2 THE FISCAL OUTLOOK FOR SPAIN AFTER THE CRISIS

1 Introduction

In 2010 the euro area sovereign debt crisis was the fundamental economic event, centred on some of the peripheral countries

The euro area sovereign debt crisis, which was the main source of concern regarding macroeconomic policy implementation in the area, was the outcome of a series of closely interlinked factors. The financial crisis had seen uncertainty and nervousness surge, restricting the channels of funding for the countries that had recently increased their level of debt. Further, there was a generalised deterioration in fiscal positions in most countries, giving rise to an unprecedented increase in public-sector short-term net borrowing. Against a background of financial instability, this prompted greater investor sensitivity to the source of the fiscal imbalances that had built up. As a result, these imbalances began to be viewed as potentially unsustainable in some countries (see Chart 2.1).

These factors were shared by other economies, such as the United States, the United Kingdom and Japan, but the crisis became particularly virulent in the euro area. The shortcomings in euro area governance proved particularly problematic in light of the macroeconomic and fiscal divergences that had arisen, which heightened uncertainty and the lack of confidence in the countries with the biggest imbalances. Moreover, the high financial integration among the euro area countries may have been conducive to the markets perceiving cross-country contagion as a possibility.

The sovereign debt crisis began in Greece and subsequently spread to Ireland and Portugal. Other countries were also affected by the contagion, as a result – to differing degrees in each case – of doubts over their growth prospects, uncertainty about the costs of restructuring their banking systems and the swift rise seen in their budget deficits and public debt, as described in Chapters 1 and 4 of this Report.

The seriousness of the situation requires a resolute economic policy response on several fronts

The first pre-requisite for overcoming the euro area sovereign crisis is the follow-through of a fiscal consolidation process, embarked upon already in some countries in 2010, that leads to firm foundations being set in place to reduce the deficit and control debt in the medium and long run, and to the entrenchment of the macroeconomic stability needed to promote economic growth. Equally important for dispelling market doubts is the application of structural reforms that help provide for the recovery in potential growth and the conclusion of the restructuring of financial systems. But such action will not suffice if, as well, the euro area's governance shortcomings that have emerged virulently as the sovereign debt crisis has unfolded are not redressed.

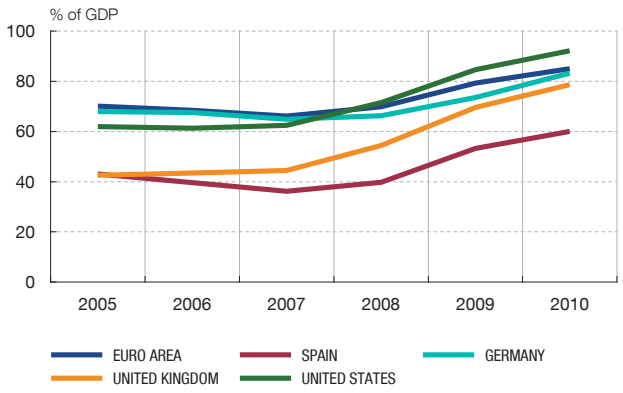
This chapter focuses singularly on analysing the fiscal consolidation challenges that the sovereign debt crisis has posed for Spanish economic policy.[1] First, changes in the fiscal position during the crisis in Spain are described. These illustrate how, despite the surpluses in the previous phase, the fiscal space available to pursue expansionary fiscal policies was limited, and they also reveal the essentially structural nature of the fiscal imbalance built up. Next, debt dynamics are analysed, highlighting the role that economic growth potential and the cost of financing play in the sustainability of public finances. That primarily helps clarify why the swift increase in the fiscal deficit resulted in strong debt market tensions, and, secondly, it allows conclusions to be drawn on how the fiscal adjust-

1 With reference to Spain, the recovery in potential growth was the central theme of Chapter 2 in the 2009 *Annual Report*. Resolving the shortcomings of policy coordination in the euro area and the financial system restructuring process are addressed in other chapters in this report.

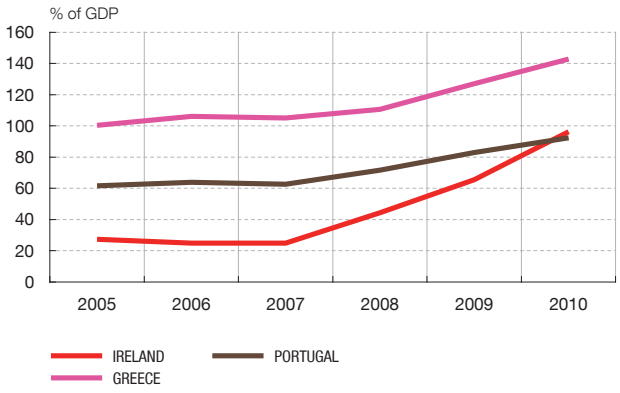
BUDGET BALANCES AND PUBLIC DEBT COMPARED ACROSS DIFFERENT DEVELOPED COUNTRIES

CHART 2.1

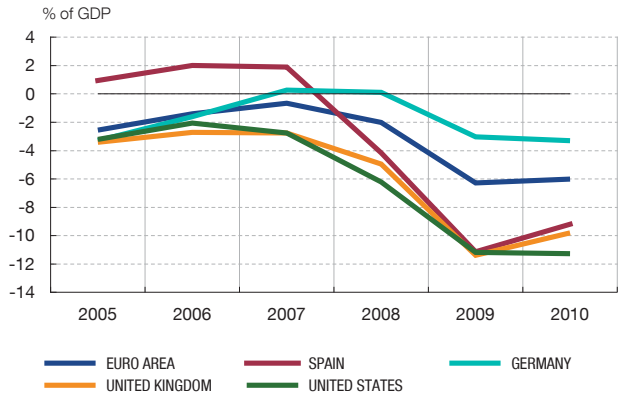
PUBLIC DEBT



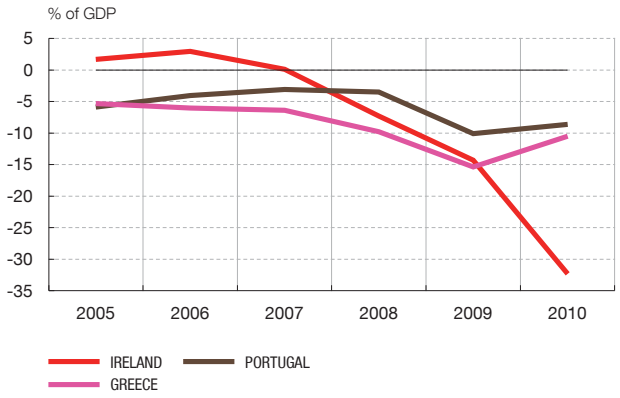
PUBLIC DEBT



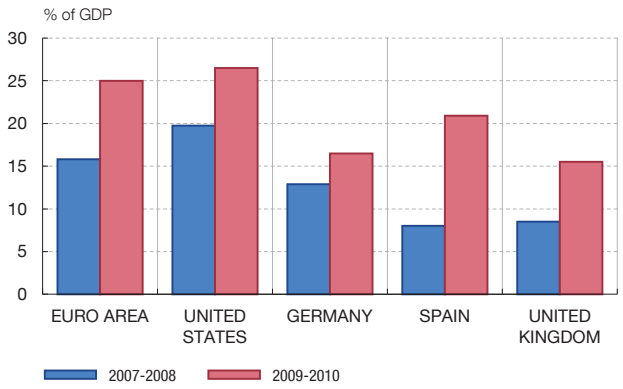
BUDGET DEFICIT (-)/SURPLUS (+)



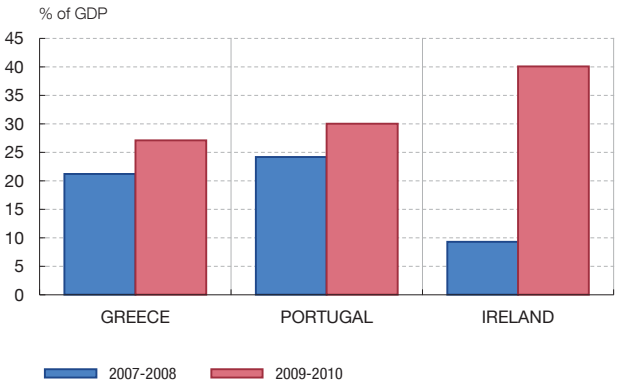
BUDGET DEFICIT (-)/SURPLUS (+)



GENERAL GOVERNMENT NET BORROWING (a)



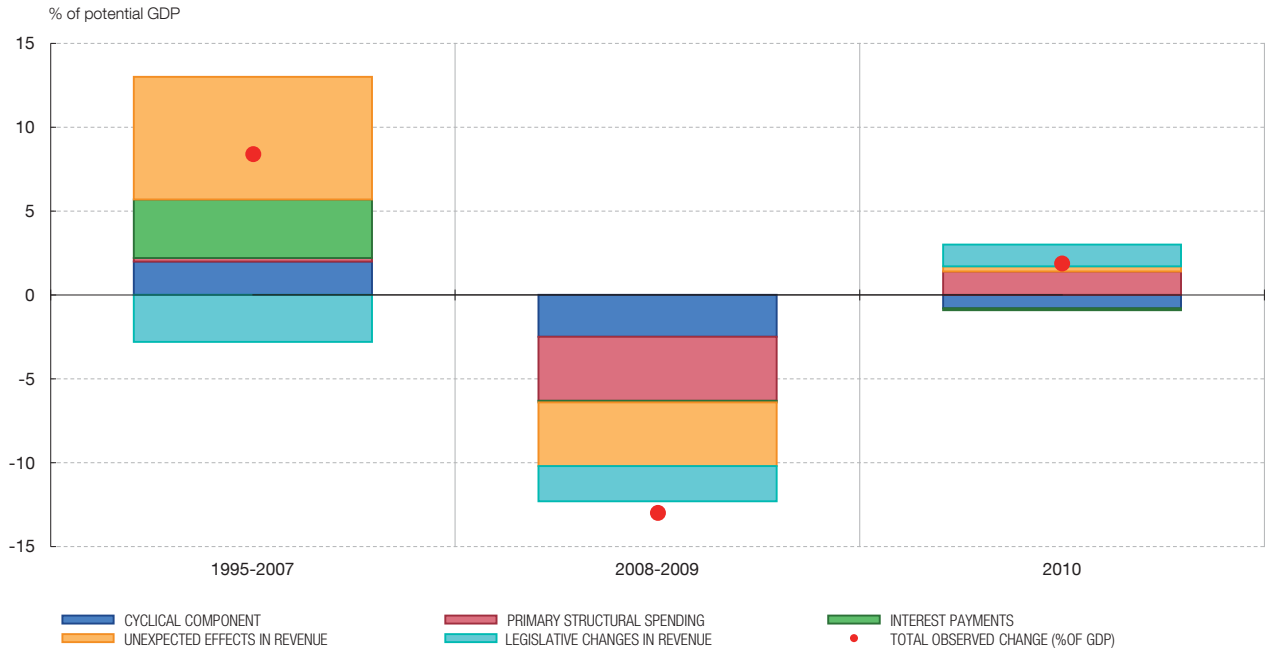
GENERAL GOVERNMENT NET BORROWING (a)



SOURCES: European Commission, IMF and Banco de España.

a Net borrowing corresponds to the sum of the budget deficit plus adjustments between the deficit and the change in debt plus debt repayment.

DETERMINANTS OF CHANGES IN THE SPANISH GENERAL GOVERNMENT BALANCE (CUMULATIVE PERCENTAGES OF GDP) CHART 2.2



SOURCES: INE and Banco de España.

ment must be in terms of magnitude, timing and interaction with other policies. Finally, the changes that should be made to the institutional framework and to public spending and revenue policies to ensure that the fiscal adjustment is successful are detailed.

2 The causes of the fiscal deterioration

At the start of the crisis the fiscal situation was favourable, albeit thanks to extraordinary revenue and worrying expenditure dynamics...

In late 2007 Spain had a fiscal surplus of close to 2% and a public debt/GDP ratio of 36%, compared with –0.7% and 66%, respectively, in the euro area as a whole (see Chart 2.1). However, beneath this healthy position lay some worrying public revenue and spending dynamics. Indeed, of the total reduction in the deficit recorded between 1995 and 2007 (8.4 pp of GDP), almost 5 pp are attributable to the business cycle and to the decline in the interest burden, associated above all with the reduction in interest rates. The rest of the adjustment was due to an exceptional increase in tax revenue – with a significant temporary component – linked largely to the excessive real estate expansion, which more than offset the reduction in revenue of approximately 3 pp of GDP arising from discretionary changes in the tax system (see Chart 2.2).[2]

Primary public expenditure (excluding interest payments on public debt), net of unemployment benefits, grew at an annual rate of more than 7%, above trend economic growth. That confirms its procyclical behaviour, something common also to other developed countries.[3] Of note was the growth of spending managed by regional and local government, which at no point in the expansionary phase attained a balanced budget, despite the high increases in tax revenue. Deficiencies in the budgetary framework contributed to this, a matter which is dealt with in greater detail in section 4.

2 See F. de Castro, Á. Estrada, P. Hernández de Cos and F. Martí (2008), "Una aproximación al componente transitorio del saldo público en España", *Boletín Económico,* June, Banco de España.

3 See P. R. Lane, (2003), "The cyclical behaviour of fiscal policy: evidence from the OECD", *Journal of Public Economics,* 87, pp. 2661-2675, and A. Lamo, J. J. Pérez and L. Schuknecht (2007), *The cyclicality of consumption, wages and employment of the public sector in the euro area,* Working Paper No. 757, European Central Bank.

... whereupon the crisis prompted a rapid deterioration in the budget deficit and revealed the size of its structural component

The crisis revealed the latent risks in the public finances situation and highlighted the little leeway available to pursue countercyclical policies. During the economic crisis, the budget deficit rose by more than 13 pp to a peak of 11.1% of GDP at end-2009 (see Chart 2.1). Contributing to the deterioration from 2007 to 2009 was the adverse trend of the business cycle by around 2.5 pp of GDP, whereas close to 4 pp of GDP were associated with the disappearance during the crisis of the extraordinary revenue previously raised (see Chart 2.2). in addition, the measures applied in an attempt to alleviate the effects of the crisis amounted to 3.3 pp of GDP, although more than half of this effect was of a temporary nature. The rest of the increase in the deficit arises from trend growth in expenditure outpacing that of the economy. The rise in the deficit would, therefore, have an eminently structural component, meaning that the cyclically adjusted deficit exceeded 10% of GDP in 2009 and stood at 8.3% of GDP in 2010.

Public debt amounted to 60.1% of GDP in 2010, almost 24 pp above its level in 2007, but still more than 20 pp below the average for the euro area. This increase in debt arose, above all, as a result of the rise in the budget deficit. The impact of the aid to the financial sector, which exceeded 5 pp of GDP in the euro area between 2008 and 2010, amounted to around only 2 pp of GDP in Spain's case.

Compounding the fiscal deterioration were doubts over the growth capacity of our economy and over the cost of restructuring the financial system

In addition to the contagion generated by the Greek and Irish crises and to the worsening fiscal situation in our country, other idiosyncratic factors played a crucial role in spreading the sovereign debt crisis to Spain. Specifically, along with the adverse effects of the economic crisis on the Spanish economy's level of potential output, according to various estimates the growth of this variable in the medium term is also expected to fall by somewhat more than 1 pp, dipping from 3% to a rate below 2%.[4] On the evidence available, this factor is estimated to have played a relevant role in the widening of Spain's spreads.[5] Market doubts also influenced the situation of the financial system, which in other countries had acted as an exacerbating factor of the fiscal situation, in such a way that the strong interrelatedness of macroeconomic, fiscal and financial problems has been particularly significant during the current crisis.

3 The scale of the fiscal adjustment

The fiscal adjustment needed is considerable...

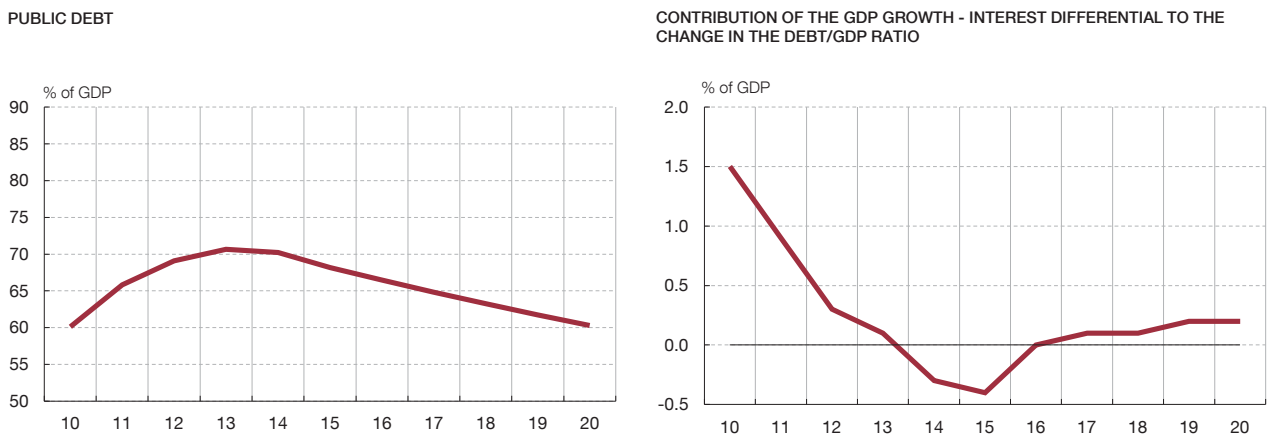
The macroeconomic effects of fiscal policy depend closely on expectations about the stability of the public debt/GDP ratio. The dynamics of this ratio hinge, in turn, on both the fiscal position, measured by the primary fiscal deficit as a percentage of GDP (the public deficit, excluding the interest on public debt), and on macroeconomic developments, via the impact of the nominal interest rate and the nominal GDP growth rate. The level to which the debt ratio tends is given, in short, by the ratio of the primary deficit, in units of GDP, to the difference between the growth rate of nominal GDP and the nominal interest rate. By way of example, this means that, with a nominal growth rate of 4% and nominal interest rate of 3%, it would be necessary to permanently reduce the primary deficit to 0.6% of GDP to stabilise the debt ratio at 60%.

Chart 2.3 plots the course of the public debt/GDP ratio over the coming years under specific assumptions of budget deficit, interest rates and growth rate. Specifically, on the estimates available, the structural fiscal deficit stood at around 8% at end-2010.

4 See P. Hernández de Cos, M. Izquierdo and A. Urtasun (2011), *Una estimación del crecimiento potencial de la economía española*, mimeo.

5 See V. Echevarría, L. Fernández-Caballero and J. J. Pérez (2011), A *note on the role of expectations on growth, public deficit and public debt in the determination of sovereign bond spreads: two case studies,* mimeo, Banco de España.

MEDIUM-TERM SCENARIO FOR THE SPANISH PUBLIC DEBT/GDP RATIO (a) CHART 2.3



SOURCE: Banco de España.

a Based on official forecasts of the budget deficit to 2013 (–3 % of GDP that year), assuming that a balanced budget is achieved in 2015, holding unchanged to 2020. Nominal GDP growth and the implied interest rate on debt are the same as those set out in the Banco de España Economic Projections Report to 2012 (3.2% and 3.3%, respectively, in that year) and, subsequently, a progressive increase is assumed in both variables to around 4% in 2015, which holds unchanged thereafter (the right-hand panel of the chart depicts the contribution of the difference between these two variables to the change in the debt ratio as a percentage of GDP). Finally, deficit-debt adjustments hold throughout the period at around 1% of GDP, similar to the average for recent years.

With this starting point and the growth scenario to 2012 included in the Banco de España Projections Report[6], if the output gap is assumed to close in 2015, the stabilising of public debt at around 70% of GDP that year would require an adjustment in the cyclically adjusted primary balance of more than 8 pp of GDP between 2010 and 2015, which is what is simulated in Chart 2.3. That would require strict compliance with the commitments undertaken to reduce the budget deficit to 2013 and, subsequently, a further reduction, until attaining a balanced budget. Given the budget outturn figures for 2010, almost half of this adjustment would have to be made by regional and local government.

Compliance with European commitments will further require resuming at a later date a level of public debt below 60% of GDP. Under the assumption of a zero contribution to the change in debt of the differential between GDP growth and the implicit interest rate on debt[7], attaining a public debt/GDP ratio of 60% in 2020 would mean that, after achieving a balanced budget, for example in 2015, it would be necessary to run a primary surplus of around 2.5% of GDP to 2020 (Chart 2.3).

... and would be even greater under harsher scenarios

If interest rates were higher or economic growth lower, the fiscal adjustment needed would be even greater. Specifically, if the growth rate were 1 pp lower throughout the period 2011-2020 and there were no additional fiscal adjustment, the rate of public indebtedness in 2015 would be 10 pp higher and amount to 85% of GDP in 2020. In this scenario, the adjustment of the average structural balance between 2010 and 2020 to place public debt at 60% in 2020 would be 1.7 pp of GDP[8], compared with around 0.8 pp in the scenario considered in Chart 2.3. and this without having regard to the effort needed to withstand the impact of population ageing on public finances.

6 Published in the Banco de España April 2011 *Economic Bullletin*.

7 By way of reference, the difference between GDP growth and the implied interest rate on debt in the period 2000-2010 provided for an annual average reduction in the debt/GDP ratio of around 0.5 pp of GDP.

8 This is a mechanical calculation that does not take into account the potential interaction between those variables subject to the simulation that remain exogenous.

It is also important to bear in mind that interest rates and the potential growth of the economy depend on debt dynamics. In particular, the higher the level of debt and its attendant growth rate, the higher the interest rate at which such debt will have to be financed and the lower potential growth will be. The estimates available[9] show that an increase of 10 pp of GDP in the debt ratio gives rise to an increase of 50 bp in long-term interest rates and a reduction in real per capita GDP growth of 0.15 pp per year.[10] These effects may, moreover, be greater if specific levels of debt are exceeded. A sharp reduction in the budget deficit and the stabilising of debt would therefore have a significant effect on the interest rates on debt and long-term growth, facilitating their sustainability.

In certain circumstances, the contractionary effects that the fiscal adjustment may exert in the short run can be mitigated

In the short run, the impact of the budget deficit on the growth rate depends on a very broad set of conditions, such as its composition, the starting levels of debt, the behaviour of monetary policy and the exchange rate regime.[11] A high budget deficit is not always a stimulus to economic activity; indeed, it may prove contractionary if it gives rise to an increase in expectations about future interest rates, which is more likely the greater the debt ratio. And the habitually contractionary effects of a reduction in the deficit may be mitigated if the consolidation manages to improve confidence and, therefore, to boost private consumption and investment, which appears to be more likely in the case of fiscal consolidations undertaken at the end of a recession and by means of cuts in government consumption.[12]

Consequently, a timely and well-designed fiscal adjustment may improve growth expectations, contributing, given a specific primary deficit, to the swifter stabilisation of public debt at a less high level. For example, a primary deficit sustained over the long run at 1.2% of GDP would be compatible with a debt ratio of 60% if the difference between the growth rate and the interest rate were 2 pp.

For this to be so, it is crucial that most of the adjustment should be brought forward in time...

Given the variables that influence public debt dynamics, the fiscal adjustment strategy should take into account not only the course of economic activity and the size of the fiscal multipliers, but also the costs of delaying consolidation in terms of risks to credibility and the impact on interest rates and agents' confidence.

Indeed, although the sluggishness of the recovery may have worked in favour of a gradual consolidation strategy, the extreme tension conveyed to the debt markets (see Chart 2.4) made it vital to bring forward the fiscal adjustment by as much as possible, to gain credibility and to reduce the financing costs of public and private debt alike, given the high correlation between the cost of both.

... and focus on public spending

As regards its composition, the fiscal adjustment may be made through various combinations of tax changes and public spending cuts, with different effects not only of a macroeconomic nature in the short run, but also in terms of likelihood of success. Further, the presence of factors that delay and hamper the recovery and long-term growth means that it is most important that the composition of the adjustment should be as conducive as possible to growth.

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9 See International Monetary Fund, *Fiscal Monitor*, May 2010 and November 2009.

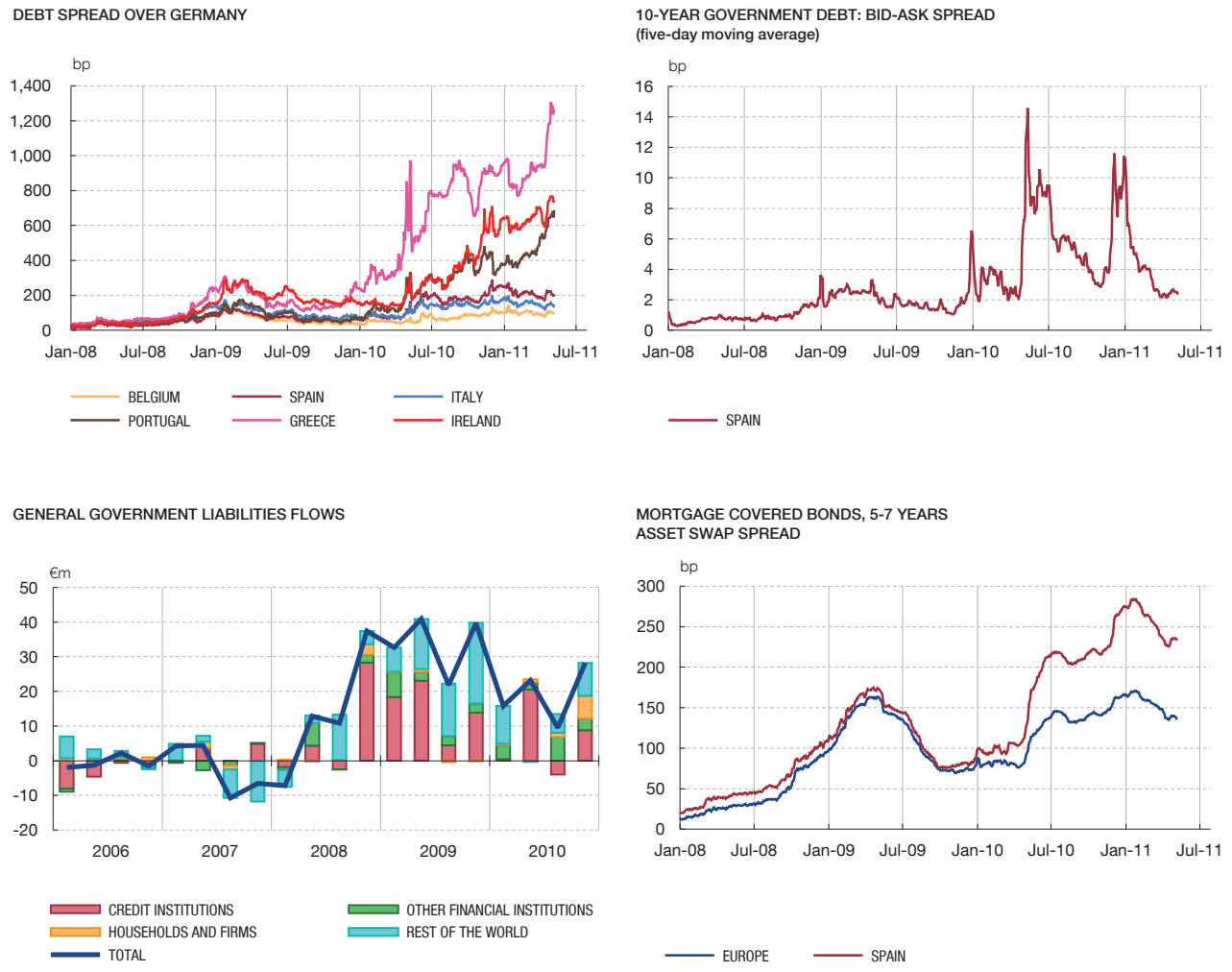
10 See C. Reinhart and K. Rogoff (2009), "The Aftermath of Financial Crises", *American Economic Review,* 99 (2), pp. 466-472.

11 For an overview of these results, see Chapter 3 of the International Monetary Fund (2010), *World Economic Outlook*, October.

12 See P. Hernández de Cos and E. Moral Benito (2011), *Endogenous Fiscal Consolidations*, Working Paper no. 1102, Banco de España.

DEBT MARKET ISSUANCE VOLUME AND PRICE TENSIONS

CHART 2.4



SOURCES: Banco de España and Reuters.

In this respect, the outcome of simulations of different fiscal adjustment strategies based on a calibrated macroeconomic model for the Spanish economy are illustrative (see Table 2.1)[13]. These should not, however, be interpreted as normative proposals, since the adjustment measures needed are contingent upon the nature of the problems of each conjunctural situation. The specific recommendations for the fiscal adjustment strategy in the current circumstances of the Spanish economy are addressed in subsequent sections of this chapter. According to the simulation exercises, a fiscal adjustment based on cuts in public investment would, in principle, exert negative effects on growth in the long run if the plans incorporated capital productivity similar to that observed in recent decades. In the present situation, however, it should be borne in mind that the return on public investments in infrastructure may have been drastically cut, following the period of sharp growth in recent years. In any event, it is the reduction in public-sector employees' compensation (wages and public-sector employment) that has greater positive effects on GDP in the long term, which are also positive in the short term in the case of wages, provided that the public sector wage adjustment passes through to the private sector. On the revenue side, indirect tax, although it has very limited negative effects in the short term, positively affects both

13 For a more detailed analysis of these results, see P. Hernández de Cos and C. Thomas (2011), *Los efectos de la consolidación fiscal sobre el crecimiento a partir de un modelo macroeconométrico,* mimeo.

SIMULATIONS OF THE IMPACT OF PERMANENT ADJUSTMENTS IN REVENUE AND EXPENDITURE ON GDP AND EMPLOYMENT

TABLE 2.1

		Year 1 (b)		Year 4 (b)		Long term (b) (c)		
	Initial change in the instrument	GDP	Employment	GDP	Employment	GDP	Employment	Taxes on wages pp.
REVENUE								
Taxes on consumption	1.75 pp	-0.1	-0.1	0.0	-0.1	0.7	0.8	-3.5
Taxes on wages	2.18 pp	-0.1	-0.2	-0.3	-0.5	0.1	0.1	-0.6
Corporate income tax	11.83 pp	-0.3	-0.4	-0.7	-0.3	-2.6	-0.4	-2.1
EXPENDITURE								
Net purchases	-13.2	-0.6	-0.9	-0.3	-0.3	0.2	0.5	-3.2
Public investment	-28.2	-0.6	-0.9	-0.4	-0.4	-0.7	0.1	-2.5
Public wages	-13.5	0.4	0.7	1.8	2.5	3.8	4.2	-7.2
Public employment	-13.5	-0.4	-0.7	-0.3	-1.0	1.1	0.2	-4.0

SOURCES: Banco de España, FiMod model simulation (Stähler, Nikolai and Thomas, Carlos, 2011, "FiMod – A DSGE Model for Fiscal Policy Simulations", Banco de España Working Paper No. 1110).

a Each change entails an initial improvement of 1 pp in the general government primary surplus.
b All variables expressed as a percentage change relative to the base scenario, except where a different notation is indicated.
c In the long run, it is assumed the fiscal authority uses the saving on interest payments on public debt brought about through the initial fiscal consolidation to reduce taxes on wage income.

GDP and employment in the long run if the rise in such tax allows a reduction in other less efficient taxes.

The evidence suggests an association between the course of public revenue and public spending and that a larger public sector gives rise to a greater deficit bias[14]; accordingly, public spending cuts are more readily sustainable over time and allow the deficit to be reduced to a greater extent and more permanently than commensurate increases in revenue. Taking a longer view, it is also desirable that the fiscal adjustment should be compatible with a restructuring of public finances in which those items with positive effects on productivity and potential growth, such as spending on education and R+D+I, gain in weight as a proportion of total public spending.

This consolidation strategy is particularly appropriate if the additional consequences of EMU membership are taken into account

Membership of a monetary union attributes a more active stabilising role to fiscal policy, insofar as monetary policy is geared to price stability in the area as a whole. But, as clearly highlighted during the crisis, for it to play this role it is necessary to have an extensive fiscal buffer, building up surpluses during cyclical upturns and reducing the public debt/GDP ratio significantly. From this perspective, fiscal consolidation is also very important for gaining room for manoeuvre in the face of potential future shocks. The new framework for the working of the European Monetary Union, in which the mechanisms for the surveillance and correction of fiscal imbalances will take on greater importance, makes the reinforcement of fiscal discipline necessary.

The fiscal adjustment strategy defined by the government is, broadly, in line with these criteria

In accordance with the latest Stability Programme Update for Spain unveiled on 29 April 2011, the consolidation strategy defined by the government means that more than 70% of the primary structural adjustment required to 2013 will be concentrated in 2010 and 2011.

14 See F. de Castro, J.M. González-Páramo and P. Hernández de Cos (2004), "Fiscal consolidation in Spain: dynamic interdependence of public spending and revenues", *Investigaciones Económicas,* vol. XXVIII.

Further, in the two years spanning 2010-2011, 60% of the adjustment already made or approved resides on the control of public spending, meaning that government consumption and public investment would decline by 1.5 pp of GDP (with a 0.7 pp contribution by employee compensation), and other spending and subsidies would decline by around 1 pp of GDP. The composition of the fiscal consolidation planned for 2012-2014 also resides, to the tune of almost 80%, on spending cuts, due above all to the adjustment of government consumption.

Parallel progress in structural reforms is crucial for the fiscal adjustment

Any measure that increases the Spanish economy's potential growth tends to be conducive to the fiscal adjustment. In particular, supply-side policies aimed at improving the workings of the markets for goods, services and factors may lead to an expansion in activity and in public revenue, and they may therefore help bring about public finances sustainability. Such complementarity comes about through several channels. The lowering of the obstacles to competition and the improved efficiency in the workings of the markets for goods, services and labour have positive effects on productivity. For instance, it has been estimated that an improvement in competition in the product market up to the level of the most competitive country might generate a 2.5% increase in productivity.[15] In parallel are the spending cuts obtained as a result of greater economic activity. For example, the weight of unemployment benefits, which in Spain's case amounted to 3% of GDP in 2010 compared with 1.9% on average for the euro area countries, would diminish. Finally, higher expected growth reduces public debt spreads. Thus, the short- and medium-term effects of a fiscal adjustment, when made separately and conducted along with structural reforms that heighten competition in the market for goods and services and increase labour market flexibility, are very different (see Box 1.3 of Chapter 1 in this Report). Structural reforms, insofar as they lessen the distortions prevailing in labour and product markets, exert a significant positive effect on activity and public finances, mitigating the adverse effects of financial tensions and allowing greater room for manoeuvre for fiscal policy.

4 The foundations of a fiscal stability programme for Spain

4.1 THE BUDGETARY FRAMEWORK AND FISCAL RULES

The institutional framework of budgetary policy in the European countries is being reconsidered, assigning greater importance to the rules that control the growth of public spending

The economic literature shows that countries that have more demanding budgetary frameworks tend to evidence greater fiscal discipline. Further, the experiences of some of our neighbours showed that the most successful frameworks of fiscal rules are those that combine a budget deficit rule with explicit ceilings on public spending (see Box 2.1). In this respect, most EU countries have enhanced the quality of their fiscal frameworks, as a result above all of the application of the Stability and Growth Pact (SGP) and its extension to an additional set of national fiscal rules. Moreover, among the new features seeking to reinforce fiscal discipline in the euro area, the reform of the SGP currently under discussion includes the need to properly develop these national fiscal frameworks and the application of a prudent public spending growth rule when assessing countries' fiscal developments.

In Spain, the budgetary stability legislation should be strengthened by extending a spending ceiling to all tiers of government. This ceiling should also be more accurately defined

Spain has budgetary stability laws that set limits on the deficit that all levels of general government, and public bodies, may incur. In particular, central, regional and local government and the Social Security system have to post a balanced budget or run a surplus over the course of the business cycle, in terms of financing capacity. However, only central government is subject to a ceiling on annual spending approved by Parliament before the budget is drawn up.

15 On the effects of the regulation of goods and services markets and of labour market institutions on productivity, see, respectively, G. Nicoletti and S. Scarpetta (2006), "Regulation and Economic Performance: Product Market Reforms and Productivity in the OECD", in T. Eicher and C. García-Peñalosa (eds.), Institutions, Development and Growth, MIT Press, and A. Basanini, L. Nunziata and D. Venn (2009), "Job protection legislation and productivity growth in OECD countries", Economic Policy, 24 (58), pp. 349-402.

The experiences of some of our European peers (Denmark, Sweden, Finland and Switzerland) show that the most successful fiscal rule frameworks are those that combine a budget deficit rule with explicit public expenditure ceilings.[1] Their usefulness lies in the fact that they are directed at the habitual source of budget deficits. Specifically, the ex-ante setting of a maximum amount of spending disciplines the drawing up of budgets for each unit of spending; these, therefore, have less room to exert upward pressure through individual demands. Further, the presence of a spending ceiling enables the rise in revenue in better-than-expected cyclical situations to be saved, ex post. Also, if the rule is well-defined and transparent, it provides for identification of the spending components that generate the deviations.

A spending rule is under discussion at the European level as part of the proposals to reform the SGP. According to the EC's proposal, its adoption would mean that, if a country failed to meet its medium-term fiscal target[2], fiscal policy would only be qualified as prudent if the increase in spending were lower than the economy's nominal potential growth, this being adjusted for discretionary measures on revenue.[3]

1 See G. Ljungman (2008), Expenditure Ceilings – A Survey, IMF Working Paper no. 282.

2 The medium-term objective of the SGP is defined individually for each country; but generally, it requires that countries attain and maintain a structural public balance that is in equilibrium.

3 This means that spending growth might exceed the economy's potential growth if a fiscal reform that is to increase revenue is anticipated (and the opposite in the case of a tax cut). The extra permitted spending growth above potential will be equal to the amount of revenue raised by the tax increase.

EX POST SIMULATION FOR THE 1998-2007 PERIOD OF THE APPLICATION OF A SPENDING RULE SIMILAR TO THAT PROPOSED BY THE EUROPEAN COMMISSION (a) (b)

Countries	Actual average growth in nominal primary spending (1998-2007)	Average growth of potential real GDP (c)	Average maximum growth in nominal primary spending compatible with the spending rule (1998-2007) (d)	Number of years with actual spending growth above the spending rule (e)	Actual general government budget balance in 2007	General government balance that would have been posted in 2007 had spending been compatible with the spending rule (f)
Belgium	4.5	2.4	3.6	7.0	-0.4	3.4
Germany	1.5	1.7	2.4	3.0	0.3	-3.5
Estonia	12.5	6.1	11.7	7.0	2.5	4.9
Ireland	11.6	5.5	7.5	7.0	0.0	11.2
Greece	9.3	2.9	6.5	9.0	-6.7	3.0
Spain	7.8	3.0	5.9	8.0	1.9	8.2
France	3.9	2.2	3.0	7.0	-2.7	1.2
Italy	4.4	1.9	3.6	7.0	-1.5	1.8
Cyprus	9.4	4.3	7.6	7.0	3.4	9.3
Luxembourg	7.2	4.0	6.6	6.0	3.7	5.7
Malta	4.7	2.2	4.0	5.0	-2.3	-0.2
Netherlands	5.5	1.7	4.6	6.0	0.2	3.4
Austria	3.2	2.2	2.7	6.0	-0.6	1.3
Portugal	6.4	1.9	5.3	7.0	-2.8	1.1
Slovenia	9.5	3.7	9.1	7.0	0.0	1.8
Slovak Republic	6.9	4.6	8.6	6.0	-1.8	-8.3
Finland	4.0	2.7	3.1	7.0	5.2	9.1

SOURCES: European Commission and Banco de España.

a The simulation is performed year by year, although columns 1, 2 and 3 show average growth.
b According to the National Accounts information available in December 2010.
c Average potential growth for the period 2004-2010 according to the report "The impact of ageing on public expenditure: projections for the EU25 Member States", Report of the Economic Policy Committee and the European Commission (2006).
d The simulated spending rule is defined as a ceiling on annual nominal primary expenditure growth equivalent to the sum of potential real GDP growth and the actual growth of the GDP deflator, adjusted by the existence of discretionary tax measures. Moreover, if the country has not in the year under analysis attained the medium-term fiscal objective, according to the EC's available estimates as at December 2010 of the cyclical adjusted balance corrected by the effect of the rule, the maximum ceiling on spending growth is reduced by 1%.
e The column indicates the number of years in which actual spending was higher than the maximum ceiling in the period running from 1998 to 2007.
f The budget balance that would have been obtained in 2007 if the estimated maximum spending ceiling had been observed in each year of the period.

The accompanying table illustrates the workings of a rule of this type.[4] Specifically, it shows the budget balance that the euro area countries would have obtained in 2007 had a similar rule to that proposed by the EC been applied each year over the 1997-2007 period. To do this, the fiscal data for 1997 are taken as the starting point and, if a country has not reached the medium-term fiscal target set by the SGP, primary public spending growth is set at 1 pp below the economy's nominal potential growth.[5] In this exercise, once the country attains the medium-term target, the increase in primary spending equals the economy's nominal potential growth.[6] it can be verified that strict compliance with this rule would have led to a much healthier situation in most of the countries during the decade prior to the economic crisis. Indeed, Germany is the only country in which its application would not have led to an improved fiscal situation, given that in the period analysed, it posted average primary expenditure growth of 1.5%, almost 1 pp below that required by the rule (2.4%). In Spain, the application of such a rule would have provided for saving on the extraordinary revenue arising from the real estate expansion, and it would have allowed a fiscal surplus in 2007 almost 6 pp of GDP higher than actually observed. This is the outcome of the fact that average primary spending growth for the period was significantly higher in Spain than that deriving from the application of the rule (7.8%, compared with 5.9%, respectively).

Defining a spending rule is not, however, free from difficulties. Firstly, a variable allowing the permitted spending growth to be anchored must be chosen. If the starting point is a balanced budget and, given that public revenue evidences approximately unit elasticity with respect to the economy's nominal GDP, the spending ceiling should be set on the basis of the growth of this variable. Evidently, if the starting point is a budget deficit, the return to a balanced budget will require spending growth below nominal growth until such equilibrium is attained. To prevent the change in public spending from being pro-cyclical, nominal GDP should be replaced by the economy's potential nominal GDP. In this way, in an economic upturn, characterised by GDP growth above potential, public spending should grow below actual GDP growth, while the opposite will occur in recessions. In any event, it should be stressed that the economy's potential growth is not an observable variable and its estimation is controversial. As a result, with a view to its application in the spending rule, a prudent estimate of potential output must be recommended.

Potential GDP growth is normally estimated only in real terms; accordingly, the definition of the nominal component is additionally required. In this connection, resort can be had to using the annual growth of the GDP deflator. However, if spending growth is allowed to accommodate any increase in the deflator, this might enable very high increases in spending as a result of the existence of likewise very high inflation. To avoid this problem, one option is to set a ceiling on the increase in the deflator incorporated into the rule (e.g. that compatible with the ECB's definition of price stability).

The rule should make explicit the spending components subject to it. On occasions, so as to prevent the ceiling from entailing a reduction in productive spending, the exclusion of investment spending has been proposed. Nonetheless, this rule is more difficult to oversee and easier to circumvent, since in practice the distinction between current and investment expenditure is not clear. In this respect, both the United Kingdom and Germany have recently abandoned this type of golden rule. The national fiscal rules in place often exclude interest payments.[7] Finally, it is occasionally proposed that spending on unemployment benefits be excluded from the rule, so as to avoid, once again, a procyclical bias. However, it is argued that its exclusion adds complexity to the rule and may leave out increases in spending arising from a structural rise in unemployment, which will not be corrected by the cyclical trend.

The spending rules should also make explicit the correction mechanism for potential deviations that may arise, in which connection their fit in the multi-year budgeting horizon may prove particularly appropriate.

In sum, spending rules have proven to be a very useful instrument for ensuring fiscal discipline, but their definition can greatly condition their effectiveness. Broadly, to maximise their effectiveness, they should: cover all public spending, including fiscal expenses; be applicable to all tiers of government; be part of a medium-term budgetary framework; be subject to a deviation-correction mechanism; and be anchored in prudent estimates of the economy's potential growth and inflation.

4 See L. Fernández-Caballero, P. Hernández de Cos and J. Pérez García (2011), *El marco de reglas fiscales en España,* mimeo.

5 Each country's potential growth is calculated as the sum of potential real GDP growth according to the European Union's Economic Policy Committee's 2006 estimates for the period 2004-2008 plus the GDP deflator observed for each year.

6 In keeping with footnote 3, the spending ceiling is raised/lowered by the estimated amount of the discretionary tax measures each year.

7 Set against growing public indebtedness as at present, this exclusion may give rise to a lower level of fiscal effort, or the opposite would occur in a situation of diminishing public debt/GDP ratios.

Given the effectiveness of these limits on spending growth - which have enabled the State's budgetary deviations to be reduced, setting aside the exceptional period of economic crisis[16] - and, above all, the decentralised nature of public spending in Spain, this type of rule should be extended to regional and local government, in particular to the former, where spending overruns compared with budget projections have been systematic and exceeded 3% per annum between 1984 and 2007. Further, even in the case of the ceiling on State spending, its definition may be better defined so that it is not only in terms of budgetary accounting, but also in National Accounts terms, and that it is anchored in a macroeconomic indicator, such as the trend growth of nominal GDP.

In this respect, Spain's recently updated Stability Programme commits to including a spending rule in the Budgetary Stability Law, of similar characteristics to the European Commission's recent proposal (see Box 2.1). Under this rule, budgeted and actual general government spending may not exceed the medium-term reference growth rate of the Spanish economy. Moreover, spending may only exceed that set under this rule if permanent revenue-increasing measures are adopted; in turn, regulatory changes entailing permanent losses in revenue will automatically lead to a downward revision of the spending threshold. The spending rule will be directly applicable to central and local government, and the government will pursue its adoption by the regional governments.[17]

Moreover, the mechanisms for enforcing the rules should be strengthened...

The fiscal rules should include appropriate mechanisms to enforce their application or, in the event of a breach, to correct this. In Spain's case, the Stability Law allows deviations from the limits set whereby, if they arise, the level of government responsible is obliged to submit a plan for their correction, which in the case of the regional governments should be approved by the Fiscal and Financial Policy Council. It is further established that, if as a result of this breach Spain is sanctioned under the SGP, the level of government responsible will pay the commensurate portion of the sanction. In addition, the Stability Law allows central government to make authorisations for the issuance of regional government public debt conditional upon compliance with these objectives. Such conditionality is, in fact, that which has been applied over the past year, and its use should be viewed most favourably, despite it not being automatically applicable. In this respect, it should be recalled that greater automaticity in the setting of specific sanctions is one of the aims of the reform of the Stability Pact. Under Spanish legislation there is, however, no possibility of establishing sanctions, beyond those mentioned arising from non-compliance with the SGP. Looking ahead, such a possibility might be considered as an additional disciplining mechanism, although the evidence shows that it is not easy to define these in a way that makes their application effective.

... and the transparency of public finances should be increased, especially at the regional and local government level

Another key element of fiscal rules is transparency, as acknowledged in the Budgetary Stability Law. Accordingly, although the dissemination of data on State activity is abundant, detailed and with relatively short lags, this was not the case for most regional and local governments until recently. That limited the ability to exert timely control over their activity and accountability, and it is particularly dangerous at times such as the present, when a lack of information might result in a lack of market confidence.[18]

16 See T. Leal and J. Pérez (2009), *Análisis de las desviaciones presupuestarias aplicado al caso del presupuesto del Estado,* Documentos de Trabajo, no. 0933, Banco de España.

17 Moreover, the Stability Programme, in line with the proposed reform of the Stability Pact (which seeks to set greater store by public debt in the European fiscal surveillance procedure), mentions that stricter rules will be set for indebtedness, extending the monitoring thereof. This will refer not only to compliance with the rules on debt as defined in the Excessive Deficit Protocol, but also to other financial liabilities.

18 See T. Leal, D. Pedregal and J.J. Pérez "Short-term monitoring of the Spanish government balance", SERIEs-Journal of the Spanish Economic Association, 2, pp. 97-119.

To redress these shortcomings, in late 2010 the government began to publish information on the regional governments' budget outturn, individually and overall, on a quarterly basis (see Table 2.2). In any event, the regular publication of the budget outturn of regional governments as a whole, and on an individual basis, with the same periodicity, degree of detail, lag and accessibility as the State outturn, would be welcome. It would also be desirable to have some information, perhaps of a more aggregated nature, for the main cities, given their relative size compared with most of the regions. The latest Eurostat proposals to strengthen the Stability Pact statistically are, indeed, geared to increasing transparency.

Greater importance should be given to medium-term budgetary planning

Medium-term budgetary planning, necessitating the regular analysis of the structural dynamics of the various public revenue and spending captions and enabling those areas where room for rationalisation and adjustment is greater to be identified, may prove particularly appropriate when adjustment measures going beyond a temporary correction of imbalances are required. Indeed, the application of binding budgetary frameworks spanning several years is indicated in the literature as a positive factor in the application of fiscal adjustment plans, with the Netherlands a successful case in point in this connection.

In some cases, the full or partial delegation of fiscal policy decisions to an independent agency has also been discussed recently at the international level as a means of increasing discipline, although the attendant design and effectiveness of such a mechanism is not free from controversy (see Box 2.2).

For fiscal discipline, defining an appropriate framework for local and regional government is vital

In a highly decentralised system such as Spain's, achieving fiscal discipline comes up against the traditional problems of inter-government coordination. In this respect, in addition to extending fiscal rules to the lower tiers of government, the Stability Law includes a clause that establishes that the State shall not be responsible for financing the deficits or public debt of the lower levels of government.[19] This clause seeks to prevent the cost of inappropriate fiscal behaviour in one region from passing through to the rest or to central government, and its presence enables the capital markets to continue to exert a significant disciplining effect on the basis of distinguishing between the risk premia on the debt of the different governments.

In addition, achieving fiscal discipline also depends on some correspondence between the level of accountability governing regions' spending and their fiscal autonomy (fiscal co-responsibility), this being understood as the ability of the regions to generate revenue to fund such spending. Without this autonomy, the regions depend excessively on inter-governmental transfers, distorting the relationship that should exist between taxation and public spending. That makes it more unlikely that citizens will penalise the undisciplined behaviour of the authorities, the appearance being that regional spending is funded, at least in part, by non-residents in the region. Indeed, the empirical literature finds a positive relationship between the level of transfers received by the regions and their levels of public spending and budget deficit.[20] In Spain, although there has been a gradual increase in fiscal co-responsibility, this has only reached a scale and, above all, acquired significant characteristics in the latest financing arrangements: in these, the State guarantees on revenue growth were eliminated, the weight of tax receipts as a

19 Specifically, the Single Additional Provision of the Budgetary Stability Law states that "the State shall not assume nor be accountable for the commitments of the regional governments, the local governments and the bodies linked or reporting to them,...".

20 For the case of Spain, see I. Argimón and P. Hernández de Cos (2011), "Fiscal Rules and Federalism as Determinants of Budget Performance: an Empirical Investigation for the Spanish Case", Public Finance Review, 3 February.

AVAILABILITY ON THE INTERNET OF INFORMATION FOR THE YEAR AS AT DECEMBER 2010 ON THE BUDGET OUTTURN FOR GENERAL GOVERNMENT, THE STATE, THE SOCIAL SECURITY SYSTEM AND THE REGIONAL GOVERNMENTS

TABLE 2.2

	Coverage	Frequency	Publication lag	First year available	Accounting framework
STATE	Revenue and expenditure	Monthly (a)	Approximately one month	Cash basis: Jan 1988 Nat. Acc.: Jan 1995	Nat. Acc., Cash basis
SOCIAL SECURITY					
Social Security System	Revenue and expenditure	Monthly (a)	Approximately one month		Cash basis
National Public Employment Service	Revenue and expenditure	Monthly (a)	Approximately one month	January 1984 (b)	Cash basis
REGIONAL GOVERNMENTS	Revenue and expenditure	Quarterly	Two months	2010 Q4	Budget
	Since December 2010 the budget outturn figures have been published uniformly on a quarterly basis for the regional governments, in aggregate form and individually.				
Other regularly published data (c):					
Andalusia	Revenue and expenditure	Quarterly	Approximately one month	2008	Cash basis
Aragon	—	—	—	—	—
Asturias	—	—	—	—	—
Balearic Islands	—	—	—	—	—
Canary Islands	Revenue and expenditure	Quarterly	Approximately one month	1990	Cash basis
Cantabria	Revenue and expenditure	Monthly	Approximately one month	2006 (half-yearly from 2001 to 2005)	Cash basis
Castile-La Mancha	Revenue and expenditure	Quarterly		1999	Cash basis
Castile-León	Revenue and expenditure	Monthly	Approximately one month	November 2009 (quarterly from 1991)	Cash basis
Catalonia	Revenue and expenditure	Monthly	Approximately twomonths	2007	Cash basis
Extremadura	—	—	—	—	—
Galicia	Revenue and expenditure	Quarterly	Approximately four months	2002 Q1	Cash basis
La Rioja	—	—	—	—	—
Madrid	Expenditure	Monthly	Approximately two months		Cash basis
Murcia	—	—	—	—	—
Navarre	—	—	—	—	—
Basque Country	Revenue and expenditure	Quarterly	Approximately two months	2004 Q2 (annual from 2000)	Cash basis
Valencian Community					
GENERAL GOVERNMENT	Revenue and expenditure	Quarterly	Approximately three months	2000	Nat. Acc.

SOURCES: IGAE, Administración de la Seguridad Social, Economics and Statistics Offices and Official Gazettes of each of the regional governments.

a The publication of the December figure for the State, Social Security System and National Public Employment Service has a lag of over one month.
b The Social Security System and National Public Employment Service figures prior to this date were published quarterly.
c Search made on public services as at 10 December 2010. The sources consulted were the websites of the Economics and Statistics Offices and Official Gazettes of each of the regional governments.
d Initial publications on the Canary Islands budget outturn only included revenue.

In the ongoing reform of euro area economic governance rules and institutions, changes to the institutional framework for fiscal policy decisions are a priority. In this respect, two recommendations currently under consideration[1] are to reinforce the independence of European fiscal policy supervision, through the creation of an independent European fiscal agency under the control of the Eurogroup, and to broaden national fiscal frameworks through the creation of independent budget offices or fiscal oversight agencies in all the member countries.

The taxonomy of these independent fiscal agencies distinguishes two main types.[2] First, there are *fiscal councils* with an analytical or forecasting role, which act as reference points, counterweights or guarantors of orthodox fiscal policy conduct and of compliance with the existing fiscal rules. Second, there are *independent fiscal authorities* which can influence budget balance directly by controlling some operational fiscal policy instrument.

The main theoretical reason for delegating a public decision to an independent authority is the existence of time inconsistency, i.e. a situation where short-term decisions are taken without considering their long-term consequences. In the case of monetary policy, *inflation bias* can be reduced by delegating control of operational monetary tools to an independent central bank with a clear price stability objective.

In the case of fiscal policy there may be a *deficit bias*, especially in the context of a monetary union[3], but the delegation of fiscal instruments is less common, given the limited consensus regarding the optimal levels of public spending and revenue. However, an example of delegation of fiscal levers to non-government authorities occurs in the management of sovereign wealth funds. In democratic countries, these funds are used to smooth public spending and taxes over time, and they are governed by a framework similar to the delegation of monetary policy, as summarised in the IMF's "Santiago Principles".[4] Under these principles, sovereign funds should have a mandate that defines their objectives and confers them operational independence from the Finance Ministry, subject to rules of transparency in their conduct. Further, central banks usually act as guarantors of the independence of sovereign funds: for instance, a division of the Norgesbank manages the Norwegian funds, while the Central Bank of Chile appoints the management committees of the Chilean funds.

In the euro area, the role of the European Commission in the application of the Stability and Growth Pact (SGP) can be seen as an example of delegation of fiscal responsibilities to a supranational agency. Nonetheless, the operation of the SGP has been complicated by a lack of effective tools to ensure fiscal discipline *ex ante*, as opposed to sanctioning indiscipline *ex post*; moreover, the empirical evidence suggests that an independent fiscal agency should be a national body, given the importance of specific knowledge of domestic fiscal conditions. Consistent with these arguments, many economists have proposed designs for possible independent fiscal authorities that would be mandated to ensure budget balance, and would be delegated effective operational control of some fiscal instruments to achieve this. Proposed instruments include changing VAT or income tax rates, without Parliamentary intervention, when budgetary or economic circumstances so require, or imposing across-the-board spending cuts if legislators approve a budget inconsistent with the mandated deficit level.[5]

However, in practice most independent fiscal bodies today take the form of advisory councils. Their mandates range from the preparation of budgetary and macroeconomic forecasts to the evaluation of government policy proposals. Historical evidence suggests that these councils may reduce deficit bias if they intervene directly in the budgetary process with their own normative recommendations, and that they can reinforce the impact of fiscal rules, laws or objectives.[6] Examples come from the United States, where Congressional Budget Office forecasts were used to calculate the fiscal adjustments needed to offset new spending programmes; from the Netherlands, where party platforms are based on the macroeconomic forecasts of the fiscal council, which also evaluates the fiscal agreements of coalition governments; and also from Chile, where two mutually independent panels monitor the maintenance of a structural surplus of 1% of GDP over the economic cycle. Another relevant role played by some independent fiscal agencies is to act as a neutral referee between central and regional governments, as stipulated, for example, by a recent reform in Australia.[7]

In Spain's case, one new institutional feature this year is the establishment of the OPCG (Parliamentary Budgetary Office)[8], which is intended as an advisory body for Parliament, designed to monitor and verify budget implementation. The specific role of the OPCG has still to be defined in detail.

1 ECB (2010), "Reinforcing Economic Governance in the Euro Area", June.
2 See X. Debrun, D. Hauner and M. Kumar (2009), "Independent fiscal agencies", Journal of Economic Surveys, 23 (1), pp. 48-81, and L. Calmfors and S. Wren-Lewis (2011), What should fiscal councils do?, CESifo WP3382.
3 See A. Velasco (1999), "A Model of Endogenous Fiscal Deficits and Delayed Fiscal Reforms", in J. Poterba and J. Von Hagen (eds.), Fiscal Institutions and Fiscal Performance, University of Chicago Press, and R. Beetsma and R. Bovenberg (1999), "Does monetary unification lead to excessive debt accumulation?", Journal of Public Economics ,74, pp. 299-325.
4 International Working Group of Sovereign Wealth Funds (2008), Generally Accepted Principles and Practices, October.
5 See J. Von Hagen and I. Harden (1995), "Budget processes and commitment to fiscal discipline", European Economic Review, 39, pp. 771-779; S. Wren-Lewis (2002), Fiscal policy, inflation, and stabilisation in EMU, mimeo, University of Exeter; L. Calmfors (2003), "Fiscal policy to stabilise the domestic economy in the EMU: what can we learn from monetary policy?", CESifo Economic Studies, 49 (3), pp. 319-353, and C. Wyplosz (2005), "Fiscal policy: institutions versus rules", National Institute Economic Review, 191, pp. 70-84.
6 See Debrun et al. (2009), op. cit., and Calmfors and Wren-Lewis (2011), op. cit.
7 Council of Australian Governments (2010), Charter, "COAG Reform Council", 30 June 2010.
8 Law 37/2010 of 15 November 2010 on the creation of the Parliamentary Budgetary Office.

MAIN FEATURES OF THE NEW FINANCING ARRANGEMENTS FOR THE ORDINARY-REGIME REGIONAL GOVERNMENTS TABLE 2.3

TAXES TRANSFERRED (percentages transferred under previous arrangements in brackets)	% transferred	Normative capacity
DIRECT TAXES		
Personal income tax	50 (33)	Yes
Estate duties	100 (100)	Yes
INDIRECT TAXES		
VAT	50 (35)	No
Manufacturing duties	58 (40)	No
Retail sales of hydrocarbons	100 (100)	Yes
Electricity	100 (100)	No
Transfer tax and stamp tax	100 (100)	Yes
Car registration	100 (100)	Yes
Gaming tax	100 (100)	Yes
GUARANTEE FUND		
Amount in base year: the regional governments contribute 75% of taxes transferred in normative terms and the State contributes an amount of around 0.8% of GDP.		
The Fund is distributed by regional government on the basis of adjusted population (population 30%, equivalent protected population 38%, population over 65 8.5%, population 16 and under 20.5%, surface area 1.8%, dispersion 0.6%, island status 0.6%).		
In future years the regional government contribution changes in step with tax takings, the State contribution according to the ITE (a) and the adjusted population is re-calculated year by year.		
SUFFICIENCY FUND		
Amount in base year: net borrowing of each regional government (including share in the additional State contribution to the system, around 0.7% of GDP), less financing by taxes transferred in normative terms and less net share in the Guarantee Fund.		
In future years, the Fund changes according to the ITE (a).		
REGIONAL CONVERGENCE FUNDS		
Two new funds are created: the Competitiveness Fund (0.2% of GDP in the base year) and the Cooperation Fund (0.1% of GDP in the base year).		
The Competitiveness Fund is annually distributed among the regional governments on the basis of adjusted per capita financing below the average or below their fiscal capacity, on the basis of their relative adjusted population.		
The Competitiveness Fund is annually distributed among the regional governments whose per capita GDP is below 90% of the average, whose population density is less than 50% of average density or, given population growth that is lower than 90% of the average, whose population density per square kilometre is lower than the figure resulting from multiplying the average density of the ordinary-regime regional governments by 1.25.		
In future years both funds will change in step with the ITE (a).		

SOURCE: Banco de España.

a The ITE comprises State takings for the year (excluding tax resources transferred to the regional governments), personal income tax, VAT and excise duties on beer, wine and fermented beverages, on intermediate products, on alcohol and derivative beverages, on hydrocarbons and on tobacco products.

proportion of total regional government revenue increased, with the dependence on State transfers diminishing, and regulatory powers over taxation were increased (see Table 2.3).

However, some elements have still to be resolved. The first arises from the lack of stability of the system, which has given rise to high incentives for the regional governments to promote negotiation processes as a means of increasing the volume of financing acquired. Also contributing to this instability of the financing agreements is the complexity of the arrangements, which hampers anticipating how they may unfold over time and, indeed, setting a specific annual amount, which only depends on actual tax receipts with a time lag. The second element, associated with the first, arises from the way in which the regional governments' guaranteed spending is determined, since in negotiations it has al-

ways been chosen to take the previous financing level as the base figure. That offers assurances to all the regional governments that, in the year taken as the base, they will see no decline in their resources. Looking ahead, it would be desirable, on one hand, to have a more stable financing system and, on the other, to use some objective method of calculating the regional governments' actual spending needs. Such a method would assess current effective spending, it would add greater objectivity to the system and it would eliminate the incentives to periodically reconsider agreements that take the previously attained level of financing as their basis.

4.2 PUBLIC SPENDING

To ensure fiscal stability, pensions reform is pivotal...

Taking the long view, the key factor for fiscal sustainability in Spain and in other developed countries is the impact on public finances of population ageing, which will push both pensions spending and health care and dependency spending upwards. Accordingly, ensuring the long-term sustainability of public finances involves, first, reforming the pensions system. This reform is particularly appropriate in the short term, since significant positive effects in terms of confidence may ensue from it, whereas its repercussions on demand are very limited. And regard should be had to its positive influence on the economy's potential growth, via the increase in participation rates, in particular those of the oldest cohorts.

... and must act on the actual retirement age and on the commensurateness of contributions to pensions, as the recent draft reform proposes

Since the increase in spending is due essentially to the rise in life expectancy and to the subsequent impact on the dependency ratio, the sustainability of the system necessarily entails raising the retirement age, restricting early retirement and encouraging a longer working life. The same considerations, along with reasons relating to fairness and encouraging participation in the labour market, also advise moving towards the proportionality of contributions paid in throughout working life to the pension received, in which connection the number of years of contributions for the calculation of the amount of the pension (the regulatory base) must be raised significantly, which would bring us closer into line with other European countries (see Table 2.4).

The draft legislation on the reform of the public pension system submitted by the government to Parliament in March 2011 marks progress in both directions, and on the projections available, it will bring about a significant saving on the increased expenditure envisaged (see Box 2.3).

The introduction of a factor of sustainability is particularly important...

The reform also includes a factor of sustainability as from 2027, which should be instrumental in the revision every five years of the fundamental parameters of the system in terms of the differences between the trend of life expectancy for the population at the age of 67 from the year 2027 to the year in which the revision is made. The prompt definition of this factor of sustainability and the bringing forward of its application from the envisaged date (2027) are particularly important, and should avoid successive rounds of negotiations on the adaptation of the parameters, which are so difficult to agree on.

Some European countries have already introduced similar measures (see Table 2.4). In some (Finland, Italy and Portugal), the factor of sustainability depends on changes in life expectancy, whereas in Germany the deciding factor is the ratio of pensioners to workers paying contributions. In the cases of Finland and Italy, it only affects the calculation of new pensions; in Germany's case, meanwhile, the factor of sustainability affects new pensions and the way in which previous pensions are updated. In most cases, the adjustment of the social security system parameters is automatic, except in Austria, where changes in life expectancy are only taken as an indicator of the need to activate the adjustment.

In March 2011, the government submitted to Parliament the draft law on the reform of the public pensions system, containing proposals to amend some of its main parameters. Firstly, the retirement age is to be generally raised to 67 (compared with 65 at present). The extension will be progressively applied in the period from 2013 to 2027, at a rate of one month per year up to 2018 and two months a year from 2019. However, workers who have contributed to the system for 38 years and six months may continue to retire at the age of 65.

The reform also states that, from the age of 63, there is a possibility of taking early retirement provided 33 years' contributions have been made. In each case an annual reduction factor of 7.5% for each year ahead of the new ordinary retirement age shall be applied, although in these cases no top-up to the minimum pension will be applicable. The only exception to this rule has it that the minimum age (63) may be reduced to 61 in crisis situations.

The second notable feature of the reform is the lengthening of the period used to calculate the amount of the pension (the "regulatory base") from 15 to 25 years (immediately prior to retirement). This will be progressively phased in at a rate of one year per annum from 2013 to 2022. 37 years' contributions will be necessary to qualify for 100% of the regulatory base of the pension, whereby the first 15 years of contributions will entitle pensioners to 50%, while the remaining 50% will be obtained proportionately between 15 and 37 years' contributions, the calculation being made monthly. In this case a transitional period has also been set, commencing in 2013 and concluding in 2027. It is further established that, in the event of gaps in contributions, those relating to the first 24 months shall be topped up with the minimum contribution base, and those exceeding 24 months, with 50% of the base. That is in contrast to the current legislation, where all gaps are supplemented with the minimum base.

The reform introduces a sustainability factor as from 2027, with the aim of maintaining the proportionality of contributions to expected system benefits. In this connection, every five years the system's fundamental parameters will be revised on the basis of the differences observed between the population's life expectancy at the age of 67 as at the year in which the revision is made and life expectancy at 67 in 2027, using to this end the projections made by the competent government agencies. Finally, under certain conditions, the reform enables women who have interrupted their working life to have a baby or to adopt to bring forward their retirement age ahead of 67, by a proportion of nine months per child, for a maximum of two years. New incentives are also provided to prolong working life,

together with greater safeguards for university and vocational training programmes, so that the entities and companies funding such programmes will have to contribute to the Social Security system for programme beneficiaries.

As regards the potential impact of this reform, information from the MCVL (Continuous Survey of Working Life) shows that a significant proportion of individuals retire at present having contributed for more than 38 years and six months. Under the new regulations, these individuals may continue to retire at 65 and, therefore, they would not be affected by the higher retirement age. In particular, since 1998 the percentage of individuals who have retired at the age of 65 or less and with years of contribution more than or equal to 39 years has held relatively stable at a figure close to 50%.

In terms of the breakdown by sex, this percentage is higher in the case of men (around 61%) than in that of women (20% in 2009). The percentage in the case of women can be seen to be on a mildly growing trend, rising from 12% in 1998 to 20% in 2009; accordingly, in the future, the increase in female participation might exert slight upward pressure on this percentage, raising the number of people who might take retirement at 65.

With regard to skills, the group of highly skilled workers evidences a slightly lower percentage than the rest, due possibly to the fact that a higher level of educational attainment is associated with entering the labour market at a later age. Looking ahead, insofar as this high-skills group continues to increase, there might be a reduction in the percentage of people who can take retirement at 65.

In sum, no clear trends are apparent in changes in the percentage of individuals who, aged 65 or less, and with 39 years' contributions or more, have retired in recent years. With a view to the future, if these percentages hold, the increase in the legal age of retirement by two years, from 65 to 67, would give rise to an impact of around 1.1 years on average on top of the actual retirement age. In any event, the increase in the female participation rate might drive this percentage upwards, while the presumed increase in the population's level of educational attainment would have the opposite effect.

As to how the average pension will be affected by the increase in the number of years' contributions taken into account in calculating the regulatory base and the new treatment accorded to gaps in contributions, information drawn from the MCVL can be used to estimate the impact that would arise from these changes had the new regulations (those corresponding to the final year of the transitional period, 2022) been applied to actual retirements in 2008. To do this, the regulatory bases of the generation that was born in 1943 and which retired in 2008 are estimated. For this group it is obtained that the application of the reform would have brought about an average reduction in pensions of 4.7%. This reduction cannot, however, be taken as an estimate of the impact of the reform on future pensions since, among other matters, individuals might change their behaviour, increasing for instance their participation in the labour market, as a result of the reform.

Calibrating the long-term effects of such a far-reaching reform of the parameters of the pensions system is a complex task and one subject to the uncertainty of the many assumptions that must be made. Possible exercises include estimates with a general equilibrium model, calibrated for the Spanish economy, with overlapping

generations of economic agents that take optimal consumption, saving, work and investment decisions. These estimates are comparable with those made by the European Commission's Economic Policy Committee, which show an increase in contributory pension spending of 6.3 pp of GDP between 2009 and 2060, insofar as they are based on the same population projections to 2060 (those made by Eurostat and which are known under the name of EUROPOP 2008) and the same projection on total factor productivity, which is a determinant of the future course of GDP and, therefore, of the sustainability of the Social Security system.

Specifically, a simulation has been made of the impact on future pensions spending of the estimated increase in the effective retirement age, the extension of the calculation period determining the regulatory base and the modification of the scale of percentages according to the number of years' contributions. The results of the simulations show that the effect of these changes might entail a saving of around 40% on the projected increase in pensions spending relative to GDP from 2009 to 2060 (see accompanying table). Consequently, the reform is a major step towards easing the effects of population ageing. The results are in line with those estimated in other papers, including the government's official estimate. Moreover, these effects of the reform might become wider following the activation of the sustainability factor, which would contribute to reducing pensions spending further if its application were to infer new changes to the system's parameters such as, for instance, increases in the number of years used to calculate the pension and/or the putting back of the effective retirement age.

THE IMPACT OF THE REFORM ON FUTURE PENSION SPENDING. A COMPARISON OF EXISTING ESTIMATES (%)

	Increase in the retirement age (1)	Lengthening of calculation period (2)	Change in scale (3)	Total effect (1) + (2) + (3)	Sustainability factor
2009-2050 period					
Government	15	15	8	38	15
Díaz-Saavedra et al. (2010= (Δ ret. 1.4 years) (b)	—	—	—	38	—
De la Fuente and Doménech (2011)	—	—	—	40	—
Banco de España model (Δ ret. 1 year) (c)	14	26	11	43	—
2009-2060 period					
De la Fuente and Doménech (2011)	—	—	—	39	—
Banco de España model (Δ ret. 1 year) (c)	7	22	10	37	—

SOURCE: Banco de España.

a The results show the saving from each reform expressed as a percentage of the envisaged increase in spending without reform.
b The estimates of Díaz-Saavedra et al. (2010) include (1) and (2), but not (3). In these, the increase in the simulated retirement age is 1.4 years.
c In this model, the minimum frequency is annual. Accordingly, to approximate the estimated raising of the retirement age by 1.1 years, an increase of one year in the retirement age is simulated. Moreover, it should be borne in mind that the total effect of the reforms, i.e. the sum of (1), (2) and (3), is not equal to individual sum of each reform, owing to the interactions between them.

...whereas, with a view to enhancing transparency and system incentives, it would be desirable to move towards the proportionality of contributions to pensions

Some countries (Sweden, Italy and certain central and eastern European countries) have opted for more extensive reforms, such as the transition towards a system which, being unfunded, is based on the defined contribution principle. Under this principle, pensions are proportionate to the contributions made by each individual over the course of their working life, they are duly updated on the basis of demographic and economic developments, and they depend on their age at the time of retirement. This rule entails greater transparency in the calculation of pensions, which encourages labour participation, lengthens working life and, in this way, ultimately raises the ratio of pensions received to wages.

The dynamics of health spending are also worrying...

The estimates available presage a strong increase in health spending as a result of population ageing, of around 1.6 pp of GDP to 2060.[21] An analysis of public spend-

21 See European Commission and CPE (2009), "The 2009 Ageing Report: economic and budgetary projections for the EU-27 Member States (2008-2060)", European Economy, no. 2/2009.

PENSION SYSTEMS IN THE EU-15 TABLE 2.4

RECENT REFORMS TO PENSION SYSTEMS IN THE EU-15

	Reforms to system parameters						Structural reforms	
	Calculation of pensions							
	Retirement age	Incentives to carry on working	Measure	Updating of contribution bases	Updating of the pension	Sustainability factor	Defined contribution	Notional accounts
Germany	X	X			X	X		
Austria	X	X	X	X				
Belgium	X	X		X				
Denmark	X	X				X		
Spain (a)		X						
Finland		X	X	X	X	X		
France	X	X	X	X		X		
Greece	X		X					
Netherlands								
Ireland		X						
Italy	X	X	X		X	X		X
Luxembourg			X					
Portugal	X	X	X	X	X	X		
United Kingdom	X	X			X			
Sweden			X			X	X	X

DESCRIPTION OF SUSTAINABILITY FACTORS IN PLACE IN EU-15 PENSION SYSTEMS

Germany	The degree of indexation of the pension to wage growth will be adjusted on the basis of the difference between the change in the number of contributors to the system and the increase in the number of pensioners.
Denmark	Increases in life expectancy at the age of 60 will translate as from from 2005 into the retirement age being put back so that the average number of years pension collection will remain set at 19.5 years. The new estimates, which will be updated every 5 years, will come into force 10 years after.
Finland	The amount of the pension is adjusted on the basis of the changes that arise in life expectancy as from 2010.
France	The reference period used to calculate the amount of the pension is adjusted on the basis of the the increases that arise in life expectancy at 60, so that the relationship between the reference period for the calculation of the pension and the number of expected years in retirement holds constant.
Italy	The amount of the pension depends directly on "transformation coefficients", which in turn depend on life expectancy. These shall be revised every ten years.
Portugal	The amount of the pension will be adjusted according to the relationship between life expectancy at 65 in 2006 and life expectancy at that same age in the year immediately prior to retirement .
Sweden	The amount of the pension will be adjusted on the basis of life expectancy as at the age at which retirement becomes effective, with no distinction by sex.

SOURCES: CPE, European Commission and Banco de España.

a Measures forming part of the draft pension system reform submitted to Parliament by the government in March 2011 are not included.

ing by function in the decade prior to the crisis reveals the strong growth of this item, with annual rates close to 9% between 1997 and 2007, and exceeding 20% of total public spending. A breakdown of the annual average growth of per capita health care spending shows, moreover, that the contribution of the non-demographic factors (associated, inter alia, with supply-side elements) is estimated to be very high; consequently, extrapolating past behaviour to the future, the increases in health spending in the long run might exceed those arising from the purely demographic effect.

HEALTH CARE SECTOR REGULATION INDICATORS AND ESTIMATE OF THE POTENTIAL IMPACT OF REGULATORY CHANGES ON EFFICIENCY

TABLE 2.5

	Value of the indicator (a)		Elasticity of changes in regulation on efficiency (b)
	Spain	Maximum in the OECD	
Price regulation	5.30	5.90	0.011
Control of access to specialists	6.00	0.00 (c)	-0.005
Control of objectives	2.80	5.70	0.009
Price mechanisms	1.30	3.10	0.020
Development of private coverage	3.00	6.00	0.003

SOURCE: Hernández de Cos and Moral Benito (2011), drawing on OECD data.

a All the indicators range from 0 (minimum) to 6 (maximum).
b Obtained using the regression of an estimated level of efficiency for each country on the basis of 20 health care policy indicators considered by the OECD. The table shows only indicators and their estimated elasticity in cases in which this is significant.
c In the case of this indicator, given that estimated elasticity is negative, the value in the table is the minimum, not the maximum, in the OECD countries.

... although gains in efficiency in this sector can be achieved

The improved efficiency of health spending might provide for cost savings by bearing on certain regulatory factors[22], including most notably price mechanisms (little used in Spain), the regulation of supplier prices and a degree of competition in the provision of services (see Table 2.5).[23]

Public-sector employee compensation should play a key role in the fiscal adjustment...

In Spain, the general government sector employed somewhat more than 15% of all wage-earners in 2009, with total gross wages amounting to close to 20% of economy-wide employee compensation, on average, in the period 1999-2010. in terms of public spending, the significance of this variable is even greater, since it accounts for around 26% of the total. In the ongoing fiscal adjustment, and according to the latest Stability Programme Update, the contribution of the cut in this total gross wage bill between 2009 and 2014 might account for around 30% of the total reduction in the budget deficit.

Employee compensation has played a dual role in other countries' successful consolidation strategies, helping make the adjustment durable and reducing its effect on economic activity in the short term. The interaction between public- and private-sector wages is the main channel through which the cushioning or offsetting of the potential restrictive effect of the containment of public-sector employee compensation on GDP is instrumented. In the case of the Spanish economy, the evidence indicates that the multiplier effect on activity of a reduction in employee compensation is positive even in the short term.[24] Using this relationship between public- and private-sector wages may be particularly relevant in a context in which the growth of the economy requires significant gains in competitiveness. For this to be possible in the current circumstances, the reform of collective bargaining is vital.

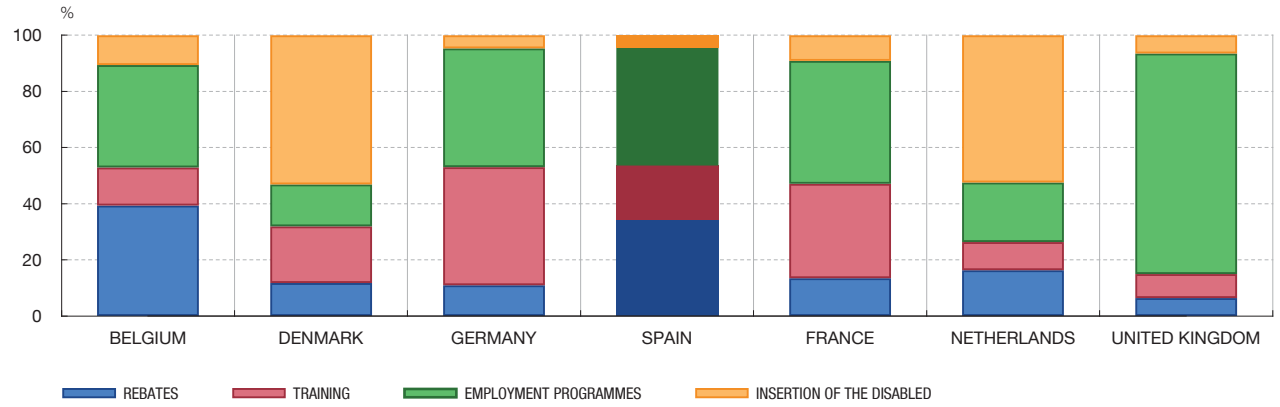
In any event, it should be borne in mind that, when aggregate fiscal adjustment needs are considerable, measures based on restricting public-sector total gross wages face certain limits, given their potential impact on the efficiency and sufficiency of services. In this respect, in terms

22 These results should be viewed with caution given that they do not always prove robust to the measure of health care spending efficiency used. See P. Hernández de Cos and E. Moral Benito (2011), *Eficiencia y regulación en el gasto sanitario en los países de la OCDE,* mimeo.

23 Specific recent regulatory decisions by the government attempt to influence the reduction in prices and distribution margins. For example, Ministerial Order SPI/3052/2010 of 26 November 2010, determining sets of drugs and their reference prices, and also regulating specific aspects of the reference price system, and Royal Decree 8/2010 of 20 May 2010, adopting extraordinary measures for the reduction in the budget deficit (Chapter 5, health measures).

24 See F. De Castro and P. Hernández de Cos (2008), "The economic effects of fiscal policy: the case of Spain", Journal of Macroeconomics, 30, pp.1005-1028.

BREAKDOWN OF PUBLIC SPENDING ON ACTIVE EMPLOYMENT POLICIES IN SPAIN AND SELECTED EU COUNTRIES IN 2008 CHART 2.5



SOURCE: Eurostat.

of restricting public-sector employment, consideration must be given to the fact that, according to the MAP (General Government Ministry), the main weight of public employment in Spain is concentrated in activities that are complementary to the private sector (Justice, Security Forces, general administration) or potentially substitutive of private activity, but which are considered basic public services (education and health, almost 45% of the total).[25] The staff employed in public corporations account for less than 5% of total public-sector employment in Spain.

As regards compensation per employee, the estimates available show there is some leeway for the adjustment, given that significant positive wage differences are observed between compensation per employee in the public sector as opposed to the private sector, even when controlling for individual characteristics.[26] These differences would be chiefly concentrated in the lower-skilled strata.

... while public investment projects should be rationalised...

Turning to public investment, it should be borne in mind that the growth of non-residential public productive capital was close to 4.5% on average between 1994 and 2007, which allowed the gap between Spain and the other euro area countries in terms of the public capital/population ratio to be reduced by more than 20 pp to 85% of the average for the euro area at end-2009. Likewise, the public investment/GDP ratio in 2009 stood at 4.4% of GDP in Spain (2.8% on average in the euro area); accordingly, the weight of this variable could be reduced without harming the necessary process of convergence.[27] The reduction in the European funds that were used in the past to fund a significant portion of this public investment also makes it necessary to rationalise future investment projects to some extent. In this connection, it should be borne in mind that the positive effects of public investment on productivity appeared to arise only from specific components, such as infrastructure, and these may moreover be cut significantly as from certain thresholds.

...as should public transfers and subsidies, whose weight in public spending is high

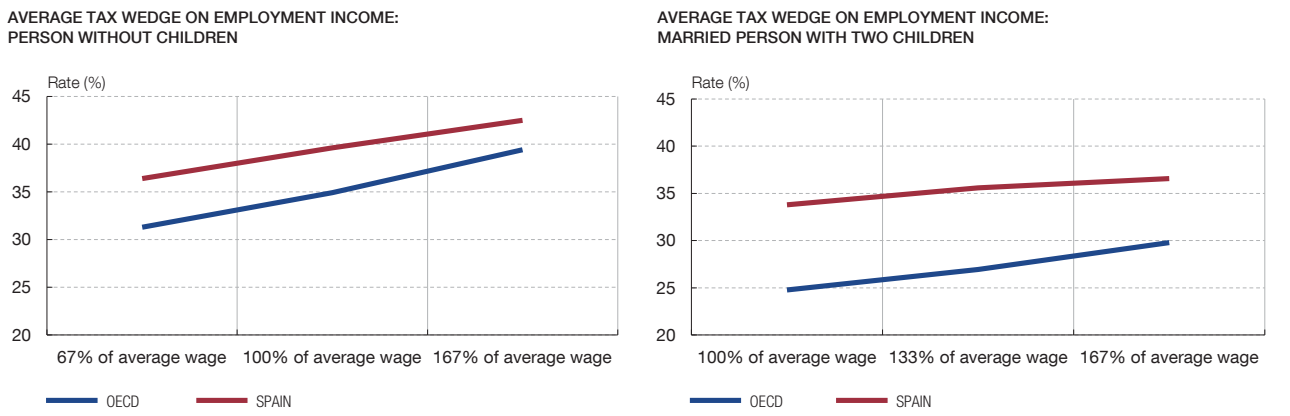
The weight of some spending items, in particular other transfers and current payments, capital transfers and subsidies, is high, accounting in 2010 for almost 9% of total public

25 For a classification of public-sector activities that are substitutive of or complementary to private activities, see R. Fiorito and T. Kollintzas (2004), "Public goods, merit goods, and the relation between private and government consumption", European Economic Review, 48, pp. 1367-1398.

26 J. I. García-Pérez and J. F. Jimeno (2005), Public sector wage gaps in the Spanish regions, Documentos de Trabajo, no. 0526, Banco de España. See also R. Giordano and D. De Palo (2011), *The public sector pay gap in selected euro area countries,* mimeo, Banca d'Italia.

27 Moreover, it should be taken into account that much of the investment in infrastructure is by the corporate public sector or funded (at least in part) by the private sector.

AVERAGE TAX WEDGE ON EMPLOYMENT INCOME (a) CHART 2.6



SOURCE: OECD (2011), *Taxing Wages 2010, OECD Publishing.*

a The average tax wedge on employment income for each standard individual is obtained as the sum of personal income tax derived from employment income plus social security contributions borne by the employer and the worker, on one hand, and the related gross average wage of private-sector full-time employees, on the other.

spending and around 4% of GDP. Currently, more than half the subsidies and transfers are aimed at public and private companies, which include most notably infrastructure and transport companies, along with those aimed at promoting employment and at international cooperation. There would therefore be room for rationalisation in this field, on the basis of effectiveness criteria and bearing in mind the potential distortionary effects that this type of transfer generates. In this area, the latest Stability Programme Update considers significant reductions in this type of spending of around 1.8% of GDP in the 2014 horizon.

Lastly, employment policy should be reorganised, giving greater weight to the so-called "active policies"

The weight of spending on unemployment benefits rose to 3% of GDP in 2010, a significantly higher level than the European average, as a result of Spain's high unemployment rate. Conversely, active employment policies accounted in 2008 for only 0.6% of GDP, below the EU average (see Chart 2.5). This difference is even greater when analysed in terms of spending per unemployed person. The breakdown of spending on active policies shows, moreover, that almost 35% of active policy expenditure in Spain was earmarked for the concession of Social Security rebates (compared with 23% in the EU), while spending on training accounted for only 19% (36% in the EU).

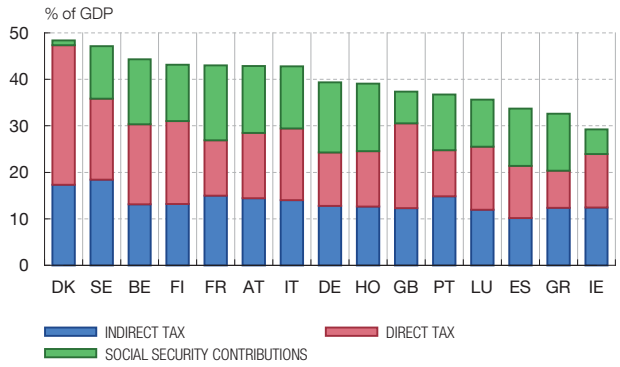
Against a background of high unemployment levels, employment policies should be chiefly aimed at preventing this increase in joblessness from becoming structural. To do this, it should be borne in mind that the available empirical evidence shows that the effectiveness of Social Security rebates is very limited, whereas unemployment benefits have negative effects on unemployment exit rates, lengthening the duration of unemployment and increasing the likelihood of it becoming structural. In this respect, active and passive employment policies should be reorganised and greater control maintained over effective job search by workers. Active policies should reduce the funds currently assigned to rebates, which should be confined to the groups facing most employability difficulties, in line with the reform approved in 2010. Also, these funds should be earmarked to a greater extent for training, with highly specific technical content.[28]

28 See C. Alonso-Borrego, A. Arellano, J.J. Dolado and J.F. Jimeno (2004), *Eficacia del gasto en algunas políticas activas en el mercado laboral español,* Documento de Trabajo no. 53, Fundación Alternativas, Madrid.

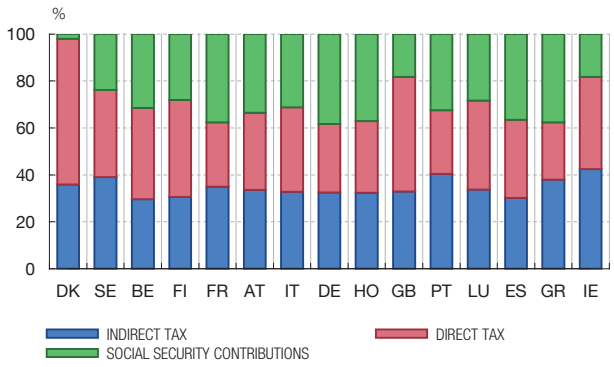
TAX STRUCTURE IN SPAIN AND IN THE EU-15 (a)

CHART 2.7

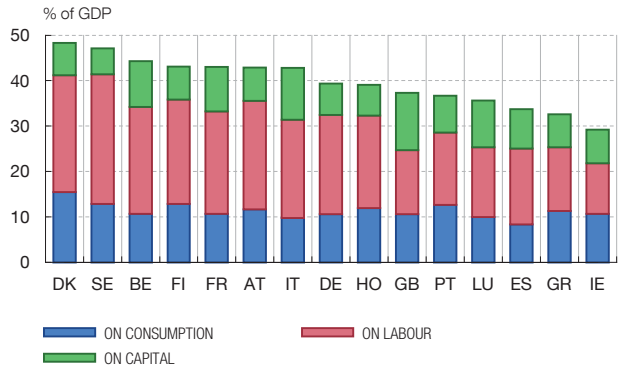
REVENUE AS A % OF GDP IN 2008



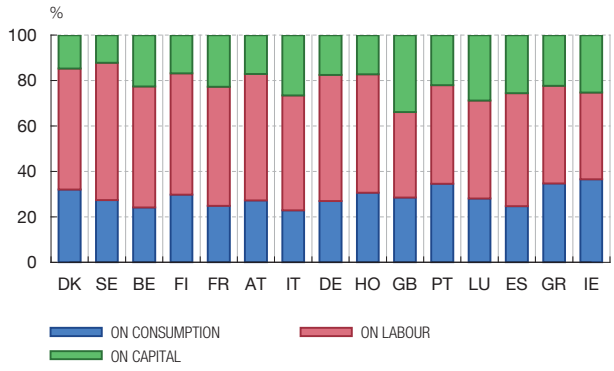
WEIGHTS RELATIVE TO TOTAL TAXES IN 2008



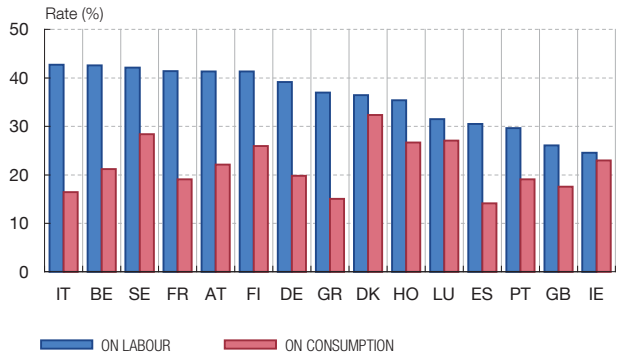
TYPOLOGY OF TAXES IN 2008



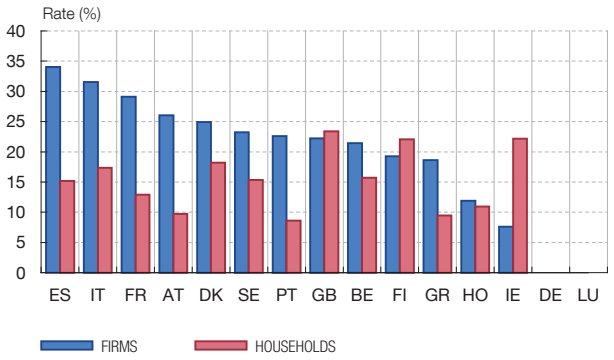
WEIGHTS RELATIVE TO TOTAL TAXES IN 2008



IMPLIED RATES ON LABOUR AND CONSUMPTION IN 2008 (b)



IMPLIED RATES ON CAPITAL INCOME IN 2008 (c)



SOURCES: *Taxation trends in the European Union* - 2010 Edition (Eurostat)

a The data for Portugal and Greece are for 2006.

b The implied rates on consumption are calculated as the ratio of the sum of revenue from taxes on consumption (VAT, taxes on energy, taxes on tobacco and alcohol, and other taxes on specific consumption) to household final consumption in national territory. The implied rates on labour are calculated as the sum of all direct taxes and social security contributions, paid both by wage-earners and employers, that are levied on employment income, divided by the total compensation of wage-earners who work in national territory.

c The implied rates on firms' capital are obtained as the ratio of all tax revenue arising from taxes levied on business income and on capital, on one hand, to the sum of firms' net operating surplus, interest, dividends and other net property income received, on the other. The implied rates on households' capital are calculated as the ratio of the sum of taxes on households' capital income and the returns on business activities, on one hand, to the sum of imputed income, the net operating surplus and households' and not-for-profit private institutions' mixed income, mixed income of the self-employed, and interest, dividends and other net property income received by households and not-for-profit private institutions.

WEIGHT OF FISCAL EXPENSES IN THE MAIN SPANISH TAXES

CHART 2.8

FISCAL EXPENSES: PERCENTAGE OF GROSS REVENUE OF EACH TAX (a)

FISCAL EXPENSES

SOURCES: 2010 State Budget (Report on tax benefits) and IGAE (National Audit Office).

a Gross revenue is the sum of actual revenue and of fiscal expenses.

4.3 PUBLIC REVENUE

Given the scale of the fiscal adjustment needed, having to introduce tax changes to accompany the foregoing spending cuts cannot be ruled out. Further, it should be taken into account that a significant portion of the fiscal deterioration has been due to the reduction in revenue, which will not foreseeably be reversed in the medium term to pre-crisis levels. These changes should take into consideration the role that the level and structure of taxation play in respect of the economy's potential growth and competitiveness. Nor should it be forgotten that another function of tax systems is to contribute to the redistribution of income among the different agents. The change in the size and composition of public spending programmes should, therefore, be complemented with tax reforms which, along with being compatible with the goals of fairness that should be established, combine an increase in tax-raising capacity with improved efficiency.

On the revenue side, measures could include increasing indirect taxation and reducing fiscal expenses

In keeping with these criteria, when tax increases are necessary, they should be in the form of taxes that have fewer distortionary effects on growth and the allocation of resources. Examples of such taxes are those on real estate and on consumption. Currently, Spain's lower tax pressure relative to other developed countries is due to the lower weight of those taxes considered less distortionary, in particular indirect taxes (see Charts 2.6 and 2.7).

VAT rates, even after being raised in 2010, remain below the average for the OECD countries. Moreover, the ratio of VAT revenue to that which would be obtained were the standard rate to be applied to all consumer spending stands in Spain at 56%; accordingly, one option to increase revenue might be to broaden the base of the tax. Along the same lines, the weight of excise duties in general, and of environmental levies in particular, is significantly lower than in other developed countries.

So-called "fiscal expenses", arising from the presence of deductions and exemptions on different taxes, represent a major cost in terms of revenue-raising, they add complexity to the tax structure and in some cases they exert significant adverse effects on efficiency and even on fairness (see Chart 2.8). They should therefore be rationalised. Specifically, according to information provided by the State budget on tax benefits, fiscal expenses in Spain account for around 42% of VAT revenue raised, for almost one-third of personal income tax revenue and for one-fifth of corporate income tax revenue. The source of these fiscal expenses is highly diverse. In the case of VAT, the biggest portion arises from the application of low rates to specific goods, while under personal income tax, they are associated above all with exemptions/deductions on employment income, but also with the preferential treatment that investment in housing[29] and contributions to pension schemes receive. Under corporate income tax, fiscal expenses correspond to various incentives in respect of investment, the promotion of SMEs and the development of R+D projects.

In sum, public revenue and spending policies should urgently redress public finances and contribute to economic growth in the medium term

In sum, the fiscal policy priority in the coming years should be a vigorous adjustment that provides for public finances to be redressed swiftly and soundly. In parallel, the spending- and revenue-side measures ultimately adopted should strengthen the contribution of fiscal policy to the economy's potential growth, which will require greater efficiency in public policy action.

29 Here it should be recalled that the habitual dwelling deduction was eliminated for taxpayers exceeding a specific income threshold. In addition to this marking significant progress in tax neutrality between house-purchase versus house-rental decisions, it will also entail a gradual reduction in the current fiscal spending derived from this personal income tax deduction.