Global Economy / Regional Analysis Spain

How to resume the fiscal adjustment after the April 28 elections

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Eurostat has just confirmed that Spain closed 2018 with a public deficit of 2.5% of GDP, six percentage points less than in 2017. The reduction of the deficit at a time of growth like the present one is good news, particularly because Spain needs to improve its fiscal margin as soon as possible in order to handle less favorable economic conditions in the future.

Social perception and narratives are very important. They often play a more important role than the data itself, particularly during electoral periods like the present one. Fiscal information is difficult to understand for most of the population. The evidence is almost always interpreted according to individual and political or opinion leaders bias, and loaded with value judgments. The adjectives used end up becoming more valuable than the actual numbers.

For a large share of public opinion in Spain, this is the case of the fiscal adjustment. The reduction of the deficit from 11.1% of GDP to 2.5% of GDP in 9 years has been described as an 'austericide' or economic self-destruction, a drastic adjustment achieved by an unprecedented reduction in public spending, which has dismantled the welfare state through insufficient and far from progressive taxes.

Beyond individual preferences and narratives, and assuming that there is always room for improvement, what does this data actually tell us? I will summarize the evidence in the following ten points.

First, the tax adjustment was neither an unwarranted nor a voluntarily inflicted punishment. It was the result of tensions in the financing conditions given the uncertainties regarding the sustainability of the public debt and the eventual implosion of the euro. At the beginning of 2012, while the cost of the 10-year public debt in Germany fell to levels around 1%, it rose to levels close to 7% in Spain. Fiscal authorities tried to delay and reduce fiscal adjustment as much as possible, within the limits permitted by markets and with the financial assistance from the rest of the Eurozone countries to bail out a large number of savings banks.

Second, between 2011 and 2012, the fiscal adjustment only succeeded in reverting a part of the spending increase that occurred between 2008 and 2009. In 2018 public spending per capita in real terms (that is, taking into account price increases) was 8.4% higher than that of 2007.

Third, this growth in public spending per capita in real terms between 2007 and 2018 was also a feature of the main items of the welfare state. Between December 2007 and November 2018, the average pension has increased by 23.1% in real terms. Current public spending on education (for the population aged between 6 and 24 years) and on healthcare per capita in 2017 (last available year) already exceeded the 2007 levels by 8%.

Fourth, letting public investment (still under pre-crisis levels) and interest on public debt aside, current government spending per capita in real terms in 2018 has been 15% higher than that in 2007, above the average increase in the EU (11%) or the US (13%), according to the latest information available from the European Commission.

Fifth, the annual public deficit has been reduced from EUR 2,677 per capita in 2009 to EUR 643 in 2018. The increase in public revenues, from EUR 8,626 per capita in 2009 to EUR 10,038 in 2018, accounts for over 83% of this deficit reduction.

Sixth, although fiscal consolidation has helped to improve its sustainability, public debt continues to be very high: in 2018 it accounted for 97.1% of the GDP, compared to 35.5% in 2007.

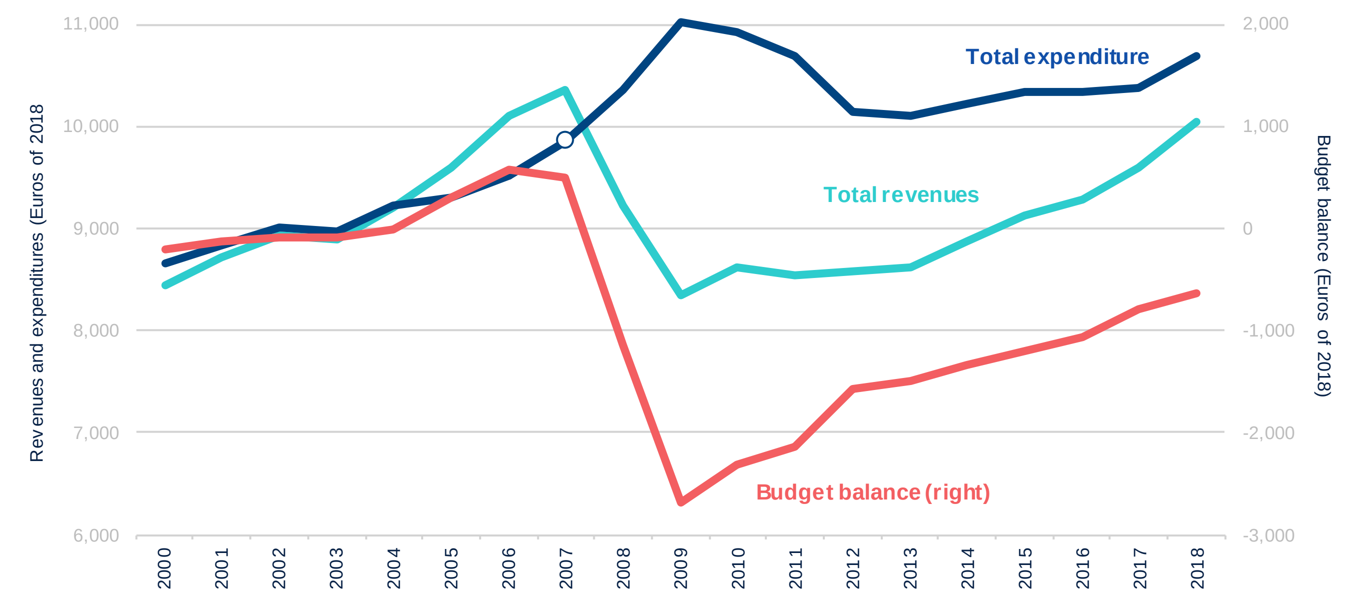
Seventh, given that the Spanish economy in 2018 was close to reaching a neutral cyclical situation (in fact the European Commission and the Bank of Spain consider that it has already entered a slightly expansive phase), almost all of the public deficit is structural, which forces the fiscal adjustment to be resumed in 2019 and the following years, once Spain has left the Excessive Deficit Procedure. However, in accordance with BBVA Research estimates, an increase of at least 0.4 percentage points of the GDP of the fiscal deficit took place in 2018, showing that that fiscal policy was procyclical.

Eighth, public revenues over GDP in 2018 accounted for 38.9% of GDP, 6.1 pp under the EU average (45%). Except for Italy and Greece, Spain follows the trend of all other European countries in terms of the relationship between fiscal pressure and the efficiency of the public administrations, according to a wide range of indicators.

Ninth, the lower fiscal pressure in Spain compared to more advanced European economies is due to the lower level of indirect (VAT, special and environmental taxes) and direct taxation on labor incomes, after excluding social security contributions – which are higher.

Tenth and last, taxes and transfers in Spain are fairly progressive, with a level of redistribution in line with other European countries. In terms of the Gini coefficient and the latest available information, between 2012 and 2012 Spain reduced inequality by 18 percentage points, from gross to disposable income after taxes and transfer. This reduction was similar to that of countries like Norway, Sweden and Denmark, with a greater weight in the public sector.

Spain: revenues, expenditures and budget balance of general government, in real per capita terms



Source: BBVA Research based on IGAE, Eurostat and INE

There are probably many examples that show that much more could have been done, reducing social costs and with a more balanced distribution among administrations, but it is fair to highlight the enormous effort made to preserve the most essential features of the welfare state in the context of an unprecedented economic crisis, where the unemployment rate rose above 26% and the income per capita fell by as much as 10.6%.

After the April 28 general election, the next government must resume the fiscal adjustment. There are no magic solutions. Spain is neither in the region of the Laffer curve with a negative slope nor do fiscal expansions finance themselves. Raising taxes without improving expenditure efficiency will have a negative effect on growth, innovation and job creation. Reducing expenditures harms the welfare state and redistribution. The best strategy involves implementing reforms that increase employment, productivity and, therefore, taxable bases and public revenues. According to BBVA Research estimates, a 9 point reduction in the structural unemployment rate in the long run would result in a 6 point GDP improvement in the budget balance and would reduce the main cause of unacceptably high inequality. The deficit in the pension system is increasing its share in the overall deficit of the public administrations, rendering the implementation of reforms that guarantee its sustainability, sufficiency and efficiency inevitable. In addition, the public sector must lead the digital transformation process and use technology as a driver to improve its efficiency. The continuous assessment and overall review of public policies being carried out by the AIReF (the Independent Authority for Fiscal Responsibility) is crucial. Not to spend less, but rather to spend more efficiently, to redesign those policies that no longer work and to improve the quality of services that the public sector provides to society.

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