario, the budget deficit would fall below 3% of GDP, which is the limit set by the Stability and Growth Pact (SGP) for exiting the excessive deficit procedure, the deadline for which, in the case of the Spanish general government sector, is precisely this year.[2]

According to the 2018-2021 Stability Programme Update (SPU), sent to the European Commission at the end of April within the framework of the European Semester, the general government structural deficit is expected to improve only marginally in 2018, by 0.1 pp, remaining above 2%.[3] In consequence, there would be no progress this year in the necessary process to achieve a structural improvement in public finances, in a setting in which, according to the SPU, the Spanish economy's output gap would be positive for the first time since 2008.

The practically neutral stance of fiscal policy in 2018, according to SPU estimates,[4] is determined by a series of budgetary measures raising public expenditure and introducing tax cuts that are included in the Budget for the State and the Social Security system for 2018, countering the broadly moderate expenditure stance under other headings. In comparative terms, the more expansionary legislative measures include, in particular, those relating to pensions, employment and public sector wages, and personal income tax, all of which are discussed in detail below.

In the case of pensions, the 2018 Budget establishes an across-the-board increase of 1.6% (both for 2018 and 2019), an increase of 3% for minimum and non-contributory pensions in 2018, and an increase in the regulatory base of widow(er)s' pensions from 52% to 56% in 2018 and from 56% to 60% in 2019 (see Chart 1). These measures combined will raise general government expenditure by an estimated 0.2 pp of GDP, approximately, in 2018, and by a further 0.2 pp in 2019, in respect of the revaluation of 0.25% resulting from application of the Revaluation Index. Moreover, the 2018 Budget defers until 2023 application of the Sustainability Factor, initially set for 2019. Both these automatic mechanisms – the Revaluation Index and the Sustainability Factor – were approved by Law 23/2013, which came into force in January 2014, aiming to ensure the long-term sustainability of the pension system. Thus the Revaluation Index, applied between 2014 and 2017, links annual pension growth to the relative change in the system's expenses and revenue, while the Sustainability Factor adjusts starting pension for new pensioners taking into account their life expectancy at the time. According to the SPU, this higher expenditure is to be countered in part by introducing a new tax on digital services, as yet undefined.

Regarding public sector wages, the 2018 Budget reflects the agreement between the government and the main public sector unions signed in March 2018 for the period 2018-2020,[5] with wage increases of more than the 1% applied in 2017. Specifically, under the agreement signed, wage rises would comprise fixed increases of 1.5%, 2.25% and 2%, in 2018, 2019 and 2020, respectively, and additional increases tied to GDP growth and to compliance with the stability target in 2020 (see Chart 2).[6] Additional funding was also agreed (of 0.4%, 0.25% and 0.3% of total gross wages in each of the respective years) to cover, inter alia, equal pay for members of certain professional corps and contributions to pension schemes.[7] The agreement also includes a relaxation of the public sector hiring policy of the last two years, increasing the replacement rate in certain sectors (raising it, in total, by some 10 pp, to 90%),[8] together with additional measures relating to working hours and temporary employment.

1 See M. Delgado, B. García and L. Zubimendi (2018), "Developments in public debt in Spain in 2017", Economic Notes, 7 June, Banco de España.

2 The Spanish general government sector has been subject to an Excessive Deficit Procedure since 2009, under the corrective arm of the SGP, with a 2018 deadline. In August 2016 the Council of the European Union updated the deficit target for the Spanish general government sector for 2018, setting it at 2.2% of GDP. It also established that the sector would have to make a structural effort (that is, an improvement in the structural balance) in the period 2016-2018 of 0.6 pp of GDP in cumulative terms.

3 On other estimates, it would be considerably higher than 2%. Thus, for example, according to the European Commission's May forecasts, the structural deficit would be 3.3%.

4 According to the European Commission's May forecasts, the fiscal policy stance in 2018 would be slightly expansionary.

5 See II Acuerdo Gobierno-Sindicatos para la mejora del empleo público y las condiciones de trabajo (available only in Spanish).

6 Specifically, wages would rise, with effect as at 1 July of each year, by an additional 0.25%, 0.25% and 1%, in 2018, 2019 and 2020, respectively, in the event that GDP growth in the previous year amounted to at least 3.1%, 2.5% and 2.5%, respectively. In addition, if the general government public deficit target of 0.5% of GDP in 2020 was met, wages would rise by an additional 0.55% in that year.

7 In 2018, this includes both the 0.2% envisaged in the agreement signed in March with the unions and the additional equivalent increase included in the Budget to place the wages of law enforcement officers on an equal footing.

8 The agreement sets the replacement rate at 100% for all sectors if the stability targets are met, providing for an additional increase of up to 8% (10% for local government) in some cases. If the targets are not met, the rate is 100% for priority sectors and 75% for the remainder, with the additional possibility of a 5% increase for certain sectors. Moreover, in the case of local governments that have had to provide more services in any year of the period 2013-2017, the replacement rate may be raised by a further 5%. Lastly, the replacement rate is set at 115% for law enforcement officers.

Chart 1
GROWTH IN CONTRIBUTORY PENSIONS (a)

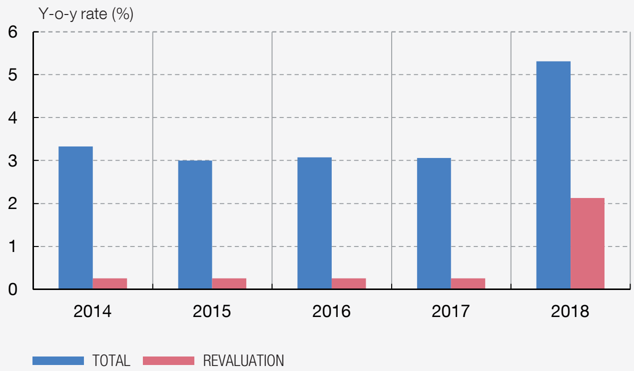


Chart 2
AGREED PUBLIC SECTOR WAGE RISE (b)

Chart 3
REDUCTION FOR EMPLOYMENT INCOME IN PERSONAL INCOME TAX (d)

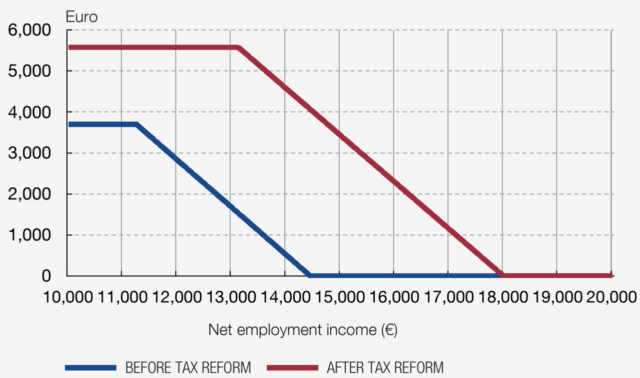


Chart 4
SPANISH GENERAL GOVERNMENT DEBT

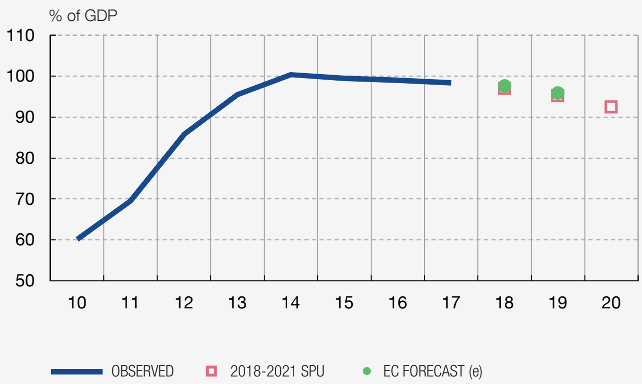


Chart 5
SPANISH GENERAL GOVERNMENT NET LENDING/NET BORROWING

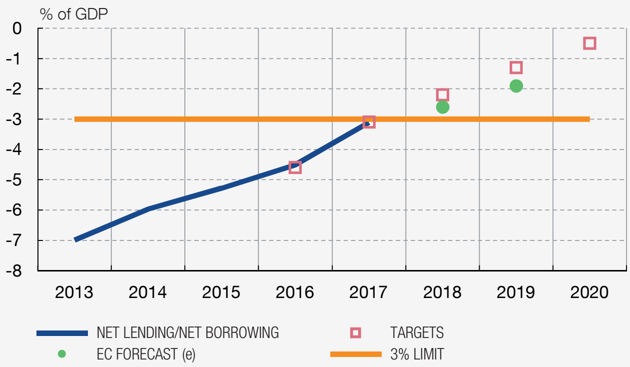
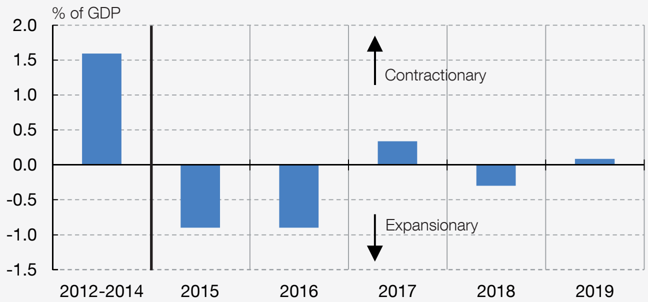


Chart 6
FISCAL POLICY STANCE IN SPAIN (e) (f)



SOURCES: European Commission, IGAE, State Budget for 2018, SPU 2018-2021 and Banco de España.

- **a** In 2018, own estimate drawing on 2018 Budget and 2018-2021 SPU data.
- **b** Includes additional funds for equal pay measures and other expenses.
- **c** Already includes the 2018 rise conditional on GDP growth in 2017, as this was equal to the minimum required (3.1%).
- **d** The chart depicts the reduction in the personal income tax base for each level of taxpayer net employment income. The maximum reduction increases from €3,700 to €5,575, and becomes zero for net income of €18,000, compared with €14,450 before the tax reform.
- **e** Commission spring forecasts, which do not take into account the across-the-board increase in pensions in 2018 and 2019, agreed subsequently. For 2018, the EC estimates an impact of the additional increase of 0.1 pp of GDP.
- **f** Change in the structural balance (cyclically-adjusted) estimated using EC methodology.

Lastly, the Budget also makes changes to the Personal Income Tax Law, raising the tax allowance (the amount a person is entitled to earn before paying income tax) from €12,000 to €14,000 gross, significantly increasing the reduction for employment income under €18,000 (see Chart 3). It also introduces new tax credits for childcare (nursery) costs and for a disabled spouse, and extends existing tax credits for large families. The government estimates that these measures will have a cost in terms of revenue verging on 0.2 pp of GDP between 2018 and 2019.[9]

If Spain is to comply with the general government deficit target of 2.2% of GDP in 2018, an extremely strict expenditure outturn will be needed, and also materialisation of the increase in public revenue projected in the Budget. In this respect, any departure from these conditions poses a risk of noncompliance. In particular, the European Commission, in its opinion on the Budget published on 23 May,[10] expects the Spanish budget deficit to amount to 2.7% in 2018, 0.5 pp above the 2.2% target (see Chart 5).[11] In the view of the Commission, this decline in the general government deficit would be fully attributable to the impact of economic growth, since in its opinion the budgetary measures adopted would give rise to an increase in the structural deficit of around 0.3 pp of GDP (see Chart 6). However, despite this departure from target, the Commission believes that the revised budgets are broadly compliant with the SGP, since in accordance with its forecasts, the excessive deficit will be corrected in a timely manner (that is, in 2018).

If Spain does in effect exit the excessive deficit procedure this year, it would become subject to the preventive arm of the SGP and should continue to make progress in the process of improving public finances. In this respect, the Commission recommendation for a Council Recommendation of 23 May 2018 asks the Spanish government to ensure that net primary public expenditure growth does not exceed 0.6% in 2019, corresponding to a structural adjustment of 0.65 pp of GDP, in view of the Commission's macroeconomic forecast. In turn, in accordance with the public debt rule whereby public debt should fall, each year, by a twentieth of the difference between the level that year and the 60% of GDP target level, the public debt-to-GDP ratio should decrease by 1.9 pp this year.

9 The effects of these tax measures on the income of different groups of taxpayers are simulated in Box 6.

10 Commission Opinion of 23.5.2018 on the updated Draft Budgetary Plan of Spain.

11 The Commission 2018 spring forecast pointed to a deficit of 2.6% of GDP in 2018, not taking into account the impact of the across-the-board increase of 1.6% in pensions that was approved subsequently. The estimated impact of this measure would be a further 0.1% of GDP. Similarly, the Banco de España's latest projections, published on 15 June, forecast a deficit of 2.7% of GDP in 2018.